

Drivers of risk management

Adapting risk management to organisational motives

Research executive summary series

Volume 7 | Issue 7

Main findings, implications and overview of project

Risk management's official argument is clear: it is good business. However, practice does not indicate the same. Based on theory and case studies, the following drivers for risk management have been identified:

- A 'progressive' argument or driver of value creation.
- Three 'defensive' arguments or drivers of value preservation:
 - The increasing production of risk in modern society, leading to an escalating experience of uncertainty and unpredictability.
 - Risk management as a mechanism of response to increasing uncertainty.
 - Risk management as a mechanism to distribute responsibility and legitimacy.

It was concluded that value creation is not a fundamental driver for risk management, but instead it seems to be largely if not exclusively, driven by a defensive motive for 'value preservation'. The suggestion is that this distinction can be used in a taxonomy guiding the development of risk management technology and how organisations can adapt their risk management approach to fit their own drivers – as shown in the table below.

Objectives

- Identify key drivers for risk management, based on theory and case studies.
- Present taxonomy to guide organisations in developing risk management according to their own drivers.

Introduction

Risk management is a relatively young management technology. During the last ten years, it has evolved from a technical economic discipline with roots in insurance, finance and engineering into becoming a mantra which has permeated the regulatory and management domains. But why has risk management evolved to such a comprehensive discourse?

The official rationale is quite simple – risk management contributes to organisational value creation. However, practice raises several paradoxes in relation to this explanation.

First, risk management frameworks such as COSO promise to enable the company to understand, handle and counter the uncertainty of the future in order to aid organisational value creation. However, the recent crisis indicates the linkage is not that simple.

Second, the growth of regulatory risk management requirements is in conflict with the argument of value creation. This is because the need for regulatory requirements would be unnecessary if value creation were already implicated. If this was the case, these activities would be conducted voluntarily by the company, seeing risk management as one of the company's strategic choices of differentiation. Since this is not the case, risk management must revolve from other motives at least to some extent.

These are some of the apparent paradoxes that trigger this article. The article discusses the drivers of risk management, based upon theory and two cases. We then present taxonomy for organisations to help adapt their risk management in accordance with their own key drivers.

Progressive driver	Defensive driver
Value creating	Value preserving
Goal seeking	Loss avoidance
Knowledge searching	Calculative
Possibility exploring	Defensive
Leadership based	Bureaucratic
Assessment oriented	Control oriented
Future minded	Retrospective
Ex-ante participation in decision processes	Ex-post justification of decisions

Method

The research project is based on seven longitudinal qualitative case studies conducted at Copenhagen Business School, two of which are reflected in this article. This article is an executive summary and synthesis of two articles published in the Danish magazine Økonomistyring & Informatikk 2010/2011.

Case companies

All case companies are among the largest in Denmark, and seen as front runners in the area of risk management.

Transport

'Transport' is an internationally-listed group, primarily involved in transport but also in other business areas such as energy. The company has a risk aware cultural heritage from the founder. Structured enterprise-wide risk management was officially initiated in 2004 by CEO mandate, due to risk exposures and experiences at the company but also triggered by losses observed at other companies. Risk management was originally located in internal audit, but along with their new CEO in 2008, risk management changed to become more integrated in the decision processes throughout the company rather than being a siloed discipline.

Pharma

'Pharma' is an internationally-listed group in the pharmaceutical industry. Systematic risk management was initiated in 1999 in relation to a risky de-mergers of a central business area, the increasing emphasis on risk management in the anglo-saxon world, and their own chairman's involvement in the Committee on Corporate Governance in Denmark. The initiative resulted in an internal risk management organisation. The company's risk management has over the past ten years matured from a bureaucratic approach to being integrated in business and decision processes.

Analysis

Progressive driver

The economical argument of risk management can be understood in the context of Weber's thesis of rationality. Weber (1978) understood rationalisation as capitalistic cost-benefit calculation. He argued that in the capitalistic system, the role of bureaucracy would increase and there would be a tendency to measure and plan everything, including the future. This can be associated with the thesis of risk management, creating a basis for informed decisions. Weber did not deal with risk

management as a modern tool, but certain aspects of his theory, such as rational value creation through bureaucratisation, can provide a qualified input on central drivers for the growth of modern risk management.

However the quote from the former head of group staff functions in Transport indicates that rational value creation may not be the key driver for risk management. 'I have never understood risk management as value creating. We used risk management to avoid unexpected surprises, losses and negative impact on our set goals.'

According to one director, risk management was triggered by 'an expensive error in a larger African business, which we could definitively have prepared and risk assessed much better. Our division was also aware of the Brent Spar and Piper Alfa cases in the late 1980s. All this in addition to the influence of consultancy companies, caused the CEO's directive.'

All told, there are few indications of a value creating risk management perspective in Transport, even though their risk management was explicitly said to be part of decision processes.

In Pharma, risk is defined as 'events which can hinder the company from reaching overall goals.' Risk management therefore seems to be value preserving rather than value creating. However, several interviewees argued their utmost ambition was to 'create increased transparency and improve the quality of decision processes.' The head of risk management even said, 'the relation to decision processes has become more evident over time.' Pharma initially emphasised loss avoidance, but they have begun to develop the relation between risk management and decision processes more strongly by exploring the uncertainty within decisions, which suggests more of a value creating approach.

Even though the official argument for risk management is progressive value creation, there are only a few explicit expressions of progressive drivers in the empirical data that we came across in our case sites. There are some implicit indications, but the Weberian arguments only partially explain the use of risk management. At best, the evidence suggests risk management approaches may be a result of process rationality (March, 2005). Process rationality is when decisions become meaningful due to the process, rather than the outcome. This is indeed a relevant argument if risk management is intended to create legitimacy and compliance. As such, doing risk management may be rational in a compliance sense even if initially purely bureaucratic.

Defensive drivers

There are possibly larger social changes behind the growth of risk concerns and risk management. These changes increase the organisational need for risk management activities for other reasons than the value creation rationale. These forces are likely defensive by being primarily reactive to external and internal pressure.

Risk production

Giddens (1999, p.3) defined the risk society as a society increasingly preoccupied with the future and safety, generating the notion of risk. Beck (1986) described the risk society as a post-modern society, where the logic of risk production dominates the logic of wealth production. Indeed, a central idea in Beck's (1997: 42, 37) risk society is 'the overproduction of risk... which abundance should be prevented, eliminated, denied or reinterpreted.' This thesis could, at least theoretically embed an obvious driver for the emergence of modern risk management.

Risk management is an attempt to anticipate causality and control the future. However, the problem is risk management does not necessarily imply it is possible to relate specific events and phenomena to specific reasons, because it is impossible, especially in a globalising world with increasing uncertainty and complexity, to identify the consequences of decisions before they are taken (Kneer & Nassehi, 1997).

Luhmann (2002) adds to this the more we know, the more we become aware of what we don't know which results in expanded risk knowledge. Consequently, we become preoccupied with the idea of risk reduction. However, as we calculate and try to predict the future, additional aspects of uncertainty and risk become evident. We find ourselves in a dilemma where risk is the always present shadow of the opportunities embedded in knowledge. Risk awareness is thereby a symptom on a provoked uncertainty.

The former head of group staff functions in Transport claimed the CEO's burgeoning interest for risk handling were triggered by previous projects, which went off track 'because people did things they didn't know the consequence of.' He further emphasised the impact the bankruptcy of Barings Bank had on the CEO's interest for risk management. Even though risk management was not a discipline at given point, he expressed that, 'I am quite certain that the CEO experienced an increasingly complex and unpredictable world.'

Pharma's chief risk manager indicated they had 'a major focus on emerging risk, because the world changes... the company is more global and internationally oriented, therefore we must pay attention to the effects of globalisation. Risk erupts faster, events take place at a high pace and sometimes with major impact.'

Similarly, the CFO pointed at the significance of external influences related to their internationalisation efforts and the drastic changes in their business environment. In addition to the increased demands from regulation and increased control and product liability, he also specifically emphasised an impetus for risk management arising from how the company's production and logistics had become increasingly complex and dynamic.

Therefore, the data fits to describe the escalating risk production revealed in risk society theory in the case companies. The increasing uncertainty affects a need to create more certainty by controlling the uncertainty parameters. The control tool becomes a crucial factor in maintaining system trust. The escalating risk experience may be a probable driver for risk management. In this relation, Douglas & Wildawsky (1982) state: 'Can we know the risk we face, now or in the future? No, we cannot but yes, we must act as if we do.'

Response mechanisms

An uncertain world provides fertile ground for the growing market and interest in risk management, which can provide an apparently formal response to acting responsibly. As humans, we try to control this experience by risk management, even though we know it is impossible. Risk management as a means for risk mitigation and security is a natural response to a world perceived as more risky. In this regard, Power (1997, 2004) indicates a paradigm shift, where risk society has evolved into an 'audit society', seeing internal control as a common and legitimised response to risk.

As Power (2004, p.7) states, 'risk is not an object of control and audit in itself, but so can the control tool be.' For example, most of the modern risk management frameworks are a response to unintended organisational and macro economical crisis.

The former head of group staff functions in Transport argues that they 'have in the process [of implementing risk management] been concerned with identifying and assessing changes in the global macro economy. At one point [before implementing risk management] we, totally unprepared, experienced that growth in China had an enormous influence on steel prices, harming a series of large transport investments.' The growth of risk and uncertainty triggered Transport to mitigate by implementing risk management. At a certain point, they employed a macro-economic scenario planner to better understand the uncertainties of the future.

The chief risk manager in Pharma perceived that 'risk erupts faster ... and sometimes with major impact.' The CFO in Pharma explained risk management made him 'sense that I know more risks.' This may indicate risk management is a response mechanism to the increasing risk.

The empirical data of which the above are only a sample, indicate the majority of interviewees see risk management as a relevant response mechanism to an uncertain and unpredictable world. Risk management becomes a form of self-assessment, documenting towards the surrounding world the company has tried to do its best. Risk management as a system is hereby trying to reinsure trust in a complex and uncertain world. The attempt to control uncertainty and risk by risk management is reactive, indicating a defensive value preservation position.

Distribution of responsibility and legitimacy

Beck (1999) states 'risk does always involve the question of responsibility.' In the relation between cause and effect, cause may be indistinguishable from responsibility (Beck, 1997, p. 282). When a company decides to adopt a generic risk management method, such as an acknowledged framework, it invests in a potential redistribution of responsibility. Scheytt et al. (2006) state the emergent view of risk management creates an isomorphic pressure on companies to adapt and use risk management models, thereby distributing responsibility and legitimacy.

In institutional theory, organisations are viewed as resource dependent systems, whereof legitimacy is the most vital resource (DiMaggio & Powell, 1983). Assessing the risk management set up is risky, leading many to look to what others do. The pursuit for legitimacy may be a driver for risk management, without value rational arguments, because institutional studies demonstrate that companies maintain structures and practices even though it seems to be economically inefficient (ibid).

The new head of group staff functions in Transport noted 'our risk management, despite all good intentions had the character of a fata morgana, an expensive folder locked in the chief's office. Information was not used. Risk management was in the line seen as a paper tiger, reporting for the sake of reporting. The exercise mainly consisted of disguising that the numbers were copied from the last report.'

He pinpoints even though risk management has become more decentralised, 'we do of course live up to regulatory requirements.' A director in the transport division further elaborates they 'listen to the business schools and consultancy companies.' Transport experienced their risk management did not provide value except for partly compliance, justifying the use of resources. Therefore, they adjusted risk management from the administrative to the governance level and adapted the risk management approach to external expectations, a feature of coercive isomorphism.

The lead time for a new pharmaceutical product is normally at least ten years and subject to major investments, huge amounts

of risk and strict regulation before reaching the market. Pharma argued their choice of risk management approach had been made under both internal and regulatory influence. The risk management link to external regulatory processes, a relation expressed among others in the extensive risk management part of the annual report, may be seen as a feature of isomorphic behaviour.

We do find strong indications in the empirical data that the organisations use risk management to create legitimacy and distribute responsibility. Risk management seems to be a response to an increasingly uncertain world, but the basic leadership perspective seems to be adoption of a documented responsibility reducing and legitimating tool. Looking at the risk management set up, it seems like one of the drivers for risk management is the external isomorphic pressure.

Discussion

By using the expression 'progressive driver' we wish to underline that if a company is able to explain the future through proper use of risk management, it may achieve value creation. As we have pointed out, it is this official rationale of risk management being good business which is marketed by risk management advocates. However, to be truly value creating, risk management must be arranged and performed as a progressive opportunity and knowledge searching process, rather than the defensive value preserving approach.

The risk definitions of our case companies reveal a pronounced value preservation focus, expressed in Transport as 'avoiding unexpected surprises and losses.' Companies rather define risk as events which may hinder them from realising set objectives. Risk management is thereby limited to maintaining territory, not winning new ground. These considerations indicate loss avoidance is seen as a bureaucratic operational exercise, rather than value creation and opportunity exploration which is seen as strategic leadership.

Enterprise wide risk management is currently characterised by ensuring risk mitigation when implementing decisions that have been already made. However, we postulate that if risk management is to create value, decision processes and their intrinsic risks should be considered commensurately because organisational risk exposures are inherent to the decision-making process. Herein, the ex-ante/ex-post decision characteristic which is used to draw a distinction between the governance and control aspects of risk management. Risk management as a progressive mechanism is therefore seen as a strategic ex-ante approach in contrast to the defensive operational ex-post approach.

Without making it a criterion for value creation, it is remarkable

the companies' initial initiatives to risk management are localised mid-level and up. It may also be noted the majority of the risk management organisations report to the treasury and finance functions. As such, risk management is often maintained in a financial and calculating context, with a consequent tendency of a defensive control-oriented approach.

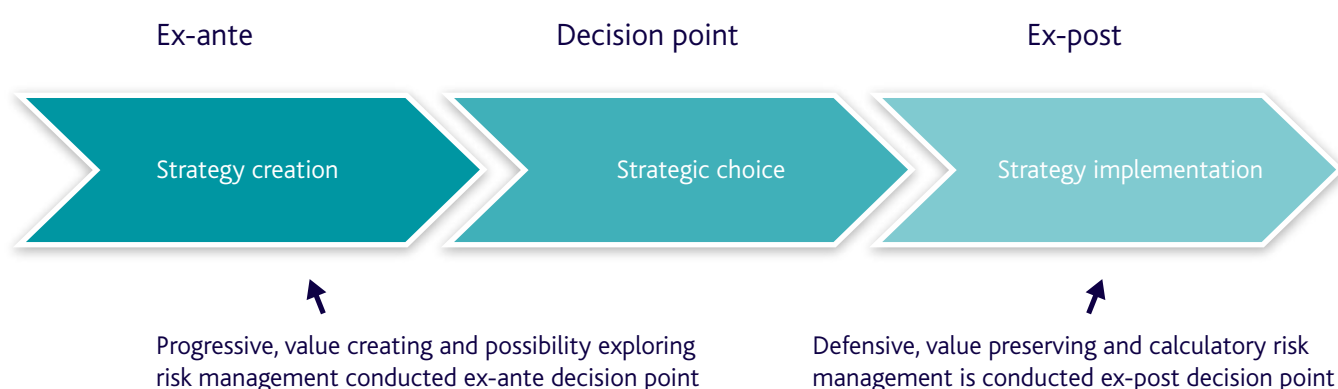
Due to the apparent significance of defensive drivers, it is important to reflect on the risk management approach in light of objectives and resources spent. We argue that as long as risk management maintains a control and calculation focus being retrospective and defensive, it is likely to retain its silo-oriented

structure and not live up to its value creation claim. If risk management is to provide value creation, it must actively explore the possibilities and threats entangled in any vital decision processes. Risk management must seek knowledge, be progressive and leadership oriented to uncover and explore an uncertain world.

Therefore the following taxonomy is suggested as a guide for developing the risk management technology and possible future risk management approaches, according to an organisation's own risk management drivers – as shown in the table below.

Progressive driver	Defensive driver
Value creating	Value preserving
Goal seeking	Loss avoidance
Knowledge searching	Calculatory
Possibility exploring	Defensive
Leadership based	Bureaucratic
Assessment oriented	Control oriented
Future minded	Retrospective
Ex-ante participation in decision processes	Ex-post participation of completed decisions

Figure 1: From defensive value preserving risk management to progressive value creating risk management – risk management being part of the decision process.



Conclusion

We have analysed the drivers and motives of two Danish companies adopting and working with modern risk management methods. The cases illustrate a line of commonalities in relation to the theoretical drivers we identify. None of the companies profess to the common rationale of value creation. The companies identify an increasing risk production and consequently implement risk management as a response mechanism to control uncertainty and create legitimacy. They rather seek value preservation and loss avoidance, a defensive motive.

We also argue that future risk management activities must be adjusted according to organisational key drivers. A guiding taxonomy for an either progressive or defensive approach may indicate how future risk management could be conducted.

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ISSN 1744-702X (print)

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