Measuring and Managing Risk Culture

John Nicholls, Lesley Brown

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Risk management framework

Risk Appetite
Identify & Assess Risks
Risk Measurement
Monitoring & Reporting
Link to Business Strategy
Stress & Scenario Testing
Risk Culture

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Towers Watson 2010 ERM Survey

- Core risk-control techniques and strong risk culture did most to enhance business performance during the financial crisis
  - A strong risk culture was cited by 64% of respondents as enhancing performance
Towers Watson 2010 ERM Survey: Core risk-control techniques and strong risk culture did most to enhance business performance during the financial crisis

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Enhanced Business Performance</th>
<th>No Impact on Business Performance</th>
<th>Hindered Business Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managing individual risk exposures (n = 450)</td>
<td></td>
<td>25%</td>
<td>8%</td>
</tr>
<tr>
<td>Risk monitoring and reporting (n = 452)</td>
<td></td>
<td>30%</td>
<td>5%</td>
</tr>
<tr>
<td>Risk culture (n = 453)</td>
<td></td>
<td>27%</td>
<td>9%</td>
</tr>
<tr>
<td>Risk limits and controls (n = 446)</td>
<td></td>
<td>27%</td>
<td>9%</td>
</tr>
<tr>
<td>Use of economic capital in risk-based decision-making processes (n = 334)</td>
<td></td>
<td>38%</td>
<td>6%</td>
</tr>
<tr>
<td>Allowances for risk within business processes (n = 412)</td>
<td></td>
<td>37%</td>
<td>7%</td>
</tr>
<tr>
<td>Risk governance structure (n = 452)</td>
<td></td>
<td>35%</td>
<td>9%</td>
</tr>
<tr>
<td>Risk resources, skills and capabilities (n = 438)</td>
<td></td>
<td>35%</td>
<td>10%</td>
</tr>
<tr>
<td>Other risk models (n = 387)</td>
<td></td>
<td>47%</td>
<td>4%</td>
</tr>
<tr>
<td>Scenario testing/planning capabilities (n = 395)</td>
<td></td>
<td>43%</td>
<td>8%</td>
</tr>
<tr>
<td>Risk appetite statement (n = 363)</td>
<td></td>
<td>45%</td>
<td>8%</td>
</tr>
<tr>
<td>Economic capital (n = 343)</td>
<td></td>
<td>52%</td>
<td>6%</td>
</tr>
<tr>
<td>Risk/reward optimization capabilities (n = 349)</td>
<td></td>
<td>56%</td>
<td>7%</td>
</tr>
<tr>
<td>Risk technology or systems (n = 371)</td>
<td></td>
<td>54%</td>
<td>12%</td>
</tr>
</tbody>
</table>

Base: Those giving a valid response (percentages exclude not applicable) for Q.2 Based on your experience during the turbulent conditions over the last 18 – 24 months, how would you characterize the contribution of the following risk management areas? Please select one response in each row.

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What characterises a good risk culture?

“Vertical escalation of threats and fears”

“Committed leadership”

“Horizontal information sharing”

“I horizonal information sharing”

“I horizonal information sharing”

“Incentives that reward thinking about the whole organisation”

“Active learning from mistakes”

“Continuous and constructive challenging of the organisation’s actions and preconceptions”

“An effective governance structure”

“Management objectives linked to risk management objectives”

Reform in the Financial Services Industry: Strengthening Practices for a More Stable System
Institute of International Finance, 2009

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A range of pressures to focus on risk culture...

“A firm’s entire risk adjustment process should be driven primarily by a culture that champions and encourages strong risk management practices within a robust policy framework. This culture should be driven from the very top levels of management. It should support effective controls and governance and an open attitude towards the regulator.”

“Unacceptable culture within firms was a major contributor to the financial crisis and so regulators should play a greater role in judging how culture drives firms’ behaviours. ... We are still seeing some decisions by management in major firms that we would judge not to be prudent. The end goal should be that firms understand their own culture and the potential risks posed by the wrong culture.”

Hector Sants, June 2010

“Underpinning the effectiveness of the entire risk-management processes is the company’s risk management culture. Risk-management culture is the degree to which risk and risk management are important considerations in all aspects of corporate decision making.”

“The matching of the own funds to the risk profile should help promote a strong culture of risk management, which in turn is a key underlying feature of the ORSA process and, more widely in soundly running the business.”

CEIOPS ORSA Issues paper, 2008

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Towers Watson 2010 ERM Survey

Which do you see as the most challenging area for achieving approval?

- Use test: 38%
- Statistical quality standards: 16%
- Validation standards: 15%
- Calibration standards: 12%
- Documentation standards: 12%
- Profit and loss attribution: 7%
A range of pressures to focus on risk culture…

- “Good risk management needs
  - …
  - The right culture
    - Risk aware & properly set the risk appetite
    - Committed to have the entity managed within RMF & the set risk appetite
    - Encourage bad news to travel upwards faster than good news
    - Make examples of bad risk managers even if they achieve profits”

APRA’s Perspective on Financial Services Risk Management (Tom Karp) 2008
A range of pressures to focus on risk culture…

- “A culture that promotes good governance benefits all stakeholders of a regulated institution and helps to maintain public confidence in the institution.”
  
  Prudential Standard CPS 510

- A life company’s RMS must, at a minimum:
  
  (e) describe the approach to ensuring relevant staff have an awareness of the risk management framework and instilling an appropriate risk culture across the life company

  Prudential Standard LPS 220
Risk culture in practice…

“Culture, more than rule books, determines how an organisation behaves”

Warren Buffet
Berkshire Hathaway
We have an effective way of measuring and managing risk culture in our organisation

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Strongly agree</td>
<td>7%</td>
</tr>
<tr>
<td>2. Agree</td>
<td>22%</td>
</tr>
<tr>
<td>3. Neutral</td>
<td>28%</td>
</tr>
<tr>
<td>4. Disagree</td>
<td>36%</td>
</tr>
<tr>
<td>5. Strongly disagree</td>
<td>7%</td>
</tr>
</tbody>
</table>

Towers Watson 2010 Enterprise Risk Management Survey

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Where is the risk culture of your organisation?
It is difficult to measure risk culture

• But company Boards need some form of measurement device
A risk culture survey

Leadership

External
- Regulators
- Ratings Agencies
- Markets

Managers

Internal
- Managers
- Employees
- Scorecards

Questionnaire

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Typical coverage of a risk culture survey questionnaire

<table>
<thead>
<tr>
<th>Category</th>
<th>Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organisational culture</td>
<td>The values and norms of behaviour within the organisation generally support effective management of risk</td>
</tr>
<tr>
<td>Risk, appetite, strategy &amp; policies</td>
<td>The company’s attitude towards risk is clear and appropriate</td>
</tr>
<tr>
<td>Leadership commitment</td>
<td>Leadership throughout the organisation has a focus on risk appropriate decision-making communication and behaviour</td>
</tr>
<tr>
<td>Roles and organisational structure</td>
<td>Roles, responsibilities and rewards are determined in keeping with effective risk management</td>
</tr>
<tr>
<td>Process &amp; controls</td>
<td>Risk controls and process are appropriate, clear, timely and effective</td>
</tr>
<tr>
<td>Reporting &amp; management information</td>
<td>There is effective reporting and documentation of risk activity</td>
</tr>
<tr>
<td>Technology &amp; infrastructure</td>
<td>IT systems are designed in a way that supports effective risk management</td>
</tr>
<tr>
<td>Tools &amp; methodology</td>
<td>The approaches to manage risk are clearly understood and appropriate to the need</td>
</tr>
</tbody>
</table>

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High level of confidence in the design of recent changes

31. Management provides a clear sense of direction in relation to risk management.

49a. Over the past year or so, changes the way we manage risk have: Been well designed
Upward communication channels are clear and used. More effort needed to seek employee views on risk management

19. It is clear who to approach about risk management issues.

<table>
<thead>
<tr>
<th>Total Favourable</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>A 79</td>
<td></td>
</tr>
</tbody>
</table>

29. The risks to which my business unit is exposed are assessed and reported on regularly.

<table>
<thead>
<tr>
<th>Total Favourable</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>A 79</td>
<td></td>
</tr>
</tbody>
</table>

48. Sufficient effort is made to get the opinions of employees in relation to risk management.

<table>
<thead>
<tr>
<th>Total Favourable</th>
<th>Differences From Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>A 42</td>
<td>-19</td>
</tr>
<tr>
<td>B 61</td>
<td>-18</td>
</tr>
<tr>
<td>C 60</td>
<td>-18</td>
</tr>
</tbody>
</table>

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Positive risk attitude

- **BELIEF** – belief that managing risk effectively is a good thing for the business to do
- **EMOTION** – personal commitment to ensure risks are well managed
- **BEHAVIOUR** – conviction that you personally make a difference to risk management
Key drivers analysis: understanding what drives risk attitudes

- **Empowerment**
  - Most of the time it is safe to speak up
  - I am satisfied with my involvement in decisions that affect risk

- **Operational risk**
  - To what extent do you believe we are exposed to people risk
  - Company compromises the quality of our services to cut costs

- **Leadership**
  - Management provides a clear sense of direction in relation to risk management
  - Our management is interested in the well-being of employees

Positive Risk Attitude
Benefits of measuring risk culture

• Carrying out such a survey yields invaluable insights, facilitating the active management of a company’s risk culture. It also enables:
  – Setting the tone from the top
  – Engaging with external stakeholders
  – Creating an internal dialogue
  – Better informed business decisions
Example interventions to improve risk culture

<table>
<thead>
<tr>
<th>Leadership</th>
<th>Rewards</th>
<th>Performance Management</th>
<th>Communication</th>
<th>Organisational Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Board Education</td>
<td>• Compensation governance</td>
<td>• Goal setting in alignment with strategy</td>
<td>• Risk reporting</td>
<td>• Coordinating multiple change initiatives</td>
</tr>
<tr>
<td>• Exec Compensation</td>
<td>• Audit of comp plans</td>
<td>• Risk-based personal objectives</td>
<td>• Company-wide Risk Awareness and Engagement</td>
<td>• Addressing rational and emotional dimensions</td>
</tr>
<tr>
<td>• Development of Risk Appetite</td>
<td>• Alignment of plan design with risk appetite and strategy</td>
<td></td>
<td></td>
<td>of organisational change</td>
</tr>
<tr>
<td>• Leadership Communication</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Questions?

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