Risk Governance as a Solution to Leadership Bias

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Conquer Risk

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The Biggest Risk is Biased Thinking

- In this talk, I'm going to argue that a primary risk in any business venture is biased thinking ('cognitive biases') among its leadership
- That biased thinking often exposes the business to too great or too little risk and it leads to a fragile, opaque company that is unattractive to investors
- Good (risk) governance, however, is an effective solution to this problem

What are ‘Cognitive Biases’?

- Ways of thinking that defy data and/or reality
  - Patterns of judgment about people or situations that are drawn in an illogical fashion
- The 2002 Nobel Prize in economics was awarded for work in this area; however, cognitive biases have been recognized in the Orthodox world for 2000 years as “logismoi” (i.e., ‘passions’)
- In either case, episodes such as the recent Financial Crisis, corporate scandals, rogue traders, etc., demonstrate <u>the significant, adverse effects of these biases</u>

Common Logismoi of Leaders

- Some of the most common mental biases we observe among business people in Cyprus and elsewhere include:
  - **Loss aversion:** Seeking to avoid losses more aggressively than smartly pursuing gains
  - **Myopia bias:** Seeing the world through one's own narrow lens (e.g., profit-seeking above performance)
  - **Optimism bias:** Overestimating favorable outcomes (e.g., the Aphrodite gas field) and underestimating unfavorable outcomes

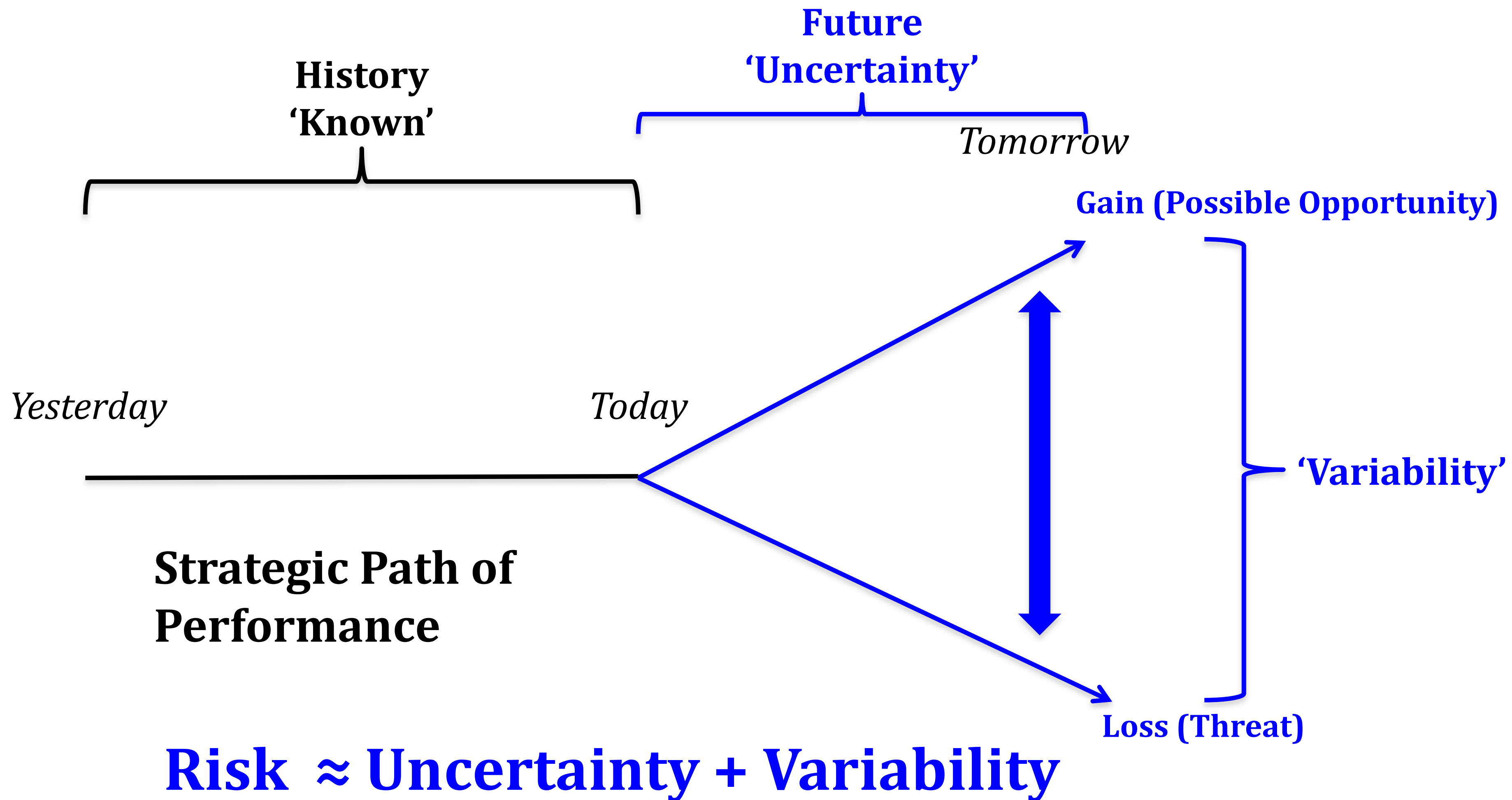
The Logismoi of Leaders

- **Overconfidence:** Excessive self-belief (refusal of advice, certainly advice that costs money)
- **Planning fallacy:** Underestimate the time and costs needed to complete a project (e.g., development projects)
- **Confirmation bias:** Focus on information that affirms our beliefs (e.g., ‘Government is corrupt, so I will dodge paying taxes’)

How biases impair Risk Perception

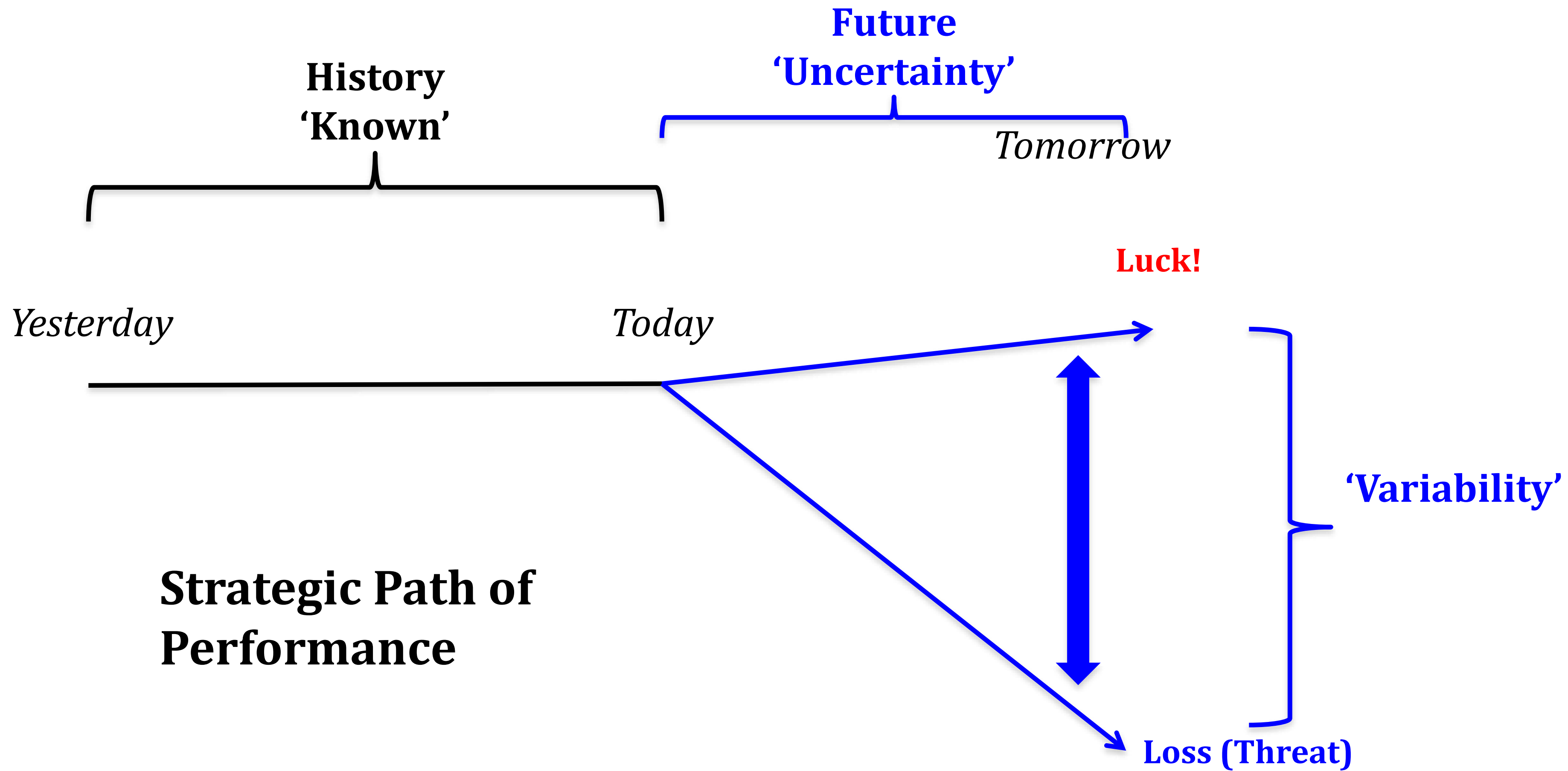
- Risk management is a data-intensive undertaking, in which one seeks to mitigate adverse challenges and capture upside opportunities
- However, the perception of risk is intensely psychological; hence, the when logismoi impair a leader's thinking, they impair *risk perception*
- For example, **loss aversion bias** leads people to view risk primarily as a downside phenomenon and drives them to overreact in avoiding it—which is contrary to how risk is defined…

"True" view of risk



Risk ≈ Uncertainty + Variability

‘Loss Averse’ view of Risk



Under Loss Aversion, people weight downside threats MUCH more heavily

Consequences

- Viewing risk as one-sided (either overweighting or underweighting potential loss), distorts actions and decisions where risk should be considered
  - **Obviously, this leads to bad management**
- For example, loss aversion might make a business manager hesitant to invest until he sees others clearly profiting from doing the same (as we often see in Cyprus)
- Similarly, an Optimism logismos may lead a developer to continue building without discernible, buyer demand

Managing Logismoi

- Most people don't see their biases (the "bias blindspot") and cannot manage them—modern psychology offers little help in overcoming biases, apart from therapy
- The ancient approach to managing logismoi, however, is fully developed
- Either one ignores errant thoughts or sharpen one's *nous* (through prayer) to discern them and fight them
- However, a third option is probably more appropriate and available to every business leader: Vetting one's thoughts with outsiders
- **This is where corporate governance can help**

Corporate Governance and Management Biases

- Corporate governance refers to the mechanisms by which a company is controlled and directed
- ***Risk governance*** are the specific governance rules, processes and mechanisms by which decisions about risk are taken and implemented—a subset of corporate governance
- **In the ideal case, risk governance acts as the third, "vetting" party of a business's leadership: ensuring that biases are mitigated or bad decisions not propogated**

Cases Where Risk Governance Broke Down

- Enron
- MF Global (commodity trader) 2012 bankruptcy because CEO did not heed advice of CRO
- Motorola
- Samsung Telecommunications
- Lehman Brothers
- Orphanides Supermarkets
- Thousands of others

Cases where Risk Governance saved the day

- Wells Fargo
- Tyco
- Alfa Mega, CarreFoure, LiDL
- Allworld Network, Algeria
- Thousands of others—in fact, most long-established, viable firms

An example

- Let's focus for a moment on the **Loss Aversion logismos**
- Many business leaders fear loss to the extent they will avoid investing in an unproven concept (and will not innovate)—or, will continue to invest in a concept, long after customer interest in the concept has dissipated
- In Cyprus, we routinely see both phenomena in the alarming amount of duplication we see in a few, core industries and in the oversupply of flats and houses under development…

A core business focus is never achieved

- Businesses that are overly conservative and underinvest never reach a core business focus—a specialized, product or service area in which they have a competitive advantage
- Correspondingly, product and service offerings do not distinguish the business from competitors—they are neither special nor creative
- Research evidence shows that this hurts profits

Potentially core customers are lost

- Underinvestment leads to shallow service and product offerings that are easily offered elsewhere
- However, core customers tend to have specific, deep needs that drive their loyalty to one or a few businesses—in exchange they seek quality, competitive services and products
- Loss averse businesses cannot provide this depth
- Again, research supports the notion that this phenomenon reduces profitability

The business becomes overstretched

- Not having a core customer base nor a core business focus, the loss averse business starts to become a jack-of-all-trades—providing a long list of generic services
- Ironically, providing a wide range of shallow services can require more resources than a narrower range of deep services
- The overstretched business then becomes **fragile…**

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The business becomes fragile (i.e., unstable)

- As a result of these challenges, the business becomes fragile
- That is, in the midst of economic challenges, it becomes much more likely to fail
- At this point, the management makes desperate attempts to save the business (say, by building up leverage)
- But this greater risk-taking only makes things worse (Orphanides?)

Risk Governance to the Rescue

- In a properly governed business, the leader’s decisions would instead be data-driven since risk management, as we said, is data-based
- Core areas would be defined and policies for core customers would be drawn
- Strategies for funding and financing would also be drafted in accordance with long- and short-term business plans
- **Importantly, decisions would not be made by one person or would not be carried to conclusion if they are hurting the business**

What Investors Want

- At the end of the day, investors (and lenders) will only want to fund businesses that have such effective risk governance—and the reasons why are obvious
- Risk governed businesses (empirical facts):
  - Exhibit greater performance and profitability
  - Exhibit greater longevity and stability
  - Have lower costs for funding
  - Have less biased leadership

Summary and Conclusions

- Mental hang-ups by a business's leadership can impair a company in many ways, but particularly in the area of **risk perception (i.e., risks can be incorrectly evaluated)**
- Corporate Governance, specifically designed around risk management—i.e., 'risk governance'—can effectively address this problem by vetting the thinking and decision-making of the leadership
- Investors and lenders demand this because it further strengthens the business and ensures profitability
- <u>**Hence, Corporate Governance can be a major, driver of profitability and performance**</u>

Thank You!

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Appendix: How can Corporate Governance Ensure Good Risk-Taking?

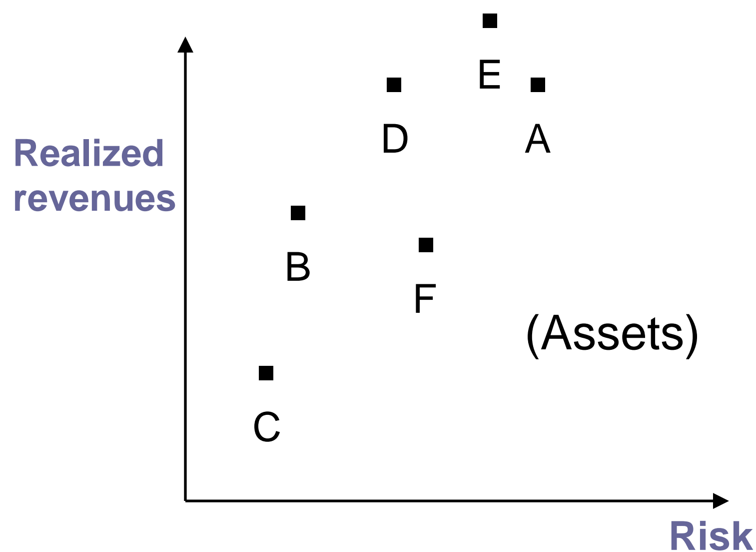
Risk-Based Performance Assessment

- An essential bi-product of a well-functioning risk governance framework is the ability to make decisions based upon comparing **risk versus return, using a measure known as:**

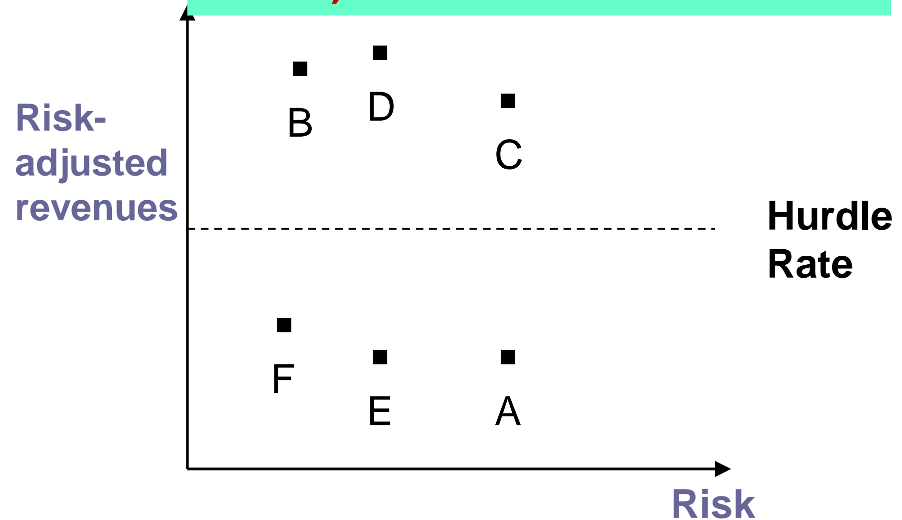
$$RAPM = \frac{\text{Performance measure}}{\text{Risk measure}} = \frac{\text{Returns}}{\text{Risk}}$$

RAPM at the micro level

- RAPM is the general term for measures that allow us to perform this comparison using **risk-adjustment**
- Without Risk-adjustment, revenues and returns cannot be directly compared



Unadjusted returns not comparable



Risk-adjustment allows comparison against common hurdle rate