

Building a Strong Risk Culture

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Even the most casual observer will notice that newspaper headlines continue to be fuelled by a steady stream of corporate scandals, malfeasance, and other assorted conduct and risk management “missteps”. While no industry, sector, or region appears to be immune to these incidents, the financial services sector seems to have gained a particularly prominent profile in this regard (e.g., rogue trading, misleading sales practices, Ponzi investment schemes, dubious accounting practices, market/benchmark manipulation, and, of course, the late-2000s financial crisis).

Not surprisingly, these events inevitably generate considerable post-mortem analysis and commentary, as regulators, boards, management, and other key stakeholders strive to understand the root causes, and how these insights might help in preventing similar debacles from occurring.

A commonly recurring theme in much of the ensuing narrative and analysis is that these events are often directly attributable to some form of material “failure of (risk) culture”.

The obvious question this revelation raises for risk managers is

“What organizational practices or conditions undermine the establishment of an effective risk culture, and hence our ability to avoid significant losses?”

or, equivalently, but framed in more constructive terms, ***“What organizational practices/conditions help to foster a strong risk culture, and thereby increase our confidence of successfully achieving organizational objectives?”***

The process of informing a response to these questions needs to begin with a clear definition of what constitutes a “strong risk culture”:

A strong risk culture can be attributed to an organization that consistently takes the right risks in the right way.

- **“Consistently”** applies across multiple dimensions, including over time (not just periodically, or only during certain parts of the economic/business cycle, etc.), across the entire organization (all business units/entities/divisions, the corporate office, etc.) and up/down the management hierarchy (from the front lines all the way up to the boardroom with risk management expectations also explicitly extended to all third-party suppliers/intermediaries, etc.).
- The **“right risks”** means only actively taking those risks that are aligned with the organization’s established risk appetite and risk-taking capacity and skill, are actually required to advance the organization’s strategy, mission, and objectives, risks for which the organization is adequately compensated, etc. Also note that this definition acknowledges that organizations need to actively “take” and manage risks in order to achieve their objectives. Strong risk cultures are not characterized by a persistent and uniform bias towards continual risk avoidance.
- The **“right way”** implies risk-taking follows robust risk assessment/measurement processes, is subject to proportionate ongoing risk oversight and control, the manner of risk-taking is aligned with organizational values, etc.

With this working definition in mind, it is possible to identify key management practices and conditions that can often play a critical role in shaping an organization’s risk culture. These include the organization’s risk appetite articulation and alignment, ability to envision low incidence/high severity risks, reward and recognition systems, leadership practices, continuous learning discipline and ability to foster constructive challenge. In order to illustrate how the above definition of a “strong risk culture” might help to shape management practices in these key areas, the first three of these are explored in more detail below. Each example is accompanied by a short description, and questions that risk managers should consider in evaluating whether the current state of this practice/condition in their organization serves to foster either a strong or weak risk culture.

ALIGNING AND ARTICULATING RISK APPETITE

Risk appetite alignment is a fundamental determinant of what constitutes the “right risks”. It is therefore impossible to have a strong risk culture without the requisite level of organization-wide understanding and consensus regarding the entity’s risk appetite. Risk appetite also provides shared context for facilitating the type of constructive challenge that is also essential for building a strong risk culture, illustrating the interconnectivity that is often inherent in these critical risk culture shaping practices/conditions.

- *Is the risk appetite aligned with the organization’s strategy/mission/objectives, or does attainment of these goals actually require higher/lower levels of risk appetite than is actually being provided for?*
- *How effective are the associated communications, training programs, etc., in ensuring that all internal and external stakeholders understand the risk appetite at a level commensurate with their risk management activities?*

- *How effectively is the risk appetite embedded into routine risk management decisions (e.g., does the business case approval process require a demonstration of how well the proposed initiative aligns with the organization’s risk appetite)?*
- *Does the risk appetite articulation sufficiently support navigating unusual, emerging, or non-contemplated risks by providing context around the organization’s underlying risk-taking core principles and philosophy?*

ORGANIZATIONAL ABILITY TO ENVISION LOW-INCIDENCE/HIGH-SEVERITY EVENTS

Organizations characterized by weak risk cultures often seem to have a systemic myopia, or at least a fundamental lack of imagination, around low-incident/high-severity events (“That could never happen here ...”). This may be attributed to various factors, including the inability to recognize and mitigate the type of cognitive biases that can often lead to a material understatement of the underlying probabilities for extreme tail risk events. For example, by definition, the probability of having observed, say, a 1:200 event may be inherently remote relative to the organization’s applicable shared history. However, risk appetites are often calibrated to very low, so heretofore unobserved, frequencies. Organizations therefore need to overcome the natural tendency to unduly rely on apparently benign past experience when formulating these risk assessments.

- *Has the organization taken explicit steps to ensure that it does not succumb to small sample size or recency biases in making its risk assessments around low-incidence/high-severity risk events?*
- *Does the organization routinely apply reverse stress-testing techniques (or what is sometimes referred to as “pre-mortems”) to help table discussions/assessments of extreme risk scenarios that might not otherwise occur?*

- Do the organization’s risk identification and assessment processes extend beyond just the direct risk impacts to appropriately capture interconnectivity and multiple-generation (“domino”) effects?
- Does the organization routinely challenge parts of the business that might appear to be running particularly well, as opposed to just focusing on the underperforming lines?

- Is the CRO engaged in a review of the design of the incentive compensation programs, and the pro forma results achieved, in order to independently assess alignment with risk appetite? Does the CRO formally report on this assessment to the board (or a designated compensation committee)?
- To what extent do key human resources decisions (hiring, promoting, terminations, etc.) explicitly incorporate assessments of an individual’s demonstrated values and overall risk management behaviours?

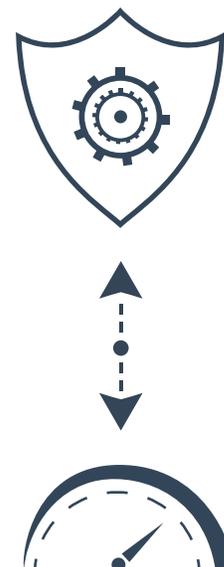
REWARD AND RECOGNITION SYSTEMS

Not surprisingly, poorly designed reward and recognition systems are often cited as the key driver of misdirected management behaviour. An incentive system’s ability to influence risk-taking behaviour (in this context, taking the “right risks” in the “right way”), and therefore shape risk culture, is well documented. Unintended consequences in risk-taking behaviour can often be traced to some form of structural outcome bias, where incentive systems focus exclusively on what results are achieved, without due consideration of how these results are achieved.

- Are performance targets embedded within incentive programs reasonably attainable by operating within the prescribed risk appetite, and with ethical business practices?
- Are key performance measures appropriately risk adjusted?
- To what extent are risk management objectives explicitly reflected in annual performance management objectives?
- Do incentive programs explicitly incorporate protocols for applying discretion whenever required in order to appropriately reflect risk-based outcomes? Do key incentive programs include appropriate levels of deferrals, claw-back provisions, etc., in order to similarly advance this objective?

By similarly applying this article’s working definition of a “strong risk culture” as a guide, risk managers can develop a comprehensive functional catalogue of the management practices required to cultivate the three risk culture principles illustrated above, as well as for other key risk culture drivers, such as the organization’s leadership practices, continuous learning discipline and ability to actively foster constructive challenge.

The resulting inventory can be used to help assess the organization’s current state of alignment with these core risk culture principles, and thereby direct efforts to establish the key management practices required to “consistently take the right risks in the right way”, leading to increased confidence for achieving organizational objectives.





About the author

Mr. Stramaglia has over 30 years of professional and leadership experience, including over 10 years with Sun Life Financial (SLF) where he served as a member of the International Executive Team and led the development of one of the insurance industry's leading ERM practices as Executive Vice-President and Chief Risk Officer for SLF's global operations. He joined SLF in 2002 following its acquisition of Clarica, where Mr. Stramaglia held the position of Executive Vice-President and Chief Investment Officer and was also head of the International Reinsurance Business. Prior to joining Clarica, Mr. Stramaglia worked for over 13 years with the Canadian operations of the worldwide Zurich Financial Services Group, where he held a number of senior executive positions including Chief Actuary, CFO and President & CEO of the Zurich Life Insurance Company of Canada. His consulting experience includes an extended mandate serving as the acting Chief Risk Officer for one of Canada's largest credit unions.

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