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GCRA: Acting the Part

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Australians are asking why it should take Royal Commissions, withering media reports, shareholder activism and litigation before boards and senior leaders recognise that issues of Governance, Culture, Remuneration, and Accountability (GCRA) represent material business risks.

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Non-financial risk management in the financial services sector is managed according to a Three Lines of Defence ('3LoD') model. This model seeks to manage risk through restrictive policies, processes, systems, and record-keeping, and to apportion accountability for such among front office business leaders (1st Line), supported and overseen by risk and compliance staff (2nd Line), with assurance coming from the internal audit function (3rd Line).

Following on the heels of risk management failures, most *post-mortems* conclude that the 3LoD model was insufficiently well 'embedded' within a firm. Typical call-outs include: inadequate clarity in roles and responsibilities, coordination challenges, broken processes, and inaccurate risk reporting, collectively enfeebling the 'voice of risk' in the organisation. To us, the striking question here is: *why* does this pattern of failure persist?

Traditional risk management typically underweights our profoundly social nature. In all spheres of life, humans operate within fundamentally *social* constructs, with informally defined expectations of behaviour guiding how we must act if we are to 'fit in.' Formal processes, systems and structures (including financial incentives) hold far less sway than does the social imperative of normative compliance – 'going along to get along.'

Looking through a structural lens, one perceives structural solutions. This characterises our approach to risk management in the financial industry: we emphasise solutions of process and system.

But if there are other factors at play—namely, social factors that system and process tweaks fail to contemplate—then we should not be surprised when structural solutions result in risk management failures.

The model doesn't manage risk, people do

At many firms, operational risk management has become little more than a *Kabuki* theatre, designed to provide comfort that things are taken seriously and to produce demonstrable (if spurious) "evidence" of thoughtful activity to placate concerned stakeholders without actually shifting things at all. Such false comforts are costly and produce immense frustration when risk management failures appear (as they inevitably do).

Spending on governance, risk and compliance systems, tools and processes across the global financial sector is estimated to exceed USD $100 billion annually. And, yet, firms continue to experience poor risk outcomes, resulting in the added expense of punitive fines and customer remediation. Estimates suggest that such added costs have exceeded USD $500 billion in the global aggregate since the GFC.

This circumstance exists because it is permitted to.

Got the right inputs? (check) The right tasking? (check) The right systems and processes to support the tasking? (check) Are appropriate tasks being done? (check) By people 'fit for purpose'? (check) Got good accountability mapping for those folks? (check)

Great! Did we get the desired outcomes? Uhhhmmm ...

Distracted by *Kabuki* theatre offerings, attention from regulators, boards and leaders is focused on GCRA *inputs*, while outcomes are largely left to chance. If this approach to risk was a trading strategy, investors would surely rush to pull their money out of the fund. Yet such is the accepted state of non-financial risk management right across the Australian financial sector, catalogued exhaustively by the Hayne Royal Commission and news headlines.

When culture and conduct problems come to light, the industry's reflexive response is to call in consultants. Firms should of course bring in expertise when it is lacking internally. But, too often, firms seek to offload responsibility for risk management by outsourcing it to consultants who are happy to produce the same shelf-ware for all clients, and to be paid twice and thrice for the same intellectual effort.

Criticism of this over-reliance on consultants was resounding in the wake of Australian Prudential Regulation Authority (APRA) inquiry into the Commonwealth Bank of Australia—and the subsequent capability review of APRA itself. 'Someone told me that cultural change takes 10 years', Graeme Samuel said at the time. 'The only [person] who would promote a 10-year program of cultural change is consultants brought in to implement it'.

Such consulting solutions are usually highly defensible—indeed, that is what they are designed to create: defensibility. Efficacy seems an afterthought. Regrettably, it is very easy to see how the current proliferation of 'risk culture frameworks' will lead industry down a similar garden path. More GCRA theatre appears set to ensue.

Effective behavioural risk management

We don't need better frameworks that help with more box-checking. We need real-time insights into cultural drivers of behaviour so that firms can course-correct when things look likely to hop the guardrails. If we fail to contemplate the established-yet-unspoken norms and cultural proclivities that permeate a firm, behavioural risks will go unidentified, unmanaged, and unmitigated.

We need real-time, evidence-based and data-driven insights that provide leading indicators of risk *before* it is made manifest, rather than backwardlooking surveillance systems designed to catch bad actors after-the-fact. 'More of the same, but better' won't cut it.

And note: the approach for which we call need not be woolly, nebulous or intangible. By marrying behavioural science to data science, it is now possible to devise quantitative metrics for the qualitative challenges of management, and to adopt risk management tools and methods that enable proactive management interventions, targeted precisely, and applied in a more timely, efficient, and effective manner.

By deploying behavioural expertise and leveraging recent advances in network theory and machine learning, it is now possible to manage risk exposures from the front-foot—and to unlock improved performance across business lines and corporate functions.

Rather than waiting for risk to materialise and suffering through the inevitable backlash from investors, customers and a more deeply aggrieved public, leading firms (and their regulators) will invest in such predictive approaches to drive proactive risk mitigation and meaningful operational resiliency.

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About Rhizome

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Rhizome is a specialist risk management advisory firm that delivers smart and effective solutions to current and emerging risk management challenges. Our practice is expert-led, providing foresight and clarity by connecting insights between different risk types as well as within them. We work with executives and Boards to deliver better risk management, enabling better outcomes for all stakeholders.

About Starling

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A globally recognized RegTech pioneer, Starling is an applied behavioral sciences company that helps customers to create, preserve, and restore value. Combining machine learning and network science, Starling's Predictive Behavioral Analytics platform allows managers to anticipate the behavior of employees and teams, and to shape it proactively.