Thinkpiece

1912–2012 A CENTURY OF PROFESSIONALISM

CII

Number 95 May 2013

INDEPENDENTLY PROMOTING DEBATE AND FRESH THINKING IN THE FINANCIAL SERVICES INDUSTRY

# Supporting Strategic Objectives or Another Compliance Exercise? Understanding Corporate Risk Culture in Insurance

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## Summary


- Much attention has been paid to problems of culture within financial organisations, and to 'risk culture' in particular. Both financial institutions and their regulators remain unsure about what risk culture is, or how to manage it effectively.
- This article summarises the preliminary findings of a major London School of Economics/University of Plymouth research project into risk culture, part funded by the CII. It aims to understand what financial organisations are actually doing about risk culture and why, and the practical challenges they are facing and how these might be overcome.
- Preliminary practitioner interviews suggest the presence of work streams and change programmes around the risk culture theme, but little consensus about what this means or how best to manage it. There was a strong focus on improving risk information infrastructure and reporting.
- CII member survey research points to three broad trends: most firms have a risk culture programme under way; these programmes were largely driven by regulatory initiatives such as Solvency II; there was limited evidence of drivers that were not related to compliance, such as error reduction, external disclosure and quality improvement. Overall, firms appear to be becoming more conservative and risk management/culture programmes are intensifying this trend.
- Survey results suggest that in terms of drivers, risk management is viewed as a hygiene activity to deal with negative outcomes, or to handle what is required by regulators. It is not seen as a means of creating potentially profitable opportunities; this is regarded as a secondary concern.
- Overall, the survey of CII members suggests that risk culture change programmes and risk management practices are both directed at regulation. Risk management is primarily viewed as a compliance exercise, rather than something to help firms achieve core strategic objectives.


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***CII Introduction: Risk culture has emerged as something of a hot topic since the banking crisis, resulting in major regulatory initiatives across financial services, such as Solvency II in insurance. It would seem that, for the insurance sector especially, risk culture and risk management has become a major compliance activity. But is this where corporate risk management should reside? The CII joined several other organisations in supporting a major research project by the London School of Economics and the University of Plymouth to better understand the drivers and practices of risk culture in the insurance sector. This Thinkpiece looks at some preliminary findings from a CII member survey, and draws some conclusions on how the trends are forming.***

In the search for lessons from the financial crisis, much attention has been paid to problems of culture within financial organisations, and to 'risk culture' in particular. Since the crisis, numerous reports identifying a range of cultural issues have been written. These include the recent (April 2013) Parliamentary Commission on Banking Standards report on HBOS, which placed a 'corrosive' culture of aggressive asset growth and excessive risk-taking at the heart of the bank's failure in 2008. Moreover, with the near simultaneous publication of Anthony Salz's report on Barclays' culture, governance and risk management activities in the light of the 2012 LIBOR scandal, it would seem that there remain lessons to learn.

***For all the post-mortems into the financial crisis, as well as more recent crises such as the LIBOR scandal, it is apparent that both financial institutions and their regulators remain unsure about what risk culture is, or how to manage it effectively.***

For all the post-mortems into the financial crisis, as well as more recent crises such as the LIBOR scandal, it is apparent that both financial institutions and their regulators remain unsure about what risk culture is, or how to manage it effectively. Put simply, 'risk culture' can be understood as the culture of risk-taking and control in an organisation. However, it remains a complex thing that is difficult to define precisely. As Salz states, "No matter how hard one tries to articulate what a culture is or is not, words rarely seem enough."[1]

Despite the vagaries of the concept of risk culture, financial organisations, including insurers, are spending significant sums trying to understand and manage their risk cultures. Regulators, such as the new Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA), both of which recently succeeded the Financial Services Authority (FSA), are eager to incorporate assessments of risk culture into their supervisory activities. However, very little of substance has been written on the topic to date, except for a helpful overview of the issues by The Institute of Risk Management in 2012. Our research aims to probe deeper, in an attempt to understand what financial organisations are actually doing about risk culture and why. Our purpose is to shed light on the practical challenges to be faced and how they might be overcome.

## Risk Culture in Financial Organisations

In this paper, we report some preliminary findings from our research on risk culture. The project began in May 2012 and is funded by several bodies, including the CII, to whose members we are extremely grateful.[2] In November 2012, we published an interim report based on desk work and initial interviews with senior risk leaders in nine institutions—a mix of banks and insurers.[3] We expect to publish our final report in September 2013.

During our preliminary interviews, we observed an abundance of experimentation in the form of 'risk culture' work streams and change programmes.

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[1] Anthony Salz, *Salz Review: an Independent Report on Barclays' Business Practices*, April 2013, p.181. www.salzreview.co.uk [accessed May 2013].

[2] This major research project is joint funded by the Economic & Social Research Council, Lighthill Risk Network, The Chartered Institute of Management Accountants and the CII. The latter two bodies also supported the project with membership research. The CII additionally hosted a member event on 8 November to launch and discuss the preliminary findings.

[3] Simon Ashby, Tommaso Palermo and Michael Power, *Risk Culture in Financial Organisations: An Interim Report*, Plymouth and London: Centre for Analysis of Risk and Regulation, Plymouth University & London School of Economics, November 2012. www2.lse.ac.uk/researchAndExpertise/units/CARR/pdf/Risk-culture-interim-report.pdf.

Surprisingly, we witnessed little consensus about what risk culture really means, or how best to manage it. However, we did see a strong focus on improving risk information infrastructure and the importance of reporting mechanisms. The aim is to help improve the communication of risk issues, and to overcome the problems of disparate organisations and the emergence of potentially destructive risk sub-cultures, as may have been the case at Barclays.

***A big question in our study going forward is whether regulation affects risk cultures in unintended ways, with potentially negative effects on risk aversion and risk-taking.***

Our initial interviewees also noted that risk cultures pose unique problems of documentation and evidence. In one organisation, those interviewed felt comfortable that the risk culture was good, but emphasised it was "hard to demonstrate", especially for committees that tended to be highly "action-oriented". One Chief Risk Officer confirmed that the organisation was "not good at writing things down and on process and formality." In another organisation, it was argued that Solvency II documentation requirements were substantively affecting underwriting decisions, i.e. making underwriters more risk-averse. One interviewee, quoted in our interim report, said: "It's bureaucracy gone mad and is destroying the culture we have. The pressure on individuals is phenomenal and has a negative impact on morale. They don't blame the company, but just looking at what was being asked of them, it was very clear it has limited real value to us or the regulator."

From this point of view, a big question in our study going forward is whether regulation affects risk cultures in unintended ways, with potentially negative effects on risk aversion and risk-taking. Since November 2012, we have continued to gather data and conducted a survey with the members of the Chartered Insurance Institute. We received 2,258 responses to an online questionnaire completed between November and December 2012.

In a previous CII article, we drew on our survey data to illustrate the characteristics and drivers of risk culture programmes.[4] This revealed that:

- More than 60% of the CII respondents claimed to have some kind of risk culture change programme going on in their organisations. As expected, the results show that the larger the organisation the more likely it was that they would embark on a risk culture initiative.
- In line with our earlier interviews, we noted from the survey results that regulatory requirements (e.g. Solvency II) were a key driver for risk culture initiatives. Many organisations were looking to change their risk culture to achieve compliance benefits such favourable FSA (now FCA) supervisory assessments.
- There were also a number of non-compliance related drivers, including performance improvements (e.g. error reduction) and enhancements to the quality of external disclosures (e.g. the quality of risk management information in annual reports). However, these were significantly less important.

***In short, it would seem that organisations are becoming more conservative and that risk management in general, as well as risk culture change programmes, are intensifying this trend.***

In this article, we develop our analysis of the CII survey data to provide further evidence about the risk cultures of financial organisations. We use this data to show how compliance activities and regulation represent a major driver for risk management activities in general. and not just risk culture change programmes. We also show that these compliance activities and regulations may be affecting the risk aversion of workers in the financial sector, promoting a culture of low risk-taking at the potential expense of achieving adequate returns. In short, it would seem that organisations are becoming more conservative and that risk management in general, as well as risk culture change programmes, are intensifying this trend.

[4] "What is driving risk culture change?" by Simon Ashby, Tommaso Palermo, and Michael Power, *The Journal*, April/May 2013, pp.20-21.

## Motives for risk management activities

We looked at the primary motives for risk management activities and found that the main focus of risk management activities appears to be on addressing existing regulations. Using risk management to grasp opportunities, or avoid negative outcomes, is perceived as less relevant. These findings are summarised in Table 1 below.

**Table 1: Risk Management Drivers**
(Mean scores: 1 = Strongly Disagree; 7 = Strongly Agree)

| In my area of responsibility, risk management activities are… | …directed to avoid negative consequences | …driven by business opportunities | …implemented in response to regulatory requirements |
|---|---|---|---|
| Senior management | 5.5 | 5.1 | 5.6 |
| Sales | 5.1 | 5.2 | 5.5 |
| Underwriting | 5.1 | 5.0 | 5.4 |
| Compliance | 5.2 | 4.8 | 5.8 |
| Risk management | 5.5 | 4.6 | 5.3 |
| **All respondents** | **5.2** | **4.9** | **5.4** |

Source: on-line CII member survey Nov–Dec 2012.

We also observed that this view is shared by respondents from a variety of different roles. In Table 1, the following roles are considered as indicative examples: senior management, sales, underwriting and compliance. The only exception is risk management staff, who favour the use of risk management to help avoid losses. Moreover, in all cases, regulatory compliance is favoured as a motive over the exploitation of opportunities. So it would seem that even risk managers view risk management as a hygiene activity, one to help deal with negative outcomes, or one that is 'forced' upon the organisation by regulators; the proactive management of risk in order to create potentially profitable opportunities is seen as a secondary concern.

We investigated the practices used to manage risk. Audits, inspections and similar activities play a more central role than practices that help envision future business scenarios and grasp new opportunities (see Table 2); a finding that reinforces the perceived role of risk management as a compliance and loss reduction tool. This trend is again confirmed across different categories of respondents, although 'compliance' and 'risk management' staff stress the relevance of risk registers and other types of written reports about risks. Meanwhile, senior people appear more open to the use of scenario type analyses. This suggests that, as might be expected, senior management more often operate in cultures where risk management is viewed as a tool for strategic decision making.

**Table 2: Use of Risk Management Practices**
(Mean scores: 1 = Strongly Disagree; 7 = Strongly Agree)

| In my area of responsibility, the following practices are used to identify, assess or monitor risk… | …brainstorm'g scenario analysis, SWOT analysis | …risk registers or other types of written reports | …audits, inspections, incident investigations |
|---|---|---|---|
| Senior Management | 5.4 | 5.5 | 5.8 |
| Sales | 4.8 | 4.9 | 5.5 |
| Underwriting | 4.7 | 5.2 | 5.7 |
| Compliance | 4.5 | 5.9 | 5.9 |
| Risk management | 4.9 | 5.6 | 5.6 |
| **All respondents** | **4.7** | **5.1** | **5.6** |

Source: on-line CII member survey Nov–Dec 2012.

***It would seem that even risk managers view risk management as a hygiene activity, one to help deal with negative outcomes, or one that is 'forced' upon the organisation by regulators; whereas potentially profitable opportunities are being seen as a secondary concern***

The finding that risk management is primarily motivated by regulation and compliance contrasts with the fact that, on average, respondents do not spend most of their working time on compliance-related activities only. Figure 1 shows that, with the obvious exception of the compliance function, respondents spend on average more time discussing future scenarios, business opportunities and alternative strategies ("business opportunities") than addressing regulatory requirements and working on compliance processes ("compliance"). Even 'risk management' staff spend, on average, almost an equal amount of time in compliance and business scenario type of work.

**Figure 1: Working Time by Respondent Level**
(Percentage of working time: 1 = 0%; 7 = 90%+)

Source: on-line CII member survey Nov–Dec 2012.

In summary, based on our CII members' survey, it would seem that not only risk culture change programmes, but also risk management practices in general, are directed at regulation. This means that risk management is primarily viewed as a compliance exercise, not something that helps organisations to achieve their core strategic objectives. The discussion of future business scenarios and implementation of alternative strategies, activities that occupy a not insignificant portion of managerial working time, happen instead through different channels.

We also appear to have observed a disconnect, especially between senior managers and risk management/compliance staff, in relation to the role of risk management. Although all groups emphasised the importance of regulatory drivers for risk management, senior business managers perceived a greater relevance for risk management activities devoted to the achievement of business opportunities (e.g. scenario based analyses). This implies that senior managers have a more optimistic view of the capabilities of risk management than risk management staff.

## Effects on risk-taking

Our findings suggest that the dominant risk culture indicated by the survey participants is one of precaution, with a focus on documentation and compliance, rather than managing risk for business benefit. Such a culture might well seem to be desirable in the light of the financial crisis and more recent scandals. However, we are concerned that such cultural attributes can have potentially dysfunctional effects on risk-taking, where taking too little risk can have the same bankrupting effects as taking too much. The difference in the case of insufficient risk-taking is that the end may come more slowly, as the organisation struggles to generate sufficient profits to achieve its business objectives.

***We are concerned that such cultural attributes can have potentially dysfunctional effects on risk-taking, where taking too little risk can have the same bankrupting effects as taking too much.***

This precautionary culture is further demonstrated by Table 3, where it would appear that CII members work for organisations that emphasise compliance (e.g. procedural checks and controls, compliance with standards, certifications, and regulatory demands) over risk-taking (e.g. employees do not hesitate to take risks, risk-taking has a positive effect on compensation, judicious risk-taking is recognised through awards). This is especially surprising in the insurance industry, where insurers exist to take the financial risks of other organisations and households onto their own balance sheets.

**Table 3: Compliance versus Risk-Taking**
(Mean scores: 1 = Strongly Disagree; 7 = Strongly Agree)

| | "Compliance" | "Risk- taking" |
|---|---|---|
| Senior Management | 5.9 | 4.4 |
| Sales | 5.6 | 4.1 |
| Underwriting | 5.7 | 4.4 |
| Compliance | 6.0 | 4.2 |
| Risk management | 5.5 | 4.1 |
| **All respondents** | **5.7** | **4.2** |

Source: on-line CII member survey Nov–Dec 2012.

## Conclusions

Are financial organisations, especially insurance organisations, where the majority of our CII survey respondents work, placing too much emphasis on compliance and regulation and too little on risk taking? Is this leading to excessively risk averse organisations? Has the pendulum between risk taking and control swung too far towards control?

In terms of our research, it is too early to say for sure. This theme will be a major line of inquiry for our continuing project, where we are currently conducting in-depth case studies of selected participant organisations (two insurers and one bank). Our CII survey (plus a similar one for the Chartered Institute of Management Accountants – CIMA) will also prove of further value here, allowing us to compare these broader findings with the results of our case studies - each of which includes a survey where we have asked explicit questions about the level of risk-taking within these organisations. The early indications from one of these cases (an insurer) is that its staff are even more risk averse compared to the broader CII sample, the organisation being characterised by an excessive increase in policies and regulations.

We also need to perform further analysis of our CII survey, as well as the survey we circulated to CIMA members working in the financial services sector. This will provide further aggregate data about how risk culture is perceived and implemented in financial organisations. In addition, we intend to triangulate our findings by comparing the practices of financial organisations with organisations from two other sectors: an airline and an oil company.

So it is still too early to conclude whether insurance organisations are becoming overly risk averse and compliance orientated. Neither is it possible yet to make clear recommendations about how this trend might be reversed, if indeed it should be. In short, much more work and analysis remains to be done and we look forward to publishing our final report in September 2013.

***If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us:*** *thinkpiece@cii.co.uk* ***or by telephone: +44 (0)20 7417 4783.***

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Describes the many links between insurance and information technology in the UK. In his view, the UK's comparative advantage is intrinsically linked to industries like financial services building increasingly strong ties with research and development centres and universities which are at the frontiers of developing new technology.

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Dr Padmavathi of the Institute of Insurance & Risk Management in Hyderabad, India focuses on issues affecting its growth. In the process, she examines how the insurance industry could play a greater role in creating a sustainable and balanced approach to disaster risk management which, as her research shows, is one of the greatest issues facing the Indian economy going forward.

## CPD Reflective Questions

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### Learning Objectives

Having read this Thinkpiece, readers will be able to:

- Explain why an understanding of corporate risk management culture is important in the context of the financial crisis and the reforms stemming from it.
- Summarise the main drivers behind corporate risk management culture within insurance firms using evidence from recent survey research of industry practitioners.
- Discuss the potential implications of this merging risk management culture on the way insurance businesses approach various aspects of their business such as strategic planning and regulatory compliance.

### Reflective Questions

1. What is “risk management” and why is it important in any organisation? What is meant by “risk management culture”? Why is the examination of risk management culture so important in the wake of the financial crisis, the response to it by regulators? The authors cite the LIBOR scandal and the Salz Review of activities within Barclays Bank. Why do you think these developments that predominated investment banking are so important for the insurance sector?
2. The authors use interview and survey research to understand various aspects of risk management culture in the insurance sector. What do you think is the messages emerging from these findings? Do you think these findings are reflective of risk management culture in your organisation? Why do you think that Solvency II compliance and other regulatory initiatives such as the FCA’s *Firm Systematic Framework* are major drivers in many aspects of risk management culture?
3. The authors look at both risk management drivers (see for example Table 1 and the associated text) and practices (Table 2), and then examine the amount of working time spent on these things at different management levels (Figure 1). What observations can you make from comparing and contrasting these different findings? What are your own views on this based on your own exposure or experience in the sector? Would you concur with the authors’ assessments or do you think other factors are at play?

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