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Can Bad Culture Kill a Firm?

By Stephen W. Hiemstra

UNFORTUNATELY, YES. Weak cultures leave firms exposed to risks that formerly had been assessed and mitigated. In my previous two articles on this subject (see *Risk Management* issues December 2008 and June 2009), I cited case studies showing how market and organizational changes have undermined risk management decisions and analyzed how cultural influences can impede learning and weaken risk management. In this article, I present prescriptions for meeting cultural challenges with large financial firms in view.

BUILD ESPRIT DE CORPS

Craft a vision for the firm carefully.

Building esprit de corps is a deliberate strategy needed to offset the organizational inertia caused by high and increasing decision costs. The rapid pace of change in the Internet age heightens the premium on adapting to change.

Managers and staff should know the firm's objectives and be able to anticipate their firm's response to changing circumstances. The ideal for risk management should be the basketball player that instinctively passes the ball when opportunity to score arises for any member of his team and can slip seamlessly into defense when possession passes to the other team.

LEARN THE RIGHT LESSONS FROM LOSSES

Learn from losses and move on.

Learning the right lessons is increasingly important. Conflict arises in post modern organizations as they confront the Internet age. The pace of market changes has increased as the Internet allows business to expand worldwide. Opportunities and threats come and go at a more rapid pace increasing the need for decisions and the opportunity for mistakes. The ability of the firm to adapt and learn quickly carries a higher premium in the current environment just as cultural trends show a proclivity to slow adjustment and raise decision costs.

The preference for democratic processes in the post modern firm raises decision costs (Buchanan and Tullock 1974, 96-116). Increased decision costs implies that fewer rational decisions will be attempted, but more inclusive decision processes also have the potential to render better decisions and greater compliance with decisions that are made. The downside is that decisions are recycled longer because they are more expensive.

The high cost of organizational decisions is magnified when decisions are executed badly or poorly anticipate states of the world.[1] Decisions associated with losses leave a larger cultural footprint than profitable decisions because upfront costs are tied to backend costs (losses), not offset by gains. It is accordingly important that the right lessons are learned.

So, what are the right lessons? If poor execution was the problem, the best solution is to improve execution. If poor forecasting was the problem, the best solution is to improve the forecasting. If the firm is recruiting and encouraging good people, personnel actions are likely not

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FOOTNOTES:

[1] Casting aspersions on the rating companies and big four accounting firms, Bert Ely (2009, p. 97) wrote: *While the division of labor can justify much of today's reliance on expert opinion…Financial and legal analysis of complex financial transactions is hard work; it is mentally taxing; and it can take a lot of time, and therefore is expensive.*

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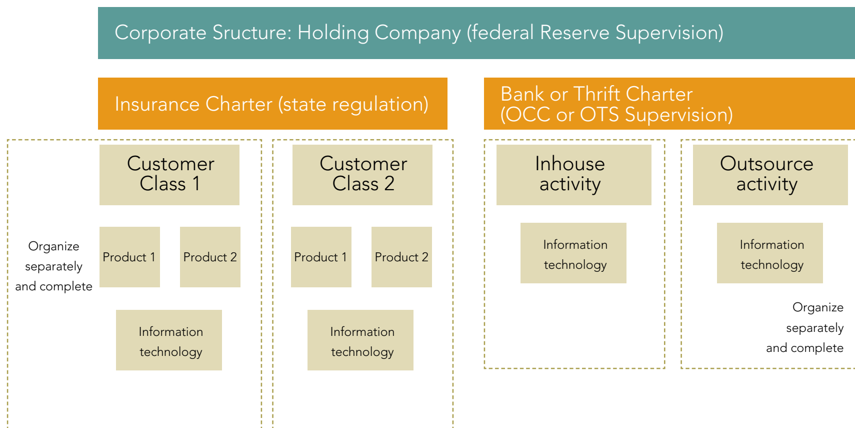
the best solution in meeting organizational challenges. This is because the current staff and managers carry forward the lessons learned in adapting to a changing environment.

CAVEAT DECISIONS UP FRONT

Define a risk appetite for each business activity and know when to revisit decisions.

Organizational inertia manifests itself in placing the burden of proof in recognizing problems on the risk manager. This presumes the wrong incentive. The two prominent strategies for overcoming organizational inertia work by moving the burden of proof in managing risk from the risk manager to the operational manager proposing a particular activity. These strategies are: develop explicit risk appetite guidance from directors/senior managers and employ risk management caveats.

Financial Conglomerate Structure



A target risk appetite is an explicit policy established to determine how much risk the firm is willing to tolerate. Having this policy determined outside of the decisions on particular programs to pursue means that risk managers need only measure the risk in particular proposals to get a hearing with senior management. No criticism of the merits of a particular proposal is required. The burden of proof in continuing to pursue the proposal then requires those presenting the proposal to hedge the risk implied in the proposal.

Risk management caveats work the same way, but in a different context. A risk management caveat is a plain English statement of when a particular decision needs to be revisited that is crafted when the decision is made.[2] In other words, decisions are handicapped at the time they are made to make sure that they are not taken out of context later on. In software, such caveats could be written into the computer code in comments. In models, they could be placed up front in the internal documentation. In decision documents or contracts, they could appear as template language required of every decision by the attorneys drafting these documents.

USE COMPETING DIVISIONS TO CREATE INFORMATION

Create decision information in mission critical business activities by risk-based pricing and allocating capital competitively among competing divisions.

A lack of market disciple has evolved with the growth of firm size and exacerbated the problem of cultural lethargy by reducing the information content of the market prices. Because markets compete with processes internal to the firm, the most effective way to offset the loss of market information is to encourage its creation within the firm (see chart).

One way to accomplish this is by creating internal markets in the firm along the General Motors model where divisions own particular products (or brands) or customers and compete among themselves for capital allocation (Williamson 1981). While this has been done by conglomerate firms since their inception, it is not clear that financial firms have explicitly employed this practice to improve the quality of internal allocation of resources and capital. This is an important benefit of encouraging deliberate redundancy within the firm.

FOOTNOTES:

[2] This is, in part, an application of a sunset clause to risk management. *In public policy, a sunset provision or sunset clause is a provision in a statute or regulation that terminates or repeals all or portions of the law after a specific date, unless further legislative action is taken to extend it* (http://en.wikipedia.org/wiki/Sunset_provision).

> "Decisions associated with losses leave a larger cultural footprint..."

A second benefit of internal divisioning is to improve the resiliency of large firms to operational and systemic risk.[3] In competitive markets, the insolvency of individual firms is a natural consequence of poor management and markets are not seriously impaired by poor performance or failure of individual firms. Poor performance or failure of large, noncompetitive firms can be catastrophic. Building redundancies into large firms can be used to force internal managers to reveal their cost structures (risk-based pricing) and improve their allocation of resources (capital and staff allocation).

A third benefit of divisioning is that it facilitates the layering of regulatory oversight and regulatory specialization. Public policy and regulation define and maintain market boundaries. Regulators facilitate the dissemination of best-practices information across firms in a market and, if functioning properly, facilitate healthy competition by improving market price content.

Product lines subject to a switching problem are obvious candidates for creation of separate divisions. A switching problem exists when products differ in significant, but subtle ways that are hard to coordinate among the teams required to execute transitions from producing one product to another. To draw on the automotive illustration, a group responsible for design, marketing, and production of high-priced cars might, for example, be perfectly capable of switching over to manufacture economy cars over the course of several years. They may lose market position, however, if they cannot execute the switch in a single product cycle or cannot execute without a substantial increase in defects. Creating separate divisions (or outsourcing) could presumably both accelerate market response and reduce the incidence of defects.[4] In the financial arena, the same switching problem may manifest itself in moving from fixed to variable rate mortgages or from serving prime to serving subprime customers because of substantive differences in mortgage contracting risks.[5]

INVESTING IN LEARNING CREATES REAL HEDGES

Hedge risk by encouraging a deliberative decision culture.

Couched in risk management terms, the modern firm maximizes profits while the post modern firm maximizes profits conditional on hedging the implied risks. An important hedge for the post modern firm is to encourage a culture where senior management articulates objectives clearly, promotes risk management (rational decision making), takes steps to be involved with and support staff, and encourages mistakes to be openly and honestly discussed without retribution.

One way to describe the difference between the modern firm and a post modern firm is in terms of Pareto efficiency. Pareto efficient solutions require that a proposed change make at least one person in the firm better off while leaving no one worse off. If compensation can be offered, a Pareto efficient solution making at least one person better off and able to compensate those made worse off (Buchanan and Tullock 1974, 171-99). The modern firm seeks a Pareto efficient solution, but generally neglects to pay the compensation. The post modern firm generally strives to pay.

Hedging risks and paying compensation (in the Pareto sense) are related. The post modern manager works to channel the energy in peer leaders through encouraging esprit de corps, honest discussion, and positive incentives.

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FOOTNOTES:

[3] I owe this insight to a presentation by Nassim Nicholas Taleb at the World Bank. *Forum 2009: Markets and Crises—What Next and How?* February 24, 2009. Taleb spoke about the inherent resiliency of biological systems because of physical redundancies.

[4] This is hardly a new topic, but it remains a timely concern even for the automobile industry. See: (Salter, Webber, and Dyer 1985).

[5] Variable rate mortgage customers bear interest rate risks that fixed rate mortgage customers do not. Subprime mortgage customers are economically fragile while prime mortgage customers should not be.

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CHANNEL LEARNING TOWARD PROFITABLE INVESTMENTS

Pick projects that teach profitable lessons.

Projects taken on with an explicit (perhaps secondary) objective of learning a new line of business have been described as an expansion option (Mun 2002, 28). This morphing of the business is an important hedge against obsolescence risk—a key risk in maturing sectors—where the more typical response is to acquire new units through acquisition and diversification without reforming the culture of the firm. The ability to adapt and learn along new and more profitable lines of business over time accordingly becomes an organizational comparative advantage.

Speaking at a recent conference on systemic risk, Alan Greenspan (2009, p2), highlighted the need for firms to take prudent risks:

Effective financial systems are too often underappreciated as major contributors to economic growth and standards of living. Economic growth requires that obsolescent, i.e., low productivity, capital facilities be replaced with cutting edge, i.e., high productivity, technologies. The role of a financial system is to facilitate this process of "creative destruction" by directing a nation's scarce savings to fund capital facilities with the greatest risk-adjusted rates of return—almost always those that offer the highest rates of productivity growth.

Risk management is a key principle in organizational strategy. A modern firm engaged in risk minimization could respond to an increase in the volatility of the demand for its products or services, for example, by morphing into a traditional firm employing a venture capitalist approach. This change in strategy and culture could actually improve the profitability of the firm but would require a serious revamping of its business model and aggressive restructuring. One way to accomplish this result would be to start small: commission a small affiliate with seed money to fund multiple small projects and a mandate to experiment with the new business model. If the affiliate is successful, more resources can be allocated from the old to the new line of business increasing the profitability and diversification of the firm as a whole. ✦

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