The Dialogue

Leading the conversation

Social Risks
– for a financial services business

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About the author

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Ian Laughlin has a deep interest in risk management and risk culture – particularly in the financial services world. He has had a long career in financial services senior management and board roles, in various countries. He currently chairs the boards of a group of insurance companies owned by one of the major banks. He also is the Advisory Board Chairman of Blackhall and Pearl, a specialist risk management and board performance firm. Until mid 2015, he was Deputy Chairman of APRA, the prudential regulator of banks, insurance companies and superannuation funds.

About the Actuaries Institute

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Actuaries have a reputation for a high level of technical financial expertise and integrity. They apply their risk management expertise to allocate capital efficiently, identify and mitigate emerging risks and to help maintain system integrity across multiple segments of the financial and other sectors. This unrivalled expertise enables the profession to comment on a wide range of issues including life insurance, health insurance, general insurance, climate change, retirement income policy, enterprise risk and prudential regulation, finance and investment and health financing.

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Executive Summary

Financial institutions have been regularly subjected to public opprobrium – in the press, in politics, on social media – for attitudes and behaviour which the community finds unacceptable. This may be partly because institutions have not managed the risks that come from changing social attitudes and norms, and the power of new social capabilities. Such risks need a fresh approach.

Risk Management Failure

How can it be that institutions spend huge amounts of money, resources and intellect on managing risk, and still find themselves being castigated by the press, politicians and social media for unacceptable attitudes and behaviour? At times this has led to outright scandal. The government has freely criticised the banks, subjected them to intense parliamentary scrutiny, and has announced its intention to impose new law on accountability and remuneration. And now, after much political battle, there is to be a Royal Commission into misconduct in the banking, superannuation and financial services industry!

This begs a question: Is conventional risk management working as it should in the contemporary world?

From the sheer weight of publicity, one could get the impression that attitudes and behaviour in the financial services industry have deteriorated sharply in recent years. While that may be true in some specific areas, my own long experience tells me that standards today in many areas are much higher than they were in the past. But the community has stepped up in two ways: First, society's expectations are (rightfully) much higher and tolerance for egregious practices much lower than they once were; secondly, society's ability to see and to call out unacceptable practices and to highlight poor outcomes has become so much more powerful.

Let me be quite clear: I do not defend the financial services industry for the genuinely poor practices that we have seen all too frequently. But at the same time, there have been situations where businesses have been strongly criticised unreasonably, and the distinction is often lost in the rush to throw stones.

Social Risks

All of this led me to ask what risks were financial institutions being exposed to by contemporary social attitudes and expectations, and by their pace of change.

We all know we have never had so much information, from so many different sources, so quickly and readily available. This can be immensely empowering, but also overwhelming. At the same time, we have never had such an ability to express our views, so quickly, to such a wide audience. These views may or may not be consistent with the facts – more on that shortly.

And so we have something of a paradox: more information, but also more wrong information.

Now all of this provides the fuel for what I might call **social risks**.

These are the risks to a business that come from changing social attitudes and norms, underpinned by new social capabilities.

By social capabilities, I mean facilities such as Twitter, Facebook, Instagram, Google, Change.org, cameras on street corners and in every pocket, and so on – all of which empower the everyday person in ways unimaginable not long ago.

To help flesh out the idea a little, I have made up some labels for sample types of social risk – see Table A.

Table A: Social Risks – examples	
Cynicism Risk	Internal
Patronism Risk	
Self-awareness Risk	
Values Risk	
True Values Risk	
Insight Risk	
Tolerance Risk	External
Generation Risk	
Revenge Risk	
Litigation Risk	
Political Opportunism Risk	
Fake News Risk	
Reverse Fake News Risk	
Post-fact Risk	

I don't pretend this is in any way definitive or exhaustive, and there may well be better ways of classifying social risks, but I hope it helps with the concept. If the reader can take the list in that spirit, let me expand on what they might mean.

Internal Social Risks

- **Cynicism Risk** – the risk that a business consciously accepts its own poor attitudes and behaviours because it believes it is in its interests to do so. An example of this might be tobacco companies promoting smoking in developing countries to young people. Another might be the systematic underpayment of staff in franchise businesses.

- **Patronism Risk** – the risk that 'we know what is acceptable for our customers/shareholders/the community,' when in fact that is not so. Have any of the boards of our major financial services providers exposed the business to this risk – for example with respect to executive remuneration?

- **Self-awareness Risk** – the risk that a business engages in or effectively condones poor behaviour without realising this is how it would be seen by others. The entertainment business may have suffered from this risk with the sexual harassment accusations that have emerged in recent months – it seems some of the practices were well-known, but a blind eye was turned.

- **Values Risk** – the risk that the business's **espoused** values are inconsistent with social expectations. Most financial services companies would have (carefully cultivated) espoused values that would sit comfortably with most people. However, some financial planning or real estate firms, for example, might foster a strong sales culture which would possibly be inconsistent with customer expectations.

- **True Values Risk** – the risk that the **actual** values, as shown through attitudes and behavior of management and staff, are inconsistent with the **espoused** values. Most companies in financial services will have suffered from the consequences of this risk – perhaps driven by culture or remuneration. An example of this might be setting targets and rewarding sales by bank branch staff, which then led to customer outcomes at odds with the espoused values. The banks would probably argue that transgressions by certain staff in recent years were completely inconsistent with their espoused values. Enron provided another great example[1] – its espoused values were exemplary, but its practices were far from so.

- **Insight Risk** – the risk that the business has a poor appreciation of current social norms and expectations, and/or their pace of change.

A good example of this is the life insurance industry in its coverage of mental health. Changes in attitudes to mental health in more recent years (people more willing to acknowledge mental un-wellness and to talk about it, more willing to make a disablement claim because of mental health issues, more willing to engage lawyers to pursue such a claim etc.) have been pronounced. This has led to increasing numbers of claims for life insurers. The industry was mostly ill-prepared for this phenomenon, and is still struggling with the issue.

The banks also have been hit because of changing social attitudes – society has become (rightly) far less tolerant of poor practices by banks e.g. pricing, trading behaviour, selling practices in branches, remuneration.

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Mental Health and Insurance

GREEN PAPER
OCTOBER 2017

Daily Times

FAKE NEWS

DON'T READ ALL ABOUT IT. STOP. USE REAS

IT'S ALL SENSATIONALISM. CHECK YOUR SOURCES AND DO YOUR HOMEWORK BEFORE YOU BEL

In the community, there appears little sympathy for banks and their boards and management, and so any critical story into the banks will have a willing audience.

External Social Risks

- **Tolerance Risk** – the risk that society's tolerance for certain attitudes and behaviours changes quickly and significantly, catching the business unaware. The sexual harassment issue mentioned above is a good example of this.

- **Generation Risk** – the risk that the differing social attitudes of various generations are not understood and addressed accordingly. This can be driven by generational inequity. An example of these differing attitudes is provided by the baby boomers and the millennials with respect to home ownership and the associated (arguable) generational inequity. The UK Brexit vote showed markedly different attitudes between young voters and older voters[2] – the young (those most affected by leaving the EU) voted to remain, the old voted to leave.

- **Revenge Risk** – the risk that a (fairly or unfairly) scorned customer effectively engages the power of social media to exact revenge through generating adverse publicity. It will be interesting to see if the Royal Commission finds any examples of this.

- **Litigation Risk** – the risk of the changing willingness of customers and shareholders to engage in litigation. Examples here include class actions on behalf of shareholders, and the active involvement of legal practitioners in the disability claims process for life insurers. The latter is very evident in radio ads during the day for example, and more than likely has had a significant impact on claims volumes (rightly or wrongly).

- **Political Opportunism Risk** – the risk that politicians, perhaps driven by social media, take the opportunity to cynically criticise a business or industry for the politicians' own ends. It could be argued that we see that in Australian politics today.

- **Fake News Risk** – the risk that the media (conventional or other) will take an accusation and blow it up into a major story, whether the accusation has merit or not. This might be supported by trolling from readers.

  I don't need to introduce the idea of fake news, but let's look at possible examples.

  In the community, there appears little sympathy for banks and their boards and management, and so any critical story into the banks will have a willing audience. We are all aware of the accusations made about Commonwealth Bank's CommInsure and the treatment of claimants – there was wide media commentary on TV and in the press. The outcomes of the investigations made as a result of the accusations were nowhere near as damning[3]. This was given some publicity (not necessarily positive)[4] but nothing like the exposure the original accusations were given. But by then the damage was well and truly done. And once trust is damaged, it is very difficult to recover[5].

  In a simpler example, there was a photo published in the press of the Prime Minister holding his grandchild while having a beer at the footy in September, 2017. This generated something of a storm over quite an innocent picture. In a subsequent article, the Sydney Morning Herald reviewed the treatment of the episode and finished up with this statement: *"When the media confect a story about a non-existent public outrage [and] then seek comment on that outrage, well, what can you call it but an outrage?"*

- **Reverse Fake News Risk** – the risk that a valid concern is dismissed as fake news. In other words, fake fake news: incident occurs (news); someone with skin in the game says don't

worry, not important (that is, the news is fake news). The recent experience with US politics comes to mind here!

- **Post-fact risk** – the risk that statements are made purporting to be true, even though they demonstrably are not, and notwithstanding this, they gain currency[6] [7]. The US President has been accused of this[8]. This risk could result in significant damage to a business's reputation.

I invite the reader to consider some of the recent scandals in the financial services world in Australia in the context of these social risks, and consider how well those risks have been managed.

While a number of the social risks mentioned previously may not be entirely new, what is different in current times is that a social risk can manifest itself in the form of significant damage to a business much more readily and quickly. This is partly because the community can respond in a much more powerful and very fast way as explained above. For example, an aggrieved customer can gain attention to their plight much more effectively, or someone could use fake news techniques to inflict damage.

Also, it would seem that the pace of change in social attitudes and norms is now much higher, so a business is more likely to misjudge the true position.

This rapid evolution leads to what is sometimes referred to as high risk velocity. Risk velocity complements the more traditional risk measures of likelihood and impact. It is the speed with which a risk manifests itself, first as an occurrence and then as an impact. Because social risks can appear and grow very quickly, risk velocity is a fundamentally important aspect of the assessment (and hence management) of social risks.

In addition to risk velocity, when dealing with social risks in particular, one or more of the social risks may build on one or more of the other social risks. For example, fake news might encourage political opportunism. This weight of risks combined with their high velocity can create risk *momentum*. So something that might have been manageable in its own right very quickly may become a multi-headed monster. It might happen quickly, with high impact and great momentum.

In Table A, I have indicated that some risks primarily have an internal source, while others will tend to emerge externally. This has implications for how the risk may be managed.

Internal social risks are those that are a function of awareness, knowledge, understanding, attitudes and behaviour of boards, management and staff. In that sense, they reflect internal weaknesses and so are much more in the control of board and management. Having said that, awareness, knowledge and understanding cannot just be 'taken off the shelf', so the management of internal risks will be very challenging for many organisations.

Internal social risks are partly a function of the organisation's *risk culture*, something the Australian Prudential Regulation Authority has given some considerable attention[9].

External social risks on the other hand are more a function of what is happening in the community and the impact of this on the business. They are therefore less within the control of the business than internal social risks, but nonetheless demand high awareness by the business as well as conscious mitigation and management.

New Capabilities Needed

Where does this lead?

What is the relevance for boards and management in financial services in Australia?

At the most basic level, social risks should be addressed like any other type of risk.

A typical text-book approach involves at least the following broad steps for dealing with risks:

- Identification
- Assessment, and evaluation against appetite
- Treatment
- Monitoring and reporting

For most risks, these steps can be undertaken systematically and with a good degree of confidence. **That may not be so with social risks.** Indeed, recent experiences suggest many businesses stumble at the first step – identification. And the other steps look no less challenging given the difficulty in developing and maintaining a deep awareness and responsiveness to rapid changes in social attitudes and norms.

Notwithstanding the difficulty, to navigate the shoals of the society in which they operate financial services businesses should have deep expertise in identifying, assessing and monitoring that society's attitudes and norms. They need these skills so that they can anticipate possible pressure points and address them early.

Businesses seem to lack these capabilities and traditional risk management methodologies and processes may not suffice when dealing with social risks.

Lessons from Elsewhere

So, for inspiration let's have a look at a different world altogether to financial services – the *Tesla Autopilot*. This allows the car to partly drive itself, and in the process deal with the risks of collisions and accidents – which we as drivers all know is a complex process.

The *Tesla Autopilot* works by monitoring what is happening in the surrounding environment to identify risks in real time, using a variety of sophisticated sensors:

"Eight surround cameras provide 360 degrees of visibility around the car at up to 250 meters of range. 12 updated ultrasonic sensors complement this vision, allowing for detection of both hard and soft objects at nearly twice the distance of the prior system. A forward-facing radar with enhanced processing provides additional data about the world on a redundant wavelength that is able to see through heavy rain, fog, dust and even the car ahead." [10]

Further, it doesn't just report in real time (in the way a warning light on the dashboard might), it actually takes action to mitigate the risk automatically.[11]

Tesla have an interesting diagram on their website which captures these capabilities and which gives a sense of anticipation in its risk sensing.

Imagine if a financial services business had such capabilities in managing social risk.

Social Risk Sensing

So that leads to the idea of social risk *sensing* in financial services. Risk sensing is a much richer concept than risk monitoring – especially when you consider it in the context of the Tesla model. Deloitte has promoted the idea of risk sensing as a tool to address reputation risks.[12]

By 'risk sensing' I mean monitoring and interpretation – preferably in real time for practical purposes - of the information that flows from the various 'sensors' that a business might/should have to provide information about risk – in this case, social risk.

Many of the key risk indicators that our financial institutions employ are actually fairly basic and they are often backward-looking – that is, telling of a breach of risk limits after it has actually occurred. They often don't assess the underlying risk, or consider the underlying causes.[13]
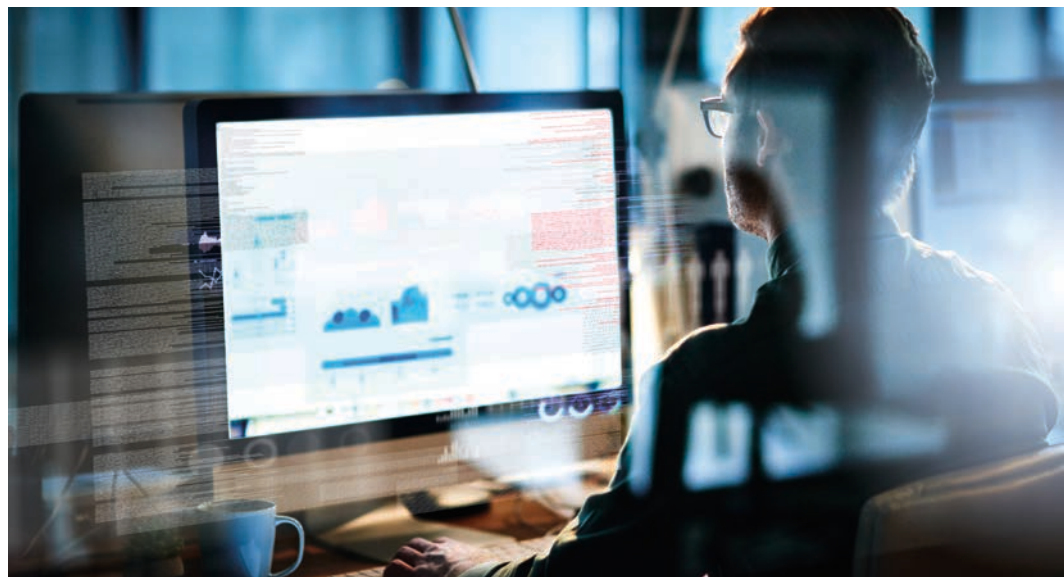
To gauge the current state of risk sensing, Deloitte, in a survey conducted with Forbes Insights in 2015, asked C-level executives in large organisations about their companies' risk sensing capabilities. Deloitte makes the observation that risk sensing ... *"often miss key elements, lack technical depth and analytical sophistication, reside in narrow technical units, fail to focus broadly enough, or otherwise leave the organization open to the very risks that risk sensing should be detecting and monitoring."*

Blackhall and Pearl[14] has had similar experiences in their work with key risk indicators used by financial services businesses. Their work suggests that many of the risk indicators used by organisations provide lagging data, rather than an assessment of the root cause of the risk.[15]

Why should we not aspire to a risk sensing system in financial services that is as effective as the Tesla AutoPilot – potentially including automatic action, or at least prompting, to mitigate a risk as it is emerging!

This in turn suggests the need for financial services businesses to have deep and effective capabilities to monitor and assess social risks. The business should have sensors feeding information in almost

real time providing assessments of social attitudes and norms, and interpreting their impact on risk for the business. The sensors could take multiple forms – for example, pulse checks of attitudes or automated analysis of trends on social media, including the use of artificial intelligence to analyse and assess attitudes as they are expressed. They would need to be much more sensitive and relevant than current measures.

Some first steps might appear obvious. Social media provides a very rich view of attitudes and opinions in almost real time, so surely there are ways of monitoring and interpreting this. However, this can be far more challenging than might be expected at first blush.

Common sense suggests that those members of society who are comfortable with the idea of tweeting will not necessarily be a representative subset of society. And then it would appear that a minority of those signed up to Twitter actually actively tweet.[16] How then would a business assess – from a social risk viewpoint – twitter commentary on a particular issue? If it is being commented on at all!

Similarly, commentary on websites may give a biased perspective. A cursory read of on-line comments on political stories published on major newspaper websites suggests that they tend to express views broadly consistent with the particular newspaper's editorial stance. Presumably this would reflect the wider readership of the paper. What, then, might be taken from those online comments to help manage social risk?

And how would contributions to Facebook, for example, be assessed for indicators of social risk, given the wide cross-section of users, and multiplicity of subjects[17] that those contributions address?

Of course, there are any number of organisations who will argue they can help a financial services business analyse social media. This would be typically for marketing purposes, however, and not for risk management. Insights for marketing purposes may be perfectly valid and useful. They may not be at all useful for social risk management – for one thing, they may not even pick up the issue that could generate risks for the business because it is not obvious.

There has been some interesting academic work on some of these challenges. For example, Peter Gloor of MIT[18] has looked at ways to monitor social media for changes in society's norms and attitudes and assessing sentiment. He distinguishes between Crowd Analysis (Twitter), Swarm Analysis (Wikipedia, Facebook, group chat rooms, etc.), and Expert Analysis (website, personal blogs, etc.).

Staff

The staff of a business is a subset of the wider society in which it operates. Internal social risks inherently involve management and staff. However, the *external* social risks are no less applicable to staff than to other members of wider society. Like society more generally, staff attitudes and behaviour – culture – are changing quickly.

There is much attention paid to culture these days by boards and management, and as mentioned above in financial services to its cousin, risk culture. In turn, effectively monitoring and understanding staff culture is very important to a business from a risk management perspective. It might be considered that there is greater opportunity to get insights from staff than from wider society because of ready access.

Artificial intelligence[19] and other analytical tools[20] are in their infancy, but may prove to be powerful aids for boards and management in this area.

Skills and Resources

All of this suggests that for social risks to be managed effectively, in the very least there is a need for focus and quite different resources and capabilities – both people and technology, and quite possibly including artificial intelligence.

Of course, it would not be enough to *monitor* emerging social risks effectively. There also would be a need to assess *implications* for the business in terms of risk (and opportunities of course) – at its most basic, likelihood, impact and velocity. This would require special skills and resources, supported by technology and, very likely, third party capabilities allied with a deep understanding of the business and its customers.

And then there needs to be a response – a sharp and effective response.

One could argue that at the heart of this should be a **Social Risk Officer,** dedicated to the risks that emerge from attitudes and norms in society, how they are changing, and the implications for the business.'

Conclusion

A lack of deep understanding of social attitudes and norms, and their rate of change, poses significant risks for financial services businesses. Conventional risk management thinking may not suffice in dealing with this. A much more sophisticated approach involving risk sensing in almost real time, supported by awareness, and swift analysis and response is needed. In turn, this may demand new skills, techniques, tools and speed of response. This may well include dedicated senior resources.

A much more sophisticated approach involving risk sensing in almost real time, supported by awareness, and swift analysis and response is needed.

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