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Culture: Risk Appetite

Cultural

Companies must demonstrate values and beliefs to show employees the way forward.

by Neil Cantle

Insurance companies around the world are increasingly told they have to actively manage their cultures—specifically their risk cultures. Most companies probably have an intuitive sense that having a good culture is beneficial; it makes sense that doing business with the right ethic is likely to impress customers and regulators and therefore, somehow, lead to good overall performance. But proving the link between good culture and business success can be difficult, so many companies, if they are honest, probably treat the assessment of culture as an additional governance check rather than really treating it as an integral part of their business performance frameworks.

What is culture? For many, it represents some sense of "the way we do things around here." A crucial factor that is often missed is that it is not just about how one or two people act; it is the emergent property arising from how everyone acts. When we think about culture in the context of an organization, we need to think about how different groups involved in delivering the different aspects of company performance do their parts. Culture is therefore a result, something we can observe as an outcome. We cannot directly act on it or choose to have a good one, but have to influence our values and behaviors so when we observe the resulting culture, we see that it is what we wanted.

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The Role of Culture

What constitutes good culture? This is more complicated and to answer that we need to explore more deeply why culture actually matters and what role it plays in company performance.

There are a number of challenges that companies face in trying to think correctly about culture and its role. The first is that the way firms are often encouraged to think about control makes the purpose of culture unclear. Traditional management thinking would have us view our companies as machines, mechanical devices that can be monitored and brought back into line if they deviate from expected behavior. In such a company, culture arguably plays a "nice to have" role. Because everything can be controlled, it surely does not really matter what sort of culture the machine has. We simply force things to work the way we want by using our controls. Culture is really just something that the human resources department talks about during recruitment and what we tell our customers in marketing messages.

But companies are not like those simple machines. They are complex ecosystems where people go about their daily tasks, interacting with countless others inside and outside the company. In the real world,

people are faced with situations every day that don't quite match the process manual description. In such circumstances, people will use their initiative and try to find a way through to a successful outcome. As soon as people deviate from the manual, their judgments will reflect their values, so the question is whether those values are consistent with the culture your board wants to see?

This introduces the next challenge. Companies don't have one culture; they are home to a number of interacting subcultures. While we might say that a company seems to exhibit some overall characteristics that describe a particular culture, it does not mean that any particular group of people in the company exhibit all of those traits. It is a kind of "average." Instead, each group will have its own subculture. Attempting to use a single cultural profile to describe all parts of the business almost certainly guarantees that many in the company will not recognize it as representing them. For each activity that the company carries out, a number of participants will be involved in making the process work. The nature of each person's contribution will be different and it is often necessary for different behaviors and attitudes to apply in order for a successful outcome to be delivered. For example, we would expect our marketing and design people to be much more unbounded and freethinking than the person with whom we are entrusting quality control or safety, where an eye for process and detail is clearly an advantage. We also expect some activities to require slavish adherence to the rules, whereas others inherently require more creative and reactive attitudes.

Each interaction moves the company forward a step at a time. The sequence of steps involves many players in different areas within the business and outside it. Some may not even know they are involved. And each step puts the company on an emerging path, one that leads to particular sets of possible outcomes, while making it impossible to reach others. So the choices we make are, in some way or another, determining the nature of the outcomes we can reach from this point on. Of course, everyone hopes their actions are reinforcing a journey along paths that ultimately lead the company to successfully meeting its objectives, but there is no guarantee.

Modifying Strictures

In a world such as this, the notion of control, therefore, requires modification. We can no longer deliver the outcome we want with certainty, but can only choose our next action. Of course, we would like to select an action that will help take the company toward a successful outcome, but we simply don't

Key Points

The Situation: Insurance companies often treat the assessment of culture as an additional governance check rather than treating it as an integral part of their business performance frameworks.

The Challenge: It's important to nurture a set of nested subcultures, which ensures that each business activity delivers successful outcomes.

The Outcome: Modern governance requires decentralized control, putting decisions into the hands of experts who are afforded a view of the big picture. The set of subcultures making up the overall company culture therefore becomes an integral part of the control framework.

know for sure which one that is. In the "company-as-machine" world, we constantly move performance back to the desired target by correcting actions back to the planned ones, but in this new world, where the plan is evolving in front of us, we need to be more nimble and responsive. We have to keep taking steps forward and constantly refresh our understanding of the ways in which actions combine to produce outcomes. We have to retain flexibility and learning as core skills, with the certain knowledge that things around us will not always go to plan.

In fact, in situations of complexity, where the environment is dynamic and changing, a model of centralized control is far from optimal and often leads to unintended outcomes. The more appropriate approach to guiding progress here turns out to be empowering local experts to make localized decisions, with the proviso that they are aware of what is happening in the wider overall context. Under these conditions, experts try to do the best they can for both the local and global situation, collectively leading to a good overall result.

Our business experts therefore have to judge which next step they should take, based upon their views about what everyone else will do, and how those collective actions will move the company along its path. Some actions will only lead to locally contained outcomes; others may have the potential to influence outcomes much farther away. By not forcing them to unswervingly follow a process manual, the experts can constantly reevaluate the likely consequences of their actions, and adapt.

Back to the Beginning

Now we return to culture. In an organization setup where we need to empower our experts to make local decisions in the best interests of the whole, we are much more concerned about whether their attitudes and behaviors are consistent with what we would like—we are trusting them to "do the right thing" rather than directly controlling what they do. Are they making decisions that expose the company to risks we would prefer to avoid? Are they being unnecessarily conservative about taking a particular action? In order for our people to make decisions in line with our risk appetite and corporate values, we need to achieve ways of working that produce cultures consistent with them. Of course, there will be some things we are so keen to avoid that we will implement very strict controls, making it hard to do the wrong thing, but we are largely going to be using our "cultural compass" to guide behaviors.

We have identified that we should nurture a set of nested subcultures, which ensures that each business activity delivers successful outcomes. And we have concluded that we should empower our experts to act locally, while keeping sight of the big picture. There is a further dimension to consider. We need to recognize that there is more than one valid perspective to be heard when deciding a course of action. Cultural Theory shows that four such views are always present: pragmatists believe that the world is uncertain and unpredictable; conservators believe the world is high risk; maximizers see the world as low risk and fundamentally self-correcting; and, managers know the world is risky, but believe it can be managed.

In conducting our work we want to ensure that each of these views is considered and debated, the surprising outcome being that the result of such a discussion is not a compromise, suboptimal for all, but rather will be a solution that actually works better for all parties. Creating a culture where this type of debate is acceptable is therefore an important, and often overlooked, part of the governance framework.

It turns out that culture is actually a much more important feature of our business than we might have thought—not just a nice-to-have after all, but actually an integral part of our control framework. When the board sets the risk appetite, it is establishing the tone for how business should be done. It must be clear what the objectives are and how you feel about the uncertainties associated with their delivery. By describing the types of risks that are to be actively sought, in return for a reward, those that are to be accepted and those that are to be avoided, the board is providing a set of guiding principles that staff can use when making its daily decisions about which actions to take next. In any situation, someone can ask: "Is this a risk we should be taking, and how much of it can we take?" Testing the likely consequences of the action against the risk appetite provides a way to move forward. The question also requires them to know what is going on more widely. Assuming the company has a finite appetite for risk, the answer to the "how much" part of the question requires you to know how much appetite has already been used elsewhere. This requires a culture that supports and promotes knowledge-sharing across department boundaries.

Modern business is now properly complex. You cannot control companies using a traditional command structure, because such an approach is focused on inputs, and it is virtually impossible to know what those inputs will lead to. Modern governance requires decentralized control, putting decisions into the hands of experts who are afforded a view of the big picture. The set of subcultures making up the overall company culture therefore becomes an integral part of the control framework. Getting it right will deliver efficiencies and an increased resilience that matters more and more if you want to succeed. BR