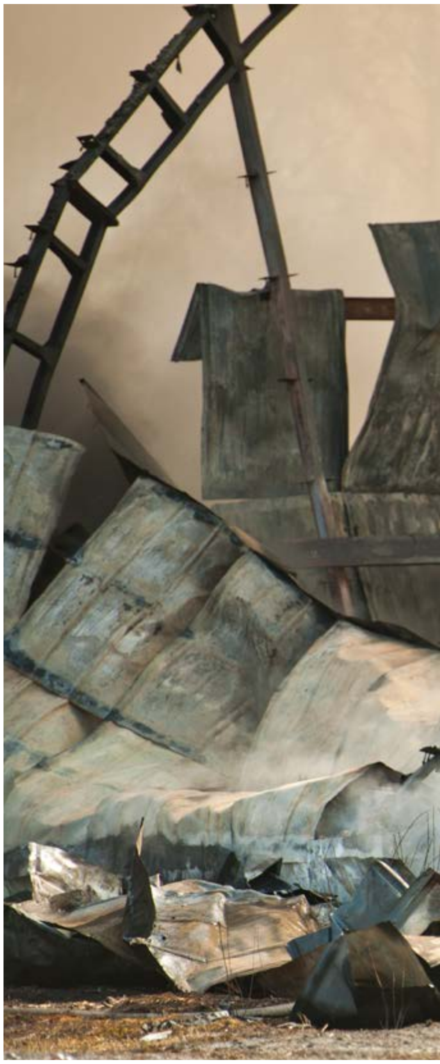

Predictably vulnerable

Why do seemingly sound organisations unexpectedly fail?

BY ANTHONY FITZSIMMONS & DEREK ATKINS

Why do seemingly sound companies led by intelligent, well-meaning leaders fail despite large, diligent risk management teams? We had been asking ourselves this question for years. We saw glimpses of patterns, but an important breakthrough came when we were part of the Cass Business School team that produced *Roads to ruin*, a seminal report commissioned by Airmic's John Hurrell. That project sparked a series of further collaborations that led to our book *Rethinking reputational risk* and to our conclusions in this feature.

Let's start with a hypothetical case study. A company announces that its profits have been overstated by £300m. The board is stunned, shareholders are furious and the board commissions an inquiry. A few months later, the answer emerges: the accounts team over-stated receivables.

As recently as the 1980s, it was common for an air accident investigation to conclude that the accident was caused by "pilot error". As Stanley Roscoe, a leading aviation psychologist of the time, wrote, this conclusion was "the substitution of one mystery for another". He thought aviation investigators could do much better. Subsequently, they have done so and so

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Left: Firemen attending the scene of a fatal airplane crash.

should we. The best tool is the two-year-old's question: why?

Why?

Going back to our hypothetical case study, we can dig deeper. Why did the accounts team overstate profits? Because they were always testing boundaries as they tried to increase profit. Why? Because they believed the CEO wanted to maintain a steady increase in profits. Why? Because they thought his self-esteem and bonus depended on steadily rising profits. Why? Because the board set his bonus that way, and his character was such that he seemed to see success in terms of ever increasing profits. Why? Because the board didn't consider risks from unintended consequences of his bonus scheme or from the character of the leader they had recruited. Why? Because the board lacked sufficient people skills, and as a result they were oblivious to their lack – and they missed other risks stemming from human behaviour.

It is worth probing in other directions too. Why didn't the board and audit committee spot the accounting problem? Because they had an inadequate understanding of how the business made its money. Why didn't the auditors push the issue? Because the lead audit partner didn't want to risk becoming the person who lost this prestigious longstanding audit for his firm.

These questions highlight risks that appear in few risk registers, yet they are key drivers of reputational risk and damage.

Leaders matter

Leaders know they are important but they are more important than they realise. Leaders matter in proportion to their influence and power because leaders set strategy, systems and powerful drivers of behaviour beneath and around them.

At the summit, boards and their equivalents have the greatest power to do good. In equal measure, that brings the power to do harm and cause damage. This applies both to what they achieve and how they achieve it. For example, Lord John Browne did great things during his time at the helm of BP. Profits soared and its share price almost tripled at its peak.

But the Baker Report into the Texas City disaster, which killed 15 people on his watch, concluded that BP's leaders had failed to lead on process safety, something the Chemical Safety Board had concluded was a cause of the accident. Lord Browne announced his early retirement four days before the Baker report was published. BP was left with a developing history that made it vulnerable to reputational damage in ways that appear in few risk maps.

The hole in risk analysis

A good place to start is our definition of reputational risk: *the risk of failure to fulfil the expectations of your stakeholders in terms of performance and behaviour.* Seemingly simple, this definition has great depth.

Our fundamental insight is that important risks to both the business and its reputation are not captured by classical risk management. These risks were identified in *Roads to ruin* as underlying risks. We now call these behavioural, organisational and board risks, and they are ubiquitous. They are also double-acting: they increase an organisation's vulnerability to crises by causing systemic weaknesses; and if a crisis occurs, they also help to tip it into a reputational calamity.

Going back to our definition of reputational risk, much performance risk is picked up by classical ERM. In contrast, relatively little behavioural risk – including organisational and board risk – is captured, especially at leadership levels. This is the hole in classical risk management and it matters. Risk managers are adept at managing the risks they do manage. But far too many calamities emerge through this hole, which goes a long way towards explaining both why, despite armies of risk professionals, the banking and innumerable other crises could happen – and why those crises caused so much reputational damage.

Hard to see

Risks in this group are difficult for current risk managers to find because most lack the know-how. Risk managers also need clear authority from the very top to seek out, report and deal with these risks because their root causes often lie with leaders. No risk manager can be expected to put their career at risk by analysing their superiors' behaviour, let alone through a risk lens.

These risks are difficult for any insider to see because cognitive biases prevent us from seeing ourselves as clearly as equally well-informed outsiders could. They are also hard to discuss because humans operate under complex social conventions including what anthropologists call "social silences". There are subjects people will not discuss because, as the *Financial Times* journalist and anthropologist, Gillian Tett put it, they seem "dull, taboo, obvious or impolite".

EXAMPLES OF BEHAVIOURAL, ORGANISATIONAL, BOARD AND REPUTATIONAL RISKS

- Inadequate diversity of skill, knowledge, experience and perspective among leaders
- Ineffective challenge to leaders
- A reluctance to listen to and digest unwelcome news
- Organisational complexity and internal silos and slabs (horizontal silos)
- Ignorance of how heuristics and biases affect perception and decision-making
- Complacency, failure to examine the role of luck in success and "if it ain't broke don't fix it"
- Groupthink
- Character weaknesses, such as a lack of courage to challenge effectively and a reluctance to listen to criticism
- Failure to set tone from top and to "walk the talk"
- Inappropriate incentives: for example the unintended consequences of bonuses; and behaviour that discourages learning from mistakes
- Communication failures
- Inability to learn systematically from mistakes
- Perceptions of corporate history
- Inadequate crisis strategy, planning and practice

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Complacency

Unseen, risks of these kinds fester and incubate, unmanaged, often for years. In the meantime, leaders understandably believe all is well. The truth is that they are sitting on a time bomb with a dodgy clock.

While leaders think all is fine and no-one questions the extent to which success is due to good luck, these systemic risks manifest regularly in small ways that are dealt with by nimble thinking

Below: The Texas City Refinery explosion occurred on March 23, 2005, when a hydrocarbon vapor cloud was ignited and violently exploded at the ISOM isomerization process unit at BP's refinery in Texas City, Texas, killing 15 workers, injuring more than 180 others and severely damaging the refinery.

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and crisis management. These mishaps are valuable sources of intelligence that should be captured, analysed, discussed and used to find and fix vulnerabilities before they cause serious harm. Missed, ignored or covered up, these opportunities are lost.

When something blows up and turns into a reputational calamity, leaders are regularly stunned to discover that almost everyone else seems to have known what had been going on under their noses.

Finding a fix

The human race is creative, so the range of behavioural and organisational risks is almost unlimited. Some examples from this risk area can be seen on page 30 (See *Key behavioural and organisational risks*).

Bringing risk management to bear on board-level risks is the top priority because a board's influence brings with it a board's ability to cause extensive harm when they make mistakes. It is doubly a priority because any attempt to tackle these risks below board level without visible action at the top will undermine the effort.

Any programme to deal with these risks should begin with education for the leadership team including the board. The programme should begin with private education for the chairman because their active support is crucial to all progress. One-to-one education with an acknowledged expert is a good place to start, but many will also demand a coherent written explanation they can mull over with plenty of examples from real life.

Current board evaluation is not designed to find such risks. A new process is needed that deploys new knowledge, skills and techniques. If it is to overcome well-recognised cognitive biases it must be led by people who can see the board as outsiders to the board's business and social circle. They also need the strength of character and independence to hold nothing back even if uncomfortable truths have to be explained to leaders.

Having tackled board-level risks, you can turn your attention to developing the existing risk team and systems to find and fix these risks throughout the organisation. New skills will be needed: risk leaders need to learn the rudiments of psychology, sociology and anthropology – and you might take HR professionals with those skills and teach them about risk.

Risk teams will need explicit authority from the chairman and chief executive to delve into these risks even when the trail leads to the board. To overcome those cognitive biases it is essential, at least in the first instance, to bring in trusted outsiders to help insiders to see what outsiders' eyes can see given insiders' knowledge. Here too, character and independence matter.

Biases, incentives and complacency may encourage delay today in the hope that you do not become a case study tomorrow. But since there is evidence that potentially destiny-changing events afflict large organisations on a scale of years, not decades, wise risk managers will lead their leaders towards bringing these risks under control. And for the FRC-regulated, doing so will also provide the material needed to comply with the regulator's explicit guidance on managing and reporting behavioural, organisational and reputational risks.

Anthony Fitzsimmons and Derek Atkins are authors of *Rethinking Reputational Risk: How to Manage the Risks that can Ruin Your Business, Your Reputation and You*. You will find case studies of BP there. IRM members can order the book with a 20% discount here: www.koganpage.com/reputational-risk using the discount code PBLRRR20.