The GlobalEthicist

The biggest risks nobody talks about

By Andrea Bonime-Blanc

The failure of leaders and the business cultures they encourage can have devastating consequences

The World Economic Forum has just published its Global Risks 2014, a very useful snapshot of risks confronting governments, companies and other stakeholders. Though it targets large systemic risks, in this and other risk assessments there is, however, a gaping hole: the risk of leadership and culture failure.

In the 1980s there was Drexel Burnham Lambert and the savings and loan scandals. At the turn of the century we saw Enron, WorldCom, Adelphi and Tyco, to mention just a few. Most recently we witnessed the probably most systemic and widespread series of scandals of them all – the global financial meltdown of the past half-decade.

What is a common denominator that runs through all of these scandals? Is it a breakdown in internal controls? A lack of proper laws and regulations? Ineffective board oversight? A poor executive team without a vision? A general counsel, internal audit or chief financial officer asleep at the wheel?

They may all have played a role. However, a closer look may take us to another level of risk we don't talk about much: the failure of leaders, the risk that leaders have the wrong motivations and incentives, the risk that motivations other than the common good of the enterprise are driving CEOs, their hand-picked executive teams and their rubber-stamping boards, to allow excess, short-termism and, in the worst cases, illegal behaviours.

But it also goes beyond leadership. It goes to the culture of the organisation. And it may even go to a systemic culture in an entire sector. It is a culture that instead of encouraging a race to the top encourages a race to the bottom. This can best be seen in the financial sector over the past two decades.

But it also happens in other sectors. Look at the construction industry, especially in developing countries where the use of the cheapest labour possible without consideration for health, safety and basic labour rights has given rise to a new form of modern day slavery. Look at the retail industry and the supply chain nightmares that have come to light through tragedies such as Rana Plaza.

So the answer to the question of what is the least discussed and potentially most devastating risk is the risk of leadership and culture failure.

Let's break that down. Leadership risk is the risk that the top leaders of an organisation misuse, mismanage, abuse or outright loot the coffers of the organisation they owe fiduciary allegiance to. Extreme examples of this risk are unfortunately not uncommon: Milliken, Skilling, Fastow, Ebbers – these are merely those who have been found to have plundered or otherwise abused their positions of power for personal gain.

Quiet but guilty?

What about the CEOs, CFOs and other executives who have not been investigated, prosecuted and found guilty of any crimes or civil violations? Maybe they've been forced out of their positions quietly or in disgrace (and then frequently found another willing corporate home). The names here are many as well: look at the turnover on Wall Street and global financial sector – especially global bank leaders who have been in the cross-hairs of prosecutors though often not directly investigated, prosecuted or convicted.

Leadership risk includes the misuse, mismanagement or abuse of the organisation's coffers

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Leadership risk is therefore the risk of a top executive either engaging in direct criminal or civil legal violations or engaging in unethical or borderline practices that may come back to haunt not just him or her but the entire organisation. This is a form of reputation risk.

So, what then is "culture risk"? We have all heard and read about the importance of tone at the top, the fact that the culture of an organisation is largely determined by its leader setting the parameters for business strategy, business plans and performance incentives. Leaders set the tone not necessarily by what they say but by what they do. Culture trumps compliance every day of the week. Culture and how we do things is way more important than written policy and codes of conduct and what we say about how we do things.

Culture risk is the risk that the culture that suffuses an organisation is the culture of a leader who is more narcissist than true leader, more self-enriching than steward of his/her company; someone who may a) not be true to the principle of legal compliance, (b) not be living up to common ethical behavioural standards, or c) be driven by a performance incentive stricture that encourages overly risky or even illegal behaviours.

Close links

Why are leadership and culture risk so closely inter-related? Every leader, especially when it comes to corporations, brings their own personal style, experience, expertise, history, values (or lack thereof), and approach to strategy, business planning and performance management. This personal package carries a lot of weight and allows the CEO to stamp the organisation with his/her way of doing things. This way of doing things then becomes part of the pervasive culture.

So, what can we do about leadership and culture risk?

First, recognise it. Executive teams and boards need to recognise that these are critical and material risks to any organisation.

Second, prepare for it. Preparation entails dealing with this danger practically and on several levels:

- Developing balanced and traceable performance and incentive structures.
- Deploying a code of conduct programme that is not a toothless tiger, that is properly resourced, positioned and measured.
- Having a robust speak-up culture within the organisation that allows for problems to rise to the top (rather than be suppressed at all levels).

Third, take ownership. Ultimately, it is the board of directors that is accountable for recognising, preparing for and preventing this type of risk. As the body that ultimately oversees the CEO's hiring, performance and firing, pay package, incentives, performance, strategy and risk management, the board needs to look out for and develop checks and balances on the risk of leadership and culture failure.

KIRSTY PARGETER

Robust communication channels vital throughout your organisation

No one else but the board has this power or ability (unless you count government regulators or investigators or hostile/activist investors/shareholders). Other executives are usually beholden to the CEO. The general employee population will act in accordance with the incentives they are given and the culture they perceive (rather than are told about). No set of beautifully printed or digitally deployed values will ever trump the way things actually get done in an organisation.

It is the responsibility of the board to deal with leadership risk by:

- Properly vetting and selecting the CEO in the first place.
- Setting clear parameters on the performance and incentives of the CEO.
- Properly gauging the performance management system the CEO has put in place for the executive team and the rest of the organisation.
- Understanding the connection between performance management and financial and other results.
- Not being afraid to discipline or dismiss the CEO when circumstances dictate.

The board should deal with culture risk by:

- Seeing the results of periodic culture surveys (or demanding culture surveys if the organisation doesn't do them).
- Having certain key executives report to the board periodically (in addition to the chief auditor): the head of ethics and compliance; the head of human resources; the head of corporate responsibility; the head of risk management.
- Delving into the employee population and the organisation itself from time to time by visiting facilities, talking to mid- and lower-level staff, and generally kicking the tyres.
- Engaging in meaningful executive sessions with key members of management.

Human nature is such that we will never eliminate egregious behaviour or actions that seeks to cut or even slice through corners. However, when boards do their jobs and hold their CEOs accountable, the rarely considered but material risks of leadership or culture failure will be addressed, understood, ameliorated and perhaps even prevented. ■

Ultimately, it is the board of directors that is accountable for recognising or preventing risk

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