RED FLAG

RISK SURVEYS CAN HELP TO IDENTIFY EMPLOYEES WHO MAY BEHAVE INAPPROPRIATELY IN CHALLENGING SITUATIONS, SAYS LOUISE REDMOND

The importance of risk culture continues to dominate industry and regulatory debates in many sectors. In banking, the calls for a new culture stem from the taxpayer bailouts of 2008/9, but also from the Libor investigations and accusations of mis-selling such products as payment protection insurance to consumers and interest-rate hedging products to SMEs. It appears that within banking a culture evolved where there was no real fear of failure, retribution or consequences. The question of culture is relevant in other sectors. For example, a poor safety culture at BP has been recognised as contributing to explosions at its Texas oil refinery in 2005 and then at the Deepwater Horizon platform in 2010. BP has reserved $38bn to cover expected liabilities arising from the Deepwater Horizon oil spill.

Although any number of unexpected incidents will challenge a business, most boards seek to set their appetite for risk and follow that through with sound processes for monitoring and mitigation. But how much attention has been paid to ensuring that the business culture matches that risk appetite? Would a board even know that a problem culture may exist?

Changing behaviours

"It's the way we do things round here." This is a familiar saying and intuitively we all have a sense of the culture of our organisations. But it has never been easy to describe a culture accurately, let alone measure or monitor it. With regard to risk management, many companies profess to have made significant progress on embedding policies, processes and committees. It is a different matter when it comes to culture since this involves changing behaviours as well as structures within an organisation.

The financial services sector has, perhaps unsurprisingly, produced the most guidance on the matter of risk culture. In June 2011, the Bank for International Settlements published its *Principles for the Sound Management of Operational Risk*. Principle one is: "The board of directors should take the lead in establishing a strong risk management culture."

The International Institute of Finance (IIF) is an industry-led body that has recently produced a definitive guide on risk governance, which addresses the issue of risk culture in detail. (*Governance for Strengthened Risk Management*, October 2012.) In the section on risk culture in the guide, the IIF recognises the fact that building and embedding a strong risk culture takes years and it can take even longer to repair an organisation's culture after a serious problem. "Risk culture requires constant attention; no organisation should become complacent in the belief that strong risk culture has been achieved," says the guide.

Creating the right governance structures to foster a strong risk culture is an essential part of this process, but policies and procedures can only go so far when culture is all about the behaviour of people. "Although the culture a firm wishes to build should be reflected in its policies and procedures," reads the IIF paper, "it is manifested in the day-to-day decisions that indicate how risk is identified, understood, discussed and acted upon."

Breaking the rules

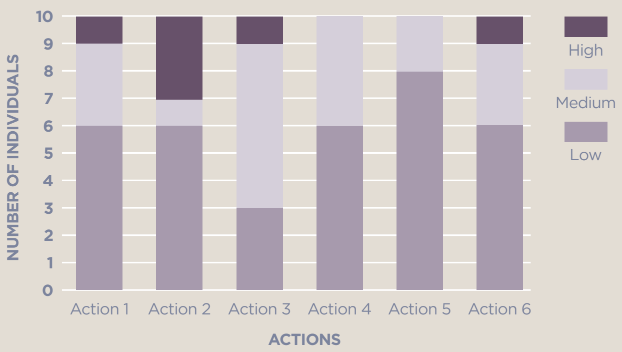
To really get a handle on risk culture, we need to explore behaviour. How do people behave in practice? Which behaviours do managers encourage? Are these behaviours rewarded or incentivised? Which behaviours are discouraged and even punished? What we want to know is: How do people behave on the job? How would managers react if someone behaved inappropriately – in other words, 'broke the rules'? Would they get caught and, if they did, would they be punished?

The IIF advises all companies to take practical steps to ascertain that risk culture is understood and embedded within their organisation. It also recommends that they use "all evidence-based means at their disposal" – specifically by conducting risk surveys – "to assess existing strengths and weaknesses, identify areas for improvement and monitor progress when the need for change is identified".

Many companies have online staff questionnaires that can be conducted on a cross-section of people in the organisation. Questionnaires of this sort can be used to find out how people feel they should behave in response to a challenging or tricky situation at work. These situations might never have happened to that employee, or even in that company, but they can be within the realms of possibility. By asking employees which actions they would take in these hypothetical situations, it is possible to get an indication of the sort of behaviours espoused or at least condoned by management. The responses of a number of employees can then be aggregated to see the degree to which they are tempted to behave inappropriately.

TEAM RISK PROFILE

Individuals by risk behaviour (high, medium and low)



Of course, it is easy to see the problem after the event. The challenge is to spot these risky behaviours beforehand. Will management turn a blind eye? Or will others get involved, such as the risk or audit function? Often there is a perception that a star performer or favourite will be treated differently from a more average performer. Will some of my colleagues get away with more than I would? These questions help to explain the behaviour of both employees and management.

Traffic lights

Some practical questions are helpful to consider in relation to risk committee meetings. Examples include: If you are about to attend a risk committee meeting, what will you see happen? Will everyone be present? Will there be a full and frank discussion? Or will there be any evidence of covering up of issues? These individuals might be on the risk committee, but do they actually turn up? And if they do turn up, how do they behave? How seriously do they take the meeting? How seriously do they take any feedback or challenges in terms of what is going on in their own areas of the business? How do people really behave in relation to the policies and procedures they have put in place?

Many risk management approaches use a traffic light approach. The same approach can be used for risk behaviours. Red flags highlight areas where there are employees who may behave inappropriately in a particular challenging situation. Equally, the red flags may indicate that employees believe that managers will turn a blind eye to inappropriate behaviour on the team. The company can reflect its own risk appetite by determining where the boundaries between red, amber and green should lie. Some companies may tolerate a higher likelihood of a particular behaviour than others would. Some may want to be particularly stringent with respect to one department, for example, and so set higher thresholds for it. There are no absolute rights or wrongs in this exercise since there are bound to be some differences of opinion.

It is key that a company works out how to act on the results of a culture questionnaire. It might issue new communications or perhaps reinforce previous communications. It might update policies or retrain managers. But it is crucial that it continues to act and monitor at the highest level. After all, as Barclays admitted in announcing a review of business practices in the wake of its fine for Libor fixing: "The burden of proof required to demonstrate change in culture is now much higher."

Louise Redmond is director governance services at Law Debenture Trustee Services. Contact her at louise.redmond@lawdeb.com