Heidrick & Struggles

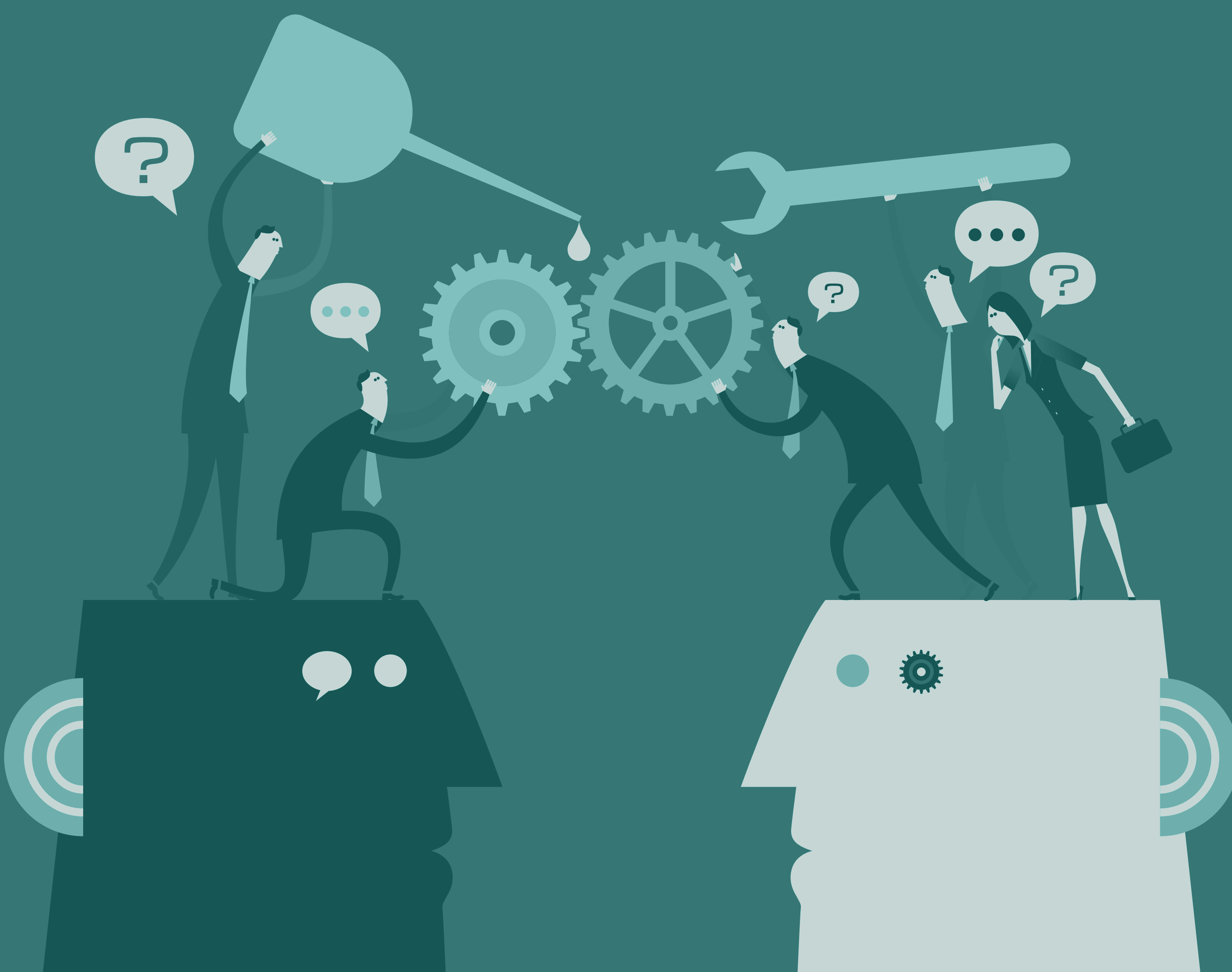
CONVERSATIONS WITH LEADERS

Operational risk is broken. What now?

Paul Gibson
New York

Mark Jackson
London

Craig Williams
Sydney



Operational risk is broken. **What now?**

Since the global financial crisis, operational risk failures globally have cost the financial services sector more than US$145.8bn.[1] While the industry has recognized that operational risk is broken, attempts to fix it have tended to take a conservative approach, recruiting risk officers from within the industry, and the impact on operational risk culture has been limited. To achieve the step change required, transforming mindsets and behaviors, financial services organizations must look outside the industry. Our conversations with global risk executives confirm the solution lies in recruiting leaders who will bring diversity of thought and challenge traditional assumptions around operational risk.

Time to look at the invisible

Financial services institutions are steeped in regulation. They have layers of legal, risk and compliance executives who oversee every aspect of their operations. Technology has also advanced to the point where almost everything that takes place is visible, often in real time.

The temptation now is for organizations to set up still more systems to keep watch and analyze data to enable pattern-recognition and put in place pre-emptive triggers. But never in the history of information technology has so much data achieved so little insight.

As one Head of Risk told us: "Around 90% of our organizational response to major risk incidents has relied on analyzing data and focusing on process and system change. Clearly, that's not where the problem lies."

State Street Global Markets Chief Operational Risk Officer David Kenny warns that setting up new structures too quickly will introduce even more risk into organizations.[2]

"There is a problem here for the operational risk discipline if we're too reactive," says Kenny, who is based in the State Street Global Exchange in Boston. "You run the risk of disconnecting the areas that are central to the management of operational risk, especially these new initiatives around conduct and ethics. It's important to get the integrated program right because ethics and culture are at the heart of practically every operational risk tail event."

1 *Financial Times*, Martin Stabe blog, "Bank fines: Get the data," updated 7 August 2014

2 *www.risk.net*, "Risk rush a worry, says State Street op-risk head," 13 August 2014

And some critics say that even huge fines are ineffective because banks have the capacity to easily absorb such penalties. "The fines can be viewed as a cost of doing business," the *Financial Times* quotes Anat Admati from Stanford University. "They don't get at the heart of the problem, and aren't effective to change behavior, because the strong incentives of individuals within the banks to keep engaging in the same practices remain in place."[3]

One thing is certain. If organizations do not demonstrate results in tackling risk, the regulators will continue to do it for them. Our interviews in Europe, Asia, North America and Australasia revealed that an overwhelming percentage of groups are quietly taking steps to address operational risks in direct response to regulatory demands.

As an example, a major United Kingdom bank is appointing project mining leaders from the resources industry, nuclear engineers and leaders from aviation industries. The organization is particularly looking for "logical thinkers with emotional intelligence, flexibility and integrity," according to the brief.

The sector offers competitive salaries and likes MBA-qualified executives who are already in senior leadership roles.

Behind the scenes, the entire financial services industry is changing its risk culture. UBS Global Head of Compliance & Operational Risk Colin Bell says cultural changes now taking place are unheralded.

"Most organizations I know about are a couple of years into an adaptive change program – it's just a question of how much of a song and dance they make about it," Bell says.

"There is no question that as an industry we are going through this type of change. But standing up and saying we are going to change our culture, and here are our five new principles, is not the way to do it. We need to move the old hierarchy of behaviors and habits into a place where new habits are formed and become automatic."

Heidrick & Struggles' clients say they have found it challenging to find a source of talent for the type of risk executive now required. One client says: "Sure, there are people with the traditional legal backgrounds who have grown up with an intellectual framework around the Basel and RSA (Revised Standardized Approach) accords – but they are not making us more robust, resilient and able to drive more insightful decisions."

Thankfully, there is a solution. As we encourage leading institutions to focus on the invisible and less obvious levers of risk management, progress is being made. The answer lies in leadership and lateral thinking about sources of leaders, along with a forensic evaluation of behaviors and culture.

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3 *Financial Times*, "Banks pay out $100bn in US fines" 25 March 2014

Fatal consequences of risk failure

We believe other sectors where the failure of risk has fatal consequences – pharmaceuticals, aviation, the military and industrial businesses such as mining and construction – are ahead of the game when it comes to leaders who are able to instill a risk culture. An interview with the Chief Risk Officer of a major global investment bank goes to the core of the issue: “We gave a one-sentence brief to a change agent brought in from the pharmaceuticals industry – ‘Restore the reputation of banking.’ We agreed that there were considerable parallels between his previous life and what we needed.

“Pharmas are massively regulated because the consequences of error can be as high as customer deaths, and the failure of the company. But at the same time, they cannot have a zero risk appetite. They need to innovate, bringing new blockbuster drugs to market.”

“Our new executive is absolutely fascinated by the amount of data we collect, but commented that it seems to generate very little insight. He calls it data for data’s sake. We believe that it is absolutely critical now to improve the quality of data, using common systems of record, so we can break up our silo culture and share information across the business,” the CRO told us.

“He is more interested in psychology than process. Banks have great ways of collecting information, but from a change perspective we need to be focused more on outcomes – the destination rather than the journey.”

“By outcomes, we mean understanding the customer from the front line to the product suite and ensuring quality of service. Our new executive feels we have got it wrong psychologically and behaviorally by letting the front line off the hook too easily. But he is also helping us fix it by empowering those staff with more data and beefing up the service benefits for the customer.”

Beyond the banking industry

With banks “becoming more like technology companies,” in the words of one of our clients, they are examining what other industries provide in the way of risk expertise.

TD Bank Operational Risk and Enterprise Risk Head Price Sloan agrees. “Risk was definitely broken before the recession,” he says. “Many banks didn’t much care about operational risk as long as the revenues were growing at unsustainable rates. They tended to ignore the expenses and then 2008 came along and it was a huge operational loss when it all went down. We are now looking at what these other industries are doing and how we can adopt those practices.”

Transitioning executives from other fields into financial services is certainly possible, he says. “I was at a law firm and then at a private company, a real estate company, and I transitioned into it – so it can be done.”

Colin Bell of UBS says that bringing executive-level expertise from other sectors is “buying leadership” which has been forged over many years of experience.

“If you think about a pharma company, for example, which is in a heavily regulated industry, there are a lot of parallels from an industry perspective,” he says.

Bell is an example of such a transition. He spent 16 years in the military, with an engineering background, and had six months “in training” with UBS.

He found the move “hugely challenging” but says that, given his experience in the military, he was confident that persistence and effort would quickly build an understanding of a new industry.

“In a leadership position, you come to the realization that the quality of the people is the cornerstone of success. It’s people who make the process work and can help you succeed – even when there isn’t a process worth talking about. With cross-industry transfers, you are hiring core skills such as leadership, structured planning, communication and the ability to influence. You need to have the confidence that these skills, when meshed with industry knowledge, provide real long-term potential.”

Jeremy Howard, former senior leader for risk management with Rio Tinto, says the transition from mining to financial services should be relatively seamless, because the fundamental principles of risk management, control and compliance are not restricted to any particular field or industry sector.

"It's all about having the framework and governance in place to steer and trigger the necessary issues as and when required, for the respective audiences.

"For example, I've spent the past five years working on the delivery of re-financing and risk financing into the insurance market and working on joint ventures. So I think anyone who has come up through the operational engineering field and then traded up into commerce, is able to bring a lot more clarity to issues that would otherwise be the case."

Howard says the biggest problem he sees in financial services is the potential breakdown in knowledge-sharing. "On the other hand, in the resources sector, transparency of knowledge is commonplace, driven by the underlying triggers of safety, corporate reputation and governance, operational efficiency, and of course, profitability."

While some risks seem huge and complex, he says this is often not the case in reality, "because the tools are now available to provide a simple, invisible but active barometer for a business to improve the management of respective stakeholders, whether internal or external."

Biggest challenges are 'fit' and culture

Big changes in any organization are usually incremental, and can be accelerated by a leader with the right personality. But even the best leader will make little headway in a business where "handbrake behaviors" are endemic. In our experience, great leadership must always be accompanied by a shift in culture.

We believe the two biggest challenges for financial services organizations are:

1. **Leadership fit**
2. **Culture**

Incoming leaders must be influencers, able to think through the psychology of change and take the team with them. They must also be on-boarded into the new culture, and the company itself must also be willing to invest in changing the way its workforce thinks about risk.

The world's top-performing banks are already working to create different cultures, not as a defensive measure, but in order to drive competitive advantage, reduce surprises, and in many cases, also reduce costs.

Executives from the military, from oil and gas and from mining industries who have moved into financial services have experienced differing degrees of difficulty with the new culture.

An oil industry CRO who transferred from a bank told us the difference in his new role was the level of risk-tolerance.

"The tolerance for risk in industrial is low, because lives can be lost, but in banking it's not only tolerated, but is actively encouraged."

He says risk executives from the resources industry planning to enter financial services would need up to two years to get up to speed in the new industry – "just to understand the deal flow and learn the nuts and bolts."

Another banking industry risk executive we interviewed tells of how he is integrating a former military intelligence expert. He confides that it is not without its challenges.

"I got an email from this very high integrity individual, who has been brought in to support our fraud experts. He was distressed and basically said, 'I think I've made a mistake – the people around me know way more than me and I don't know enough about op-risk.'

"My response was that I knew this would be the case, but it is our intention to invest in him to increase his domain expertise around frameworks we use to manage risk.

"I told him, 'We value the fact that you are smart, sensible, thoughtful, can problem-solve and have a certain gravitas and care that will allow you to be an extremely effective risk officer after we've made this investment in you.' I just felt it was great he worried about how good a job he was doing."

Jerry Temko, General Counsel and Chief Compliance Officer of the European arm of Japanese pharmaceutical giant Astellas, says on-boarding would be the key to bringing non-financial services experts into banking.

"It depends on the industry from which the individual is coming," he says. "In any transfer from a different sector, there has to be some appreciation of the business drivers of the sector to which you're going into and you obviously need business acumen plus risk management. You also need a mandate from the top. If the company culture is inherently hostile or not receptive to a newcomer coming in and doesn't have proper on-boarding, then depending upon where you have this person come in – at board level or in a risk management department – there would have to be some receptivity, some terrain that has already been prepared to allow that person in."

Pharma leaders going into financial services have the advantage of being well-connected with peers within their sector and related industries, which can be useful when placing risk in a more macro framework.

Temko believes "activist regulators" are looking to trip up banks and financial institutions, and the only way to comply is with proper audit trails and stress testing.

"In pharma, you do not want to be risk-averse but as a chief risk officer you want to do some probing and stretching before the proposal sees the light of day. We identify the points of risk and put together an audit file prospectively so that six months from now we can ask our people to visualize themselves in an environment of investigation. We ask them to look ahead and imagine themselves on the front page of *The Time*s or *The New York Times* and then ask themselves, 'Is all my compliance documentation able to withstand public scrutiny?' When you do things in haste and you don't document properly, you are at your most vulnerable."

Newcomers who change mindsets

HSBC Global Operational Risk Head Mark Cooke says he "absolutely agrees" that banking has much to learn from the industrial and other sectors. He has several risk executives on his team from outside of banking, from organizations such as BP, who have influenced his perception of risk management.

"The oil industry plays extensively in the space of high resilience and risk with a mindset which constantly monitors the downside," he says. "It's even down to teaching people walking down the stairs with a cup of coffee to hold on to the handrail. It's not just perception, but a state of mind where individuals start to feel that it is very odd to behave in a risky way."

Cooke says banks need to move from a culture where some individuals care that "they don't do anything bad" to a culture where nobody does anything bad, and everyone feels empowered to challenge those who look as if they are out of line.

"It's a journey of maturity and many banks are miles away from that. Most people think about good outcomes but few think about the downside. They think that if it goes bad they'll probably just break even."

He says the resources sector and pharma companies tend to have a more intuitive conversation about risk versus reward. "They are constantly asking if they have the platform capability to deliver a product where opportunity and downside are balanced in the decision-making.

"If we can get this sort of thinking into the banking DNA across our industry, it would be extremely valuable," Cooke says.

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Mark Cooke

The oil industry executive and former financial services CRO we interviewed adds that banks need to develop a culture where people can speak up when others are adopting behavior that exposes the institution: "They need to firstly have the right culture, and then be self-selecting in terms of people who fit the culture."

He says the major difference between where he used to work and the resources industry can be summed up in one word: transparency. "In mining, for example, everything is visible and audited, but in financial services it's mind-boggling – everything is done by email."

Critical competencies: Influencing and agility

In examining the competencies required in operational risk executives today, many companies focus on people who demonstrate a correct understanding of the risk framework and how they draw together all the elements systemically.

But we believe the most important competencies are:

- **Ability to influence**, and to have a voice at the table that drives a different outcome in terms of risk decision-making.
- **Agility of leaders and functions** – the market is evolving so rapidly, along with the types of risks institutions face, that the agility of leaders is mission-critical.

The ability to bring clarity and actionable change to a complicated industry is also a factor. As one risk leader told us: "Mechanical activity does not create that risk insight we are looking for. Any fool can make something complex but it takes genius to make it simple."

TD Bank's Price Sloan agrees. "Flexibility and self-directed learning are also keys to success. You need to be comfortable stepping into different environments. You have to be comfortable teaching yourself. It takes a certain amount of confidence and you've got to be a quick study. I don't think linear thinkers would make the transition very well."

Deloitte Australia Risk Services Managing Partner Harvey Christophers says the sometimes over-formulaic and standards-driven response to the new regulatory environment has given risk management a bad name – "but the key is to build authentic risk-intelligence in order to have the confidence to take on new risk and drive competitive advantage."

Many 21st century businesses are seeking to innovate and transform because they face disruption, and according to Christophers, this means "engaging risk intelligent thinking at a faster rate" when moving into the innovation and strategy process. "Building that intelligence into the way you innovate will mean you can manage the risk effectively. You will make the mistakes that inevitably accompany innovation in a 'eyes-wide-open' way. This is partly what risk intelligence is about – being prepared for risks that are not under your control but which you can simulate and respond to better than your competitors."

Conclusion

In today's changing financial services environment, with vastly increased regulatory, shareholder and public scrutiny, institutions needs to evolve their control functions in a more effective way than at any other time in their history.

While the industry has been pioneering, its perspective has often been insular and homogeneous in thought.

It is clear the industry could leverage significant experience from other highly regulated sectors that have had inherent operational risk culture as part of their DNA for decades. But this mind-shift will take time to fully integrate.

Operational risk as a function needs to evolve and innovate before it can truly move away from its troubled past. This will not come by maintaining the status-quo and hiring leaders who followed the same procedures for years. Change will come only through challenge, diversity of thought, and courage.

Heidrick & Struggles

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www.heidrick.com

Paul Gibson
New York

+1 212 867 9876
pgibson@heidrick.com

Paul Gibson is a member of the global Financial Services Practice. He leads the Financial Services Infrastructure sector in the Americas and is a functional expert within the Legal, Risk & Compliance Practice. He also conducts assignments within the firm's CEO & Board of Directors Practice.

Mark Jackson
London

+44 (0)20 7075 4047
mjackson@heidrick.com

Mark works primarily in the risk and compliance space. His clients include global investment banks, asset managers, hedge funds, life and general insurance companies, and broker/dealers recruiting both risk and compliance executives from chief risk officer and head of compliance, to divisional or product leads.

Craig Williams
Sydney

+61 2 8205 2010
cawilliams@heidrick.com

Craig is a member of the Financial Services Practice and leads the Financial Services Infrastructure Sector in Asia Pacific. He focuses on C-level risk and compliance roles as well as front office banking executive searches. He has completed board appointments in corporate and not-for-profit sectors, and also focuses on helping companies drive innovation and change across banking, insurance, funds and professional services firms.

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