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ERM **fit**

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The authors of this article contend that **THE RIGHT ERM FIT** for a company can be found by involving the company's employees.

IN THE INSURANCE INDUSTRY, enterprise risk management (ERM) has been in the spotlight and hot seat. The National Association of Insurance Commissioners' (NAIC) Solvency Modernization Initiative (SMI) and the European Union's (EU) Solvency II have extensive requirements including embedding ERM into culture, decision making and business activities. The ERM literature is often focused on the acquisition and delivery of information (from models and dashboards). Another essential dimension of ERM, however, is how that information is interpreted to create intelligence or used by decision makers and the role culture plays.

BACK TO BASICS

Over the past decade ERM has gone from a novelty to a cornerstone of management practices. Thousands of pages have been written by consultants, academics, practitioners and rating agencies on ERM topics ranging from definitions, frameworks, risk models and measures. The financial crisis reminded us that designing ERM on paper is not the same as effectively implementing and executing ERM in reality. Post-crisis activities have focused on better economic capital models and risk measures, stronger corporate governance, compensation structures and more disclosures. While these are well-intentioned actions, we believe effectiveness ultimately resides with people and their culture.

First we go back to the basics. We ask, "Why ERM?" If you peruse Annual Reports, a ubiquitous component of Company Missions/Visions is long-term top-line and bottom-line growth. Long-term implies being able to balance and manage risks, revenue and earnings; aligning risk preferences, appetite and tolerances with strategy; and linking core risks and collateral risks with core competencies. But why?—to attain a sustainable competitive advantage.

Next we ask, "What is ERM?" Common words to nearly every ERM definition are: it is a *process* and it is about *decision making*. ERM seeks to gain a holistic view of risks by breaking down silos and inconsistencies to make better informed decisions. Decisions are made by people, not by models, policies, frameworks or even companies. Basic rules of thumb for decision making say the process should be simple, understandable, useable, relevant, timely, tangible and actionable. What is the best ERM? The best ERM is the best *fit*—the fit that is aligned with vision, strategy and strengths. ERM enables the speed to act, to respond and to exploit op-

portunities. But what?—to attain a sustainable competitive advantage.

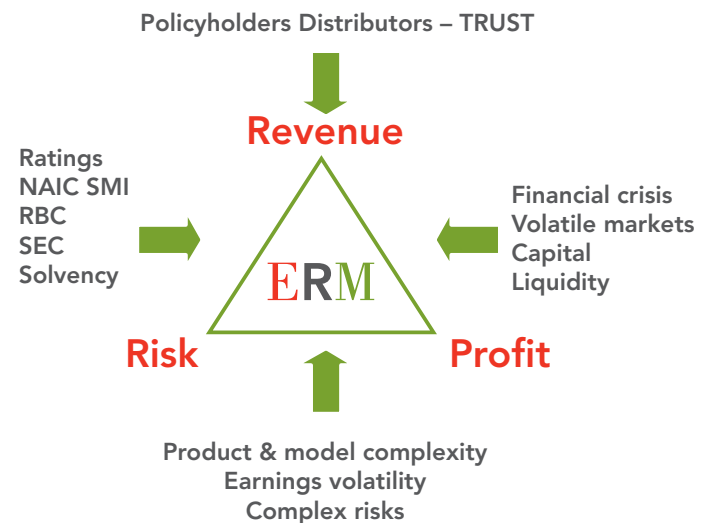
FORCES DRIVING ERM

The fundamental foundation of insurance products is *trust* in management's ability to deliver on long-term promises. Perception is a strong component of strength, trust, and distributor and consumer confidence. Numerous forces have shaped ERM. (See Figure 1.)

ERM EVOLUTION—CONVERGENCE

Convergence is a theme that has been

Figure 1: Forces That Have Shaped ERM



gaining momentum. Supervision, reporting, solvency and capital standards are converging within and across jurisdictions worldwide as well as becoming less rules-based and more principle-based. Convergence is also occurring in models, systems, processes, infrastructure, departments,

attention is given to the acquisition of (risk) intelligence. We must also consider how intelligence is put into action. There are five stages to formulate and make intelligence useful²: 1) acquisition, 2) delivery, 3) acceptance, 4) interpretation and 5) implementation. We explore these five stages from

and the why/what are sustainable competitive advantages. SOB studies how.

What follows is a crash course in SOB covering communication, decision making, teams and groups and conflict from Chapters 1 and 9–12 of *Organizational Behavior: A Strategic*

... to be successful, **ERM** requires decentralized networks and **High Involvement Management throughout the entire process.**

functions and people. ERM evolution can be described as a convergence of silos and business management. ERM is simply another manifestation of business and performance management.

Convergence has and will unleash a Pandora's box. The *hope* saving us from panic is encapsulated by collaboration, wisdom and judgment. ERM acquires and implements business intelligence in decision making in the face of ambiguity by an organization's decision makers. Thus ERM is inexorably tied to Strategic Organizational Behavior (SOB).¹

**A CRASH COURSE IN SOB
HARD VS. SOFT SCIENCES**

We classify the following as hard sciences: governance, frameworks, models, metrics and reports, risk controls and monitoring, and technology. Hard sciences focus on quantitative things, rules or policies. The hard sciences are necessary but not sufficient for successful ERM execution. Much

an ERM perspective in ERM & BI—Lessons From WWII Codebreakers.³

The soft sciences study culture and decision-making processes and thus consider how ERM intelligence gained from the hard sciences is put into action. SOB is people- and process-centric and studies the actions of individuals and groups in organizations. SOB studies how people, processes, teams, collaboration and decisions result in competitive advantages for organizations resulting in performance. Earlier ERM was defined as a process about making business decisions

Approach, by Hitt, Miller and Colella. Our short article cannot hope to do this discipline justice. We encourage readers to read these SOB chapters and the entire book as part of their Continuing Education and to implement the theories of SOB to their work culture.

MANAGING FOR COMPETITIVE ADVANTAGE

There are three criteria to consider when striving for a competitive advantage. Is the good or service valuable, rare and difficult to imitate (a fourth criteria often included is, is it non-substitutable)? See the chart below.

Criteria For Competitive Advantage

VALUABLE?	RARE?	DIFFICULT TO IMITATE?	COMPETITIVE IMPLICATIONS
NO			Disadvantage
YES	NO		Parity
YES	YES	NO	Temporary Advantage
YES	YES	YES	Sustained Advantage

ERM spin: Hard sciences focus on things. Even the most cutting edge things can only, at best, provide temporary advantages. People and the processes that create the thing lead to a sustainable advantage. Each component of an ERM framework such as risk models, dashboards, policies, governance and compensation structures can be imitated. The process in which all the components interact and how people behave and make decisions within the process are extremely difficult to imitate. ERM satisfies all the criteria for achieving a sustained advantage.

PATTERNS OF WORK

Networks can be used to describe different dimensions of work patterns such as communication, access, information sharing, collaboration, etc. (See Figure 2.) Different networks are better suited for different needs. The traditional command-and-control hierarchal management can be described by a centralized network and is appropriate for simple tasks requiring efficiency, speed and accuracy. High Involvement Manage-

ment can be described by decentralized networks that integrate within and across organizational units and hierarchies and are appropriate for solving complex problems. High Involvement Management is also better at timely and reliable intelligence and response time.

ERM spin: ERM is certainly complex, crossing many disciplines, functions and hierarchal levels. Thus, to be successful, ERM requires decentralized networks and High Involvement Management throughout the entire process. ERM is not just an end-of-project approval process—transparency and collaboration at the beginning are essential. Early in the process, management should consider what is missing in design or in the implementation plan and how it can be strengthened or broken. Firms that respond quickly to market changes share information widely across the organization. Middle managers are fundamental to ERM execution, working as a bridge between senior management and domain experts and

are crucial to sharing, communicating and collaborating upstream, downstream and across the organization.

Post-crisis responses include increased disclosures. Disclosure reveals end information, but is not the same as transparency. Transparency shares what, how and why decisions are made before, during and after the process. Transparency is related to integration and incorporates the process of enlarging internal circles of engagement and information sharing. Transparency goes well beyond disclosure to the board or external audiences and should be construed as a process not a result.

COMMUNICATION BARRIERS

Communication can be described as encoding, sending, receiving, decoding and providing feedback to the sender. Communication barriers are an obstacle to ERM execution. Individual barriers include differing perceptions, semantic differences, status differences, self-interest considerations and poor listening skills. Organizational barriers

Figure 2: Different Dimensions of Work Patterns

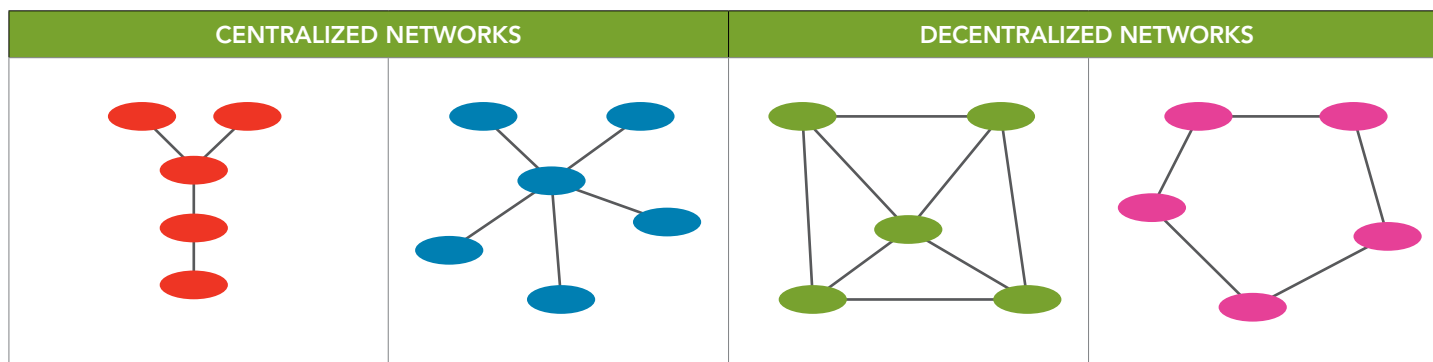
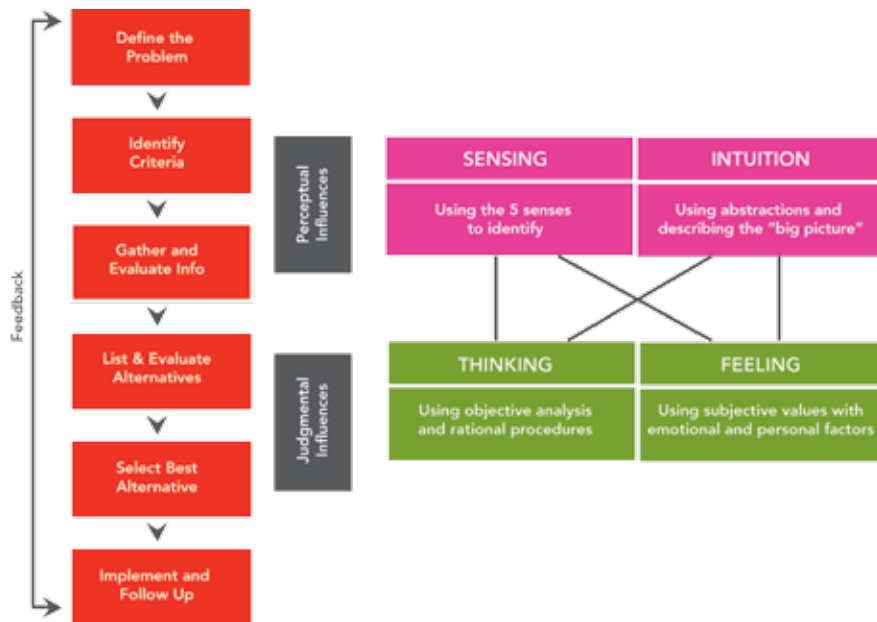


Figure 3: Predisposition and the decision process



include information overload, noise, network breakdowns, time pressure, information distortion and cross-cultural barriers such as time zones, different languages and different regulatory jurisdictions.

ERM spin: Intelligence distortion such as withholding or filtering intelligence vertically and horizontally severely limits ERM performance. Single node network connections between silos, hierarchies and stages of intelligence exacerbate distortion. Later we look at several recent headline failures. A ubiquitous characteristic is that those cultures suppressed meaningful communication and requisite dialogue.

DECISION-MAKING STYLES AND PITFALLS

Decisions can be highly complex and situ-

ational. According to Carl Jung’s theory, an individual’s predispositions can affect the decision process at two critical stages: 1) the perceiving of information, and 2) the judging of alternatives. (See Figure 3 above.) There is a wide spectrum of objective and subjective factors. Additional considerations include: intelligence vs. speculation, certainty vs. ambiguity, importance vs. urgency, and organizational vs. personal dimensions and degree of acceptable risk.

There are numerous pitfalls that even seasoned veterans may fail to successfully navigate. Individual decision making is fraught with challenges and biases such as cognitive, confirmation, anchoring, ease of recall and sunk-costs. Group decisions must overcome challenges such as groupthink,

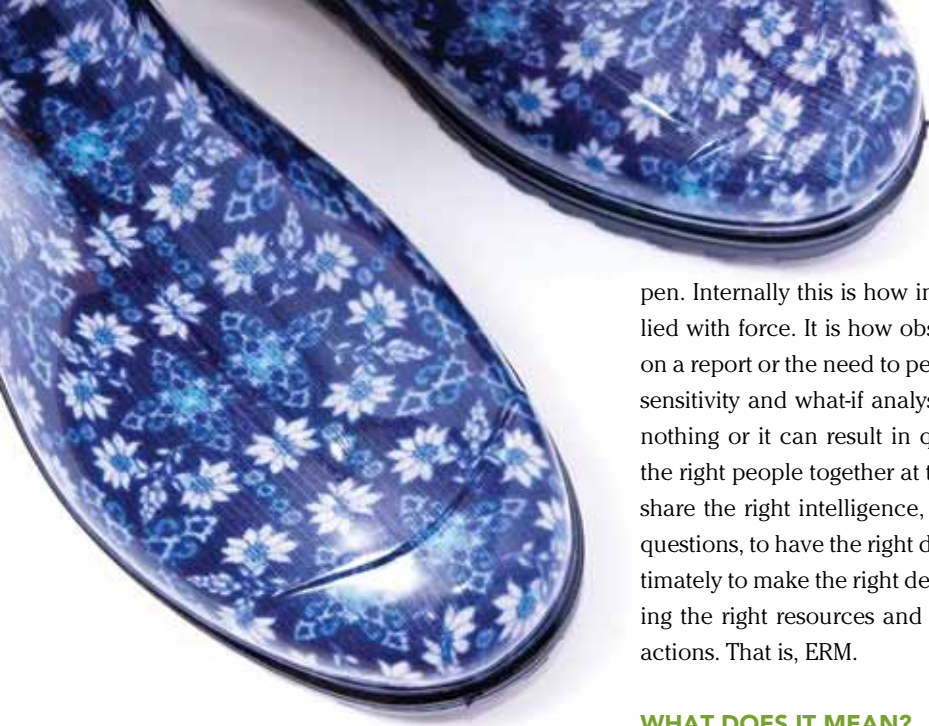
common information-bias, diversity-based infighting and risky shifts (in the risk management arena, groups tend to make riskier decisions than individuals).

ERM spin: Considering all the factors in decision making it is not surprising that very different decisions can be reached by different people, or even by the same person in seemingly similar contexts. ERM incorporates an overwhelming amount of intelligence involving a plethora of perspectives, decision criteria and people who will likely disagree over the relative importance of various factors. We return to our “back to basics” holy grail of being able to balance and manage risks, revenue and earnings. Is there a right answer? Is there a right problem? There are many decision makers. How do they collaborate? The answers to these questions are manifested within the ERM process.

CONFLICT AND RESPONSES—POWER

Conflict can be dysfunctional or functional. Three types of workplace conflicts are relationship, process and task. The first two tend to be dysfunctional; the third can prove constructive. Causes of conflict include: a) structural factors—increased specialization, interdependence, centralization vs. decentralization, and poor communication factors such as talking but not listening and too little or too much communication; b) cognitive factors—differing expectations and perceptions; and c) individual characteristics—personality, value differences, goals, past performance and previous interactions.

There are five potential responses to conflict: competing, accommodating, avoiding, compromising and collaborating. Responses can



be described in terms of assertiveness and cooperativeness. The appropriate response is situational. Thus rules or policies are limited. Effectiveness relies on people, judgment, collaboration and processes. Ability to manage conflict effectively is better captured by Emotional IQ than by Cognitive IQ.

Power can come from many sources. French and Raven developed one of the most commonly used typologies: legitimate (formal authority), reward, coercive, expert and referent power. Individuals and organizational units can also obtain power by being able to address the major problems and issues faced by the organization (strategic contingencies model of power).

ERM spin: Appropriate escalation and resolution are essential to the ERM process. Taking ERM beyond a set of policies on paper and functional or dysfunctional conflict reflects how ERM is truly embedded into culture and decision making.

Whether through one's ability to sell ideas, influence, negotiate, incentivize, command or execute plans, power makes things hap-

pen. Internally this is how intelligence is allied with force. It is how observed risk data on a report or the need to perform extensive sensitivity and what-if analysis can result in nothing or it can result in quickly bringing the right people together at the right time to share the right intelligence, to ask the right questions, to have the right dialogue, and ultimately to make the right decision by applying the right resources and taking the right actions. That is, ERM.

WHAT DOES IT MEAN?

SOB AND ERM PERFORMANCE

Now let's apply that crash course in SOB to recent ERM failures. Toyota's 2010 brake recall public relations fiasco was only rescued by BP's even bigger disaster. Evidence suggests BP ignored basic SOB and ERM principles. Communication barriers, information distortion, faulty decisions, conflict and lack of transparency were all contributing factors. When Katrina struck in 2005 these same factors highlighted that New Orleans, La. and federal disaster emergency plans were nice in appearance but ugly in substance.

In testimony pertaining to the U.K. government bailout of HBOS, Paul Moore said,⁴ "no-one wanted or felt able to speak up for fear of stepping out of line ... I am quite sure that many, many more people in internal control functions, non-executive positions, auditors, regulators who did realise that the Emperor was naked, but knew if they spoke up they would be labelled 'trouble makers' and 'spoil sports' would put themselves at personal risk." In the aftermath of AIG's \$85 billion bailout, it was revealed that, "debate and discussion that was common under the

previous CEO ceased. The way you dealt with Joe was to start everything by saying, 'You're right, Joe'.⁵ Although in 2005 Merrill Lynch's CEO stated, "We've got the right people in place as well as good risk management and controls," the culture was seemingly much different as it was remarked, "There was no dissent, so information never really traveled."⁶

The above quotes aptly capture these institutions' SOB and ERM shortcomings. The shortcomings were not in the hard sciences but rather many of the SOB soft science topics we briefly covered—centralized networks, communication barriers, decision making pitfalls, and conflict, responses and power. A common element is the risks were known, to some degree, and often understood but ignored or not explored.

These failures highlight three common cultural diseases we call the "Yes, Afraid and Safe" symptoms which suppress warning signs and stunt creativity, innovation and solutions. To illustrate a point, let us consider these symptoms in the extreme. Escalation procedures exist in policy but not in practice possibly due to organizational rewards or punishments or individual self-interest behaviors. Meaningful risk discussions and warning signs are filtered up in the best possible light by sugar coating, misinforming, suppressing or covering up. ERM reports are filtered, sanitized and contain the sanctioned or politically correct view. It is easier to agree and say yes. Subordinates are afraid to disagree, dissent or debate. They know bottom-up ideas and alternatives will be poorly received and result in reprimands. By not providing candid alternatives to su-

periors they are de facto making decisions on behalf of the decision makers. But making safe choices often results in defeat similar to prevent-defense in sports. In business, playing it safe may lead to risky behavior, but not bold behavior. Bad ideas get through since they are not challenged, but bold innovation does not get considered. Subordinates know what management wants to hear. Employees know what the “correct” answers to a question are and even what questions should or

minority reports? In a control culture that is likely political suicide. What drives ERM at a company? Is it based on appearances or substance? Do risk reports look nice or do they stimulate heated dialogue? In the end what counts is, “does it work?”

IN CONTRAST

It is usually easier to find faults in hindsight. There were success stories during the crisis. The news has a tendency to report negative

might not have been a covered-up *Minority Report* but the pursuit of truth was just as thrilling—a rapid escalation of events to decipher, distill and debate new intelligence, problems and questions. They exhibited decentralized networks and high involvement management, shattered communication barriers, harnessed conflict and allied resolution with power. The result was intense dialogue amongst experts, managers and management for a week. Their competitors

Business intelligence is suppressed when subordinates do not trust superiors or fear reprisals.

should not be asked. Career mobility is rewarded to the “yes” man. These might be the symptoms in the extreme, but in truth, they exist to some degree in reality. Our critique reminds us of Steven Kerr’s classic management article, “The Folly of Rewarding A While Hoping for B.”⁷

An unmentioned risk in the literature is “career risk.” Business intelligence is suppressed when subordinates do not trust superiors or fear reprisals. Warnings, deficiencies and caveats are not encouraged or well received from superiors who do not want to hear negative feedback. In the Tom Cruise movie *Minority Report*, the existence and cover-up of a report that disagrees with the majority places lives at risk and results in a thrilling pursuit of truth. What ERM culture would accept

events not positive ones. For the most part, insurance companies were not newsworthy. Companies were able to respond and take appropriate actions by increasing liquidity and raising capital. For example, as the crisis emerged, investment policies changed. The new minimum percentage to be invested in cash was likely to be greater than the pre-crisis maximum percent allowed to be invested in cash. Such a policy change indicates ERM worked since it requires asking new questions, finding new answers, having heated dialogue and making decisions.

A success story was featured in the *Wall Street Journal*.⁸ Goldman Sachs had the same risk intelligence during the crisis in 2008 as their competitors, namely, actual value at risk (VaR) trading position results differed from their models. At Goldman Sachs it

rationalized away the intelligence to fit the existing paradigm. Goldman Sachs did not know what the new paradigm was, but felt they did not understand the old one. They took action to reduce exposures before the brunt of the financial crisis. They later stated, “The firm’s risk management processes did not, and could not, provide absolute clarity; they underscored deep uncertainty about evolving conditions in the U.S. residential housing market. That uncertainty dictated our decision to attempt to reduce the firm’s overall risk.”⁹ They performed and soon afterwards had record earnings in Q2 2009.

CULTURE

An ERM mantra is, “Set the tone at the top” and is a message that employees should change their actions and be held accountable. Perhaps it should be “lead by example.”

Where does your company as a whole fit?

CONTROL ERM	HIGH INVOLVEMENT ERM
Silos	Enterprise/global/functional/cultural integration
Centralized work networks	Decentralized work networks
Single points of connectivity	Multiple connectivity points
Power resides in positions	Power resides in interactions
Need to know; secretive	Transparent
Club member only	Wide circles of engagement/delegation
Separation/Partition	Collaboration
Exclusive	Inclusive
Withhold business intelligence downstream	Take in confidence/information sharing
Filter/censor up	Inform, Alert
Top dictates solutions; bottom carries out orders	All levels engaged; top receptive to bottom up ideas
Reports far-removed from source	Reports from/close to the source
Non- and Miscommunication	Dialogue
Single perspective/measures	Multiple perspectives/measures
Delays	Speed
Fixated beliefs	Receives and explores alternatives
Limits sharing	Promotes sharing best practices
Cost minimization	Investment maximization

If management changes its behaviors and actions towards an SOB high involvement culture, it will cascade down, through and back up the organization. We summarize our personal observations in the above table. Where does your department's culture fit in the spectrum between these two polarized cultures? Where does your company as a whole fit?

CONCLUSION

We restate our assertion that ERM effectiveness ultimately resides with people—people through collaboration, wisdom and judgment—in a culture that unleashes and harnesses unimaginative capabilities. All the components of the hard and soft sciences in tandem are essential to ERM efficacy. ERM relies on people and processes. People and processes are

valuable, rare and very difficult to imitate resulting in sustained competitive advantages. However, SOB, ERM and advantages are a means, but not the end. The end is performance. **A**

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ENDNOTES:

- ¹ All the SOB material is derived from Hitt, M., Miller, C. and Colella, A. *Organizational Behavior: A Strategic Approach*, 2nd ed. Hoboken, N.J.: Wiley, 2008.
- ² Keegan, J. *Intelligence In War*, New York: Knopf, 2003.
- ³ Cardinal, T. and Li, J. ERM & Business Intelligence—*Lessons From WWII Codebreakers*, *Contingencies* Mar/Apr 2011 Issue.
- ⁴ Moore, P. *Memorandum from Paul Moore, Ex-head of Group Regulatory Risk*, HBOS Plc. Available at www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144w243.htm.
- ⁵ Lewis, M. "The Man Who Crashed the World," *Vanity Fair*, June 2009.
- ⁶ Morgenson, G. "How the Thundering Herd Faltered and Fell," *New York Times*, Nov. 9, 2008. Available at www.nytimes.com/2008/11/09/business/09magic.html.
- ⁷ Kerr, S. *The Academy of Management Executive*, 1995 Vol. 9 No. 1 7–14.
- ⁸ Kelly, K. "How Goldman Won Big On Mortgage Meltdown," *Wall Street Journal*, Dec. 14, 2007.
- ⁹ Available at <http://online.wsj.com/public/resources/documents/goldman0424.pdf>.