Risk re-imagined

Governance model needs a rethink

Management New pressures are exposing the old lines of defence.

James Dunn

As companies in all industries grapple with a business environment in which the risk management function is being challenged, traditional models of governance are being upended.

The standard corporate governance model of three lines of defence — bringing with front-line staff, through the risk management and compliance function, and then to the internal audit department — has been exposed by a new era of higher regulatory scrutiny, increased public expectations and heightened social media exposure.

Companies face the challenge of balancing cost pressures and creating shareholder value while accepting far greater involvement of broader stakeholders, and vastly higher visibility of their every action.

Risk has had to be reimagined, as a core function of the business, at all levels.

Essentially, the new environment dictates that the risk function is "brought out of its silo," says Sally Herman, a non-executive director at Suncorp Group Limited, Premier Investments Limited and Evans Dixon Limited.

"Any organisation has to think about risk as a core part of doing its job, which means it can't be the responsibility of some faceless department in the centre. It's like HR, in that managers outsourced 'people leadership' to the HR function, but that's now been devolved back into the front line; risk has to be, too."

Herman says the risk function will always be a combination of people and data to produce insights: "Insights into what could go wrong, and where there could be an opportunity to do better for customers."

"You've got to have the senior risk people involved at the outset around strategy-setting, but you also have to have the people who are interacting with the customer day in and day out thinking about the terms of the company's risk appetite, not just in terms of risk elimination. Because you still need to grow, companies can't stand still."

David Clarke, chief risk officer at Queensland Investment Corporation (QIC), says risk needs to be managed in real time — which heightens the risk management challenge for risk teams, for boards, and for the executive. This also means that an understanding of risk has to be built-in to an organisation's training.

"The HR and risk functions must be on the same page about training," he says. "I work very closely with our executive director of HR; we do joint training, joint inductions, teach people all aspects of the business from the beginning."

If you make commercial decisions, you should be thinking risk and reward.

Stephen Allen, KPMG consultant

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"I work very closely with our executive director of HR; we do joint training, joint inductions, teach people all aspects of the business from the beginning."

Sally Herman says the risk function is the combination of people and data, and in general, the new era of higher scrutiny on business by regulators, governments, stakeholders and the public, with social media as their lens.

"As organisations have gotten bigger, there's been more formality develop around the risk management function, but then you get an addiction of responsibility," he says.

"Grant calls it 'Management 101', I call it 'first principles' — if you make commercial decisions, you should be thinking risk and reward. Where there is a central risk management function, and it becomes seen as 'The Cops', well, it's easier for front-line people to simply say 'no' to opportunities, and it doesn't work."

The challenge is to "make sure your people are thinking both sides of the fence," Allen says. "This involves the risk function having that commercial element — what's the risk, what's the reward we're getting, what are our boundary conditions — but you also want your front-line people thinking in terms of what's doable?"

"You have parameters — you're obviously not going to break the law, you're not going to do things that are bad and that have an obvious reputational damage, and you want a win-win outcome for you and your client; because at the end of the day, you're in business."

Allen says the interface between the front line and the risk function should work like this: "The front line proposes doing something; risk comes back and says, 'Actually that doesn't work, and here are the reasons why, but we could do A, B or C. It's your client, and you own the risk.'"

"What you're hoping for — because you hope you have bright people — is for the front-line person to come back and say, 'If I could get D, does that work?' And you say, 'Sure, actually that does.' "That's ideally the way you want a risk function to work, but the challenge is promoting that among all your staff."

The risk function's key role is to be independent, he says: it is not emotionally wedded to the product or the deal, but it sets the parameters for the front line.

"You're saying, as the risk function, if you want to launch a product or do a deal, you've got to care about the reputation and risk — and you've got to care about all the pieces," says Allen.

"The optimum risk function is where the risk people have the credibility to be seen as partners of the front-line business, says Matt Tottenham, director, audit, assurance and risk consulting at KPMG.

"Where the risk function becomes really valuable is where it has the credibility, experience and gravitas that can actually challenge the front-line business — and then the business wants it viewed," he says. "Where the business is saying, 'I still make the final decision, but I really want your opinion,' that's a partnership, and that's when it really works well."
Diversity of skills key to tackle challenge

Problem-solving

James Dunn

With the broadening array of risks that organisations face working to increase the importance of the risk function, the mix of skills that are utilised in that area is changing.

And with non-financial (at least, in the first instance) risks becoming more prominent, risk is no longer seen as exclusively a quantitative speciality. Diversity of skills base, background and thinking is increasingly demanded.

“How successful organisations handle risk has matured and changed a lot, just in recent years,” says David Clarke, chief risk officer at Queensland Investment Corporation. “Diversity and different modes of thinking is increasingly central to the risk function, to make sure ethical and moral decision making is front and centre.”

With the business world evolving at the rate that it is, one of the biggest challenges for anybody in a risk role is how to “keep open-minded enough and diverse enough in your views”, says Stephen Allen, consultant at KPMG. “That’s at absolutely every level.”

Allen offers two examples from his own career. “One, because I don’t happen to be a big social media user, I had to be warned by other people who were more tuned into it than me how big social media would be in terms of reputational risk.

“Second, I was involved in a business in the US, in California, that lent money at high interest rates to people to buy second-hand cars. It was easy to just look at the interest rate and say, ‘Wow, that’s high, is this a sustainable business?’ But I had a couple of people on my team who were from a socioeconomically less affluent background, who made the point to me quite strongly that in those parts of California, if you didn’t have a car, you didn’t have a job. So, it was a good business.”

The problem for many organisations, says Allen, is that historically, risk may have been seen as more of a “back-office function”. “You definitely want to make sure that your risk function is seen as a good place to work at – that it’s not a penalty to work there,” he says. “Obviously, it’s critical you have the right people, because if you break a problem are critical, but at the end of the day, there’s no magic to it – it’s about thinking through the issues. You want diversity of thinking.

“The rising importance of non-financial risk – such as conduct risk, ESG (environmental, social and governance) risk and modern slavery – has to be matched by the skills available to the risk function, says Anna Hopely, partner, audit assurance and risk consulting at KPMG. “This means that your risk people can’t simply be focused on quantitative analysis,” she says. “They need to be comfortable in ambiguity, they need to be highly resilient, and they need to be comfortable in qualitative data that supports a measurement not a financial risk. That’s very much a shift that we continue to see. As long as there’s the ability to have broader interaction between people with different backgrounds, then you’re going to get a much better risk outcome.”

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Stephan Allen, consultant at KPMG.

Social condition of businesses fundamental to success

Company culture

Mark Eggleton

Australia’s largest banks, insurers and superannuation licensees might be managed rather well in a financial sense but the industry is grappling to manage non-financial risks, such as culture and accountability. According to APRA, one of the consistent themes of the self-assessment process was “risk culture is not well understood, and therefore may not be reinforcing the desired behaviours”.

APRA deputy chairman John Lonsdale said the self-assessment process made clear that many of the issues identified within CBA are not unique to that institution.

Lonsdale said the findings would be used to help APRA better target its efforts to lift standards of non-financial risk management.

“Boards must be committed to uplifting governance and management of non-financial risks. Where this commitment is not forthcoming, APRA will consider the need for further regulatory action,” he said.

APRA’s report follows the release of a paper prepared for the Actuaries Institute last month outlining the need for Australia’s major financial institutions to better understand their social risks and the social condition of their business.

The thought leadership paper, titled The Social Condition Report, was prepared for the Actuaries Institute by authors Ian Laughlin, a former deputy chairman at APRA, and Haydn Berrau, a principal at Finity Consulting. It said the “social condition” of a financial services business – the state of its relationships with its customers, employees, regulators, intermediaries, politicians and the wider community – is “no less important to a company’s long-term success than its financial condition”.

“The basic premise underlying this paper is that relationships with key groups in society are so fundamental to the success of a financial services business, and of such great value, that there should be a systematic approach to the management of those relationships,” the paper states.

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The authors argue many social risks are being “poorly managed – perhaps not even being identified”. According to the paper’s co-author Haydn Berrau, loss of social capital has occurred suddenly and quickly in Australia’s financial institutions, with little or no warning provided by current management indicators and reporting.

He suggests there is a lot of public relations speak involved in reporting based around jargon such as “net promoter scores” but they are shallow and underdeveloped.

He says social capital is just as significant as financial capital but social

Anna Hopely says risk people can’t simply be focused on quantitative analysis. Photo: Jeremy Piper

“Should we? is essentially an ethical question. The risk and compliance functions have sometimes been historically about risk elimination,” he says.

“The new world is around risk assessment, it’s not around elimination, you can’t eliminate it. But is this the right thing to do? That’s a hard skill set, it requires judgment. If you’re someone who’s spent your entire career trying to eliminate risk by making people adhere to policies and procedures, you probably haven’t developed the skill sets to look at a situation and judge it.”

Herman is keen to see curiosity in risk professionals. “There has to be a curiosity about how customers interact with the business you need to have that always pretty much at the front of your mind, about what will be the customer experience of this product or service.”

Ultimately, however, an effective risk function still comes down to data and insights, she says. “What we want is chief risk officers (CROs), and risk functions, to be reimagining risk all the time, which is how they use artificial intelligence, how they use data more effectively, and how they evolve and partner with the business to bring better insights to boards,” she says. “Because boards are only going to be as smart as the risks that are within the business.”

Allen knows what he wants in a risk professional. “Smart, hard-working, driven people, who are analytical and intellectually curious, and I want them from a whole range of backgrounds.”

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Pace of change a genuine threat

Liability

James Dunn

Not only does the range of risks the modern company faces get ever broader, risk comes at the modern company fast. And that can become an additional risk in itself.

“The pace of change now has to be a fundamental part of the way that an organisation thinks about risk,” says Grant Murdoch, a non-executive director at ALS Limited, Lynas Corporation Limited, Redbubble Limited and OzForex.

“That’s the additional risk that’s in there. A number of risk analyses now are putting velocity in risk philosophy along with consequence and likelihood, because a risk that has a high velocity means that you’re going to have to deal with it very differently to other ones.”

Reputational risk is at the forefront of this change, Murdoch says.

“Reputational risk is now much more important because of the pace.

“The pace means that if you’ve got a reputational risk, it’s on social media within minutes. And that’s something that the organisation’s risk function is going to have to learn how to deal with, as well.”

Matt Tottenham, director, audit, assurance and risk consulting at KPMG, says social media has brought it with it the additional risk of losing control over the narrative – unless they are very alert and ready to respond.

“You just have no control over the messaging anymore once it gets into the public domain. And it’s there in seconds – potentially very large reputational risk.”

Traditionally, when the risk function has mapped its risks, the two axes have been about likelihood of the risk occurring, and the dollar impact, but preparedness to respond is now a critical element.

“A reputational risk can be only a small financial outcome but a disastrous reputation outcome. These are the things that good risk people are able to bring some clarity to,” says Sally Herman, a non-executive director at Suncorp Group Limited, Breville Group Limited, Premier Investment Limited and Evans Dixon Limited.

“Cyber risk is another new risk that can be on a company before it even knows it.”

“Take modern financial institutions: how long can they survive without being connected to the internet? Two, three hours? If all of a sudden all your apps stop working and your customers can’t get in, it could be a modern-day ‘run’.”

“That is a very big risk,” says Stephen Allen, consultant at KPMG.

Data risk is another risk that has emerged to become a major consideration for the risk function. "One of the most interesting conversations we’ve had on one of my boards is about data risk: not cyber risk, but data in its own right,” says Herman.

“Just some key questions along the lines of who owns our data, where is it held, how old is it. There are all sorts of interesting conversations, where people who aren’t normally interested in risk say ‘Oh gosh, I had better get involved in that’,” says Herman.

"You want to look per sector and see what drives each of the individual sectors.”

Thomas Reif, State Street Global Advisors portfolio analyst

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"Bearing this in mind, SSGA has built an ‘R’ or responsibility factor into its metrics, which is designed to focus on the financial material factors of a company in respect of its ‘E’ score. To work out the score, SSGA first looks at how financial material environmental and social issues are that ‘we believe are statistically relevant you want to have more than 10 years’ worth of data.”

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Social condition of firms vital to success

risks are considered intangible and difficult to measure and quantify. Bearing this in mind, the Actuaries Institute paper proposes companies undertake an annual social condition report broadly modelled on the mandatory financial condition report – a report that is highly valued by insurance companies and APRA because it provides a comprehensive view of the financial dynamics of complex businesses.

The social condition report (SCR) could be valuable for banks, ASX and APRA because of the insights it will provide into the quality of the relationships with society, and the risks to those relationships.

Bernau says the first part of the report would be about measuring relationships. “You can start one relationship at a time. It might be with the customers, or a group of customers, or it might be your internal relationships. “The point is to get a better understanding of them, measuring them and managing them.”

“If you get really good at understanding the social risks, or relationship risks, then you would of course report on it comprehensively.”

“Two’s a step process. Step one is mapping out all your different stakeholder groups, and understanding how significant each of those groups is to your business. Then you most rank them and divide each group in terms of their strategic significance to your business and then measure the risk they pose,” Bernau says.

For Bernau, these risks apply to any business that has significant value in its intangible assets and relationships, which is the case for most companies.

And like the financial condition report, Bernau says the SCR should be presented directly to the board in an unfiltered and independent way so the board has impartial reporting around the state of the organisation’s social capital and social risks.

“Importantly, it’s just good hard-headed business to understand your social capital and it will generate a financial return if you do it right.”

He says Australian businesses are lagging behind in coming to factoring in social risk factors and it is something his co-author Ian Laughlin noticed at APRA where social risks are not featured in risk frameworks.

Bernau believes this might be because Australian business is too focused on short-term profit. He says his company measured the social capital in the big four banks over the last few years and their conclusion was they had lost almost all of their social capital in the last three years.

Moreover, this loss of social capital can be factored into their market capitalisation over the same period as the short term does not illustrate the whole picture.

Bernau says in the good times, a bank’s total value for example is made up of about 40 per cent financial capital, about 20 per cent in human and intellectual capital, and 40 per cent in social capital.

Comparing the good times of three years ago to now, Bernau says the banks have lost 30 to 40 per cent of their value “but they didn’t lose any financial capital, they didn’t lose any of their human or intellectual capital, so it must have come out of their social capital.”

Distant relationships affecting social capital more than bad conduct.
Helyn Bernau, Finsbury Consulting

Interestingly, he does not attribute this fall in social capital to perceived corporate malfeasance because their “conduct and behaviours didn’t suddenly drop off a cliff.”

“I think it’s more like that their stakeholder relationships have become a lot more distant.”

He suggests technology such as artificial intelligence, machine learning and the growth of call centres has put more distance between banks and their stakeholders.

The upshot is people are less forgiving because there is not a personal edge to relationships with banks anymore. “When you’ve got a close relationship with a customer and you make a mistake or something goes wrong, the customer might even overlook it, understand these things happen, or they’ll work through it and solve it with you together. But when it’s a distant relationship, you’re much less likely to understand, you’re more likely to point the finger and think badly of them.”

“I think the rise of distant relationships is affecting social capital more than bad conduct because conduct hasn’t got much worse.”

Furthermore, Bernau says the huge focus on “customer centricity” is also affecting social capital across business because it often means neglecting other stakeholders such as service providers, suppliers, regulators and even the media.

“We’ve had a period of shareholders’ primacy and shareholder focus and we’re now in a period of customer primacy and customer focus but the more mature approach would be to just consider all the stakeholders,” Bernau concludes.

Trade disputes between the United States and China, if they continue, could slow the global economy. PHOTO AP

Macro factors can act as handbrake on markets

Economy
Lydia Maguire

The continued tough talk emanating from China and the United States around trade is just one of the major risks currently affecting business as handbrake on global markets.

Adding to the trade tensions between the world’s two largest economies is the continuing kerfuffle around Brexit and the United States’ muscle-flexing with Iran. Throw in the disparate reactions to climate change and the added threat of technological disruption and the risks to a slowing global economy appear challenging.

Yet while in the past, business has always been able to navigate around most risks because individual businesses have known it.”

Beyond the US-China divide, it would seem the consensus around global free trade is weakening in a number of countries and with it, disruption to global supply chains. Bearing this in mind, the head of global strategy at Aberdeen Standard Investments, Andrew Milligan, says we are looking at a period where “a higher political premium must be priced into the outlook for corporate earnings.”

Closer to home, Australian business also identified big political risks as a growing concern according to results from the 2019 Allianz Risk Barometer, based on the insights of 2415 risk experts across 86 countries, including Australia.

Looking at Australia, the top risk nominated was changes in legislation and regulation incorporating everything from trade wars to the dismantling of the Eurozone. Thirty-six per cent of respondents rated it as the No.1 risk in 2019, with business interruption such as supply chain disruption ranked second and cyber incidents third.

Last year’s No.1 risk was a potential cyber incident and while it had moved down in the rankings, it is still a major concern for Australian businesses with 61 per cent of Australian respondents citing cyber incidents as the cause of business interruption they fear the most.

Furthermore, sentiment around the impact of “new technologies”, which ranks as the fifth-highest business risk in Australia for 2019, is seen as a double-edged sword.

When asked which new technologies are the most useful or valuable for a company, the top answer by Australiаn respondents (60 per cent) was artificial intelligence.

Yet when asked which new technologies pose the greatest risk on a business, Australians again answered with AI (66 per cent).

Speaking on the release of the report, CEO of Allianz Global Corporate & Specialty Pacific, Willem Van Vlyk, said the increased pace of change; both in terms of legislation, regulation, market disruption and new technologies, is heavily influencing business risk concerns within the Australian market.