

What is the impact of People and Organisational factors on Risk Appetite?

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INTRODUCTION

Risk Appetite is a statement that drives all risk taking and risk mitigation activity within an organisation, defining boundaries within which risk-based decision making can occur (4). Typically, in publishing their Risk Appetite, businesses are trying to make their attitude towards risk explicit and, in doing so, find a balance that is right for them. On the one hand they will typically want to avoid inappropriate risk taking, which most would agree would lead to commercial exposure. On the other hand, a business that is risk averse and constantly erring on the side of caution is unlikely to seek or exploit opportunities (10).

THE RELATIONSHIP BETWEEN PEOPLE AND ORGANISATIONAL FACTORS IN DEFINING RISK APPETITE

One would expect people and organisational factors to play central roles in defining Risk Appetite but this is not always the case (21). Trying to isolate people and organisational factors can be frustrating. There is plenty of good advice to assist in defining Risk Appetite but this may not explicitly mention people or organisational factors (8). That said, there are a few more recent examples that seek to recognise the importance of human dynamics; Director mindset; operating context and; Board culture (20).

RECURRING PEOPLE AND ORGANISATIONAL FACTORS INFLUENCING RISK APPETITE

Recent evidence points to the following recurrent themes:

1. “Tone at the top”
2. Risk culture
3. Prevailing management style
4. The role played by individual factors found in management decision-makers at all levels, such as personality and risk intelligence.

I. “TONE AT THE TOP”

“Tone at the top” refers to the attitudes, beliefs and experience within the top management of the business and how it is key in driving most (or many) things risk related. Risk Appetite provides a means of expressing top management’s attitude to risk, which can then be communicated throughout the organisation as part of promoting a risk aware culture. Hence, “tone at the top” plays a key role in, for example, clarifying the relationship between risk and profitable business (11). The nub of this has been summarised as follows, “whatever approach taken, Board and senior managers are properly engaged in agreeing and monitoring the appetite for operational risk and setting acceptable and unacceptable boundaries for business activities and behaviours” (11).

A key factor to consider is that, in the context of Risk Appetite, many top management teams are not practiced in discussing risk in the context of strategic decision-making or articulating those expectations to the organisation (8). Therefore, there is plenty of scope for people-related issues to become lost. The potential problem is that defining Risk Appetite just becomes a tick box exercise with all that this implies for missed opportunity (21). In our experience, tick box exercises often provide the perfect environment where people or organisationally-related issues are subjugated by those seen to be of greater commercial importance.

2. RISK CULTURE

The premise and content of a business ‘culture’ are well accepted and are recurrently mentioned in reviews of its relationship with effective risk management. In the context of Risk Appetite, culture is meant in several ways: its usual meaning, i.e. assumptions, practices, the “way things are done around here”; as a metaphor for most things people-related and; as a catch all term for people-related issues stemming from or supporting the “work environment” (7). On the positive side it is a conventional management term but on the negative side it is rather too broad brush and one must take care so as to not prescribe one “best” culture (2).

The proposed model in Box 1 prompts some relevant key thoughts. It is most likely that the ‘winning hearts and minds’ parts of the model will be paramount, for example. So too will the proposed method for assessing and classifying businesses according to its closeness to four risk culture profiles: Engaged; Complier; Sleep walking and; Chaotic (12). If we accept that risk culture is a qualitative expression of Risk Appetite and the best way we have to describe attitudes and behaviours of the business (11), then we must recognise that we will need to capture the intangibles of ‘know how, relationships, brand and work culture’ (13). What we are advocating is that in considering Risk Appetite we need a management culture and set of processes that allow for the consideration of Risk Appetite in these terms and one that does not focus exclusively on the more tangible side of risk management (9).

Box I

IRM Risk Culture Diagnostic



Risk Culture Diagnostic (IRM2011)

3. PREVAILING MANAGEMENT STYLE

The key aspects of management style that relate to Risk Appetite would appear to be:

- The need for a ‘Champion’ to advocate managing Risk Appetite as part of a coherent approach to Enterprise Risk Management and recognise the need for internal organisational leadership (17)
- The quality of management decision-making, which is about addressing Risk Appetite in the context of an operational risk dashboard (11)
- Skills in moderating and negotiating, i.e. through a process of interpretation and arbitration Risk Appetite is used as an effective management tool rather than a mechanical procedure (11)
- The ability to project confidence in translating the implications of the Risk Appetite statements into meaningful and acceptable performance thresholds and to ensure that the right conversations occur with employees
- How statements of Risk Appetite are challenged and interpreted, i.e. its practical ‘operationalisation’ (13).

Given that prevailing management style has such a pervasive impact, the argument for enhanced management of Risk Appetite is great, but it will require some businesses to think differently and forge stronger partnerships between the risk and finance functions. However, until business leaders make the connection between talent management and risk management (16), getting employees to make the connection between prevailing management style and Risk Appetite will remain problematic.

4. EMERGING INDIVIDUAL FACTORS

Looking at individual differences in personality traits, for example, is well established. It is based on the fact that if we can establish specific factors that underpin an individual's psychology, we should be able to make some fairly good predictions about how they will make risk-related decisions. The basis of individual assessment for selection and development is usually done through psychometric and interview-based techniques. Most of us, at some point in our careers, will have encountered this and most organisations deploy such techniques. There are two main sets of issues important here that impact on Risk Appetite: risk-related personality traits and risk-related intellectual skills and abilities.

4.1 PERSONALITY TRAITS

The basis for understanding an individual's decision-making style is provided by assessing their personality traits. There is an argument that the level of risk a business is prepared to take over time gravitates towards the level laid down by the CEO, Board and senior management (and hence getting an insight into their individual personality traits will help explain Risk Appetite more clearly and enhance the way it is managed).

Personality traits, such as spontaneity, caution, or reliance on facts as opposed to intuition are obvious relevant factors, as are objectivity, detail orientation and creativity. Psychologists can now make fairly good comments on this (18). In fact, one school of thought recently developed purports to comment directly on 'Risk Types' where individuals are classified on the basis of them being spontaneous; intense; wary; prudent; deliberate; composed; adventurous or carefree (19). Not only can the profile of traits be measured and benchmarked but we are also able to provide indicators of Risk Tolerance and Risk Attitude. A key point therefore is that there is the potential to make some good predictions about traits, style and Risk Appetite if assessed properly.

4.2 RISK APPETITE AND RISK INTELLIGENCE

Similarly, there is a long history of examining the nature and structure of intellectual differences between individuals. This falls under the broad heading of 'Cognition' or 'Cognitive skills' and most of us are familiar with the pre-employment selection tests of verbal, numerical or diagrammatic skills, for example. Psychologists have created quite an extensive list of such skills each supported by scientifically rigorous research.

It has been proposed that the list should be expanded to include 'Risk Intelligence' (1). Essentially the proposition is that there is another skill individuals have to varying degrees that has hitherto existed undetected, accounting for why to date it has not been subject to the same research by specialists as other types of intellectual skills. 'Risk Intelligence' has been defined as the ability to estimate the likelihood of outcomes; the probability of a positive or negative outcome; an assessment of its desirability, i.e. "pay-off"

and; the ability to think ahead and assess the advantages or otherwise of the risk-related consequences of jumping one way or the other (5).

It is too early to present any clear conclusions about the relationship between Risk Intelligence and Risk Appetite. However, one can see that if it exists then Risk Intelligence will potentially be a fundamental component in determining Risk Appetite. It will enable the development of measurement tests in much the same way they currently exist for verbal or numerical skills. A further implication is the possibility of determining a fundamental component of individuals' decision making characteristics and hence we will be able to establish (and by implication manipulate) directly the nature of Risk Appetite as driven by the individual psychologies of the Directors, Boards or management.

CONCLUDING POINTS

Risk Appetite is often embedded in the culture of the business and implicitly therefore in almost all strategic, financial and operational statements. In fact, it could be argued that it is not mentioned because it is so fundamental (3). While it would be easy to deem it ambiguous and therefore dismiss it as not being valid for meaningful attention, it seems more reasonable to conclude that Risk Appetite is a key determinant in management decision making albeit, in many cases, subconsciously (14).

A second conclusion is that in order to unravel the current status of the business's Risk Appetite or to start to discuss it with the aim of managing it more tightly, a focus on the four key sets of factors would be useful. It is no surprise that Risk Appetite, like any other topic, is embedded by communications; assessment and metrics. People and organisational factors play a key role since such frameworks are used for communicating the "Board's" Risk Appetite to the organisation and for evaluating responses to risk (10). This is especially important in the context of emerging business risks that require speedy reporting; flexibility; creativity of approach; sharper communication skills and the ability to influence others to act. These are all people, team and organisational factors.

Our third conclusion stems from the relatively embryonic nature of risk management itself as a discipline and the thinking that underpins it (6). A simple 'Human Factor' is that reward is still a direct lever in which businesses can influence employee behaviour. This is probably most obviously applicable to banks and similar organisations where risk is at the heart of how the business generates its income, but the principle applies elsewhere too. If the reward structure encourages excessive risk taking, for example, then any attempt to manage Risk Appetite sensibly and to address people and organisational factors is likely to be trumped by the overarching role played by reward. The impact of our four key factors ("tone at the top"; risk culture; management style and individual personality traits and risk skills) still prevails. By implication, however, one could also add performance management, for example.

Ultimately, one can only agree with those who call for a mindset change in how Risk Appetite is developed, managed and implemented. The more important role for Risk Appetite is in making forward predictions as to how the business should respond to risks rather than to provide the benchmarks for retrospective, post risk event analyses (15). A focus on the future, in turn, requires business leaders to make the link between Risk Appetite and people and organisational factors. Alas, in our experience to date, many are not able to provide illustrations of how they organise talent management and risk management so that they operate together seamlessly.

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Stephen's corporate and consulting career has included: the delivery of organisation, people and change management consulting projects to a range of FTSE250 businesses; an interim line management role managing 30 project consultants; senior management in a "Big Four" consultancy and; a consulting and management role within a US commercial Insurance business. His focus has been on the management of top teams, change management, people-related and HR issues. Stephen has spent over eight years in Risk Management roles. Over the last six years much of his work has also included strategic business redesign and IT implementation assignments. He has recently completed projects to outsource HR and payroll systems, relocate a large scale manufacturing facility and the transition from a fully owned to joint venture status of a national distribution business. Stephen is a Chartered Psychologist and his early career included the directorship of a management consultancy business and internal project positions in telecoms and the US Air Force.