Managing Risks Under Stress

Challenges for Senior Executives

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Executive Summary

Companies under stress have to take more risks – that's the nature of business. This stress creates a bigger challenge for senior leaders on the Board and in the C-suite to govern that risk. Risks, both intended and unintended, increase. Resources to manage those risks decrease or are spread thinner. Leaders cannot be paralyzed by these risks; if they are, their companies will not survive. The companies that succeed are the ones who adapt, not abandon, their risk governance. Under stress, how do leaders make sure they are making the right business decisions? How do they make sure they are sending the right risk signals? How do they identify the on-the-ground risks before it's too late? These questions are not academic; they have real business, ethical, and, in some parts of the world, legal implications for senior leaders. There are no easy answers, but there are lessons to be learned and applied.

Life Under Stress

People take more risks under stress. We all do it. When we're running late for an important meeting, we cross a busy street without waiting for the traffic light, drive a little faster, perhaps run a yellow signal. When times are tough at work, many of us work longer hours, eat more junk food, exercise less, and drink more coffee or even more alcohol.

How do we govern our risk? Sometimes we're more proactive. We weigh ourselves regularly and chart the results, counting our calories, steps, and heart rate. We listen to a watchful spouse or vocal children. We may even go for regular check-ups.

Many of us govern our risks more reactively. We wait for the risk signals to reach us: tighter clothes, the onset of a hangover, a near-accident while absently crossing the street. Unfortunately, some ignore the signals until the consequences are much more serious, such as a heart attack.

But what if the risk signals were distant and less obvious? What if when we ate too much, drank too much, and exercised too little, *somebody else's – a stranger's* – blood pressure and weight went up, not ours? What if when we crossed the street against the light, *somebody else* on another continent was nearly hit?

Increasingly, that's what happens in companies under stress. In a recent review of the post-recession experience in companies across a number of different sectors, ERM found that companies under stress have dangerous tendencies to simultaneously:

- Make higher-risk decisions with limited risk information and insight;
- Reduce their capability to monitor and manage those risks; and
- Let their culture drift toward more risk-tolerance and even risk-blindness.

Corporate Life Under Stress

All companies have to make difficult decisions, even in "normal" times. Companies under stress have to make tougher decisions. The challenge is making sure those decisions are smart as well as tough, informed by good understanding of the risk implications for the business.

Companies routinely face several kinds of risks. There are operational risks, disrupting supply chain, slowing production, and jeopardizing markets. Employees face the very real, tragic risks of serious injury or death. (Too many companies have had fatalities in the last few years, even companies that had gone years or decades without one.) There are also potential "catastrophic" risks, such as major environmental releases, fires or explosions. These can lead to loss of life, capital equipment, or business disruption, or even end the useful life of an entire facility. The business risks are enormous and varied: the death of an employee at your facility is tragic, but the death of your employee while providing a service at your customer's facility, while equally tragic, may also endanger your entire book of business with that customer or even sector globally.

Several circumstances add stress that complicates all these risks, including:

- **Tough economic times**, when companies confront difficult decisions and sacrifice important processes and resources.
- **Rapid growth**, when everyone is too busy chasing opportunity to worry about risk. Entire sectors (such as high-tech) can quickly outgrow their nascent management infrastructure, like healthy adolescents outgrowing their clothes. This stress may be exacerbated if the culture celebrates the "garage start-up" self-image, even when that image is a distant memory for a global enterprise with 100,000 employees in dozens of countries.
- **Boom and bust**, when rapid growth is followed by tough economic times (e.g., the recent patterns in mining and unconventional oil and gas). In the boom times, no one had time to get permits, let alone keep track of them; in the bust, no one has time (or money or staff) to track down those permits, let alone comply with them all.
- **Changes in ownership**, when new owners may not realize how much their company depended on expertise and support processes from a former parent. They may not appreciate the resulting risks, especially if the new owners are from Private Equity, unfamiliar with the nature of the business and focused on a short horizon for selling off the company.
- **Volatility**, when disruptive shifts cause their own stress, including shifts in product or service mix, supply chain, markets, exchange rates, or prices; even favorable shifts can introduce stress if too rapid or uncertain. Businesses shifting rapidly from manufacturing (factory-based) to service (field-based) may find belatedly that their risk management depends overwhelmingly on now-irrelevant on-site management.

Decisions Under Stress

During times of stress, most of the attention is focused on risk-related *actions*: if employees are operating in a situation with less margin-of-error, are they careful to perform safely, according to protocol? Less attention is paid to the *decisions* made by managers and executives, though calm decision-making is the first casualty of stress. “Swift, tough” decisions create the risks that employees are then expected to manage.

Companies have safety rules and procedures for how employees should operate. Some audit whether employees follow those procedures. But few companies – even in “normal” times – have rules and procedures for whether executives should continue running a facility if funding has been cut below safe operating levels (e.g., if cuts prevent necessary maintenance or supervision). Who audits management decisions under duress?

Some risky decisions are particularly likely to occur during tough times:

- Decisions to cut OPEX (operating expenditures) often translate directly into decisions to defer maintenance, with equipment run longer and harder, often not replaced or repaired until after something goes wrong.
- Decisions to cut CAPEX (capital expenditure) result in existing equipment kept in use beyond its useful life, and employees who become “resourceful” in adapting equipment to inappropriate uses.
- Decisions to reduce headcount often stretch coverage. Leaders can make decisions that reduce supervision on site or ask supervisors to cover multiple facilities across wider geography, creating work shifts or entire facilities without adequate supervision.
- Decisions to offer “voluntary” buy-outs may thin out process knowledge. These sorts of buy-outs often attract a disproportionate number of older, more experienced employees, sometimes in high-risk process businesses where those exact employees may be best able to adapt and operate safely with fewer resources and older equipment.
- Decisions to cut budgets may be decisions to create stranded operations – facilities or equipment that are too old or unprofitable to invest in, but too costly to shut down properly. These can be as small as a single piece of equipment like an electrical board left unused and unmaintained but still electrified – a hazard that could result in fatal injury. Stranded operations can also be a portion of a facility (e.g., shutting down the legally required wastewater treatment plant while still operating a facility that creates wastewater) or even an entire facility, staffed by “walking dead” who know they have no future yet have to continue operating.

Leaders under stress sometimes make these decisions without exploring the consequences. The assumption is that good managers will know how to cope with these risks; after all, these same leaders would never authorize a major new revenue project without examining the cost. Arguably, making reductions without considering the risk is just as incomplete a decision.

Resources Under Stress

At the same time, resources to monitor and manage risk are likely to be cut. Some of these reductions are aimed at risk management and assurance activities: for example, during the 2007-09 recession, many companies reduced the level of auditing and risk reviews for environment, health, and safety or even skipped entire years.

The people who have to implement these decisions and manage risk are also under stress:

- Both management and labor are distracted. Suspecting or even knowing that their jobs are short-lived, they may be focused on getting the next job instead of performing their current one.
- Labor usually knows far more than management realizes about plans for reductions or shutdowns, and speculation runs out ahead of knowledge. Tension tends to increase between management and labor, which can be particularly destructive in facilities where labor-management cooperation is the basis for many safety-related programs.

The Risk-Resources Trap

As discussed, companies face a double challenge in times of stress: riskier decisions are made at the same time that risk monitoring and management resources are cut.

Even in "normal" times, companies struggle to keep the gap between risk and resources as small as possible. They seldom get it exactly right, and usually err on the side of tolerating a little more risk than their control resources might warrant ideally. The margin of unmanaged risks is generally small; otherwise, companies would go out of business or face crashing stock values due to constant explosions, serious violations, and fatalities.

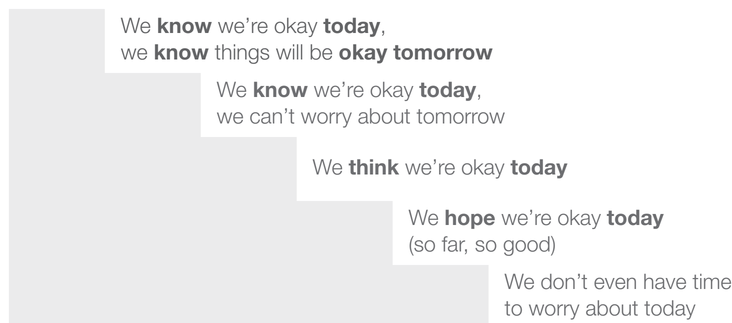
In times of stress, the amount of risk and resources to manage risk tend to move in opposite directions. The simultaneous increase of risk and reduction of resources can exponentially increase the amount of unmanaged risk.

The Culture Trap

Some companies like to think that they can weather this risk-resources trap because their "culture is strong." In reality, culture is often one of the casualties of stress. In many companies, culture drifts dangerously during difficult times and can even exacerbate the risk-resources trap.

Under "normal" conditions, companies often try to articulate and reinforce a culture of high expectations and assurance. They declare compliance and safety as important corporate values. (Though when was the last time you saw a company declare "Safety Fourth," even if revenue, costs, and share price really do come first?)

Under stress, cultures tend to become increasingly tolerant of risk. There is a strong tendency to drift down from that emphasis on assurance and durability. Step by step, we see company cultures drift downward:



Along the way, risk tolerance creeps upward without any conscious decisions about how much risk to accept or how to prepare for that risk.

Cultural Drift and Risk Tolerance

The messages sent through the organization can lead to even higher risk tolerance than any conscious decisions may have intended. For example, a piece of equipment or part of a facility may usually be inspected every three days. That is the standard. Under stress, if nothing has gone wrong, this may be extended to four days. That becomes the new standard. If nothing goes wrong, as staffing is cut and demands increase, this may go to five days and then perhaps to six. One colleague refers to this as "deviation blindness": no one decided to cut the frequency of inspections in half, but nonetheless that is the incremental result. An industry veteran summed this up differently: "Everything's okay … until someone dies."

Cultural Drift and Feedback Loops

What response can someone in the company expect – whether employee, manager, or even executive – if he or she sees unanticipated or unmanaged risks and raises those concerns to the level above them? One way to test cultural drift is to ask, **at each step of the staircase**, how likely is it that:

- The concern will be taken seriously?
- The concern will get acted upon?
- The concern will get passed up to the next level?
- They will have no negative impacts on their job or career?

For some of us who have worked in very proud "can-do" cultures, it can be very difficult to point out that, in some circumstances, we "can't do" or, more accurately, "shouldn't do" because of unmanaged risks.

As a company slips down the culture staircase, the answers are less and less likely to be positive. As a result, it is also less likely at each step that feedback loops will operate and that critical information about risk will reach from the ground back up to senior management and the Board. This breakdown can be critical. As one manager noted, this is the last line of defense to "tell you something's wrong before you have blood on the floor."

Some cultures are particularly prone to this. In cultures that romanticize the cult of toughness among managers, hubris will trump risk management. Leadership says, "bring me solutions, not problems." Managers at all levels pride themselves on being able to deal with budget cuts and other factors without "complaining" to the people above them.

This behavior isn't limited to rogue cultures; it can happen in the best, as well. For some of us who have worked in very proud "can-do" cultures, it can be very difficult to point out that, in some circumstances, we "can't do" or, more accurately, "shouldn't do" because of unmanaged risks.

Solutions: What Companies are Doing

Many companies are wrestling with risk governance under stress. There are no perfect solutions, but there are lessons to be learned.

The wrong lesson is to micromanage from the top, with more small decisions requiring more bureaucratic processes and more sequential hierarchical review. In practice, that may not help either business imperatives or risk. This micromanagement makes the business less efficient and agile at a time when agility and speed are essential. At the same time, it suppresses risk insight and oversight, as managers learn to keep key decisions away from these cumbersome processes if they want to get anything done.

In looking at how companies manage risk governance under stress, three key questions have emerged:

1. Are you making informed business decisions?

Ask balanced, integrated questions and require balanced, complete answers. For example, if managers report that "*we cut staffing by X percent*," ask, "*What risks does that create or increase? What are you doing about those risks?*" or "*Where will that leave us short-handed? What are the consequences of that?*"

Then probe the answers:

- Ask repeatedly, "*What happens then?*"
- If told, "*We are confident that we will still be able to manage these risks,*" then ask, "*How do you know? How will you know if it's not working?*"
- Bring personal responsibility back into the room when making important decisions. After discussing risks, ask the very powerful question, "*Are you okay with that?*"

2. Are you sending the right risk signals?

Risk signals under stress are often isolated and stilted. CEOs record videos or send out letters urging productivity and revealing some cuts. At the end, an exhortation is added, with complete sincerity (eyes looking directly into the camera), avowing that "safety is still paramount and nothing is more important than that everyone returns home safely every day." There is no integration of the two messages, no discussion of how safety will be maintained if cuts are implemented.

Effective leaders go out, look, ask, and listen during times of stress. (They do not spend most of their time hiding in internal meetings looking at ways to cut costs more.) They create opportunities to talk with employees, to hear and encourage honest signals by:

- **Asking more than telling.** This is especially important in smaller group or one-to-one settings while walking around facilities.
- **Knowing what to ask.** Probing, open-ended questions will elicit far more meaningful answers than closed-ended questions. Ask how staffing levels are working rather than asking, "*Are you following all safety procedures?*"
- **Listening to the answers.** People can tell the difference.
- **Reacting constructively to what they hear.** Leaders need to give managers and employees "permission" to speak honestly, especially in times of stress. The most important form of permission comes from leaders' reactions when problems are raised. Follow-up is equally important.

3. Do you know what's really happening on the ground before it's too late?

Ironically, assurance efforts – the things companies do at the top of the staircase to **know what is going on** – are often perceived as a luxury to cut in times of stress. Effective companies use assurance efforts as a key component of risk governance, and as key mechanisms to navigate through stress.

It is important to focus risk assurance resources on the risks that matter:

- **Focus on the risks you care about.** Look honestly at your risk tolerance. If the critical risks for your business are fatalities, focus on the situations that create the greatest likelihood of fatalities.
- **Focus on the operations and locations under the greatest stress.** Don't skip the operations you're cutting or stranding; they need the greatest attention.
- **Stop worrying about the risks you're willing to tolerate.** You may have the world's greatest procedures. Do you really need to maintain the same cycle and intensity of auditing against those procedures? Can you shift those resources to higher-risk issues and locations?
- **Conduct "deep dives."** Don't skim along the surface everywhere. Select a few high-risk, high-stress operations or businesses and do "deep dives," going all the way down to what's really happening on the ground. The findings will be crucial, and will give you clues to what's going on elsewhere.

Leadership Under Stress

Reading about these lessons is easy. Applying them under stress is hard. Implementation is not the problem; there are lots of tools and programs to support these leadership approaches, once the decisions and signals flow from the top. The hard part is carving out the time and attention. Under stress, leaders face multiple, competing, urgent demands for their attention. Customers, unions, lenders, lawyers, investors, deal proponents, deal opponents, and the media all clamor for attention.

Risk governance does not clamor for attention. In fact, risk itself doesn't clamor for attention – until it's too late. Risk looms in the background until something awful really happens. Then risk management becomes quite urgent, and pushes out many of the other business decisions leaders should be making.

Leadership is not about managing risk. Leadership is about assuring that risk governance is in place before it is too late. That is the challenge.

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