

Marionettes, or The Human Factor

Understanding the drivers of human behavior will help us manage risks better. People, after all, design the processes, build and implement the systems, and put in place the organizational structures that lead to risk taking. People engineer the products, establish networks of suppliers, and solicit the clients. Even when acts of God disrupt our affairs, people make the judgments and

How people behave creates risks. Our colleagues, customers, trading partners, and suppliers all contribute to the operational risks we must manage. How much risk these people can create depends on the uncertainties that they face, their capabilities, and their scope of action, which, in turn, depend on the specifics of their situations, training, roles and responsibilities, and the design of the organizations in which they operate. But it also depends on the people themselves and the incentives they face, their perceptions, their motives, and their resultant behaviors.

Biases About Risk

Individuals exhibit predictable biases, especially where risk is concerned. Empirical work shows that, in general, people prefer gambles when they feel “behind” and safety when they feel “ahead.” And then there are behavioral biases in human decision making that tend to increase risk: overconfidence in our own abilities; overoptimism about the future; overreliance on our own experiences; anchoring decisions around suggested solutions; following the herd for no good reason; and spending too much time on small decisions rather than large ones.

How these decision-making responses are rooted in our nature is something that evolutionary psychologists are exploring, while the effects they have on our behavior are the focus of behavioral economists. Amos Tversky and Daniel Kahneman, who developed Prospect Theory, did the seminal work in this field. The broad effect of their work is to remind us that the risk appetite of an institution may well be distorted by the biases of the individuals who comprise it, unless we correct for biases in the design of our organizations and incentives.

© 2004 by RMA. Jonathan Howitt is director of Operational Risk at Dresdner Kleinwort Wasserstein, London, UK; Michael Mainelli, FCCA, is executive chairman, Z/Yen Limited, London, UK; and Charles Taylor is director of Operational Risk Management at RMA—The Risk Management Association.

Masters of the Universe? in Operational Risk

by Jonathan Howitt, Michael Mainelli, and Charles Taylor

take the emergency actions that shape the outcome. Put very simply: We assume risk to make money and deliver value. Operational risk is our own creation. The implication is equally simple—when things go wrong, we have only ourselves to blame. Our misunderstanding, miscommunication, or, worse, our own misconduct cause failure. Understanding ourselves, both as individuals and as organizational people, is where we need to start.

Individuals and Groups

Some of the earliest theories of human behavior would have us believe that we are merely a set of innate reflexes. Like Pavlov's dogs, we respond to signals and can be socially conditioned or trained for specific tasks. Others have seen us as driven by basic subconscious desires but restrained by social norms.

These ideas give little credit to human self-awareness. We are a fundamentally self-determining (if biased) species and, once basic physical needs are met, our preferences are often about meeting social needs and raising our acceptance in the groups with which we live and work. We strive to raise our self-esteem and enhance our self-image, and this happens when a group we care

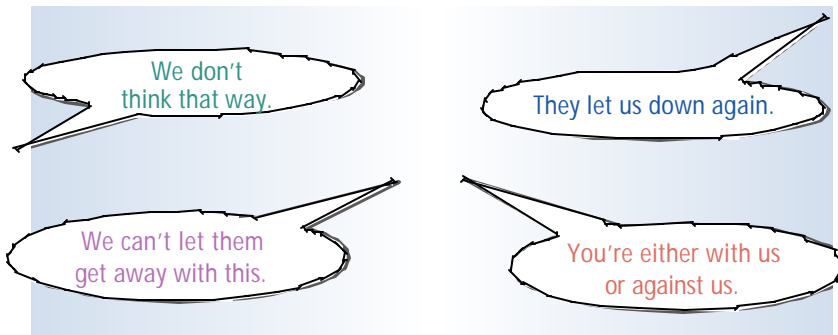
about somehow tells us we are doing better.

Group behavior develops as we label and categorize our experiences, forming shared assumptions and common language with others in the process. Our family, our school friends, and our first job have these effects on us. We assume roles that match our individual needs with the perceived expectations of the groups we are part of—to get ahead in some way. Through various means, these groups, large and small, define our behavioral norms, common value systems, and accepted culture as well as our rules of conduct, law, and social institutions. Groups end up almost defining who we are—where we fit, what we stand for, and what we try to do. Not for nothing is it said that

you know people by the company they keep.

So, much of our motivation for accepting or avoiding risk, or choosing a course of action in a risky situation, comes from our desire to raise our stature or to minimize any censure in the groups we care about. Our attitudes to these groups shape the operational risks we take and create.

1. Tribalism and the herd mentality. A group of people with similar perspectives and experiences often develops a tribal loyalty that increases their individual sense of belonging and the group's cohesion. By producing care and motivating integrity, loyalty can be of enormous value in managing operational risks—we



may recall the close-knit culture of a particular organization as something everyone could depend on in a crisis. But this same loyalty sometimes produces a “them and us” mentality: An external threat or sense of otherness becomes a symbol behind which the tribe unites. Back-office tribes and front-office tribes stop talking to one another, for example. So loyalty can come with a cost—an increased risk of poor communication and conflict with other groups.

The herd mentality is an extension of tribalism and represents social conditioning in a simple form—an innate reflex to follow the pack, to achieve safety in numbers. Sometimes it works. Empirical research suggests individuals are, in general, better at analytical choices than are groups, so there are many situations when a herd mentality will increase the risks an institution faces.

Tribalism that cuts across the boundaries of an institution—the brotherhood of bond traders, for example—dilutes the loyalties individuals feel toward their institution and so increases its risks. But tribalism may also impose codes of behavior essential for the marketplace to work, which reduce risk, so those brotherhoods have a good side, too. Likewise,

crowd behavior may have its place as a risk-avoidance strategy, but it is equally easy to be lulled into behaviors that create a great deal of risk—the recent lowering of ethical standards in Corporate America, for example.

The fact of the matter is that unrewarded loyalty must also be a source of risk for financial institutions today. Ours is an industry going through continual upheaval through globalization, mergers, and technological change. Loyal, hardworking people are all too often the victims. Institutions must not ask for more loyalty than they can deliver.

2. “Keeping face” and trust.

If identity derives from our perceived fit in society, then a loss of position or loss of face represents a kind of social isolation. “Keeping face” is a powerful behavioral driver, especially in close-knit cultures. If individuals believe they will lose face by escalating a problem, they may cover it up instead, whether or not it is their fault. This is because individuals may cover up something because they fear a loss of wealth or status for the group, not just for themselves.

This has important implications for operational risk: Establishing transparency and

ownership of problems is often the key to solving them. But in certain cultures, such clear accountability doesn’t exist, and problems will be addressed only if the group within which they arise takes collective responsibility.

Based on a mutual understanding of motives and roles, trust is about shared goals and a long-term, mutually beneficial relationship, that is, an implicit assumption of reciprocity—a favor given will be returned. By increasing trust, we can reduce risk through improved communication and reduced conflict.

But trust also can be a distorting factor in relationships and may sometimes actually increase risk. In situations of excessive trust, people may paper over issues and leave themselves vulnerable to being duped. The exclusion of outsiders can hurt an institution’s interests, as can clubbiness, back-scratching, and, of course, collusive activity.

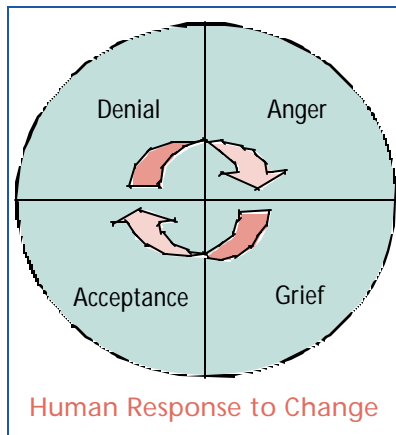
By affecting the relationship between individuals and groups, face and trust can create risk, change risk-taking behavior, and complicate risk management options. The desire to maintain both may generally increase care and integrity and thereby reduce operational risks, but their clear identification and management when they arise may be more difficult.

3. Turf and ownership.

Even the world’s least-evolved creatures know how to defend their territory. The human instinct to defend turf is well evolved and, although gregarious and sharing, we carefully define what is ours versus what is not, and our proto-

cols of possession and ownership are very well developed.

We need turf and ownership rules to function. Groups reward those who own and solve problems, but we can only solve problems with time and resources over which we have some ownership rights and some assured claim.



This imperative to defend one's turf against incursion is a major reason people resist change, and that, in fact, is something that can add to risk. Often threatening and uncertain and sometimes prolonged and demanding, organizational change can easily lead to stress, resistance, and even sabotage.

We are inherently skeptical about proposals that involve redrawing our boundaries—the sorts of things that happen in mergers and acquisitions, for example. Even change that is represented as thoroughly positive and win-win must overcome a built-in preference for the familiar: We know we can cope with the familiar, and we don't know whether we will be able to cope with whatever new challenges are coming our way.

This should influence how we design organizational change.

Involving people in execution and communicating the necessity and likely nature will reduce not only the number of snafus but also the risk of resistance and rejection. Managing these territorial imperatives can lower the risks of change.

4. Greed and fear. Greed and fear are very social impulses. People fear other people; they are greedy for what other people have. Fear causes people to join defensive alliances, and greed keeps people loyal to successful, offensive alliances. While these are primitive impulses and not to be encouraged unduly, they are powerful, and we regularly harness them in many social institutions.

So do they add to or subtract from risk? Greed can certainly encourage risk taking, if success is sufficiently rewarded, and fear can certainly hold risk taking in check, if failure is sufficiently punished. Unconstrained, risk takers can destroy an institution if they bet too much at one fell swoop; they also can wreak havoc if they lose a little and misrepresent it, then bet and lose again. Greed drives rogue traders, without a doubt. Hence the need for separation of duties, limits, authorizations, and controls.

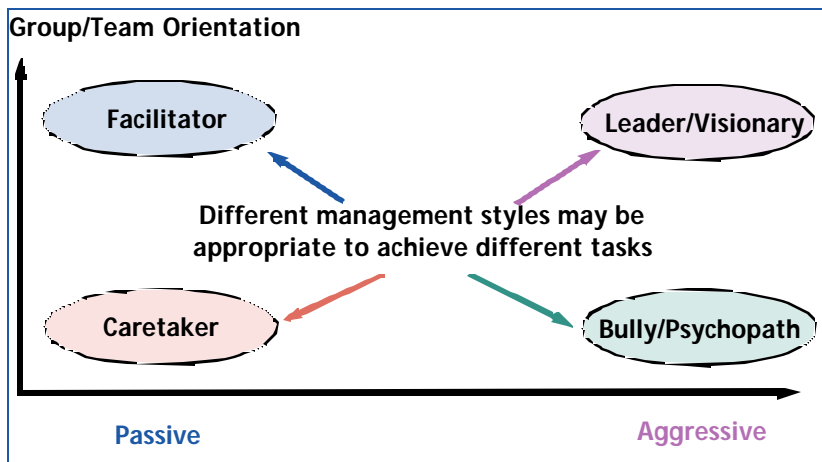
Controls can disguise poorly structured rewards and sanctions. Indeed, excessive controls carry risks themselves—of extreme bureaucratization, rising overhead

costs, and, ultimately, commercial failure. Institutions should decide on the right balance for themselves, taking account of their size and their culture and their need for nimbleness versus their need for stability. Greed and fear need harnessing as well as suppressing in the management of risk.

5. Power corrupts. Finally, there is the CEO whose role usually involves the greatest concentration of power in any organization. From this single fact, recent corporate history has shown amply that this is a very difficult role to execute well. Incumbents initiate, sponsor, order, and structure the activities of the rest of the group. They are vulnerable to challenge and in danger of isolation. When they make mistakes, the mistakes can be big ones.

Hence, the importance of good governance. No one needs the support of a well-ordered, experienced group of advisors and directors more than a CEO. Good governance is not really a part of organizational risk management per se, but it is its first cousin. It is, if you like, good operational risk management for a CEO. Similar concerns lie behind it; similar principles direct it. And, most certainly, good governance at the top is a prerequisite for good risk management at all levels below.





Lessons for Leadership

The best leaders have a flexible style—they know how to draw the most out of their team, whatever the situation. Sometimes this means taking a passive, facilitator role, and at other times with different teams it just means bullying people to get things done. Consciously or otherwise, managers set the standards for risk culture within a firm by the way they behave. Although it may be intuitive that the aggressive manager who creates a climate of fear exposes the firm to greater risk, the negligent caretaker-manager, paralyzed by indecision and failing to communicate, is also a source of risk. In this respect, risk is typically lower where group or team orientation is strongest.

Team orientation implies a mutual understanding within a group of the necessity and value of each person's contribution. It means more than just functional representation within a team; it means recognizing differences in individual skills between the creative versus administrative and the advisory versus delivery or decision-making inputs. Dysfunctional teams are typically dogged

by confused perceptions of roles and subsequent poor communication. Teams have to be structured with an appropriate balance and mix of roles, depending on the task they aim to fulfill. Project teams, for instance, require a broad mix of skills, usually organized in a flat "empowered" structure, whereas production tasks usually require narrower and more focused sets of skills, organized in a hierarchical and directive fashion. Choosing the right style and structure reduces operational risks. Choosing the wrong ones exacerbates them.

Lessons for Incentive-Setting

So how should we encourage appropriate behavior? What about a culture that rewards individual success with big bonuses? The premise behind this is that internal competition is healthy and risk taking is good, and that, in turn, can lead to quick decision making, a clear chain of command, and a results-oriented culture that is open to change. But such a star system is often divisive. Wasteful infighting can lead to high staff turnover. And it can be detrimental in the long term if

a big bonus culture leads to one-way bets—"If I win, I win big; if I lose, I leave"—that leave painful legacies for others to pick up.

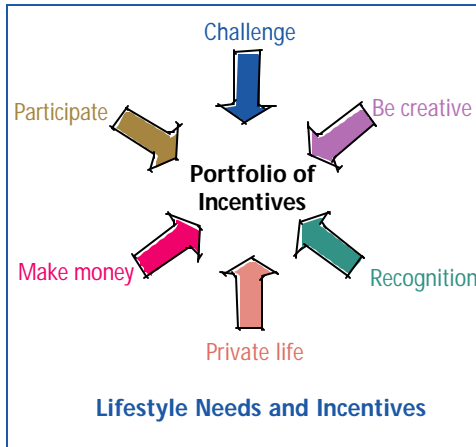
Stock and stock option plans seem to offer a better solution for setting wider team incentives. Recent abuse, though, has exposed many schemes as just another way for senior management to smuggle money out through the back door. The brouhaha over expensing options shows what a sacred cow they had become. Stock gains that are just average are not really earned.

Perhaps the first lesson of both bonus schemes and option plans is that badly designed incentive schemes can create large risks by affecting behavior in destructive ways. The second lesson is that financial remuneration is only a part of the story. Status, in fact, often matters more. Titles and position matter as much as money, and absolute remuneration is not so much the issue as relative compensation versus the peer group.

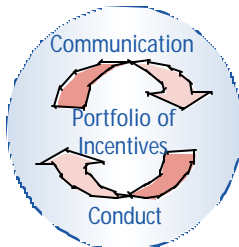
We have more resignations over job titles and promotions than over pay and bonuses.

Moreover, behavior is governed by different things at different points in people's lives. Ambitions and aspirations change. Companies attract and retain the best talent and instill the best behaviors by offering a portfolio of incentives, including such intangible benefits as the right work environment, job satisfaction, the chance for a worthwhile private life, and a career progression that respects people's needs to develop

professionally. Understanding and connecting individual incentives to



the groups they belong to will improve performance and reduce risk over time.



It’s not just the carrot, though. Sanctions and penalties for the wrong behavior need to be real and visible. The recent scandal around executive “rewards for failure” is understandable—the impression given from the apparent workings of compensation committees was one of institutionalized corruption.

So, if individual behavior creates risks, leadership and the full panoply of pecuniary and nonpecuniary incentives can shape behavior. Many of these incentives work by altering the relationship of individuals and the groups to which they belong and about which they care—whether it is their firm, their profession, their cadre of traders, or their local community. Choosing the right style of leadership and the right pattern of incentives to manage

operational risks for a particular team in a particular situation can go as far as, and maybe farther than, all of the measures, controls, and reports with which we normally preoccupy ourselves in the operational risk management profession. □

Contact Jonathan Howitt at Jonathan.Howitt@drkw.com; contact Michael Mainelli at michael_mainelli@zyen.com and contact Charles Taylor at ctaylor@rmahq.org.