THE Frontier Line

Thought leadership and insights from Frontier Advisors

Issue 118 June 2016

Risk Management -

Is it all just smoke and mirrors?

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Risk management – Is it all just smoke and mirrors?

Risk management continues to play a critical role in any organisation's success. Most organisations have taken substantial steps to improve their risk management processes, but has it all been superficial – have their attitudes toward risk really evolved along with it?

In an Australian context, APRA's focus on risk has also intensified with regulations under APRA's risk management and governance prudential standard, CPS 220 Risk Management, stating that the Board (of an APRA-regulated institution) is ultimately responsible for having a risk management framework that is appropriate to the size, business mix and complexity of the institution.

APRA requires organisations maintain a risk appetite, risk management strategy and a business plan that sets out its approach for the implementation of its strategic objectives. Australian Registrable Superannuation Entities (RSEs) are also required to have a similar focus via SPS 220 Risk Management.

Most well run businesses today take similar approaches to business and risk management, and businesses in the financial industry have increased their focus in order to meet best practice prompted by recent failures and bad practices, many of which came to light in the period following the Global Financial Crisis. With such a clear focus, it is surprising that there continues to be many examples (and not just in the financial industry) where an organisation's risk governance has failed. What has been the common factor in each of these examples and what lessons can we learn from these?

Australia and New Zealand Banking Group Limited (ANZ)

Australia and New Zealand Banking Group Limited (ANZ) is the fourth largest bank in Australia. As one would expect from one of the largest organisations in the country, it has clearly defined frameworks which include code of conduct, ethics and risk policies, to name just a few.

Ultimate responsibility for risk management lies with the ANZ Board, but the organisation also has a Risk Committee and an Audit Committee to assist the Board in its risk management strategies. The ANZ's risk appetite is defined in a Risk Management Governance document, dated December 2013:

ANZ's risk appetite is set by the Board and integrated within ANZ's strategic objectives. The Risk Appetite Framework underpins fundamental principles of strong capitalisation, robust balance sheet and sound earnings, which protects franchise and supports the development of an enterprise wide risk culture. The Framework provides an enforceable risk statement on the amount of risk ANZ is willing to accept. It supports strategic and core business activities and customer relationships ensuring that:

- *Only permitted activities are engaged in;*
- *The scale of permitted activities, and subsequent risk profile, does not lead to potential losses or earnings volatility that exceeds ANZ approved risk appetite;*
- *Risk is expressed quantitatively via limits and tolerances;*
- *Management focus is brought to bear on key and emerging risk issues and mitigating actions;*
- *Risk is linked to the business by informing, guiding and empowering the business in executing strategy.*[1]

However, on 4th March 2016, ASIC commenced legal proceedings against the ANZ for unconscionable conduct and market manipulation in relation to the ANZ's involvement in setting the bank bill swap reference rate (BBSW).

BBSW is the reference rate used to price derivatives such as interest rate swaps, cross-currency swaps, forward rate agreements as well as business loans and bank bill futures and bonds. BBSW has been identified by ASIC as a financial benchmark of systemic importance in our market[2].

Since 2013, the Australian Financial Markets Association (AFMA) has calculated BBSW benchmark rates as the midpoint of the (nationally) observed best bid and best offer for Prime Bank Eligible Securities, which are bank accepted bills and negotiable certificates of deposit (NCDs). Currently, the Prime Banks are the four major Australian banks[3]. ASIC alleges that ANZ traded in a manner intended to create an artificial price for bank bills on 44 separate days during the period between 9th March 2010 and 25th May 2012. ASIC alleges that ANZ was seeking to maximise its profit or minimise its loss to the detriment of those holding opposite positions to ANZ's[4].

ASIC has also announced a similar case against the National Australia Bank on 7th June 2016 and had also done so against Westpac on 5th April 2016. All three banks have indicated they disagree with ASIC's view and it seems likely that it will be settled in a court environment.

Volkswagen

On 20th November 2008, the Volkswagen Jetta TDI was named Green Car Journal's 2009 Green Car of the Year. Ron Cogan, editor and publisher of Green Car Journal and editor of GreenCar.com stated at the time that:

"The 2009 Volkswagen Jetta TDI epitomizes what the Green Car of the Year honour is all about. It raises the bar significantly in environmental performance with its EPA estimated 41 mpg highway fuel economy, reduced greenhouse gas emissions, and extremely low tailpipe emissions. This is all the more impressive when you consider the Jetta TDI is a clean diesel, achieving the kind of fuel efficiency offered by gasoline-electric hybrids but in a more affordable way."[5]

At the same time, the Volkswagen Annual Report 2008 stated that:

"We consider increasing our enterprise value on a sustainable basis to be our most important task. The trust of our customers and investors is crucial to achieve this. We gain this trust by managing the Company in a transparent and responsible manner. This takes the highest priority in our daily work."[6]

In regard to risk management, the 2008 Annual report stated that:

"A forward-looking approach to identifying and controlling risk is pivotal for ensuring sustainable business success. Our comprehensive risk management system enables us to deal responsibly with potential risks."[7]

In its 2014 Annual Report, the section titled "Report on Risks and Opportunities" stated that:

Only by promptly identifying, accurately assessing, and effectively and efficiently managing the risks and opportunities arising from our business activities can we ensure the Volkswagen Group's sustainable success and the systematic implementation of our Strategy 2018.[8]

On Volkswagen's website it outlines the organisation's approach to risk management which is based on the framework by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) for enterprise risk management. "Volkswagen has chosen a holistic, integrated approach that combines a risk management system, an internal control system and a compliance management system in a single management strategy."[9] Volkswagen's risk management system (RMS) and internal control system (ICS) has three lines of defence (pictured right) which have been designed to protect the Company from significant risks occurring.

Figure 1: The three lines of Defence Model[10]

Volkswagen states that its RMS and ICS is regularly monitored to assess if areas are needed to be improved. Volkswagen's Strategy 2018 states:

The Volkswagen Group is aiming to become the most successful, fascinating and sustainable automobile manufacturer in the world by 2018. Sustainability means simultaneously striving for economic, social and environmental goals in a way that gives them equal priority. To us this means creating enduring value, facilitating good work, and using the environment and resources with care.

However, on 18th September 2015, the Environmental Protection Agency in the US issued a Notice of Violation of the Clean Air Act to Volkswagen AG, Audi AG and the Volkswagen Group of America, Inc. alleging that model year 2009 – 2015 Volkswagen and Audi diesel cars included "defeat device" software as defined by the Clean Air Act.

Volkswagen has since admitted that around 11 million cars worldwide, including eight million in Europe, are fitted with the so-called "defeat device" (when the cars were operating under controlled laboratory conditions, the device puts the vehicle into a safety mode in which the engine ran below normal power and performance).[11]

Since news of the scandal broke, Volkswagen has reported record losses, its share price has fallen, it faces legal action and its chief executive, Martin Winterkorn, and the Head of American Operations have stepped down and several high-ranking executives have been suspended.

Essendon Football Club

“We can beat anyone, as long as we do whatever it takes." This was the slogan for the Essendon Football Club as it prepared for its 2013 Australian Football League season, on the eve of the biggest sporting drug scandal in Australian history.

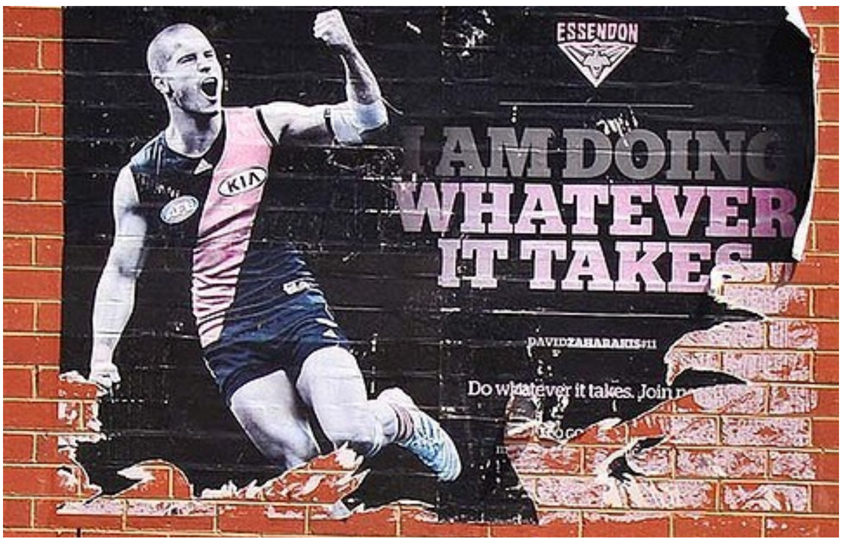
On 13th February 2013, the Essendon Football Club held a press conference where the then-chairman, David Evans, announced it was investigating a supplement program it had run the previous year. This was the beginning of the supplements saga and three years on, in January 2016, the Court of Arbitration for Sport (CAS) suspended 34 past and present Essendon players after finding them guilty of taking the banned substance Thymosin Beta-4 during the club's supplements program in 2012.

A report by Dr. Ziggy Switkoski into the Essendon Football Club in 2013 found that there was a “pharmacologically experimental environment never adequately controlled or challenged or documented” by coaches or management. In particular, the report found that “there was a lack of clarity about who was in charge of the Football Department. There were two separate roles with fuzzy lines of responsibility.”[12] It’s clear that the Essendon Football Club had a culture focussed on striving for high performance and management was prepared to push the boundaries beyond normally accepted limits in order to achieve its goals. It also appears that risk and risk management may not have been a priority and focus at the club prior to the drugs scandal, given Essendon’s 2012 Annual Report does not mention the word risk in the entire document.

Whether one agrees with the findings of the CAS or not, it can be strongly argued that Essendon’s risk management and governance (or lack thereof) failed them during this time.

The supplements saga at Essendon has had a profound and devastating impact not only on the Essendon players banned from playing but also their fans as well as the Essendon Football Club itself, which now sits in last position on the AFL Premiership Ladder. The financial cost to the Club has also been staggering with it reported to have spent around $5.5 million fighting the anti-doping charges – and this has not included ongoing expenses ahead of the players' appeal against the ban.[13]

Today, Essendon’s website has a focus on governance, where it outlines that in light of the events of the AFL/ASADA investigation into the 2012 supplements program, the club has taken the following steps. These include; completing a full review of the football department and football program, enhancing the club’s risk management framework, reinvigorating the cultural framework to embed new organisational values, behaviours and purposes and establishing an integrity manager position to monitor compliance and risk management among other things.



Lessons learned

It is hard to believe that scandals of this magnitude can occur at these large, prominent organisations given the risk frameworks and structures these organisations have in place or should have in place. Nonetheless it highlights the disconnect that can exist between the policies and frameworks and how organisations actually function on a daily basis. We believe the common link between these examples is the organisation's attitude toward risk, or its risk culture.

The concept of risk culture has increased in prominence of late. For example, ASIC believes that culture "is a key driver of conduct within the financial industry. Bad conduct flourishes, proliferates and may even be rewarded in a bad culture. A good corporate culture uncovers and inhibits bad conduct, and rewards and encourages good conduct."[14]

Culture plays a critically important role in an organisation's success. A recent episode of MasterChef (a reality television cooking competition) where contestants were challenged to prepare a meal for 80 diners in a popular restaurant and forced to repeat "Yes Chef" after being given their orders, highlighted the type of culture that can exist in the cooking industry. For many years, commercial kitchens have operated under the guise of a culture of aggressive and egocentric behaviour where it is not unusual (or so the stereotype would have you believe) for chefs to yell at their apprentices or for plates to be thrown in disgust. In fact, recent studies have linked the greater number of suicides of many chefs to the bullying and stress brought on by the culture in the kitchen. René Redzepi, Danish chef and co-owner of the two-Michelin star restaurant Noma in Denmark, recently wrote an article about his life as a beginner chef.

"I watched chefs use bullying and humiliation to wring results out of their cooks… But then I became a chef. Suddenly I was going crazy about someone's mise en place or some small thing they said wrong…This was how I had been taught to cook, and it was the only way I knew to get a message through… How do we unmake the cultures of machismo and misogyny in our kitchens? Can we be better?[15]

Redzepi's poignant questions can be echoed across the kitchen to many other industries, from sporting groups, to school boards to the financial markets. In 2013, in the wake of the London Olympic Games, Swimming Australia commissioned an independent review after the Australian swimming team experienced its worst performance since 1972 with no individual gold medals. The Bluestone Edge Culture Review into Australian Olympic Swimming found that cultural factors did play a significant role in the disappointing results. "The report highlighted a failure of culture and leadership and the creation of a toxic environment..."[16]

Three years on, Swimming Australia has taken steps to change its culture and the results from the recent World Championships in Kazan (second on the medal tally) are perhaps evidence that the organisation has been able to change its culture for the better. Swimming Australia now has a Risk Management Plan which states that "its challenge is to infuse risk management into our culture, our everyday business operations and those of our contractors and business partners."

In 2004, four foreign exchange traders from the National Australia Bank (NAB) were jailed for their involvement in an options trading scandal which cost the bank $370 million. In the court proceedings, Luke Duffy, the former Head of the Foreign Currency trading desk, described the culture at the NAB as "male dominated and aggressive..." and admitted speaking about his co-workers in a derogatory manner. Duffy said the prevailing philosophy at the NAB was "profit was king" and that it didn't matter what you were doing, so long as you were making money.[17]

Not surprisingly, APRA's report into the irregular trading attributed the traders' behaviour to an operating environment characterised by lax and unquestioning oversight by line management; poor adherence to risk management systems and controls; and weaknesses in internal governance procedures. Ultimately, APRA found that cultural issues were at the heart of the failings:

The culture that exists within NAB contributed to many of the control breakdowns that led to the currency options losses. While their effect is difficult to measure, we are in no doubt that cultural issues had a significant bearing on the extent of the losses that emerged - influencing both excessive risk-taking behaviour and the bank's capacity to detect it.[18]

In the case of Volkswagen, it's easy to blame the Supervisory Board along with the Board of Management (who according to the 2014 Annual Report "regularly, promptly and comprehensively informed the Supervisory Board on the development of the business …including the risk situation and risk management") but it really comes down to Volkswagen's culture and more importantly, its attitude toward risk.

Volkswagen has been described as having a culture that focussed on being "aggressive at all times" with its leaders taking a tough stance with workers who were afraid to stand up to them and admit failure. Matthias Muller, the new Chief Executive Officer, has since stated that he does not want to be surrounded by "yes men but rather by people who follow their instincts and are not merely guided by the possible consequences of impending failure."[19]

Risk conscious culture

A risk conscious culture is a necessity for all organisations across all industries and sectors. Under CPS 220 Risk Management, APRA expects a sound risk management culture is established and maintained throughout the institution and that all persons within the institution have awareness of the risk management framework and for instilling an appropriate risk culture across the institution. ASIC also plans to incorporate culture into its risk-based surveillance reviews, using the findings to better understand how culture is driving conduct and communicate this to industry and the firms where there is a problem.[20]

Many organisations, such as the ANZ, appear to be doing the right things when it comes to both AISC and APRA's regulations and CPS 220 Risk Management. In fact on the ANZ website, under the heading Risk Culture states:

"Risk culture is an intrinsic part of ANZ's overall Risk Management Framework. Risk Culture is led from the Board down and across the whole group. At ANZ, Risk is everyone's responsibility. There are a number of policies, processes and controls in place to help ensure that a sound risk culture is established and maintained throughout ANZ. We also regularly review industry best practice to continually enhance ANZ's current risk culture."

However, in early 2016, an ANZ trader accused ANZ's global markets division of fostering a toxic culture of sex, drugs, profanities and excess. The trader claims that drug use on the dealing room floor was rampant and his first day on the job involved being taken to a strip club. Etienne Alexiou also claims that in September 2011, after "white powder" was found in the male toilets of the dealing room during a birthday party celebration, he was told by a senior executive trader at ANZ "what a waste, someone should have sprinkled it on the birthday cake."[21]

At this stage, these are allegations and are not yet proven. However, if they are true, then it highlights the disconnect which can exist between the risk policies in place and the way the organisation inherently behaves. This can occur in any organisation and a 2015 survey by PwC of senior executives and non-executive directors in Australian financial services organisations found that while two thirds of respondents said their organisation had a clear and defined state for risk culture, less than half said they had mechanisms to assess progress against the desired outcome. Two thirds of respondents believed that their company did no analysis whatsoever to understand which behaviours are critical, or the levers to get them from their current to their desired state.[22] There is clearly room for improvement.

In 2014, the Financial Stability Board (FSB), an international body which monitors the global financial system[23], produced a report outlining a framework for assessing risk culture. The FSB highlights the foundation elements of a sound risk culture, which includes risk governance (roles and responsibilities of the board and senior management), risk appetite (RAS and risk limits etc) and compensation (effective alignment of employee compensation with prudent risk taking).

Accordingly, the risk culture must be set from the top. The board and senior management are the starting point for setting the core values and expectations and drive these values down through the organisation. Accountability is important such that all employees at all levels are accountable for their actions, having understood the core values of the organisation. Communication between employees and the ability to challenge one another is paramount. Remuneration and compliance with the risk management framework should play a part in the performance evaluation and appraisal, further supporting the value placed on risk culture.

The final word

Risk continues to be one of the most important factors driving organisational performance today, with a corresponding impact on financial markets and investors. This paper looked into some of the more recent failings of risk governance frameworks to assess if there is a common link and what we can learn from these. What is surprising, is in most cases, such as the ANZ and Volkswagen, the organisations had the necessary risk policy documents in place and yet still their risk frameworks failed. This disconnect can be linked to the organisation's risk culture or lack thereof.

An organisation's attitude towards risk plays an integral role in best practice risk management. While an organisation's culture can be complex, there is no doubt that the risk culture of an organisation is inherently linked to the organisation's culture. The root cause of the GFC is often linked to flaws in the risk culture. The Financial Stability Board has provided guidance on risk culture and states that "risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution's attitude toward its stakeholders."

It is one thing to be seen to be doing the right thing and another to actually live it. Fundamentally, risk management needs buy-in from all levels of the organisation otherwise, time, money and resources can be wasted in a supposed focus on risk that is divorced from the organisation's objectives.

In a risk-conscious culture, risk management plays an integral part of an organisation's governance and culture. The core values, risk and governance of the organisation are all driven from the top and infiltrated down through the organisation such that everyone, at all levels, understands and believes in the culture. Employee education is paramount such that everyone in the organisation understands the role they play in risk awareness and management. Such a culture begins with clear policies and procedures in place which includes providing the necessary resources, outlining the risk philosophy and risk appetite as well as ensuring full and open dialogue across internal teams within the organisation. The structure of the organisation should be such that employees have the confidence to speak out if they believe actions are inconsistent with the risk culture, knowing that the organisation has clear whistleblower policies in place and they will be protected. In the words of the FSB, "a sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures that emerging risks or risk-taking activities beyond the institution's risk appetite are recognised, assessed, escalated and addressed in a timely manner." Risk will remain one of the most important factors driving financial markets and it is critical that organisations recognise that their attitude toward risk, or risk culture, is central to their ability to avoid, navigate and mitigate risks.

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