The Power of Feedback Loops: Attaining and Sustaining a Healthy ERM Program

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Don't Lose Sight of the Big Picture

Enterprise risk management (ERM) is a practice that has gained momentum in response to the global financial crisis. Across the financial services industry, ERM is moving to the center of strategic decision making and many institutions are revamping their entire approach to better understand and mitigate the risks that they face.

Today, managing risk is a continual process of systematically assessing, measuring, monitoring and managing risks in an organization. Effective risk management ensures that the "big picture" is not lost to the daily demands of running a business. Infusing a risk management strategy into an organization's culture helps ensure that employees are focused on identifying and anticipating potential risks rather than ignoring their existence.

How do we know if risk management is working effectively? One way is through establishing a risk management "feedback loop" to continually assess whether the assumed risk is reasonable and appropriate, or whether the situation should be reassessed. Increasingly, boards and senior executives are looking to develop effective key risk indicators (KRIs) to drive the effectiveness of their ERM process and improve the execution of the organization's strategy while pushing responsibility and accountability into the front-line business units. These KRIs serve as a type of feedback loop, providing organizations with an early warning sign of increasing risk exposure in various areas of the enterprise.

This white paper examines how feedback loops are effective tools for positively impacting and changing risk behavior. By integrating feedback loops into organizational structure, financial institutions can address minor issues at the lowest level and empower business lines to self-correct—while keeping the focus of the executive team on more high-reaching business concerns.

The Psychology Behind Feedback Loops

The impact of feedback loops on human behavior has captivated psychologists for decades. From B.F. Skinner's classic "Skinner Box" to Albert Bandura's study of the role of self-efficacy toward attaining goals, research has continually shown feedback loops can greatly condition and influence behavior.

Feedback loops are particularly effective when it comes to setting organizational goals. This theory was first observed more than 40 years ago by researchers Locke, Cartledge and Knerr, who found that when people are assigned a goal and given meaningful feedback regarding their performance relative to that goal, they will use the feedback to adjust their actions to better match the goal. In his article, *Self-Regulation Through Goal Setting*, Locke and his team determined that goal setting is not very effective without feedback; concluding that goals supported by feedback are more effective in motivating high performance or performance improvement than either one is separately.

The ability of a feedback loop to positively impact performance and desired behaviors is well documented within the cognitive psychology discipline, but there are also more approachable examples in the broader media.

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The Power of Feedback Loops

In a June 19, 2011, *Wired* article, the author illustrates how feedback loops helped resolve speeding problems in school zones in a California community. The small city of Garden Grove in Orange County was plagued by repeat accidents because of excessive speed in school zones. Ticketing and replacing old speed limit signs with new ones had only limited success. So, city engineers decided to take another approach. In five Garden Grove school zones, they put up dynamic speed displays that digitally posted the driver's speed as he or she passed by. The result? In the vicinity of the schools where the dynamic displays were installed, drivers slowed down an average of 14 percent. At three schools, the average speed dipped below the posted speed limit.

Feedback loops also helped influence more positive behavior on the Tidy Street energy project based in Brighton, United Kingdom (www.tidystreet.org). A group of neighbors monitored each other's energy use and painted a gigantic graph with the results on the street in front of their houses. Each day, their energy usage over the previous 24 hours was marked and compared with the average Brighton household's electricity usage. The result? In three weeks, Tidy Street residents' average energy use dropped 15 percent—with some households reaching a 30 percent reduction.

There are two forces at work on Tidy Street. First, meaningful and actionable information was delivered to homeowners and second, the power of shame. Nobody wants to be identified in a public forum for behaviors opposing the overall goals of a community. The same forces are in play within the employee sphere of financial services institutions.

Feedback Loops = Effective Key Risk Indicators

Feedback loops present meaningful information to managers in real-time, allowing them to modify tactics and behavior to better align with corporate interests and strategic goals. A feedback loop involves four distinct stages.

Stage 1 ***Data***: A behavior must be measured, captured and stored.

Stage 2 ***Context:*** The information must be relayed to the individual, not in the raw-data form in which it was captured, but in a meaningful context.

Stage 3 ***Choice:*** The individual can now determine one or more paths to take with this information.

Stage 4 ***Action***: The individual can recalibrate his or her behavior, make a choice and act. Then, that action is measured and the feedback loop restarts.

In today's ERM setting, feedback loops are the equivalent of developing effective KRIs. Key risk indicators are metrics used by organizations to help better monitor potential future shifts in risk conditions, or new emerging risks, so that management and boards can more proactively identify potential impacts on an organization's portfolio. When applied within a financial services setting, KRIs can help board members, senior executives, risk managers and front-line employees ensure that their organization lives within its established risk appetite.

The challenge to establishing effective KRIs is that most organizations collect an enormous amount of data and extracting truly meaningful information can be very difficult. Technology research firm Gartner predicts that "through 2012, more than 35 percent of the top 5,000 global companies will regularly fail to make insightful decisions about significant changes in the business and markets because they lack the necessary information, processes and tools."

Organizations must sift through all the extraneous data and work toward developing effective KRIs that will allow them to identify relevant and meaningful metrics. To accomplish this, management must have a firm grasp of the organizational objectives and risk-related events that might affect the achievement of these goals.

Doing the Right Thing

The steps in the risk management process are not static; they are part of an interactive and dynamic flow of information from the front-line to the business unit to senior management and back to the front-line. These steps are part of a continual risk management feedback loop that consistently asks whether the assumed risk is acceptable. The risk management feedback loop includes:

- Identification of risks to be controlled
- Development and implementation of strategies and policies to control risk
- Evaluation of their effectiveness

If results indicate that risks are not adequately controlled, then policies and strategies are redesigned, re-implemented, re-tested and reevaluated.

In a financial services organization without an institutionalized risk management culture, employees often make the wrong decisions even in the face of good policies. A business unit within that organization may place bets the firm can't cover. Or, executive management and the board may not know of their exposure to these risks until it is too late to save the firm. One might compare the lack of a risk-oriented culture to the drivers in Garden Grove, California. Without the graphic, public display of speeding, they weren't going to let up on the gas pedal.

Conversely, in a well-controlled organization with an institutionalized risk management culture, employees will do the right thing even in the face of unclear policies. Organizations that establish a strong risk management culture, supported through the

use of effective KRIs to heighten risk awareness, will foster informed decision making that is embraced by the entire company.

Additionally, the use of KRIs can lead to fewer episodes of crisis management where normal tasks must take a back seat for full-time devotion to a developing issue. This allows for an improved workplace environment and a more stable and smoothly functioning organization.

Edge of the Envelope

For a true risk management culture to take hold within a financial services organization, there must be a pervasive philosophy communicated from top management down through the organization and embraced by staff. Every employee must understand the organization's risk appetite and where the "edges of the envelope" are for each business line, product and geographic unit. Front-line managers must buy into the risk appetite, and operate under it, for the risk culture to be effectively implemented.

As a rule, KRIs should be monitored closer to the "front" than in the higher reaches of management. It is important to establish a good working relationship between the risk management function and the business units, so that employees view risk managers as making a positive contribution—rather than just someone who enforces the rules. Instead of relying on the risk function to manage risk, financial institutions need to hold accountable and empower the front-line managers to make decisions in a more risk-aware way. The best ERM practice has business managers, profit centers, business units and functional heads assume full responsibility and accountability for the risks they take.

Senior management and boards of directors do not need to know, nor are they necessarily in a position to fully appreciate, all KRIs employed within the organization, but they should be expected to understand and be kept updated on KRIs related to the organization's top risk exposures.

Therefore, most KRIs should be propagated throughout the operational units, giving them the information they need to understand what the board and senior executives expect from them. This can be accomplished by:

- Providing clear risk appetite statements
- Developing effective policies and procedures that support the risk culture
- Implementing the appropriate risk controls

When operational units are given critical information on their performance, such as a KRI scorecard, it pushes them to make decisions that are more in-line with their organization's risk culture. It also enables front-line managers to practice early intervention strategies versus having to wait for a critical escalation point.

By presenting front-line managers with information they not only understand, but also can act on, resolution can remain local and every risk event does not necessarily need to be addressed by higher-ups in the organization. As a result, each department within the organization, such as compliance, IT, risk and internal auditing, can address the risks that are important to them, but still fall within the common framework.

The Bottom-Line: Clear and Actionable Information

Today, implementing a solid risk management program is simply good business. As in all other aspect of business, financial services organizations cannot tackle every risk at once and with the same priority. Therefore, it is critical that organizations focus on the areas of risk that are most closely associated with the ongoing success of their communicated business strategy.

To do so, clear and actionable information, presented as KRIs or feedback loops, not only empowers employees, but also motivates and encourages them to continue operating within an organization's defined risk appetite. After all, as the *Wired* article states, "the true power of a feedback loop is not to control people but to give them control."

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