ALEXANDER PROUDFOOT

people • productivity • profitability

Risk Management

Taking the lead

The harsh reality is a potentially long lasting impact
on both financial health and reputation.

Manufacturer facing a product recall issues
Food company with a product contamination issue
Financial Services organisation challenged by a disgruntled rogue employee
Telecom company failing to respond swiftly to emerging trends in the market

Risk management: Taking the lead

History shows how the failure to adequately assess and handle risk leaves not only market reputation in tatters and stock prices under intense pressure but worst still in certain instances, has led to the ultimate collapse of the company affected.

In the aftermath of a series of high profile corporate crises, chief executives know they need to act. However many remain unclear on the details of a revamped policy, and their own role within it. So what should they do to take the lead in changing the risk management culture within their organisation?

Immediately after becoming CEO of BP in October 2010, Bob Dudley announced the establishment of a new Safety and Operational Risk function with full authority to oversee all aspects of the company's technical activities throughout the world.

With this sweeping organisational change, Dudley was signalling to investors and the media that BP had learned from the mistakes that caused the Deepwater Horizon disaster. After the whirlwind of criticism directed at his predecessor, Tony Hayward, in the aftermath of the disaster, Dudley was making a clear statement that here was a CEO firmly in control, someone who knew exactly what needed to be done.

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>
> Lothar Riedle, Alexander Proudfoot

Dudley's decisiveness about his risk management strategy, however, is worryingly untypical. Many CEOs appear to have a contradictory approach. On the one hand, the PricewaterhouseCoopers Global CEO survey revealed that more are planning a "major change" to this area than any other aspect of the corporate agenda. On the other hand, many have appeared to baulk at active personal intervention. In a Deloitte review of S&P 500 proxy statements from 2009, only 22 per cent of companies cited that their CEO had any involvement or responsibility for risk management.

With corporate risk such a prominent issue for regulators and, increasingly, for shareholders, such lack of attention is simply unsustainable: "If the CEO is neglecting risk, he is overlooking one of his most pressing responsibilities," says Lothar Riedle, risk management expert at Alexander Proudfoot, and a former senior executive in the insurance industry. "Just like an insurer, each company has a duty to calculate its total risk exposure and ensure that it has sufficient capital to cover it."

Filling the vacuum

If CEOs are genuinely serious about the need for change, there are three ways in which they must now start to use their authority to forge progress. First, they need to oversee a renewed and transparent definition and allocation of responsibilities for risk management within the organisation. Second, they should strive to communicate, through words and action, about the importance of risk management and how corporate culture needs to change. Third, they must thoroughly prepare their own response as leader, and the organisation's emergency procedures, should a potentially disastrous event befall the company.

Management systems need to be watertight, all supervisors should know exactly what the company expects of them, and all employees must be properly trained in what they need to do.

Bruce Slatton, Alexander Proudfoot

In a large company, the psychological phenomenon of "the bystander effect", where individuals opt to withhold their contribution if they feel there are plenty of others with the matter in hand, can allow many unseen risks to fester in the cracks. Indeed, an army of regulators and internal managers failed to warn of the inherent dangers in the financial system that eventually led to the global economic crisis in 2008. The need for crystal clear accountability is paramount.

As a result of the crisis, the position of Chief Risk Officer (CRO) is growing rapidly in popularity within the finance sector. According to a Grant Thornton and Bank Director survey from 2010, 71% of publicly listed financial institutions in the United States now have a CRO, up from 40% just three years ago.

By contrast, a Conference Board study of 2010 proxy statements by leading US non-financial companies showed that only 12% had a CRO. However, the appeal of a dedicated senior executive focused only on the constant identification, measurement and management of risk is now also likely to spiral in non-financial companies in tandem with the evident impetus for a major change in approach.

Additional layers of security can be provided by making one individual accountable for each major identified risk, and appointing an independent risk brainstorming team that reports regularly to the board. This team would seek to pinpoint previously undiscovered or unarticulated risks, and might include representatives from suppliers and customers and independent-minded personalities within the organisation.

However, delegation to specialists should not invite abrogation of responsibility. Warren Buffett wrote to his shareholders in 2010, "a CEO must not delegate risk control. It's simply too important…If Berkshire ever gets in trouble, it will be my fault. It will not be because of misjudgements made by a risk committee or chief risk officer."

Similarly, although the risk management function performs an influential advisory role, tracking legal and regulatory changes and other relevant developments outside the company, individual business units must retain ultimate responsibility for the management of their own risks. After reporting these risks to the CRO, company management can then decide whether to mitigate them, absorb them or transfer them to insurers.

Fronting up to risk

Complacent attitudes to risk are commonplace. "The longer individual employees are exposed to risk on a daily basis, they become desensitised," explains Lothar Riedle. "A catastrophic event hasn't happened on my watch before, they think, so why should it happen now?

CEOs must take the lead in the attempt to resensitise the organisation to risk, stating regularly what needs to change, why this is necessary, and how it will be done. "The CEO has to communicate exactly how, in practical terms, the culture of risk-awareness will be embedded throughout the organisation," says Bruce Slatton, Senior Vice-President at Alexander Proudfoot, who has held several senior executive positions in the construction industry. "Management systems need to be watertight, all supervisors should know exactly what the company expects of them, and all employees must be properly trained in what they need to do."

But perhaps the most important contribution of the CEO comes when all the brainstorming, models and safeguards prove in vain, and a crisis erupts.

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Risk management:
Seven priorities for the chief executive

1. Planning: Formulate a clearly defined disaster plan.
2. People: Appoint a management team to run the disaster plan, clearly distinguishing between this team and the team responsible for 'business as usual'.
3. Transparency: Assume the lead in establishing transparent individual roles and responsibilities for risk management throughout the organisation, including within these teams.
4. Preparation: Set up another team to brainstorm risks that the organisation has not yet prepared for. Rehearse regularly for a broad variety of disaster scenarios.
5. Active management: Ensure all levels of management, right down to supervisor, are involved and actively managing their teams so that everyone understands who does what, by when and who is managing that process.
6. Measurement: Establish a system to measure and monitor risk management performance to provide the required visibility for executives.
7. Communication: Communicate repeatedly to the organisation the need to change the risk management culture, and how exactly this will be achieved.

An Oxford Executive Research Briefing from 1997 found that the stock price of major public companies that mishandled crises plummeted an average of 15 per cent over the first year, whereas those with an effective response actually saw an increase of 7 per cent from their pre-crisis price.

With the scrutiny of the internet and 24-hours television news coverage, the average negative impact of perceived mishandling is now even more devastating, and is certainly not a risk that can be transferred to insurers. After the 2010 recall of millions of Toyota cars prompted by faulty accelerator pedals, the company's share price tumbled 16% amid criticism that the company's admission of responsibility had been half-hearted and that its plan to regain control was weak and confused.

Regular rehearsal exercises for a variety of disaster scenarios should be undertaken by the CEO and the board. What crisis management experts call the "golden hour" is crucial. The company needs to seize immediate control of the narrative before a voracious media wrests it from them.

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Johnson & Johnson's efficient handling of the Tylenol contamination case in 1982 is often held as a classic example of how companies should act in a moment of crisis. Other, more recent, examples abound.

In 2004, the CEO of McDonald's, James Cantalupo, died suddenly of a heart attack while leading the company's move away from a fat-rich menu to more healthy alternatives. The clear irony made the company vulnerable to negative reporting. But the company grasped the moment, with the announcement of a new CEO within hours of their notification of Cantalupo's death. Rather than pursuing a negative slant, media and analysts concentrated on the future potential of the company under new leadership, and the share price quickly recovered.

Mattel, the toy manufacturer, recalled several million items in 2007 because of lead paint or magnets that could be swallowed and cause serious injury. Straight after the recall announcement, and sticking to the details of its comprehensive disaster plan, a 16-strong public relations team was set to work. In one day, CEO Robert Eckert appeared in 14 television interviews, and that week the company responded to 300 media enquiries in the US alone.

"I thought it was important for us to be transparent, to provide information openly and quickly," Eckart said. "The alternative is to stick your head in the sand and hope it goes away. And it doesn't."

In difficult economic circumstances, and with competition intensifying in many industries, CEOs can be understandably preoccupied with the quest for innovation and expansion in new markets. Perhaps, indeed, this pressure best explains the apparent inaction of many on risk management, despite claiming to realise how important the issue is. It is hard to prioritise strategy towards highly unlikely events in the future, when demands for constant growth are so unrelenting.

But, again, this is no excuse for inaction. Lax CEOs and their management teams urgently need to reorient their everyday mindset to achieve that necessary balance between opportunity and risk. Or, an alternative approach, for those wishing to reduce risk, remains to partner with an objective third party to establish powerful, meaningful and dynamic risk management processes.

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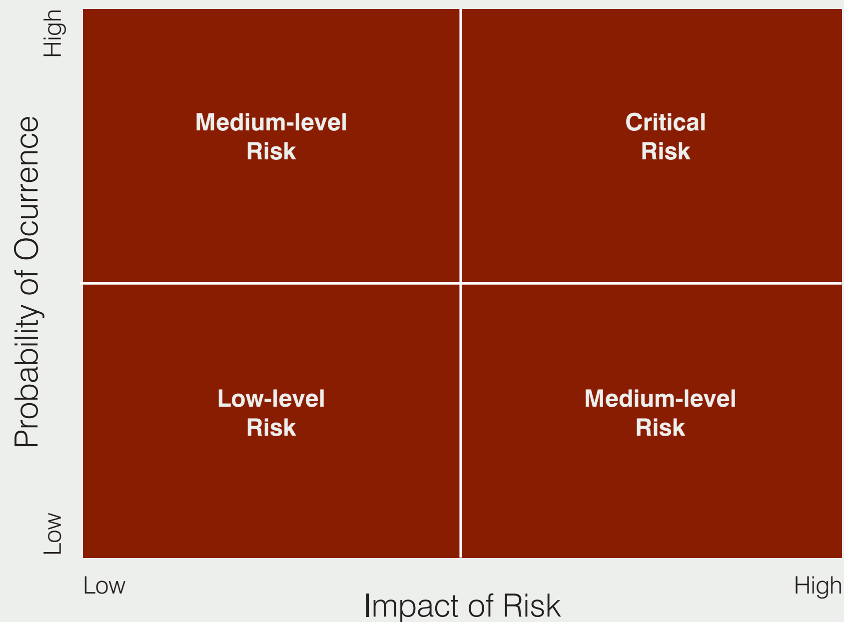

As a responsible manager, you need to be aware of these risks. Does this mean that you should try to address each and every risk that your project might face? Probably not – in all but the most critical environments, this can be much too expensive, both in time and resources.

Instead, you need to prioritize risks. If you do this effectively, you can focus the majority of your time and effort on the most important risks.

The corners of the chart have these characteristics:

Low impact/Low probability – Risks in the bottom left corner are low level, and you can often ignore them.

Low impact/High probability – Risks in the top left corner are of moderate importance – if these things happen, you can cope with them and move on. However, you should try to reduce the likelihood that they'll occur.

High impact/Low probability – Risks in the bottom right corner are of high importance if they do occur, but they're very unlikely to happen. For these, however, you should do what you can to reduce the impact they'll have if they do occur, and you should have contingency plans in place just in case they do.

High impact/High probability – Risks towards the top right corner are of critical importance. These are your top priorities, and are risks that you must pay close attention to.

Tip 1:
High-probability/high-impact risks are the most critical, and you should put a great deal of effort into managing these. The low-probability/high-impact risks and high-probability/low-impact risks are next in priority, though you may want to adopt different strategies for each. Low-probability/low-impact risks can often be ignored.

Tip 2:
In some industries, you need to pay close attention to even very unlikely risks, where these risks involve injury or loss of human life, for example. Make sure you pay due attention to these risks.

A fresh look from an objective pair of eyes

Daily exposure to risk makes numb. An external review of an organisation can spot those elements that are missed as a product of repetition. An open manhole that never gets covered will be constantly skipped or jumped over, until someone not paying attention misses it. It's in the very human nature to get used to things and take them as normal. Interestingly, these issues don't go unoticed to a trained external eye dedicated to review risks and to address them.

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Alexander Proudfoot's impact

Our business is disciplined execution to enable you to achieve your growth targets, revenue goals, and profit goals with greater speed, predictability, and control.

Through our methodology, we address processes, behaviours and management systems, which identifies and reduces the chances of risk spiraling out of control.

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