Risk Practice

McKINSEY WORKING PAPERS ON RISK

Taking control of organizational risk culture

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Introduction

As the global financial crisis has evolved, so too have references by regulators, market commentators and the media to failures in institutional "risk culture," as a key contributing factor to the various bank collapses and losses witnessed over the past few years. The concept of "risk culture" featured prominently, for example, in the 2008 report by the Institute of International Finance (IIF) on the failings that led to the credit and liquidity crisis among global banks.

> *"Cultivation of a consistent 'risk culture' throughout firms is the most important element in risk management."* – IIF, Final Report on Market Best Practices for Financial Institutions and Financial Products, August 2008

While references to "risk culture" are proliferating – often in connection with a wide range of catastrophes – the term, however, is rarely defined adequately. It is usually only spoken of narrowly, in the context of incentive and organization structures, while its essential attributes are left undetermined. This narrow focus has led to risk culture being seen as too difficult to grasp, and so, within the broader context of efforts to improve understanding and management of risk, it has been essentially ignored.

This is a mistake. Risk culture is at the heart of the human decisions that govern the day-to-day activities of every organization. It is relevant to all parts of the organization, not just risk managers. And when it goes wrong, as in the SocGen rogue trading scandal in 2008 or the Challenger Space Shuttle disaster in 1986, the consequences can be devastating and even fatal.

Failures such as fraud, the collapse of complex derivatives positions, safety breaches, operational disasters, and over-leveraging have their origin in flaws in unique organizational cultures that allowed particular risks to take root and grow.

This working paper is intended to bring the concept of risk culture into the light, where it can be usefully understood. First, it offers a methodical, rational definition of the essence of risk culture. Second, it puts forward a model for how organizations of all kinds can assess their risk culture, and then intervene in areas where this culture might be vulnerable. Third it provides real case examples of the application of this approach.

Risk culture in context

With the global economy still finding its footing, many organizations are in "lock-down" mode. They are concentrating all their energies on surviving in the changed environment by stemming losses, cutting costs and stabilizing their revenue base. Where attention is paid to risk, the focus is more often than not on improving existing risk management systems and models rather than tackling the underlying culture.

While the burden of today's short-term economic pressures is undeniably heavy and time-consuming, managers should recognize that a strong risk culture plays a critical role in determining an organization's health and performance. As such, it should therefore be among the first things that managers consider as their organizations move through the economic cycle, not the last.

Defining risk culture

Many managers and analysts feel they have an intuitive understanding of risk culture, but may not be able to define this precise and concretely. Without a clear and holistic understanding of risk culture, however, organizations tend to address risk with narrow structural approaches (e.g., a strong CRO and empowered risk function) and incentives (e.g., deducting a capital charge from the bonus pool, deferring bonus payments). Although such approaches in and of themselves can be helpful, we would argue that in the context of the post-crisis world, they are insufficient in addressing the concept of risk culture. To do this adequately, a definition of risk culture is needed. In consultation with clients, practitioners, and academics, we have therefore distilled the following definition:

Risk culture: *"The norms of behavior for individuals and groups within an organization that determine the collective ability to identify and understand, openly discuss and act on the organization's current and future risks"* [1]

In a strong risk culture, these norms or attributes of an organization nurture and sustain a common set of standards whose rigor and disciplines define its approaches to risk-taking. This sense of common purpose and understanding was described by author Edgar Schein as the "deeper level of basic assumptions and beliefs that are shared by members of an organization, that operate unconsciously, and that define in a basic 'taken for granted' fashion an organization's view of itself and its environment." [2] It is what McKinsey's late managing partner Marvin Bower meant by his simple phrase, "*the way we do things around here.*"

A strong risk culture demonstrates several critical and mutually reinforcing elements:

- A clear and well communicated risk strategy
- High standards of analytical rigor and information-sharing across the organization
- Rapid escalation of threats or concerns
- Visible and consistent role-modeling of desired behaviors and standards by senior managers

1 McKinsey has contributed this definition and key elements of its analysis and risk culture framework to the IIF working group focused on the Risk Culture section of the IIF report, "Reform in the Financial Services Industry: Strengthening Practices for a More Stable Industry" (December 2009).

2 Edgar Schein, *Organizational Culture and Leadership* (Jossey-Bass, 2004).

- Incentives which encourage people to “do the right thing” and think about the overall health of the whole organization
- Continuous and constructive challenging of actions and preconceptions at all levels of the organization.

The behaviors of people – the choices they make and their judgments about the behavior of others – take place within the context of their organization, a complex mechanism of systems, processes, and structures. The formal organizational context sets boundaries for acceptable behaviors. Consequently, fragilities in risk culture behaviors are, more often than not, the consequence of weaknesses in these formal systems and structures.

A successful risk culture model therefore needs to account for all the meaningful interactions that happen inside organizations, including those between individuals and between groups of individuals acting in teams or business units, as well as interactions at the institutional level, involving senior management and strategic decision-making processes.

Understanding the sources of risk culture failure

The character of risk culture failures can range from the relatively mundane, such as a failed trade or a lapse in a routine safety procedure, to the fatally catastrophic, such as a gas pipeline explosion or the Space Shuttle disaster. Whatever their degree of severity, such failures have important common causes and implications.

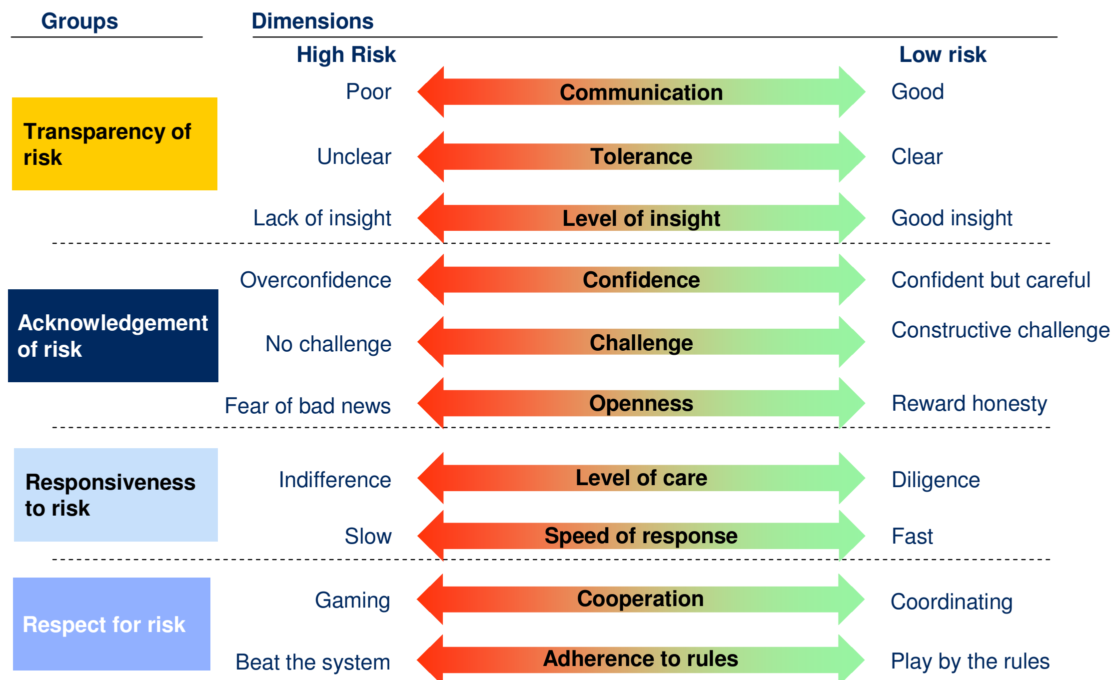
- Whether triggered by an internal or external agent, risk culture failures often expose a long-standing cultural weakness or a linked series of weaknesses that have been incubating over time and that can be clearly recognized after the event.
- Failures and near failures often offer managers and key stakeholders a window of opportunity to demand changes that strengthen an organization’s risk culture and make it more robust. Unfortunately, some of the most powerful stimuli to change come when bad things happen, or are only narrowly averted.

We organized our research around 20 detailed case studies of risk culture failure. We analyzed them from an external perspective and then also interviewed people close to the actual situations. The case studies included hospital disasters that led to multiple patient deaths, operational and safety failures that cost lives and large sums of money, legal settlements in which firms paid significant damages to avoid further reputational harm, and rogue trading and other banking-related losses. In each case, we sought to understand the cultural factors that had contributed to each failing and to recognize any common factors or patterns.

This approach allowed us to identify ten key risk culture factors that were consistently observed as contributing to the failures, although to a greater or lesser extent in each case (see note 1, p. 3). These factors are present in every organization and are measurable along a continuum from weak (higher risk) to strong (lower risk) (Exhibit 1).

Exhibit 1

Risk culture framework



The ten factors can be gathered into four associated groups which can indicate the principal risk culture failure tendencies of particular organizations. We have named these groups: Transparency of risk, Acknowledgment of risk, Responsiveness of risk, and Respect for risk. A description of each risk culture dimension in terms of the "weak" end of the continuum each encompasses is described in more detail in the box on the following page. The examples of failure provided in these descriptions are intended to be illustrative of particular elements of risk culture weakness, but it is worth keeping in mind that failure events are usually the result of more than one cultural factor.

Risk culture: Defining the weak end of the continuum

Transparency

- **Poor communication.** A culture where warning signs of both internal or external risks are not shared. Example: the global engineering firm where significant project delays routinely surprised senior management, since there was no process to generate insights from data that aggregated minor issues.
- **Unclear tolerance.** A culture where the leadership does not communicate a clear risk appetite or fails to present a coherent approach or strategy. *Example: the global logistics firm where cost-cutting decisions were taken without accounting for their potential impact on operational risk failures.*
- **Lack of insight.** A culture where the organization fails to understand the risks it is running or believes that such an understanding is the preserve of risk specialists. *Example: the meat processing company that made a series of bets on corn prices without having the right information to understand and manage their positions.*

Acknowledgment

- **Overconfidence.** A culture where people believe that their organization is insulated or even immune from risk because of its superior position or people. *Example: the energy trading company whose self-perceived market expertise eventually contributed to its collapse, as it took on too much risk.*
- **No challenge.** A culture where individuals do not challenge each others' attitudes, ideas and actions. Example: the leading European bank, where senior management formed a very tight unit that neither allowed nor invited internal debate and ended up making a series of disastrous strategic and M&A decisions.
- **Fear of bad news.** A culture where management and employees feel inhibited about passing on bad news or learning from past mistakes. *Example: the deadly outbreak of MRSA (an antibiotic-resistant strain of bacteria) in a hospital where junior staff were afraid to report early signs of trouble for fear of being blamed or criticized.*

Responsiveness

- **Indifference.** A culture which discourages responding to situations or fosters apathy about the outcome, either due to bad faith or incompetence. *Example, the retail bank that incurred a large fine after it knowingly allowed unqualified sales staff to sell inappropriate loan guarantee products.*
- **Slow response.** A culture where the organization perceives external changes but reacts too slowly or is in denial about innovation or the likely impact of change. *Example: the overleveraged hedge fund that collapsed after failing to respond quickly enough to a market shift.*

Respect

- **Beat the system.** A culture where risk appetites are misaligned with the organization's risk profile, leaving room for the conception and implementation of inappropriate activities. *Example: the options trading group of a large bank that took unauthorized positions and incurred major losses.*
- **Gaming.** A culture where individual units take risks or embrace projects which could benefit the unit, but are out of line with the organization's risk appetite. *Example: the derivatives structuring unit of a major bank that exploited inconsistencies in credit approval processes to maximize their chances of sign-off from the risk function.*

Diagnosing organizational risk culture

The identification and definition of the factors and groups of risk culture failure has created the opportunity to design a diagnostic approach to assess a given organization for its vulnerability to risk culture failure (Exhibit 2).

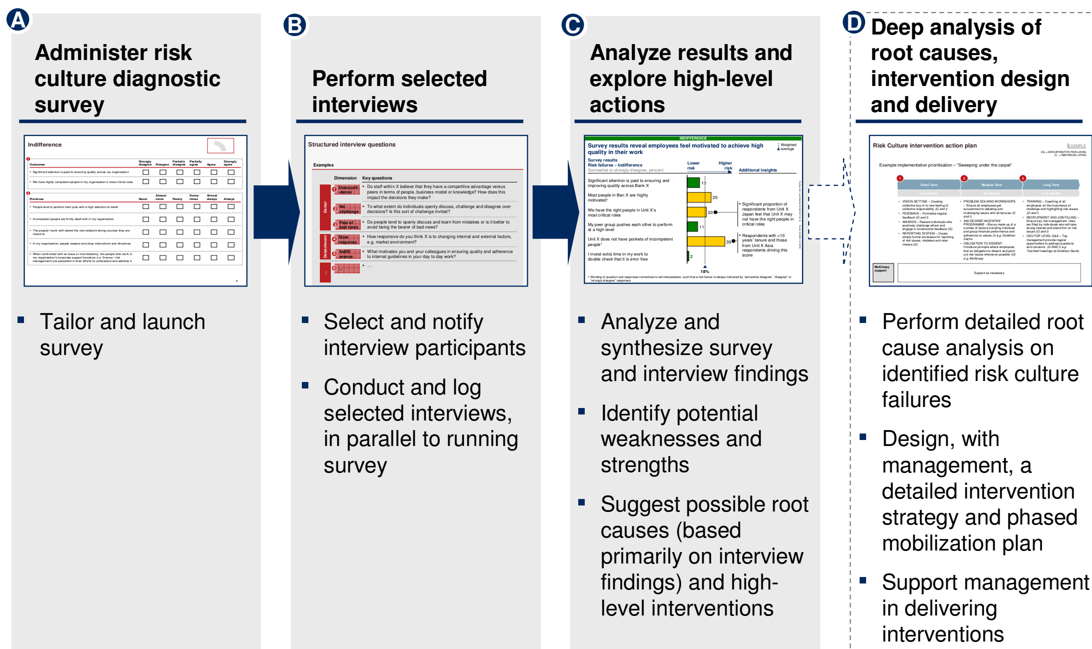
In partnership with organizational psychologists McKinsey has accordingly used its case studies to devise a survey tool to “backward engineer” the questions that should have been asked if cultural weaknesses which can lead to major risk failures would be diagnosed. The backward-engineered questions are then refined through conversations with survey and risk experts and through client pilots, to create a survey optimally designed to discover leading indicators of potential risk culture failures.

Exhibit 2

Risk culture diagnostic approach

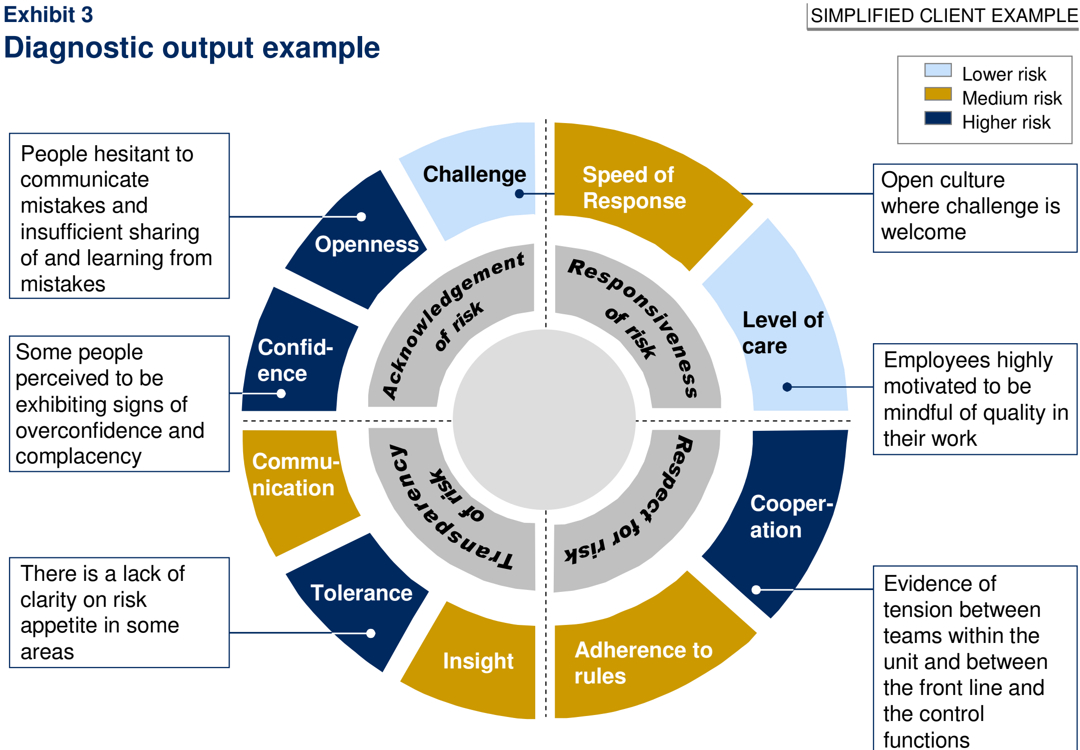
Core risk culture diagnostic

Intervention design



This survey tool is administered electronically and the results can be organized according to different demographic splits to reveal risk culture “hot spots” within different business units, geographies, tenures, or seniority levels (Exhibit 3).

Exhibit 3
Diagnostic output example



Complementing this diagnostic survey are a series of interviews, designed to get beneath the survey results and add an extra dimension to our understanding of the problem, and also to detect any factors that have not been captured within the survey. Both the survey results and the interview findings can then be analyzed to illustrate to management the risk culture challenges they face. By then leveraging our well-tested performance transformation toolkit, managers can design a specific set of interventions to address the root causes of the risk culture weakness and reduce the likelihood of a failure taking place.

For the first time, therefore, managers across the business – not just in the risk function – can call upon a structured approach and fact-based mapping to identify and describe potentially damaging tendencies or patterns of behavior that might previously have been hidden from their gaze, and then take specific actions to reduce their overall vulnerability.

The risk assessment journey: benefits for managers

Managers considering embarking on a journey to better understand and then strengthen their risk culture are justified in asking themselves what the benefits of such an exercise will be. This journey will not cure all an organization's risk-related ills, nor will the attained result – a strong risk culture – protect an organization from all harm.

What this journey will do, however, is foster a common language and framework for describing an organization's risk culture, and provide managers with a concrete program for engaging and intervening in problem areas. The findings of the survey and interviews can be shared

with all staff, not just the risk function, so that the entire organization has the collective understanding needed to sustain a strong risk culture.

The survey scores and interview responses also provide a fact base that can help reveal potential weaknesses, support the case for change, and indicate whether further investigation is required or where action might be taken. The fact base can thus turn a critical but previously little understood long-term driver of business health into an accessible and user-friendly management tool for enabling a more complete and robust enterprise risk management framework (Exhibit 4).

Exhibit 4

Demographic analysis – example output

SIMPLIFIED CLIENT EXAMPLE

Demographic split – Designation
Frequency of failure driver designated as somewhat to strongly agree, %

Legend: Lower risk; Medium risk; Higher risk

Percent, lower % = higher risk

Designation	Acknowledgement			Respon-siveness		Transparency			Respect	
	Confidence	Openness	Challenge	Speed of response	Level of care	Communication	Tolerance	Insight	Cooperation	Adherence to rules
Total	90%	76%	81%	80%	82%	82%	80%	80%	59%	80%
Managing director	83%	69%	75%	69%	76%	75%	77%	74%	60%	78%
Director	89%	82%	83%	81%	80%	85%	79%	79%	62%	84%
Vice president	97%	79%	82%	84%	85%	83%	78%	80%	51%	80%
Associate or analyst	92%	72%	84%	85%	86%	83%	85%	84%	60%	75%

Scores over 90% in this dimension were deemed to be potentially suggestive of a lack of reflection, or risk complacency

As we build a database of survey results, organizations become able to benchmark their risk culture scores against other similar organizations and assess where they are particularly strong or weak versus peers.

Selected pilot findings and interventions

In the course of developing our thinking and tools, we have piloted our approach with leading global institutions in both the private and public sectors and across a range of industries. As well as highlighting possible improvements to the survey questions, the pilots have also helped confirm the effectiveness of the underlying methodology and how it can be used to provide management with a clear set of observations, root causes, and priority interventions, which can then be further detailed in subsequent phases of work if required.

Taken together with the other pilots we have run, these case studies confirmed the durability and usefulness of our survey and interview diagnostic tool, including its ability to stimulate highly effective management discussions and targeted actions to strengthen an organization's risk culture.

Case study 1 – global investment bank

At a global investment bank, we assessed the risk culture of a unit within their sales and trading division. This unit had only recently been formed by integrating a series of previously independent and product-aligned structuring teams. Managers were therefore worried about the unit's ability to gel and function as one team, and how market pressures, including downsizing, might affect people's behaviors and the risk choices they were making.

The unit displayed relative strengths in challenging each other's ideas, attitudes and actions ("Challenge") and cared about doing a good job and protecting the bank's reputation ("Level of care"). However, management's concerns around the unit's lack of cohesion were confirmed, with "Cooperation" emerging as a priority hot spot.

Less expected, however, was the insight that some parts of the unit found that the bank's risk tolerance was unclear ("Tolerance") and inconsistently applied, with communication and joint working lacking between the risk function and the front-line. Other insights emerged in the analysis of some of the demographic splits. More senior and more tenured employees, for example, perceived the unit's risk culture to be weaker than their more junior colleagues.

Given this diagnosis, we suggested three major intervention themes for management to consider.

1. **Senior leadership team should (visibly) align and engage around a shared agenda,** on the basis that their people would only behave differently if they saw their leaders speaking and acting differently.
2. **The way the unit's risk tolerance is communicated should be radically changed,** so that there is more clarity on risk decisions and more front-line involvement in how the risk appetite is set.
3. **Internal structures and processes should be rethought,** so that product boundaries are clearer and trade approval mechanisms tightened.

Case study 2 – global professional services firm

We assessed the risk culture of a unit of a global professional services firm. Although management had no particular in-going concerns, believing the overall risk culture to be very healthy, they were interested in understanding where they could improve and if there were any meaningful variations by tenure or role.

An analysis of the findings indicated that the overall risk culture was indeed robust, especially with respect to the "Speed of Response" and "Level of Care" factors, where the scores suggested that people were very responsive to change and deeply concerned about the impact and quality of their work.

"Confidence," however, emerged as a potential hot spot, with a risk that more junior staff might over-extend themselves. "Challenge" was also an area of concern, with some junior tenures

perceiving that upward challenge was not welcomed by more senior colleagues. Finally the "Tolerance" factor also emerged as a potential hot spot, with people perceiving a need for far clearer guidelines and communications on what was and was not an acceptable risk, and that a much stronger process was needed to identify and discuss risk during the yearly planning process.

Given these results, a number of possible interventions were identified:

1. **Joint working practices between senior and junior staff should be reinforced,** to ensure that i) more junior people are appropriately guided in the decisions they make, ii) that "war stories" of past mistakes were shared, and iii) that a climate of trust within teams is maintained.
2. **Risk training should be upgraded,** especially at the more junior levels, to address the concerns for clarity about what levels of risk are acceptable in people's day to day work.
3. **A new process** should be introduced into the annual planning cycle to ensure that the risks being faced by the organization are indentified and discussed.

* * *

Organizations across all sectors have an opportunity to rethink their traditional approach to risk management and tackle the underlying cultural drivers of risk failure.

The good news for managers is that our research shows that risk culture need no longer be considered as an inscrutable black box. Rather, risk culture can be defined, categorized and diagnosed, using a combination of a survey tool and interviews which can reveal leading indicators of vulnerability based on past examples of risk culture failure. This approach to a risk assessment journey enables specific interventions to be designed and implemented to reduce the likelihood of a failure taking place.

Of course risk will remain an unavoidable and essential element in the DNA of most organizations. It is inconceivable that a technology company could wholly avoid new product risk, or a bank avoid trading risk, or a hospital avoid the risks of complex surgeries. Certain risks are inherent in each field and cannot be entirely eliminated by any active organization. What can be minimized, however, is exposure to unnecessary risks. It is therefore vitally important that management actively shape a risk culture in which only these inherent risks are being managed and run, and that their people, in accordance with the organization's risk profile, are playing their part in excluding all other risks as extraneous and nonessential.

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