SOCIETY OF ACTUARIES

Article from:

The Actuary Magazine

August/September 2012 – Volume 9 Issue 4

DESCRIBING RISK CULTURE

HONEST AND ASTUTE DIALOGUE AND DEBATE ARE THE HEART AND SOUL OF THE ENTERPRISE RISK MANAGEMENT (ERM) PROCESS. ERM MAKES A DIFFERENCE BY COALESCING INTELLIGENCE WITH POWER, FORGED INTO ACTION. BY TIM CARDINAL

IN THE OPENING SCENES of Russell Crowe's 2010 *Robin Hood*, the king looks for someone who will not "mollycoddle" him and says, "let us see if we can find an honest man." The king encounters Robin Longstride and, observing him as "brave and honest" says, "Are you honest enough to tell a king something that he does not want to hear?" Robin responds to the question honestly and astutely. The king responds, "Honest, brave *{pauses}* and naïve." Moments later, Robin finds himself locked in the stockade awaiting torture and punishment. Imagine the next time the king pursues a challenging goal or asks subjects or risk managers for input.

Randomly choose an insurance company or financial institution and read its annual report. Many, if not most, companies state they have a strong risk culture. And that is not always true. Shortly before their downfall, Merrill Lynch's CEO said, "We've got the right people in place as well as good risk management and controls."[1]

What exactly is meant by "strong risk culture"? How would you describe it? Culture does not have color, shape or mass. What is best practice? Would you know it, if you saw it? Some ERM framework components, such as corporate governance and policy, best practices and company-specific adap-

tations are readily identified and implemented. ERM processes regarding people, dialogue, judgment, decisions, leadership and culture are fuzzy, elusive and difficult to implement.

This excursion into describing culture is a sequel to "Strategic Organizational Behavior: Finding The Right ERM Fit," (*The Actuary*, Feb./March 2011).[2] In that article, Jin Li and I show that ERM is a complex, people-centric process and the topics of transparency, communication, conflict, and decision-making pitfalls are explored. We conclude ERM is more effective in decentralized networks employing high involvement management, and the right ERM fit can be found by involving the company's employees. A crash course

in strategic organizational behavior is continued by exploring culture from *Organizational Behavior: A Strategic Approach* by Hitt, Miller, and Colella.[3]

CULTURE

Culture represents the shared norms and values governing appropriate behaviors. Organizational cultures go through development and reinforcement processes (see Figure 1 below). Positive and negative aspects of culture become self-reinforcing and difficult to change and are based to some degree on the homogeneity of associates and managers and the length and intensity of shared experiences in the organization.

ERM Spin: It can be difficult to discern ERM reality from appearances and the way management would have others perceive them. Culture exposes whether risk management is a

Figure 1

SHARED VALUES

REINFORCING OUTCOMES

NORMS

INDIVIDUAL AND GROUP BEHAVIOR
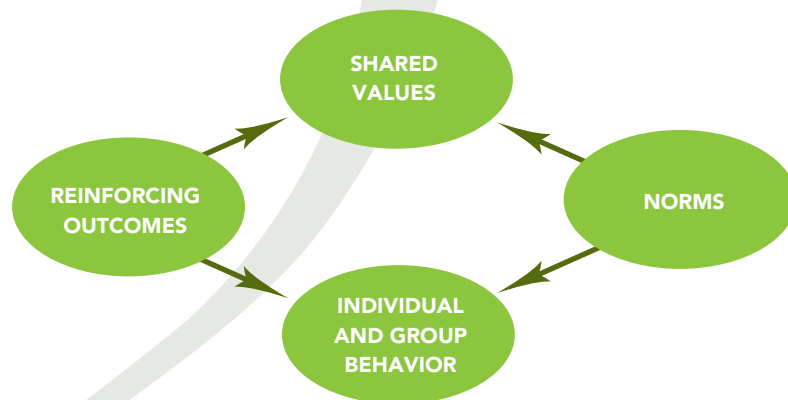
façade or a competitive advantage. When used to describe culture, the adjectives strong and weak indicate the nature and degree of alignment of associates with organizational values. Weak cultures often exercise control through rules and punitive force. Is risk management a framework of checkbox policies and procedures followed, and reports created, sent and dutifully filed? Or does ERM increase participation, stir dialogue and result in engaged employees productively, effectively and creatively implementing management strategy, tactics and decisions? The stories that are told within the company—challenges met, mistakes, near misses, poor decisions but lucky outcomes, well-thought-out failures, and how people are treated and valued—portray its culture.

STRUCTURE

Organizational structure can be described by structural characteristics and structuring characteristics. Structural characteristics include height (how many layers), span of control (number of reports) and departmentation (groupings of resources). Structuring characteristics are policies and approaches used to prescribe the behavior of managers and associates. Four dimensions of structuring characteristics include: 1) centralization is the degree authority is retained at the top; 2) standardization is the degree rules and operating procedures govern behavior and organization; 3) formalization is the degree rules and operating procedures are documented; and 4) specialization is the degree job scopes are narrow and limited in variety. Numerous factors have an effect on structure such as corporate strategy and size, environmental uncertainty, and technology.

A variety of self-explanatory labels can be used to describe two contrasting cultures and the spectrum between the two including: organic versus mechanistic, learning versus non-learning and boundary-less versus traditional. Whatever the label, a more flexible empowering type of structure is associated with fewer management levels, broader spans of control, and lesser amounts of centralization, standardization, formalization and specialization. The flexible approach provides freedom for lower-level managers and associates to think for themselves, communicate with anyone who could be helpful, and try new ideas.

ERM Spin: ERM provides centralized coordination but decentralized command—local authority and responsibility are unchanged. ERM is like the Central Intelligence Agency—a business intelligence agency—but also quite unlike the Central Intelligence Agency. ERM is not secretive but transparent and supports the decision-making process by aggregating and disseminating intelligence.

Some risks are simple to measure, monitor, interpret and manage. Other risks are infinitely complex and difficult to measure or monitor. Structural and structuring characteristics impact whether risk management enables or disables business opportunities or the company's ability to anticipate and manage changes such as strategic and emerging risks. Attempts to control risks through rules can actually increase risk by reducing the ability to respond to change or changing circumstances. The appropriate balance between policy and judgment must be considered. Vertical and horizontal layers increase the distance, create communication and collaboration challenges, and potentially decrease dialogue between acquirers and interpreters of risk intelligence and decision makers. A shared behavior of great leaders is that they are at the scene and go and get the intelligence from those acquiring it.

COMPETING VALUES MODEL

The Competing Values Model is based on two value dimensions: the first dimension relates the value placed on stability and control versus flexibility and discretion and the second relates the value placed on internal focus and integration versus an external focus and marketplace differentiation. See Figure 2 on page 27.

Four types of culture emerge: 1) clans are friendly workplaces with a great deal of commitment and loyalty; 2) hierarchies are formal and standardized; 3) markets can be difficult places to work due to a constant focus on results and outperforming colleagues; and 4) adhocracies tend to be vibrant workplaces with significant risk taking. Organizations usually possess elements of all four cultural types and need all four because morale, innovation, success relative to competitors in the marketplace, and efficiency are all important for long-term performance and survival. An organization often emphasizes one cultural type over another as each can be useful depending on circumstances.

ERM Spin: Companies and leaders should vary the what and how and adapt styles and cultures to global and local circumstances. Different people within the company have different responsibilities and their departments or divisions have different needs along these two dimensions. They will have different attitudes and perspectives towards risk/reward/revenue resulting in different preferences in risk taking and management strategies and decisions. The inherent conflict cre-

Figure 2: Competing Values Model

Stability and Control
vs.
Flexibility and Discretion

Clan	Adhocracy
Leadership – Mentors and Coaches	**Leadership – Entrepreneurs and Innovators**
Effectiveness – Cohesion and Morale	**Effectiveness – Creativity and Innovation**
Hierarchy	**Market**
Leadership – Mentors and Organizers	**Leadership – Hard Drivers and Competitors**
Effectiveness – Efficiency and Order	**Effectiveness – Goal Achievement and Winning**

Internal Focus and Integration
vs.
External Focus and Differentiation

tices inside and outside the company? Are risk dialogues embedded broadly and deeply in the organization and occurring throughout the decision-making process not only at the end but at the beginning? Interpreting and implementing decisions requires a high involvement culture and capable associates. ERM execution is more than controls, compliance and check-boxes. ERM anticipates, enhances speed, puts a finger on the pulse of emerging risks, and uncovers opportunities to exploit strengths and business potential.

ORGANIZATIONAL CHANGE
Organizations are not static entities but constantly face internal and external pressures for change. Internal pressures include aspiration-performance discrepancies and life-cycle forces as a company grows. External pressures include technological advances, regulations, societal values, political dynamics, changing demographics and increased

ated by these differences can be functional or dysfunctional. Deciding the appropriate course of action for the circumstances based on sound ERM processes is reached through dialogue before, during and after. If one does not understand causes for success (and the risks taken) one will not understand what went wrong when one fails.

CULTURAL AUDITS
A cultural audit is a tool for assessing and understanding the culture's shared values and entails four steps. It is a complex and lengthy process requiring careful planning and preparation and is full of political landmines. When subcultures exist, one or more could include values substantially counter to organizational values. Such a counterculture may be difficult to manage but can also produce positive outcomes such as inducing a revo-

lution, forcing change in a staid outmoded culture, or encouraging the development of new and creative ideas not allowed by existing norms. There are four audit steps:

1. Analyze socialization process/content of new associates/managers;
2. Analyze responses to critical incidents in the organization's history;
3. Analyze values and beliefs of culture creators and carriers (current leaders); and
4. Explore anomalies discovered in other analyses.

ERM Spin: Poorly developed or weak cultures are less likely to tolerate a critical assessment. Strong cultures are more likely to welcome opportunities to learn and to become even better. Is the organization a learning culture that identifies, develops and shares best prac-

global interdependence. The process of planned change can be described as unfreezing, moving and refreezing. Change agents must consider tactical choices regarding the speed of change and the style of change. Organizations often encounter resistance to changes due to a lack of understanding, different assessments, self-interest or low tolerances for change. The biggest challenge is changing people's behavior.

ERM Spin: Effective change requires effective leadership. The chief risk officer (CRO) is a recently created position. For companies that have appointed a CRO, what has changed or is different? If the culture has deficiencies, how does a CRO go about changing the culture? When drastic change is needed, oftentimes new and external senior management are hired precisely because it

is too difficult to change culture from within. In addition to breaking down risk silos, ERM also breaks down cultural silos.

TRANSACTIONAL VERSUS TRANSFORMATIONAL LEADERSHIP

Leadership is the means of providing direction and influencing individuals or groups to achieve goals. Effective leaders are more concerned with strategy (do the right things) than tactics (do things right). The right things include the ability to create and communicate vision, communicate with and gain support of multiple constituencies, persist in the desired direction even under bad conditions and create the right culture to obtain results.

Transactional leaders understand what followers want from their work, clarify links between performance and reward, respond only if performance is unsatisfactory, and utilize a contingent reward behavior and active management-by-exception style.

Transformational leaders increase followers' awareness of achieving valued organizational outcomes, vision and required strategy, encourage placing organizational interests first, raise level of followers' needs in part by continuous development/improvement to strive for higher levels of accomplishment and utilize charisma, intellectual stimulation and individual consideration. They communicate vision through personal action, emotional appeals and symbolic forms such as metaphors, delegate significant responsibility and authority, eliminate unnecessary bureaucratic restraints, provide coaching and developmental experiences, encourage open sharing of ideas and concerns, encourage participative decision making, promote cooperation and teamwork, modify organization structures and policies such as selection and promotion criteria to promote key values

and objectives. Charismatic leaders are tied to higher stock prices—stakeholders make larger investments, innovation, creativity and long-term performance.

Transformational leadership has the strongest impact on the situations demanding that associates perform outside explicit expectations by providing extraordinary effort or being innovative. Integration of transformational and transactional leadership approaches is the most effective leadership strategy.

ERM Spin: Decisions are not made by institutions, corporations or policies. Decisions are made by people exercising integrity, wisdom and judgment. Recent failures such as Merrill Lynch, HBOS, Countrywide, Hurricane Katrina, Madoff, Toyota and BP all share failed responsibility and judgment in behaviors, decisions and actions as a common cause. A leader that has the right stuff also needs to know how to get things done, i.e., the right stuff done the right way. Leading by example starts with how associates are treated and valued. Gen. Patton wrote, "There is a great deal of talk about loyalty from the bottom to the top. Loyalty from the top down is even more necessary and much less prevalent." Dozens of applicable words could be substituted for loyalty. Transformational leadership provides a cornerstone for high involvement management and managing significant risks.

A TALE OF TWO CULTURES

In "Strategic Organizational Behavior: Finding The Right ERM Fit," (*The Actuary*, Feb./March 2011), to illustrate a point we considered the symptoms of three cultural diseases, "Yes, Afraid and Safe," in the extreme. Now consider the additional disease of Autocrat. Autocrats (managers, department heads or C-positions)

dictate ideas, problems and solutions. Collaboration really means communicating marching orders. Autocrats equate delegating busy tasks as delegating meaningful responsibility, authority and resources. Autocrats restrict engagement at idea formation, participation in problem definition, and exploration of different perspectives and alternatives and solutions. Instead, ideas, initiatives, innovation and creativity are dictated. Autocrat risk managers practice control ERM, not high involvement ERM. Associates only need to know enough to do their jobs, not how their job pertains to the whole. Rules and policies are established forbidding or curtailing others from having or exercising responsibility, authority or judgment. Fearful of Autocrats, Chicken Little managers must be seen by superiors and peers as always right and in control. Thus authority and resources are micromanaged and misused. The staff responds NOW! to perceived mistakes and the crisis of the day as life or death. The modus operandi is a short-term, threatening and reactionary focus with a lack of long-range planning and lack of learning and improving by understanding and addressing root causes of successes and failures. Proactive capabilities, infrastructure and work processes are not built, thus perpetuating the next crisis. These managers do not make choices—all work is a high priority. Through adept office politics, blame is transferred, credit is stolen, and good associates are miscast in a negative light. Morale suffers and staff burnout results.

In contrast, transformational leaders promote a high involvement culture and have the courage and confidence to admit when they are wrong rather than maintain they are right. They would rather be right in the

end (results). Great leaders go to the scene, initiate getting intelligence firsthand from acquiring sources, and encourage participative exploration of alternatives even when it suggests their own views might need to be reconsidered. They champion true team players who define what winning means (strategic/tactical/project objectives), give credit and take blame, ask tough probing questions, speak up when something can be done better or should not be done at all, and strive to do the right thing even when difficult or poorly received. They exercise unity of command (i.e., one decision maker). The way they treat and value the contributions of associates inspires followers to give their best.

DIALOGUE: OPEN AND CLOSED

Compare our *Robin Hood* scene with the culture described by Gen. Stanley McChrystal in his 2011 SOA Annual Meeting Presidential Luncheon speech. In 2003, the United States' fight against al-Qaida was not going well. The United States needed to collaborate fully with global agencies yet the U.S. intelligence agencies were themselves operating in cultural silos. Global and U.S. leadership assessed and determined change was needed. Gen. McChrystal assumed command. He did not blame the staff as incapable or try to change the culture with words or exhortations. He accomplished changes by leading and by being an example through his day-to-day actions. He successfully navigated many of the issues covered in the cultural section above and built a strong risk culture. One example he gave was his 90-minute daily Web conference call with 200+ participants (and more people lurking) representing intelligence agencies from 27 countries. He described a typical exchange via a brief given by a young junior intelligence officer.

He addressed her by name, Susie, and asked her questions he knew she could answer so she could demonstrate her expertise and abilities to everyone on the call. Then he asked her point-blank for her opinion on what she would do. He thanked her for contributions. Follow-up discussions occurred between small groups across the globe including those who didn't get air time during the Web call. He contrasted this with an executive's BlackBerry response of "OK" to reports, emails or recommendations. What does OK mean—go ahead or don't waste my time? Another contrast given was the corner office and the isolation it creates versus going to the sources, sharing information and involving and valuing people. Imagine the next time the general pursues a challenging goal or asks for input. Staff, knowing it will be read, heard, discussed and valued, will give brilliant briefings and will not mollycoddle the general. With the culture being indoctrinated day in and day out, staff produced extraordinary efforts and achievements.

ALL THE RIGHT WORDS

One insurance company cited its strong risk culture was due to collaboration, bottom-up involvement, non-silo teams, everyone is a risk manager, etc. Competitive advantages in risk management included their investment department and hedging capabilities. The CRO and management portrayed a culture freely exchanging ideas with risk management embedded in every process including hedging and product development begin-to-end stages. However, the culture was described by risk management associates as silos and walls—they were excluded from interdepartment dialogue. Product and investment departments (and hedgers) were off limits to ERM staff. The risk management department VP attended many meetings, but seldom apprised staff, providing directives

instead. The CRO's direct reports never disagreed. When asked to cite an example, one VP said that in the past five years he had not once disagreed, stating the CRO was smart and always right.

NOT OPEN FOR DISCUSSION

Another company appeared to have a strong risk culture. It was an early adopter of ERM, appointing a CRO, defining risk appetites and tolerances, and identifying and monitoring risks with a risk dashboard. All the appropriate buzz words were, and are, used by management. However, as narrated by several mid-level actuaries (at various times in the years prior to the risk failure), associates were expected to perform tasks with little delegation of responsibility, authority or involvement. The culture was indeed strong, but negatively. Which questions were allowed

to be asked or issues to be pursued and debated and by whom were indoctrinated in their culture and associates' behaviors. The risk dashboard was dutifully and timely circulated to the management and board. The dashboard indicated risk exposure to stocks, and in particular bank stocks, was red and had been red for a few years. However, it was politically advantageous to overlook this risk exposure. During the crisis, the value of their bank stocks fell precipitously, representing more than 30 percent of the company's surplus, and resulted in a downgrade.

CONCLUSION: THE D'S OF ERM

Risk managers should be honest, astute, and brave—enough to tell a king something he does not want to hear. They shouldn't be naïve or fearful or punished. ERM is built on five pillars (see Figure 3 below). People are

at the center—responsible stewards with authority built on a high involvement learning culture. Each layer of D's encapsulates the ERM process and corresponds to Keegan's stages of making intelligence useful, which we illustrated in "ERM, Lessons From WWII Codebreakers," (*Contingencies* March/April 2011).[4] The first layer (discipline, etc.) permeates the entire process. The second level is the first two stages (acquisition and delivery). Next, ask questions and gain insights into what really matters. Honest and astute dialogue and debate are the heart and soul of the ERM process. The third and fourth levels are Keegan's third and fourth stages (acceptance and interpretation). The fifth level is Keegan's fifth stage (implementation). ERM makes a difference by coalescing intelligence with power forged into action. Our sixth level is winning, performing and delivering results. To paraphrase Churchill, effective ERM can't guarantee victory, but a strong risk culture built on the D's and pillars can ensure that we deserve to win. **A**

Tim Cardinal, FSA, CERA, MAAA, MBA, is vice president, Polysystems, Inc. He can be contacted at *tcardinal@ polysystems.com.*

Figure 3: The D's of ERM

DELIVER   DECIDE   DESIGN   DEPLOY   DISCUSS   DISAGREE
DIALOGUE   DEBATE   DISSENT   DRIVERS   DISTILL   DISCERN
DATA   DETECT   DISCOVER   DECIPHER   DEBRIEF   DYNAMIC
DISCIPLINE   DISSEMINATE   DEMONSTRATE

LEARNING   INVOLVEMENT   PEOPLE   RESPONSIBLE   AUTHORITY

Another company appeared to have a strong risk culture. It was an early adopter of ERM, appointing a CRO, defining risk appetites and tolerances, and identifying and monitoring risks with a risk dashboard. All the appropriate buzz words were, and are, used by management. However, as narrated by several mid-level actuaries (at various times in the years prior to the risk failure), associates were expected to perform tasks with little delegation of responsibility, authority or involvement. The culture was indeed strong, but negatively. Which questions were allowed to be asked or issues to be pursued and debated and by whom were indoctrinated in their culture and associates' behaviors. The risk dashboard was dutifully and timely circulated to the management and board. The dashboard indicated risk exposure to stocks, and in particular bank stocks, was red and had been red for a few years. However, it was politically advantageous to overlook this risk exposure. During the crisis, the value of their bank stocks fell precipitously, representing more than 30 percent of the company's surplus, and resulted in a downgrade.

Figure 3: The D's of ERM

DELIVER   DECIDE   DESIGN   DEPLOY   DISCUSS   DISAGREE
DIALOGUE   DEBATE   DISSENT   DRIVERS   DISTILL   DISCERN
DATA   DETECT   DISCOVER   DECIPHER   DEBRIEF   DYNAMIC
DISCIPLINE   DISSEMINATE   DEMONSTRATE

LEARNING   INVOLVEMENT   PEOPLE   RESPONSIBLE   AUTHORITY

instead. The CRO's direct reports never disagreed. When asked to cite an example, one VP said that in the past five years he had not once disagreed, stating the CRO was smart and always right.

NOT OPEN FOR DISCUSSION

Another company appeared to have a strong risk culture. It was an early adopter of ERM, appointing a CRO, defining risk appetites and tolerances, and identifying and monitoring risks with a risk dashboard. All the appropriate buzz words were, and are, used by management. However, as narrated by several mid-level actuaries (at various times in the years prior to the risk failure), associates were expected to perform tasks with little delegation of responsibility, authority or involvement. The culture was indeed strong, but neg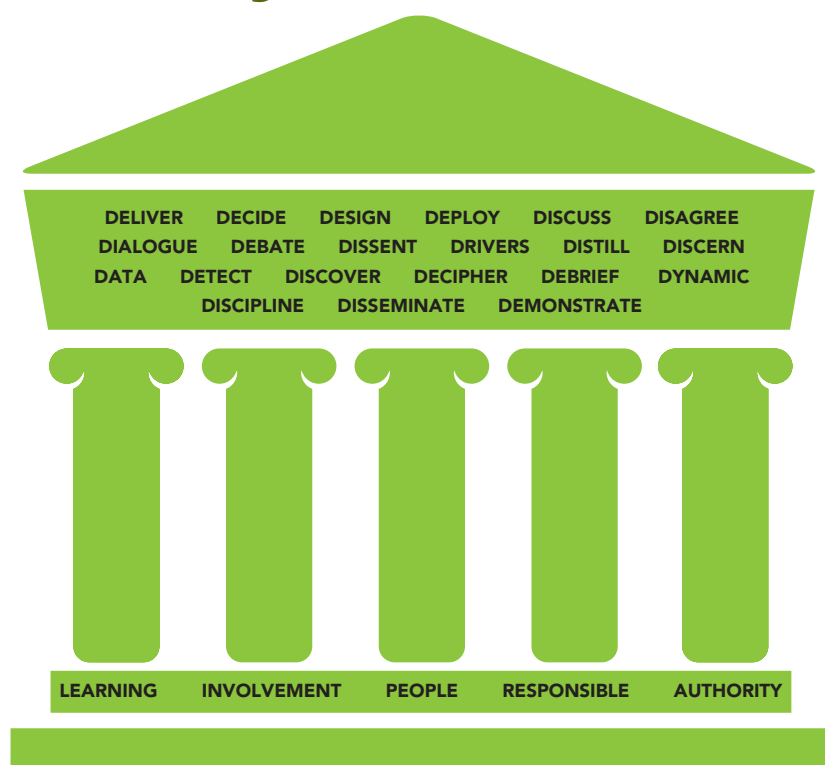atively. Which questions were allowed to be asked or issues to be pursued and debated and by whom were indoctrinated in their culture and associates' behaviors. The risk dashboard was dutifully and timely circulated to the management and board. The dashboard indicated risk exposure to stocks, and in particular bank stocks, was red and had been red for a few years. However, it was politically advantageous to overlook this risk exposure. During the crisis, the value of their bank stocks fell precipitously, representing more than 30 percent of the company's surplus, and resulted in a downgrade.

CONCLUSION: THE D'S OF ERM

Risk managers should be honest, astute, and brave—enough to tell a king something he does not want to hear. They shouldn't be naïve or fearful or punished. ERM is built on five pillars (see Figure 3 below). People are at the center—responsible stewards with authority built on a high involvement learning culture. Each layer of D's encapsulates the ERM process and corresponds to Keegan's stages of making intelligence useful, which we illustrated in "ERM, Lessons From WWII Codebreakers," (*Contingencies* March/April 2011).[4] The first layer (discipline, etc.) permeates the entire process. The second level is the first two stages (acquisition and delivery). Next, ask questions and gain insights into what really matters. Honest and astute dialogue and debate are the heart and soul of the ERM process. The third and fourth levels are Keegan's third and fourth stages (acceptance and interpretation). The fifth level is Keegan's fifth stage (implementation). ERM makes a difference by coalescing intelligence with power forged into action. Our sixth level is winning, performing and delivering results. To paraphrase Churchill, effective ERM can't guarantee victory, but a strong risk culture built on the D's and pillars can ensure that we deserve to win. **A**

Tim Cardinal, FSA, CERA, MAAA, MBA, is vice president, Polysystems, Inc. He can be contacted at *tcardinal@ polysystems.com.*

ENDNOTES

[1] 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.*

[2] Cardinal, T. and Li, J. "Strategic Organizational Behavior: Finding The Right ERM Fit" *The Actuary*, Feb./March 2011.

[3] Hitt, M., Miller, C. and Colella, A. *Organizational Behavior: A Strategic Approach*, 2nd ed. Hoboken, NJ: Wiley, 2008.

[4] Cardinal, T. and Li, J. "ERM, Lessons From WWII Codebreakers" *Contingencies*, March/April 2011.

Figure 3: The D's of ERM

DELIVER   DECIDE   DESIGN   DEPLOY   DISCUSS   DISAGREE
DIALOGUE   DEBATE   DISSENT   DRIVERS   DISTILL   DISCERN
DATA   DETECT   DISCOVER   DECIPHER   DEBRIEF   DYNAMIC
DISCIPLINE   DISSEMINATE   DEMONSTRATE

LEARNING   INVOLVEMENT   PEOPLE   RESPONSIBLE   AUTHORITY

30 | **THE ACTUARY** | AUGUST/SEPTEMBER 2012