Giving Risk Management Culture a Role in Strategic Planning

Tuba Bozaykut-Bük

Abstract Strategically planned and implemented risk management paves the way for competitive advantage and a decisive edge for global financial institutions. The importance of risk management becomes more evident in financial instability periods. The failure of global financial institutions in the recent financial crisis revealed that firms with strong risk management and culture were more prepared and economically less damaged. As financial institutions have been criticized severely about risk management practices, it also becomes clear that most financial institutions have difficulties in developing a risk management culture. To have a clear understanding of risk management culture, the chapter aims to highlight a need to extend our understanding of risk management culture and how it can find a voice in the strategic planning of global financial institutions.

1 Introduction

Risk management has always been a top priority issue for financial institutions in terms of enhancing performance (Krause and Tse 2016), competitive advantage (Fiegenbaum and Thomas 2004) and increasing value provided to the shareholders (Cooper 2000). As it is well proposed, risk management constitutes one of the most important veins of survival, attainment of strategic goals and an important determinant of success in financial turmoil. Along this line of thinking, financial firms approach risk management as a strategic tool both in their daily operations and in crisis preparedness, detection and prevention because of its continuous evaluation of environmental threats.

The one thing researchers reach a consensus on is that doing business means taking risks and risk is a "strategic issue" (Clarke and Varma 1999). As the risk

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management has a role in gains and losses of the firm, the value created and offered to shareholders is directly linked to risk management practices (Elahi 2013). The shareholders' aim is to have higher returns in lending or investing their capital. They expect managers to take risks, but at the same time; they refrain from making investments in the institutions that would take great risks for these returns. The artistry of risk management comes from the difficulty of satisfying the shareholder demand of higher returns without losing the shareholder trust.

To develop a strong risk management culture is of strategic importance to the success of risk management. According to the worldly accepted regulators of financial markets such as Institute of International Finance (IIF), not having a proper risk management culture strategically set is one of the main reasons why many global banks and other financial institutions faced with the catastrophic economic consequences of the recent crisis. On the other hand, institutions with strong risk management culture had the chance to overcome the crisis and surpass their competitors. Hence, it is now evident that to set, manage and assess the risk management culture is both a challenging issue and a source for competitive advantage for today's financial institutions.

Risk management culture refers to common norms and values related with risk identification, management and assessment within the organization (IIF 2009). Also, risk management culture is an organization-wide issue (Elahi 2013) and has to be designed according to the risk attitudes and behaviors defined strategically in order to attain corporate objectives. Likewise, firms need to introduce analytical and statistical tools for risk assessment as well as they have to make employees get familiar with the common language and the tone of the behavior in identifying and managing risks. Thereby, all these factors make risk management culture a strategic issue. To identify certain attitudes and behaviors related with the risks faced and to embed risk management culture throughout the firm, risk management culture should find its place in strategic planning.

In the chapter, the risk management's significance to financial institutions is firstly discussed. Then, risk management and factors for enhancing risk management are highlighted. The chapter continues through the examination of risk management culture together with strategic planning and ends with final remarks and implications on the topic.

2 Global Financial Institutions and Risk Management

Risk is defined by diverse disciplines with their own unique lenses. The finance theorists approach risk in three manners (Cooper 2000). The first approach evaluates risk as an "opportunity" and asserts that the gain will increase as the risks increase. According to this perspective; for more profit, the institution would have to undertake greater risks. Conversely, risk as "hazard or threat" connotes negative meanings as failure or loss. Approaching risk as something to be avoided, the institution would use techniques to refrain from situations that would put them in a

risky position on the sake of benefitting from the potential advantages of risks (March and Shapira 1987). The third approach, namely the futuristic point-of-view, takes risk as "uncertainty" that can bring both positive and negative outcomes. The main point of the approach is to minimize the difference between what is expected and what is attained by the risky operations. In line with the third perspective, researchers associate risk with a decision making process about the future (Cooper 2000). In other words, the notion of future refers to uncertainty and the claim for controlling the uncertainties lies in the essence of risk management (Power 2007; Cooper 2000). Also, to some authors, risk is the various combinations of these approaches. For instance, risk can refer to "uncertainty" with negative consequences (Elahi 2013).

Similar with risk approaches, there is a traditional and a modern way of thought on risk management. Traditional risk management approach risk negatively and propose that risk would harmful or costly effects on the firm (Elahi 2013). Conversely, modern risk management thinking is in the manner of seeing risks as a positive phenomenon that would create improvement and growth as the creativity level of the firm would increase (Bowers and Khorakian 2014). Meanwhile some studies support the notion that firms that have enriched risk capabilities stand one step ahead of its rivals in the market and have greater competitive advantage (Elahi 2013).

Another matter to be mentioned is the dilemma that resides in the risk taking behavior. From time to time under different conditions, the risk appetite of the firms can rise or decline. Being always either on the risk-averse side or on the risk-lover side can also have hazardous effects on the survival and the competitiveness of the firms (Kahneman and Lovallo 1993; Fiegenbaum and Thomas 2004). Whether to take that risk is a big question to answer and requires a detailed analysis in diverse perspectives. In that decision making process, another problem encountered is the bounded rationality issue. From the bounded rationality lenses (Simon 1972; March 1978), the firm cannot control every factor that can affect its operations and has to give decisions depending on its limited knowledge. Although there are statistical and scenario-based methods for measuring risks, it is not possible to estimate every single factor in the market and the results of risk taking behavior can be the Schrodinger's cat paradox for financial institutions.

Through a closer gaze on the global financial institutions (GFIs), it can be proposed that GFIs need to manage diverse risks encountered not only in their constant daily operations but also have to be prepared at the strategic level when faced with crises. To create a risk management culture, a financial firm needs to identify the risks to be encountered. For instance, risks encountered by banks are defined as credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk by Basel 1998 Framework (Cooper 2000). Basel 1998 Framework also offers an internal control system that would detect and control risks listed for banks. Similarly, Bilal et al. (2013) in their paper on re-modelling of risk management in banking summarizes the process for control mechanisms recommended after the global financial crisis as such: "To ensure the circumvent from potential risks, the Banking Supervisory

Committee has taken up Basel Accord-I in 1988, followed by Basel Accord-II in 2004 and the recent agreement of Basel Accord-III in 2010 in which global regulatory standards are developed on market liquidity risks, capital adequacy and stress testing in order to introduce new regulatory requirements on "leverage" and "liquidity" of financial institutions" (p.469).

The new regulations and new technological tools for assessing market and non-market risks help to prevent the unexpected consequences of the financial instabilities. However; with every crisis it becomes more evident that GFIs need more than technological or analytical control systems and tools for the uncontrolled or unanticipated risks. To overcome the unanticipated risk especially faced at economic crises, risk management culture expressed in the strategic planning of the firm would be a strong hand of mitigation of damages. Besides these standards and analytical techniques, firms should adopt a certain set of norms and common attitude related to risks. When supported by a commonly accepted and implemented risk management culture, risk management practices would reach to a success. Therefore, for the long term success, having a strong risk management culture comes forth as a big asset for GFIs.

3 Risk Management Culture

Like many terms in social sciences, it is difficult to define what "risk management culture" (RMC) is. To have a broad understanding of the meaning of "risk management culture", it would be enlightening to focus firstly on the term, organizational culture. Since Peters and Walterman's (1982) inspiring work, *In Search for Excellence*, organizational culture is approached as something to be managed (Willcoxson and Millett 2000). Peters and Walterman (1982) suggest that if managed well, organizational culture would help organizational performance to be enhanced and competitive advantage would be gained over competitors. After a decade, Schein (1992: 12) with his study entitled *Organizational Culture and Leadership* attracts the attention to the organization's relations to external environment and defines the organizational culture as:

> A pattern of shared basic assumptions that the group learned as it solved its problems of external adaptation and internal integration that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems.

As by internal integration, Schein refers to forming a collective identity among members, and by external integration, the corporate's interaction with others as it strives for achieving its goals. Through his definition, Schein implies that culture is not a closed but dynamic system evolving according to other factors in the environment.

In the finance literature, it is seen that many related terms such as "risk culture", "risk management culture" and "strategic risk management" are referred in the studies. To McConnell (2013) different terms are used for RMC because institutions have different layers of culture related with different risk perceptions. Thereby, to McConnell (McConnell 2013: 36), the 'risk culture' refers to how individuals within an organization approach risk and 'risk management culture' addresses specifically to the culture of the risk management group(s) and its interactions with the organization; and we can also talk about a culture of 'risk-taking' in organizations.

In some other works, authors use the term of risk-oriented culture. The awareness of risks and of the ways to approach risk at all levels of the organization means that organization has a risk-oriented culture. Similarly, to create and develop a risk-oriented culture may require an "organizational paradigm shift" through which the organization revises itself in order to develop risk management and vision as a core competency (Cooper 2000: 19). To achieve this paradigm shift, an awareness of the risk types faced by the institution should be developed (Girling 2013). That's to say, employees and managers at all levels are expected to have the awareness of what risks are encountered, how they are assessed and controlled (Girling 2013).

Although admitting there is no consensus on a definition, IIF (2009) defines risk culture as such: "risk culture is the set of norms and traditions of behavior of individuals and of groups within an organization, that determine the way in which they identify, understand, discuss, and act on the risks the organization confronts and the risks it takes". Along with this definition as with others, it is still difficult to suggest a prescription for developing a risk culture environment when taking into consideration the contingencies specific to each institution (Institute of International Finance 2008). Contingencies do really matter so it would be difficult to define an "ideal risk culture model"; yet it is possible to talk about some common elements that would help to create a RMC. In their studies, many researchers outline some factors that help to flourish a strong risk management culture. As to the studies, for instance, the role of managers is an important facilitator of RMC in the GFIs (McConnell 2013; Girling 2013; Geretto and Pauluzzo 2015). What's more, managers' attitude towards risk is another element that comes to the forefront. Especially the managers who approach risks negatively would definitely affect the development of risk management and culture. March and Shapira's study (1987) is a significant example of this assumption and it empirically indicates that managers mainly focus on the potential losses instead of potential gains.

On the organizational level, RMC is a governance issue strategically designed by top managers (De Marchi and Ravetz 1999). Specially, The Chief Risk Officer (CRO) has an influential part on the cultivation of RMC. CRO has the role to develop and reinforce risk culture by interacting with managers and the Board (IIF 2013). On the individual level, RMC is related with some ethical issues as the bad behavior or showing indifference towards risks. As individuals, members have to detect, speak out loud and document risks, and be responsible about factors threatening the risk management culture of the institution (Ashby et al. 2012; Girling 2013).

As an organization-wide issue, developing a RMC covers all members from top to the bottom. Strictly speaking, the rationale behind RMC is to furnish all members with the mentality to identify, understand, manage and assess the risks. All members should feel responsibility and accountability in managing risks. Hence; risk must be the concern of all at every level of the organization and its presence should be felt from strategic planning to daily operations (IIF 2012; Girling 2013; Geretto and Pauluzzo 2015).

Another important factor for RMC development is to create a language of risk for mutual understanding. The common language is a facilitator for establishing set of values among members and it also can get things done or understood more quickly by not letting managers spend too much time in communicating risk issues within the organization (Espersen 2007). Further, a high quality of information flow is another significant element for an effective RMC. The easiness of asking questions and not hesitating to raise voices are clear signs of a healthy organizational communication. IIF (2009: 31) specifies the importance of communication in such sentences: "...a risk culture depends not only on both formal and informal channels for employees to raise these questions but also on their being accountable for those who do or do not step forward". Similarly in a recent report on risk culture, IIF (2013: 2) points out that the attitude of "bad news must travel faster than good news" should be embedded in the governance of the firm. Along with the issues mentioned in the IIF reports, a need to create awareness about the key concepts and training should be on the agenda to keep members updated about risk related issues within the organization.

The use of incentives and other human resource practices that promote the ethical way of approaching risks also are offered as factors for developing RMC (Geretto and Pauluzzo 2015). Through the use of incentives that would promote ethical working manners, all employees would know how to act in cases of uncertainties or when faced with any type of risks. Besides HR practices, the alignment of organizational goals with the objectives of risk management, the managerial and personal attitudes towards risk, high quality communication, awareness of the significance of a sound risk management are listed as the other facilitating factors of creating and developing a RMC at financial institutions (Geretto and Pauluzzo 2015).

A strong risk management culture has also some positive consequences on firms. To exemplify, Oliver Wyman & RMA (2010) provided empirical evidence that GFIs with strong RMC have better business performance and innovation capability during the financial crisis. IIF (2013: 2) also affirms that strong risk culture in firms is essential to "their safety and soundness and to financial stability".

4 The Role of Risk Management Culture in Strategic Planning

Likewise the term culture, "strategy" is mainly interested with the relation of organization and environment and the basic premise is that organizations develop strategies to cope with the changes in the environment (Mintzberg 1994). For instance, the adaptive model of strategy implies that organizations have to be active and not solely cope with the environment but "change with the environment" (Chaffee 1985: 92). Hence, culture and strategy are two terms propounded as means for dealing with changes in the environment.

Studies suggest that institutions engage more with strategic planning process if the environment is complex and the rate of the change in the environment is increasing (Bird 1991; Steiner 1979; Hopkins and Hopkins 1997). The economic ups and downs are examples of transition periods in which institutions return to their strategic planning and are more deeply concerned with the process. For instance to overcome the economic turmoil of the recent global crisis, top managers have started to develop their strategic plans on the risk governance mechanisms (Cooper 2000).

Strategic planning is "an iterative, comprehensive and systematic approach to developing a firm's overall direction, one that allows 'management to analytically determine an appropriate strategic path for the whole organization'" (Andersen 2000: 185). To Mintzberg (1994), strategic planning has the technical aspect of strategic management and it is associated with analysis. Further mission, vision, goals and values constitute the base of a strategic plan and strategic planning is the "road map of the organization determining where the organization is now to where it would like to be in five or ten years" (Bouhali et al. 2015: 74). With a future projection in mind, strategic planning sets a direction to achieve organizational goals through analysis.

Basically a strategic planning has three main processes (Hopkins and Hopkins 1997: 637): "(1) formulation, which includes developing a mission, setting major objectives, assessing the external and internal environments, and evaluating and selecting strategy alternatives (2) implementation and (3) control". Through these processes, the strategic planning also serves a symbolic function in developing cognitive maps for common understanding (Duncan and Dutton 1987). To some studies, strategic planning also serves a symbolic function in developing cognitive maps for common understanding (Duncan and Dutton 1987). Besides developing mission, vision and objectives; the values and standards of behavior in doing business are also identified and developed in the strategic planning. To illuminate this issue, IIF (2013: 2) implies that the Board has to be sure that culture fits the business model and asks themselves constantly "What is the organization doing to support things that we value? What are we doing to deter things that we don't value? Do we have an organization that is constantly risk aware?"

In the strategic planning, it is critical to determine the major risks faced, determine the risk tolerance level of the firm and how to control these risks through internal and external environment analysis (IIF 2009; Holmquist 2012). Especially

the recognition of risks related to the business strategy is of great importance at this stage (IIF 2009). After identifying these major issues of risk management, the manner and behaviors of the employees should be identified as to create mutual understanding of risk and to form a common set of values and attitudes in managing risks. In a RMC, members have the responsibility and accountability of the risks they face and take precautions against not to eliminate but to control these risks (Cooper et al. 2011; IIF 2009). As a consequence, RMC consists of dynamic processes that require the whole organization's participation.

In a dynamic environment, it is expected that the employees of GFIs should internalize the common premises of the risk management culture so as to follow the strategic plans. If financial institutions expect their members to detect and manage risks in their daily operations in an ethical manner, the tools and symbolic actions for a risk-oriented climate should be set in their strategic planning (IIF 2013). Besides the role of CRO, the meetings or forums for discussing risks or introducing analytical tools for managing risks are all to be set up in the strategic planning (IIF 2009; Cooper et al. 2011).

To lighten the significance of RMC in the strategic planning, the global economic crisis of 2007–2009 can be an example. The crisis demonstrated that the risks were not calculated as they had been and firms were not behaving ethically. What's more, many did not adopt sound risk management awareness and culture that should have supported daily operations. Though believed to have efficient risk calculation techniques and methodologies, GFC pointed out that the relevant skills had not been developed to embed risk management in the organizational structure and culture (Girling 2013 Geretto and Pauluzzo 2015). In line with this, regulators of financial markets all around the world such as US Financial Crisis Inquiry Commission or UK Parliamentary Inquiry pointed out the missing link of cultural support as one of the paramount reasons why institutions face the global financial crisis (McConnell 2013). After the crisis, although the problems with the risk modeling have been tried to be solved by the regulations based on Basel standards, yet; it is still a search to how to set up the risk management culture and risk management practices (Bilal et al. 2013). Also recent researches interestingly have showed the fact that GFIs still lack the mentality of risk management culture. For instance, Geretto and Pauluzzo (2015) study the risk management of 50 large banking companies around the world and find out that GFIs still evaluate risk management mainly as "financial trading or insurable risks"; "something negative, or to be avoided without having a clear risk organization responsibilities or culture" (p.313).

As the crisis proved, it is vital to give an effort for developing RMC in the strategic planning of the firm. This would not only provide an alignment of culture and strategy but also help to increase firm performance and value creation to the shareholders in the long run. In brief, to have a strong risk management culture requires a strategic thinking and planning approach for long term success and when strategically formed, RMC would minimize the negative consequences of the economic fluctuations.

5 Conclusion

One of the topics raised by governments and regulators is how financial institutions approach risks and the "criticality" of the implementation and improvement of risk management. The complex and turbulent business environment makes it difficult to manage risks, requiring a more detailed approach for an effective risk management. Thereby, risk management and culture embedded in strategic planning can be be an enhancer of sustainable competitive advantage while firms react to the threats and opportunities in the environment.

The recent global crisis revealed that global financial institutions failed in behaving ethically and the risk management of these firms had many shortcomings. Especially, the banking sector is criticized severely in not having a strong risk management structure and culture supporting the corporate strategies. It is now clear that the risk management has to be supported culturally and GFIs have to approach risk management also as a "cultural phenomenon". All in all, to achieve competitive advantage and create value to shareholders, GFIs have to develop solid risk management culture.

Because of the increased significance risk management attained after the global crisis, banks and other financial institutions aim to form a risk management culture strategically. To do this, in their strategic planning, firms map how to flourish risk management culture on instrumental and symbolic level. On the instrumental level, analytical tools to be used in detecting and controlling risks are introduced. Further to that, the common jargon and attitude in approaching risk has to be implemented throughout the organization for the symbolic level.

As a solution to the problem of how to implement a strong risk management culture, it is suggested that firms have to identify their risks, risk appetite and the tolerance level in their strategic planning. Besides, the articulation of these critical factors to the members by top management is indicated as an important factor to create the base for a mutual risk understanding and behavior. Also, Chief Risk Officer and Board have pivotal roles on the development of risk management culture. The use of analytical tools and the acceptance of common set of norms and values in assessing risks are the main elements of the risk management culture. Yet, for today's managers, it is a highly challenging mission to form the risk management culture within their organizations.

This chapter has set out to attract attention to risk management culture and its place in the strategic planning. Being the compass of the firms, strategic planning process should also cover the cognitive terrains and should direct tools, techniques, attitudes and behaviors for developing risk management culture. The literature is weak in explaining the cultural aspect of risk management. It is hoped that the alignment of risk management culture with strategic thinking and planning would be examined from diverse perspectives in the future studies.

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