REVAMPING RISK CULTURES

IT'S TIME FOR COMPANIES TO FOCUS MORE ON BEHAVIORAL BLIND SPOTS

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One employee treats a client poorly. Another allows key equipment to rust. A third witnesses poor conduct by colleagues yet does nothing. A leader makes a snap decision without thought.

Taken separately, each one of these actions may seem trivial. But together, they add up to one of the main reasons why the many initiatives undertaken by companies over the past five years to strengthen their risk cultures continue to fall short: Too few firms give behavior the attention it deserves.

Companies have invested significant time and effort into implementing structural changes designed to prevent a repeat of past egregious risk management lapses that have cost them hundreds of billions of dollars in fines and litigation costs. (See "Fines and Financial Misdemeanors.") Many have strengthened their enterprise risk management frameworks by carefully defining and communicating their risk appetite, clarifying accountabilities and responsibilities for risk taking and risk management, and sharpening operational rules and procedures. They have reinforced their so-called three lines of defense, enhanced their reporting capabilities, and taken steps to better embed risk management in performance compensation. (See "Three Lines of Defense in Financial Services.")

In many cases, these structural remedies create a false sense of security, in part because most are not accompanied by an interest in understanding why people act the way they do. The behavioral dimension of a risk culture is often more difficult to detect and address than blatant misconduct. A trickle of low-level transgressions and oversights can erode a firm's value over time – and can also help to serve as an early warning for more serious and significant incidents. That's why, for example, firms in high-hazard industries track first-aid cases at their facilities: They know that the manifestation of low-level injuries is symptomatic of actions that could result in a fatality. At the same time, they need to be mindful that focusing on slips, trips, and falls does not blind them to different types of cultural challenges that may lead to catastrophic incidents.

The structural aspect of building a strong risk culture is, for the most part, defensive in nature, seeking to place constraints on poor practices, decisions, and activities. The behavioral dimension, on the other hand, primarily focuses on influencing and promoting good practices, decisions, and deeds. It relates more to maintaining, or in some cases regaining, a "social license" through the disposition of individual personnel; the respect they have for colleagues, customers, and suppliers; and their level of commitment to the risk agenda and the values of the firm. (See Exhibit 1.)

OVERCOMING BIASES

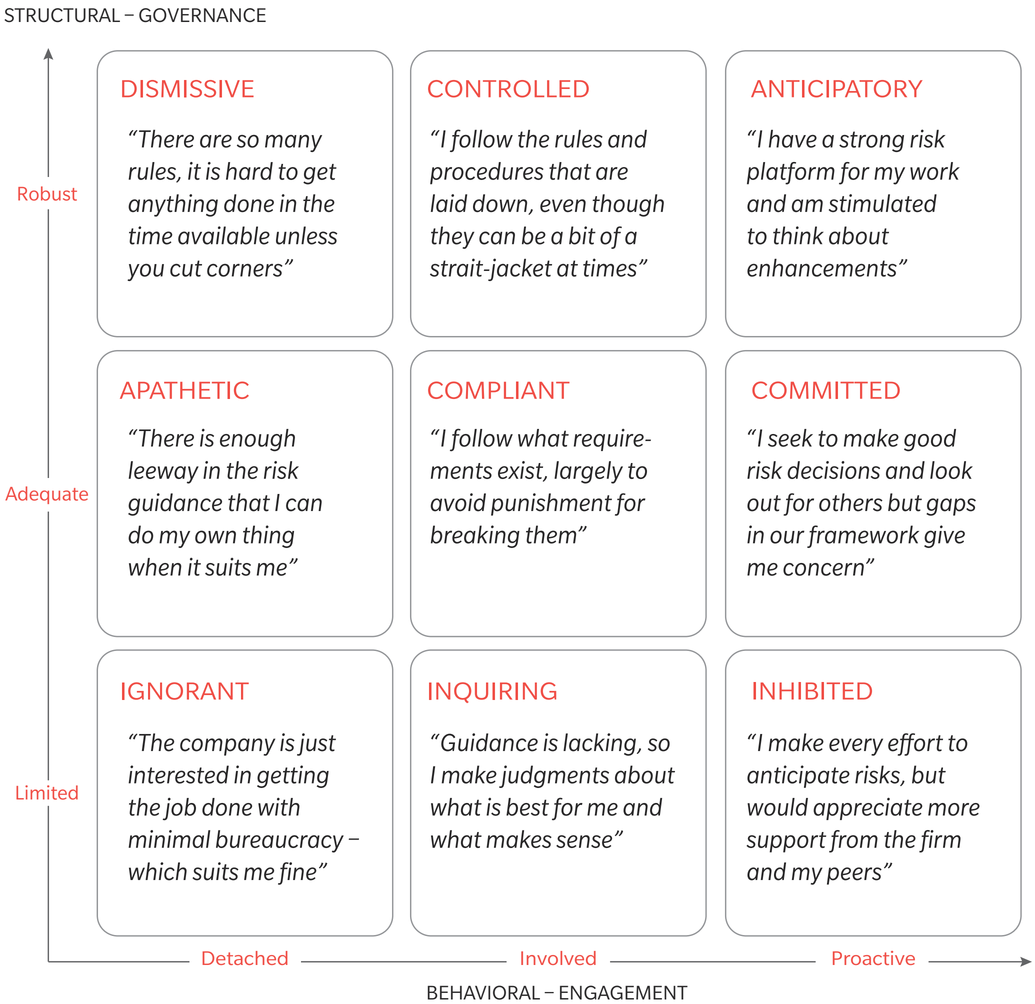
Sustained behavioral change requires influencing people both rationally and emotionally, formally and informally, consciously and subconsciously. Personnel must be guided and supported to act in an appropriate manner, rather than being tasked to do so. They must feel like they are choosing to behave in the right way for the right reasons.

Neuroscience has shown that changing or developing a behavior is different from learning or doing a task. The part of the brain where new behaviors are learned and embedded is rarely engaged when someone is given an instruction or offered short-term incentives.

To address the behavioral neural networks where beliefs and habits reside and to "rewire" them, individuals and teams must be taken

EXHIBIT 1: RISK CULTURE AND PERSONNEL BEHAVIOR

COMPANIES CAN APPLY DIFFERENT APPROACHES TO STRENGTHENING RISK CULTURE. THE DIAGRAM BELOW INDICATES WHAT PERSONNEL BEHAVIOR MIGHT LOOK LIKE DEPENDING ON WHICH TYPES OF INITIATIVE ARE PRIORITIZED.



Source: Marsh & McLennan Companies

on a journey led by their company's board of directors and top management. Studies show that employees take cues from their leaders and immediate supervisors to determine whether a commitment to a shift in conduct is real or merely rhetoric. If the board and senior executives hope to motivate their staff and employees to undertake the journey, they first must make strengthening the risk culture a personal goal of their own. They must embody the desired risk culture through their own actions. Their passion for change must be both visible and felt, with meaningful consequences for both right and wrong behaviors.

Leaders must also be aware that changing actions and the associated culture is a long-term endeavor. Boards and management teams must not only own the firm's risk culture, but also must monitor its impact on a regular basis. Progress can easily be undermined. A set of posters announcing a new corporate culture does nothing to persuade people the effort is real. And six-months' work can be destroyed with a single poorly phrased communication from leadership.

TAPPING INTO PERSONAL MOTIVATION

Leaders that are successful in this endeavor are able to tap into two powerful factors: personal motivation and iterative learning. In regard to the first one, management can ensure that risk issues resonate deeply with staff by appealing to their commitment to the firm's success, the impact on customers, the implications for their career, and the power of their own agency.

At a high level, employees must understand how their individual activities link to the strategy of the firm and its long-term success – and ultimately to their own individual rewards. Then they must be given objectives consistent with the broader purpose and set of desired actions, so that assessment of their performance relative to expectations, either positive or negative, can be attributed to outcomes.

This is often easier said than done, as it can be difficult to predict the impact of initiatives. For instance, after a fatality on the United Kingdom's North Sea, it became apparent that conducting "temporary" maintenance on one oil rig had become permanent. When asked why, staff said they thought their leaders wanted them to reduce costs, irrespective of risk, despite countless presentations from leaders highlighting how safety should come first. In another instance, an energy supplier inadvertently demoralized its employees and did little to raise its standards when it benchmarked its safety record against its competitors. But when the company introduced an internal competition between its own facilities, employees were motivated to improve risk practices and become "safety champions."

Understanding what drives behaviors is more complex than one would think. Psychologists have proven that there are many cognitive biases hard-wired into the human mind. The most commonly cited is "normalization." This term refers either to situations when unacceptable risk-taking becomes accepted as the norm due to the lack of incidents or to a readiness to accept accidents as a matter of course and an inherent cost of doing business.

> Few firms give behavior the attention it deserves

Organizations with stronger risk cultures develop practices that enable employees to become aware of and overcome these biases. For instance, it is now common for engineers in high-hazard industries to brainstorm all potential risks and outcomes every three to five years to test that current processes are still adequate. Other industries, such as healthcare, have started to collect performance data to identify where decisions are being repeatedly made as a result of certain cognitive biases.

LINKING PROMOTION AND PAY TO BEHAVIOR

One way to underscore the link between a strong risk culture and the firm's long-term success and individual compensation is for management teams and staff to integrate

cultural and value evaluations into year-end performance appraisals. These components should consistently and significantly affect remuneration and advancement – even at a senior level. For example, some banks have begun to adjust their executive team's compensation by 50 percent based on the bank's financial performance and 50 percent based on assessments of tangible improvements to its culture, as defined in terms of desired conduct and values. Some energy firms recognize and reward employees for adopting a sound risk-management practice pioneered by someone in another division.

Firms must also reward behaviors that are positive and are beyond the minimum threshold set by their internal code of conduct, as part of staff development and promotion decisions. Companies should go out of their way to celebrate individuals who escalate potential issues, support colleagues who clearly put the company ahead of themselves, perform outstanding client or community work, or demonstrate internal leadership on diversity or inclusion initiatives. At the same time, recruitment processes should be recalibrated to support these values and "cultural fit."

By celebrating those who exhibit the desired values, while also having effective sanctions for bad behaviors, leaders can encourage employees to escalate difficult issues, which is essential for companies seeking to embed desired behaviors on a sustained basis. For example, some energy firms publicly honor and reward employees who stand up for safety against the odds. Without such public acknowledgement, employees may be afraid of the consequences and prefer to engage in "willful blindness." But care needs to be taken that the financial incentive is not so big that it tempts personnel to "rig" feedback.

ITERATIVE LEARNING

It is also important for leaders to encourage individuals to experiment with new behaviors and repeat them until they become second nature. Companies need to be creative about engagement opportunities – developing learning loops to nurture new actions, blending formal training with informal nudges, and paying attention to such details as discussion formats, vocabulary choices, and even office design.

Initiatives should not only embrace experimentation, but also be regularly repeated and new behaviors periodically discussed over a number of months. For example, one bank that set out to tackle inconsistent training and development messages systematically inserted values and examples of appropriate conduct into all of its training and development processes.

At the end of the day, the art of molding desired actions requires making subconscious decisions conscious and then engraining new practices into subconscious behaviors again. Initiatives that simply focus on the conscious brain and overt, rational decision making will fall short of their goals, as will efforts that assume behavioral adjustments follow from a single intervention. Instead, a firm's risk culture must be continually reviewed and improved, as it is constantly evolving and influenced by leaders and events.

SEEING WHAT'S COMING

By allowing behavioral blind spots to flourish, companies permit their risks to remain invisible. No one wants to hurtle straight towards a full-blown crisis because they didn't see it coming. Making behavior an integral part of risk culture should be at the top of every company's "fix-it" list.

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