SOCIETY OF ACTUARIES

Article from:

Risk Management

December 2008 – Issue 14

Can Bad Culture Kill a Firm?

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The buzz this past April at the Enterprise Risk Management (ERM) Symposium in Chicago revolved around several incidents over the past year, including: the Bear Stearns failure; the $7 billion rogue trader event at Société Générale; and the sub prime crisis. Chief risk officers' (CROs') comments included: Problems do not exist in a vacuum; Controls should assure that rogue traders cannot exist; models were adequate, but incorrectly used. If risk measurement in 2007 was adequate, why are so many CROs looking for work in 2008? One hypothesis is that weak corporate cultures left firms exposed to risks which managers thought had been assessed and mitigated.

Several attributes of the current environment exacerbate the influence of weak corporate culture in ways that threaten losses and insolvency:

- Monetary bubbles running through markets weaken traditional analysis and controls;
- Technological innovations concentrate information and decisions in the hands of new experts and senior managers.
- The postmodern environment undermines the preconditions for modern corporations.
- Predatory elites increasingly threaten firms because the current environment favors peers over traditional managers.

The good news is that the firms serious about implementing ERM are better positioned to cope with the challenges of a changing corporate environment.

Little Bubbles Make for Big Risk Management Challenges

The U.S. economy has been rocked by monetary bubbles since the late 1990s. *Monetary bubbles consist of price inflation that concentrates in particular sectors or markets.* Bubbles have characterized stock markets, housing markets and, most recently, commodity markets, including energy, metals and foodstuffs.

Why has a bubble economy undermined corporate cultures? Monetary bubbles reward firms that adopt a timing strategy in managing their trading positions. Bubble persistence and the high rates of return of innovative firms eventually generate a me-too response from traditional firms. This new line of business (or expanded line of business) alters the distribution of winners and losers within the firm to favor traders and derivative experts which traditional managers find especially hard to understand and manage. [2]

Technology Allocates Information to Favor Experts

Many observers have lauded the new democracy of information created by the Internet boom. While access to information has improved for everyone, not everyone can make sense of it. The principle at stake is that access to technology and information is a necessary but insufficient condition for making informed decisions.

For example, consider the effect of installing a new statistical package. The software automates techniques which require serious expertise and experience to understand and use. Everyone on the staff may be given a copy, but few are likely to use it correctly. Access to the software accordingly provides a necessary but insufficient condition for effective use.

Ease of information access can automate errors. Consider day trading. Day traders presumably benefit from more timely information than other traders. Because of the steep learning curve, however, most new entrants suffer large losses.

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2 It is unclear in 2007 that any of the market players in subprime markets correctly called the changes that took place. The only contender for this honor was Goldman Sachs (Anderson and Thomas). Questions have circulated, however, ever since on the prudence of their actions (Clark).

Survival depends on capital management, carefully study, focus on particular markets, and disciplined execution. Success yields extremely high rates of return, but few amateurs succeed.

The moral to the story here is that in current market environment efficiency in learning potentially carries a high rate of return. At the same time, ineffective learning carries enormous risk.

Postmodern Firms May Fail under Modern Management

We live in a peer culture. Changes in the legal environment to level the playing field among ethnic groups, age groups and genders reinforce this peer culture. Managers and directors still have formal authority to make decisions, but peers rule the postmodern firm. This is, in part, true because of the concentration of information and decisions in new key individuals and, in part, because of the extension of the democratic ethos of society into the firm.

In the early 1990s, an information technology manager told the story of a surprise visit to the local office of a software company by a senior management team. Appalled by the personal hygiene of one of the local programmers, the senior-most manager wanted to fire him on the spot. The office manager pulled him aside and told him, "You cannot fire this man. He is the only one on the staff that knows how our software products work."

Uneven dispersal of technical information has also seriously affected the performance of government agencies. For example, a recent postmortem on the Challenger disaster associated the disaster to a rigid management structure at NASA that ignored warnings from its engineering staff (Campbell). The need to respond promptly to decentralize terrorist threats has motivated the U.S. military to adopt a more open information-sharing architecture (Cartwright). These adaptations would be unnecessary if modern bureaucracies were still competitive in the emerging postmodern world.

The rise of a peer cultural ethic legitimizes democratic principles in the context of the firm, not unlike the legitimization of democratic principles among nations (Fukuyama, p. 21). While this is an appealing idea, the ethos of the firm is likely also influenced by relative costs of transacting business under alternative corporate cultures. The peer culture likely evolves more rapidly and more often in organizations and firms that can afford the relatively high transaction costs involved in consensus-style decision processes. Where resource constraints are tighter, other cultures likely dominate. It also seems likely that resource constraint changes would favor the development of more efficient corporate cultures.

Predatory Elites Pose Special Threat

The rise of a peer culture carries the special risk of predatory elites. *Predatory elites are key individuals who use expertise, position or authority to blackmail the firm to enhance personal prestige, authority or compensation at the expense of the firm.* In effect, predatory elites are the principal-agent problem on steroids.[3]

The principal-agent problem is more pervasive in the current postmodern firm because the concentration of information and decisions in new key individuals expands the scope and volatility of their activities. Performance measurement and monitoring is easier for specialists than for generalists and easier for stable job functions than for volatile job functions. Predatory elites are more likely to evolve in the evolving, high tech environment. Changes in the legal, social, and philosophical environment can likewise provide fertile ground for predatory elites. These are circumstances that lead to an adult supervision problem (Iacocca).

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> "If risk measurement in 2007 was adequate, why are so many CROs looking for work in 2008?"

3 Principal-agent conflicts occur when one party, the principal, contracts with a second party, the agent, to perform a task for the principal. The agent chooses to maximize the agent's benefit from the contract at the expense of the principal's benefit. The conflict happens because it is difficult to enforce a duty of loyalty to the principal, since the principal cannot monitor the agent perfectly (Kane).

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Examples of predatory elites abound throughout organizations worldwide, including:

- Executives who earn extra-ordinary bonuses while their firms lay off workers and/or misses earnings targets.
- Corporations fail due to *rogue trader* events or destroyed reputations.
- Government agencies unable or unwilling to focus on legislated missions.
- Nation states exploited by narcotic traffickers, warlords and unscrupulous multinational corporations.
- Church leaders that engage in criminal acts.

In each of these cases, the problems posed by predatory elites are out in the open for everyone to see and are as shocking, in some cases, as the assault and murder of Kitty Genovese in 1964 in New York City where 38 people witnessed the event and did nothing (White). This openness of this predatory behavior makes the predatory elite a key symptom of a bad culture.

ERM Provides an Antidote to Bad Culture

Several characteristics of Enterprise Risk Management mitigate the effects of bad corporate culture, including:

- The whole firm is considered the system in view (holistic characteristic).
- Peers are empowered to lead in positive ways (intensive management characteristic).
- Risk taking should be separated from risk management (objective assessment characteristic).
- Risk management is a key corporate value, second only to profit maximization (postmodern characteristic).

The elevation of risk management to be a key corporate value makes ERM a postmodern management philosophy because senior management profit-maximization objectives are no longer the only objectives that count. Key staff across the firm must buy into ERM, or losses will rise in ways that senior managers cannot control. ERM firms necessarily need to worry about attitudes and incentives throughout the firm that affect risk. In the words of one director, "risk management is all about corporate culture." Implementing ERM assures that your corporate culture is moving in the right direction. ✦

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