Society of Actuaries in Ireland

Joint Life and Non-Life Forum

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Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Risk Culture: Hidden in Plain View

Jenny Minogue and Dr Allan Kearns
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Introductions…

About the event

It's a well-known saying that "Culture eats strategy for breakfast". In the seminar, Dr. Allan Kearns and Jenny Minogue discuss culture and its relevance for risk management in a financial services context. The speakers seek to take the abstract concept of risk culture, and discuss more specifically its importance, how the topic can be broken down into constituent elements, and how supervisory authorities are beginning to think about culture in a regulatory context.

About the speakers

Dr. Allan Kearns was deputy head of the Central Bank's risk management division, and a past member of the Central Bank's and the Eurosystem's risk management committees. His current role as head of analytics involves the development of risk analytics to support supervisory risk assessments. Allan lectures on risk management and corporate governance topics, both domestically and abroad.

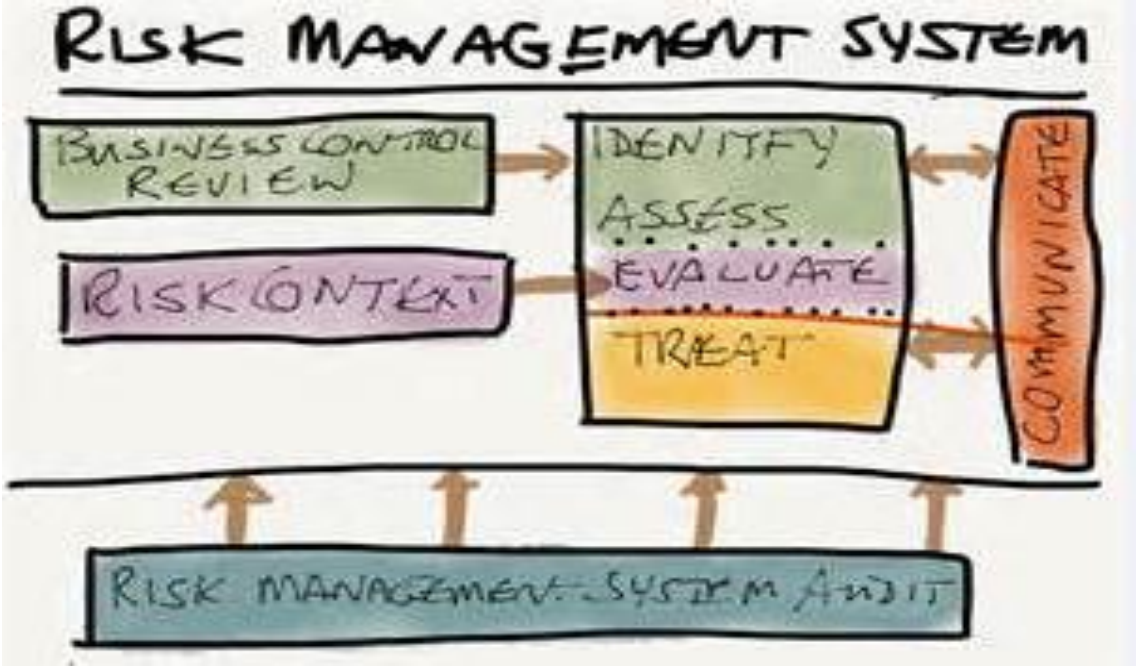
Jenny Minogue is a Chartered Organisational Psychologist with the Psychological Society of Ireland. She has been with the Central Bank of Ireland since 2014 and prior to this, worked for five years in the field of Applied Behaviour Analysis. Since 2016, Jenny has worked in the Insurance Supervision Directorate developing an approach for integrating behaviour and culture into supervisory practices.

Agenda

- Part 1 - Risk Culture and Risk Management
- Part 2 - Understanding Risk Culture
- Part 3 - Looking Ahead

Part 1 Risk Culture and Risk Management

System of Risk Management…



How do we think of embedding risk culture into this system?
Culture has been embedded for a while now, hidden in plain view…

Culture - A Cornerstone of Risk Management and Beyond...

The Financial Stability Board defines risk culture as an "institution's norms, attitudes and behaviours related to risk awareness, risk taking and risk management, or the institution's risk culture."

"Culture therefore drives the values and beliefs that govern how individuals treat others, perform their tasks, take decisions, assess risk, and perhaps most importantly, do the right thing to ensure they operate in a safe and sound manner. It is the foundation upon which effective governance is built and is critical to firms' long-term prosperity. Importantly, experience shows that behaviour has a predictive value with respect to firms' future stability.

Deputy Governor, Ed Sibley, 2017"

Culture - Chief Risk Officer Job Spec…

- Relevant Expertise, qualifications and background
- Sufficient seniority and independence to influence proposals or challenge decisions which affect a credit institution’s exposure to risk
- Effective processes in place to identify, manage, monitor and report the risks to which the credit institution is or might be exposed
- Establish a risk appetite with the Board and enable Board to understand the overall risk profile
- System of risk management shall promote an appropriate risk culture

Source: Central Bank of Ireland Corporate Governance Code

Culture - Risk Committees Terms of Reference…

"The Walker Review states that the board risk committee should have responsibility for oversight and advice to the board on the current risk exposures and future risk strategy of the entity, including strategy for capital and liquidity management, and the embedding and maintenance of a supportive culture in relation to the management of risk across the company, alongside established prescriptive rules and procedures."

Source: *The Walker review available from the HM Treasury website at http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf*
See also UK Institute of Chartered Secretaries and Administrators for model terms of reference.

Culture - Appetite Statements…

"Establishing an effective RAF helps to reinforce a strong risk culture at financial institutions, which in turn is critical to sound risk management. A sound risk culture will provide an environment that is conducive to ensuring that emerging risks that will have material impact on an institution, and any risk-taking activities beyond the institution's risk appetite, are recognized, escalated, and addressed in a timely fashion."

Relevant for all three lines of defence…

- 1st Line Business Line Leaders: embed the risk appetite statement and risk limits into their activities so as to embed prudent risk taking into the institution's risk culture and day to day management of risk;
- 2nd Line CRO establish a process for reporting on risk and on alignment (or otherwise) of risk appetite and risk profile with the institution's risk culture;
- 3rd Line Internal Audit Report any material deficiencies in the RAF and on alignment (or otherwise) of risk appetite and risk profile with risk culture to the board and senior management in a timely manner

Source: Financial Stability Board

Culture - Enterprise Risk Management (Standard & Poors)…

- ►ERM examines whether insurers execute risk management practices in a systematic, consistent, and strategic manner across the enterprise that effectively limits future losses…
- ►ERM analysis is tailored to each insurer's risk profile and focuses on five main areas: risk management culture, risk controls, emerging risk management, risk models, and strategic risk management...

Table 2

Scoring The Five ERM Subfactors

Subfactor	Positive	Neutral	Negative
Risk management culture (see paragraphs 18 to 34)	ERM is well entrenched in the organization with a formal ERM framework, an independent and well-staffed ERM department, and active Board participation.	The insurer has some ERM functions at the enterprise level that cover most material risks.	ERM is not practiced, or is practiced inconsistently, across the enterprise, with limited Board participation.
	The insurer has a clear vision of enterprise risk profile and risks are managed both at a business unit and an enterprise level within risk tolerances.	There is limited or infrequent Board participation.	The insurer lacks clear understanding of its enterprise risk profile.
	The insurer's risk appetite framework is clearly communicated and linked directly to risk limits.	Risk and risk management are mainly responsibilities of business functions with limited enterprise view.	The insurer manages risks predominantly in silos.
	The insurer has a culture of risk communication and information sharing, internally and externally.	The insurer understands its enterprise risk profile around key risk exposures and manages them within chosen risk tolerances.	The insurer lacks a formal risk appetite framework supported by clear rationale; risk limits do not exist or are very basic.
	The insurer's incentive compensation supports ERM goals.	The insurer's risk appetite is less clearly defined or communicated; risk limits are fairly simple or do not align with overall risk tolerances.	

Source:https://web.actuaries.ie/sites/default/files/erm-resources/219_enterprise_risk_management_sandp.pdf

Culture - Corporate Governance…

How do you define corporate governance?

1992 - Cadbury Report defines corporate governance as:

“ the system by which companies are directed and controlled”

<u>More recent definitions:</u>

Central Bank of Ireland defines corporate governance:

“ Procedures, Processes and attitudes according to which an institution is directed and controlled”

What does good corporate governance look like?

PRMIA – Corporate Governance Principles – Principle 10

“ Trust, honesty and fairness of key people - the key people involved in the application of good governance and risk management must be trustworthy and honest and treat others fairly at all times.”

What impacts on successful corporate governance?

“ *In fact, corporate governance is more about human behaviour than about structures and strictures, rules and regulations. Corporate governance involves the use of power. It is a political process.”*

Bob Tricker (2012) Corporate Governance

Part 2 Understanding Risk Culture

How do we define risk culture?

Institute of Risk Management:

"shared values, beliefs, knowledge, attitudes and understanding about risk, shared by a group of people with a common intended purpose, in particular the leadership and employees of an organisation"

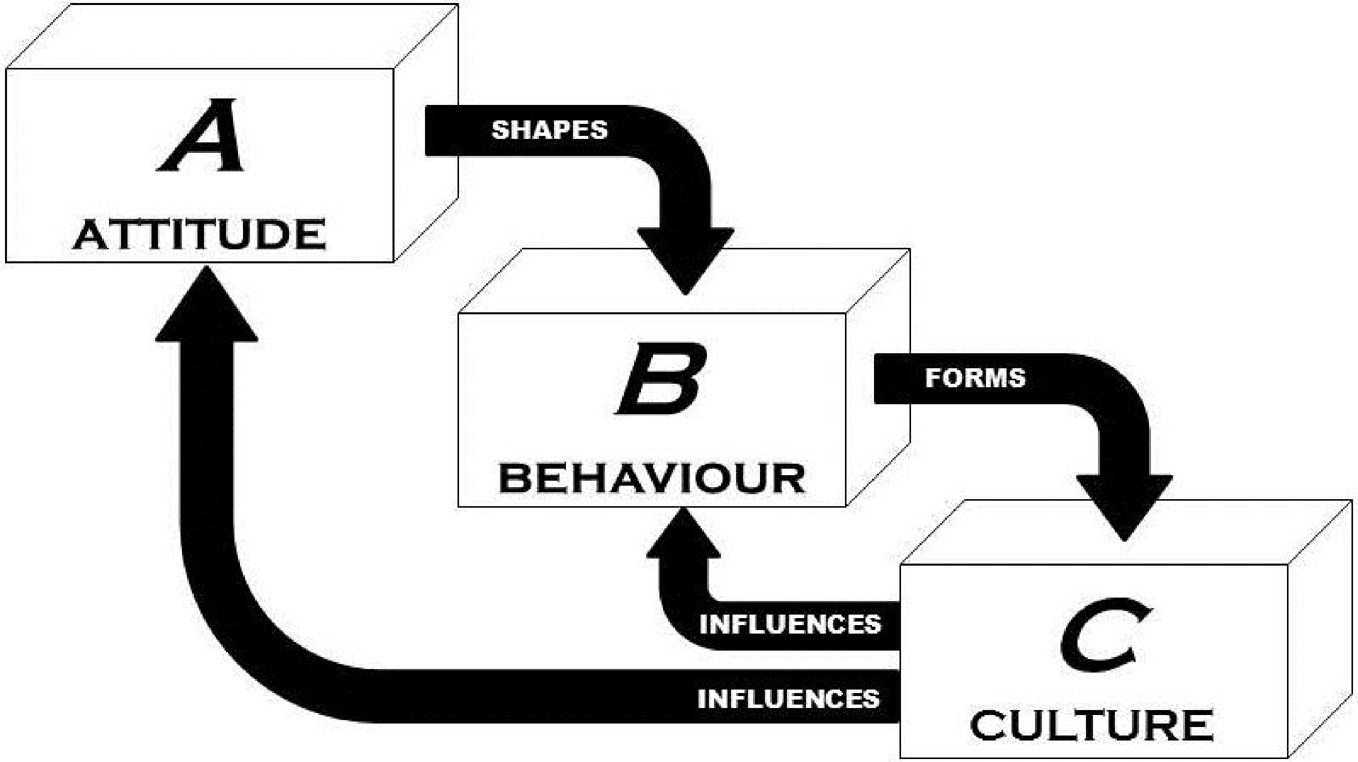
The Financial Stability Board:

"an institution's norms, attitudes and behaviours related to risk awareness, risk taking and risk management, or the institution's risk culture."

Insurance Supervision Directorate, CBI

"*the system of values and behaviours present in an organisation that consciously and unconsciously shapes the consideration of risk at all levels in the organisation*"

It’s easy as……



(Hillson & Murray-Webster, 2007)

How do you get a risk culture?

Effective ☑

Ineffective ☒

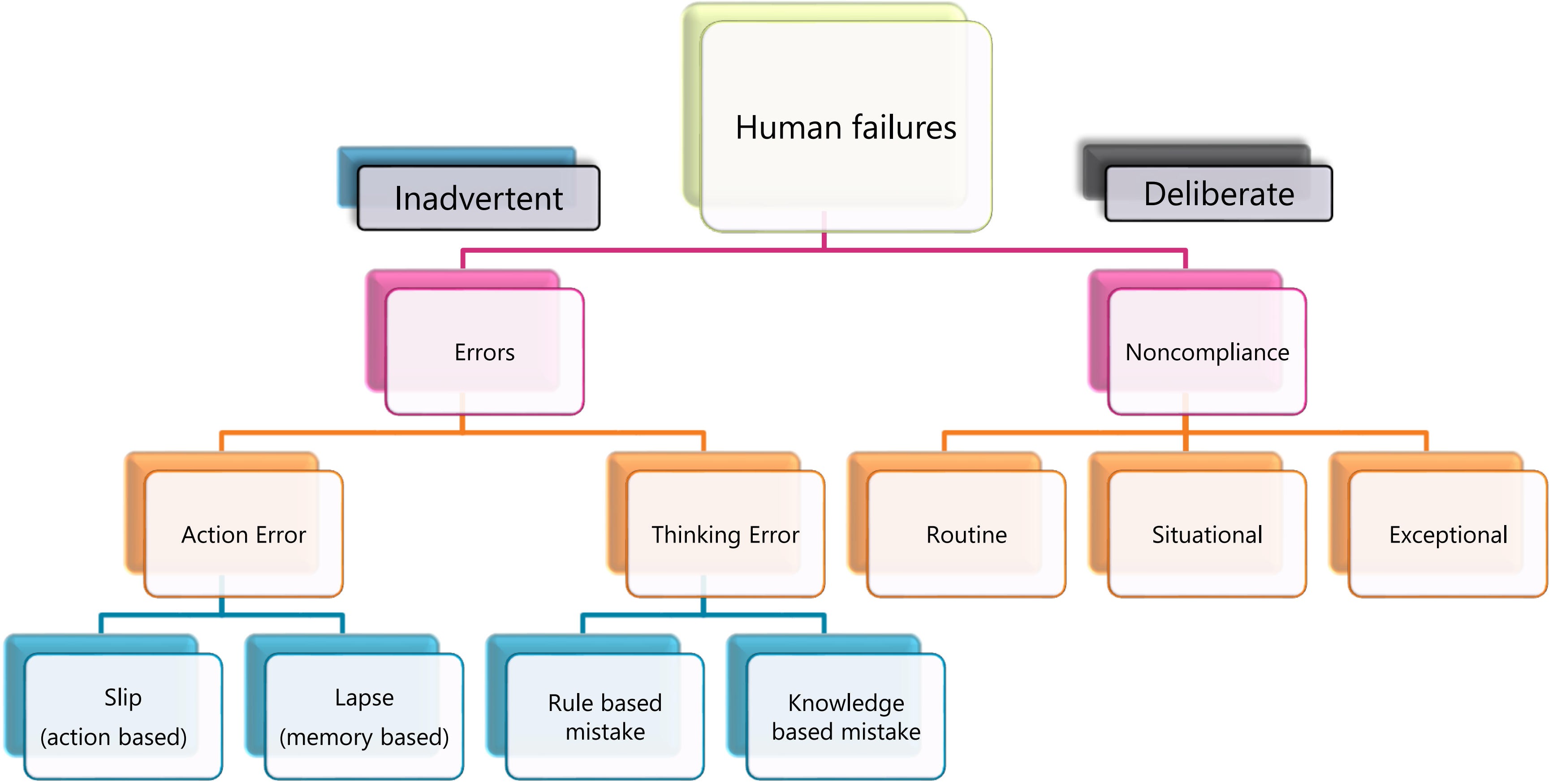
Insurance Supervision Directorate Risk Culture Model…

Components that underpin the factors of risk culture…

- Structural factors
  - risk framework effectiveness
  - risk manager quality
  - risk training quality, knowledge and skills
  - remuneration
  - KPIs
  - communication channels

- Behavioural factors
  - individuals’ risk behaviours
  - accepted risk behaviour in the firm
  - decision making biases
  - role-modelling
  - support for speaking up
  - risk and human factors
  - attitude to errors

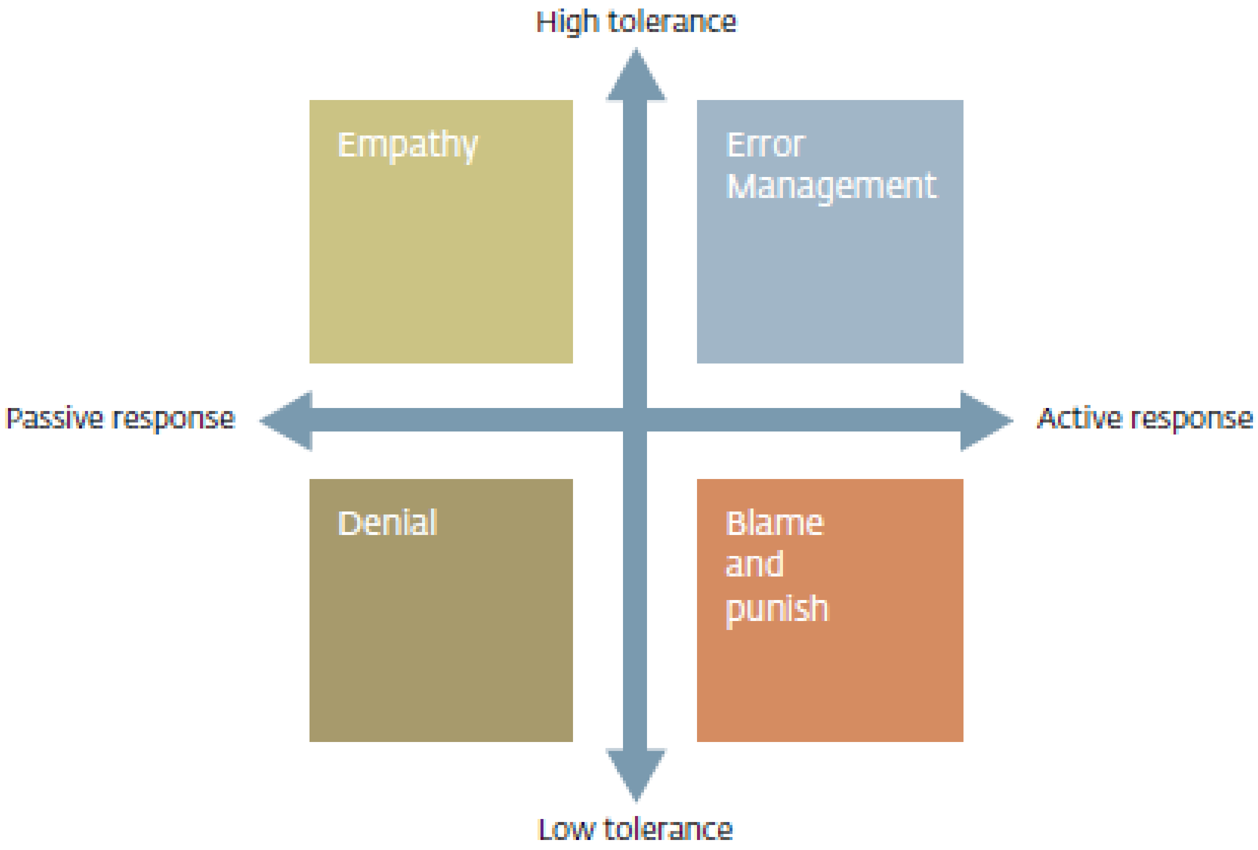
Risk and human factors…



Health and Safety Executive (UK)Model of Human Failure

Attitudes to errors…

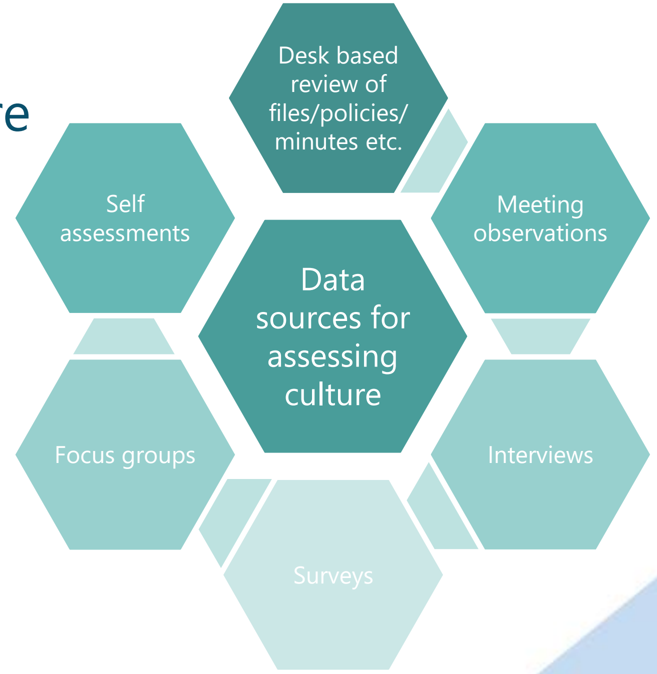
(based on Homsma, 2007).



Part 3 Thinking Ahead

Supervisory Approaches…

- Central Bank of Ireland – Insurance Supervision Directorate Risk Culture Assessment
- De Nederlandsche Bank: Board/Change Effectiveness and Risk Culture
- Australian Prudential Regulatory Authority - Risk Culture



Consider this....

Have you observed:

1. Poor risk behaviour being tolerated and normalised
2. Communication break downs e.g. messages were prevented from getting to the board/management decisions trumping expert advice
3. Risk **as** the key organisational priority
4. Undertakings being unjustifiably overconfident
5. The influence of external/internal pressures
6. Oversight failure

Appendices

- Decision making biases
- Additional resources

Decision making biases

- **Choice architecture** – how the framing or context of a scenario can influence one's choice e.g. if something is presented as a loss, people are more inclined to engage in risky behaviour
- **Overconfidence** – people are systematically overconfident about their abilities and outcomes, such as overestimating the success of their marriage, business acquisitions, exams and earnings and underestimating their chances of contracting diseases
- **Discounting time/ present bias** – people are disposed to place more value on gaining something immediately at the expense of future gain
- **Herding –** the tendency of decision makers to follow the lead of other decision makers outside the group
- **Extrapolation bias**- when people disproportionately concentrate on recent events when making future decisions
- **Confirmation bias** The inclination to place greater weight on and to actively seek information consistent with prior beliefs
- **Ambiguity aversion** Greater willingness to take risks in contexts where people feel able to quantify the risk, or where people feel relatively competent in assessing the risk
- **Behavioural convergence**- the tendency that people have to copy the behaviour of others and to feel discomfort in behaving in a manner inconsistent with the norm. Interesting example here: https://www.youtube.com/watch?v=VgDx5g9ql1g


Dr. Anthony Pratkanis
University of California at Santa Cruz

Additional resources

- Video with Edgar Schein: fundamentals of culture https://www.youtube.com/watch?v=4Fw5H7GWzog
- Jackson, P. (Ed.). (2014). *Risk culture and effective risk governance*
- CRO Forum https://www.thecroforum.org/2017/10/06/a-guide-to-defining-embedding-and-managing-risk-culture/
- Smart and Dumb Questions About Risk Management (Power, 2011) http://www.lse.ac.uk/accounting/pdf/MKP%20RiskWatch%20(6).pdf