

Reducing risk and protecting reputation

Long before the global financial crisis, the finance sector was consistently one of the most crisis-prone areas of business. Yet many organisations have failed to recognise and implement the emerging concept of strategic crisis prevention instead of just conventional crisis response.



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THE INSTITUTE FOR CRISIS MANAGEMENT

(ICM) in Louisville, Kentucky¹ has monitored international media coverage of business crises since 1990 and their annual reports show that banking has been listed among the top 10 most crisis-prone business sectors for each of the past 10 years, closely followed by securities brokers and dealers and then by insurance.

Moreover, the ICM data also shows that the most common categories of crises are not high-profile casualty accidents, environmental incidents and natural catastrophes, but white-collar crime, mismanagement, class action legal suits and labour disputes.

At the same time, an Australian study published in 2004² showed that a quarter of major crises cost over \$100 million, and more than one in four of the local organisations at the center of the crisis did not survive the event.

Given this background, it is surprising how many Australian organisations continue to delegate responsibility for crisis management to middle managers in operational functions such as: corporate security; environment, health and safety; or public affairs. While such functions have important roles, their principal focus is putting systems in place to respond to a crisis when it occurs rather than helping to prevent a crisis from happening in the first place.

Financial risk management is also a well-established discipline, which makes an essential contribution to crisis prevention. But it typically does not fully address the broader range of risks that face any organisation, such as reputational and societal



issues. These may arise from a range of internal and external threats, including allegations of sexual or racial discrimination, breaches of privacy, employee misconduct, infrastructure failure, fire and floods, industrial action, adverse public reaction to branch closures, investment in controversial projects, political interference, allegations of non-competitive behaviour, customer fraud, ethical breaches, high-profile litigation and management misconduct. Sadly, the list is endless, and growing. Indeed, a paper in FINSIA's Journal of Applied Finance, JASSA, recently examined defamation risk as yet another corporate threat.³

Whatever the triggering event, virtually nothing damages organisational reputation and financial performance more rapidly and more deeply than the impact of a major crisis. Yet conventional crisis management still has a strong focus on the traditional response processes, such as a formal crisis management manual, establishing teams, equipping a 'war room', running simulations and exercises, and media training for crisis communication. These are essential tactical considerations, and international studies have shown that organisations with good response systems in place suffer less impact to their share price and recover more quickly. However, these tactics do nothing to prevent the crisis, which invariably causes reputational and financial damage, no matter how well the crisis is managed once it has occurred.

Scholars and crisis experts around the world agree that most, if not all, organisational crises are preceded by red flags and warning signs. Analysis by ICM reveals that most crises are not sudden events at all, with about two-thirds categorised as 'smouldering crises' – where management could have, and should have, taken early action. Their figures also show that executives and managers continue to be responsible

for just over half of all crises that strike organisations of all sizes, while employees are credited with sparking 29% and outside forces trigger the remaining 19%.

These realities underpin the emergence of a new approach to crisis management, which emphasises that steps can and should be taken to prevent crises before they happen, and that attention needs to move from operational tactics to senior executive involvement.

Moving from crisis response to crisis prevention

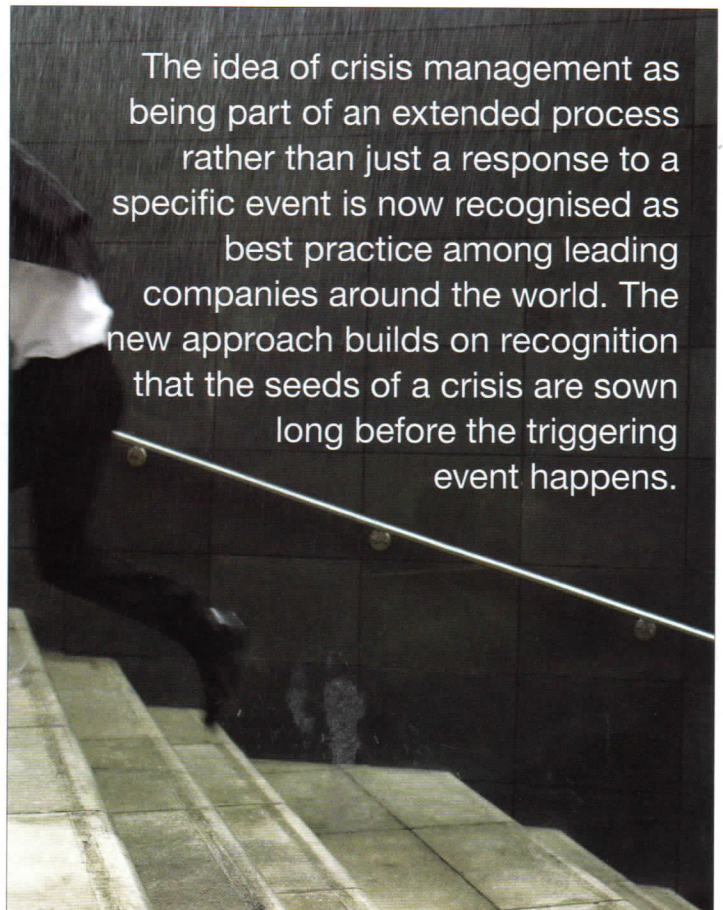
The idea of crisis management as being part of an extended process rather than just a response to a specific event is now recognised as best practice among leading companies around the world. The new approach builds on recognition that the seeds of a crisis are sown long before the triggering event happens.

A striking example occurred in early 2008 when Société Générale reported about \$7 billion (4.9 billion euros) lost on unauthorised transactions by a single rogue trader. An independent panel found that the French bank had failed to act on 75 red flags or early warnings over 18 months.

More recently, in the wake of the \$65 billion Bernie Madoff investment scandal, SEC Inspector General David Kotz reported that the agency missed 'numerous red flags' from 1992 until the fraudster was arrested in December 2008. Kotz said five separate failed investigations into the affair had been bungled and he called for major organisational change.

And, in Australia, inquiries and prolonged litigation over recent years involving a succession of financial crises have revealed that underlying problems existed long before each crisis. These contributing factors include issues such as poor accounting, inadequate training, loose supervision, lack of transparency, misjudgment, failed regulation, weak internal controls, misreading of stakeholder expectations, bad communication and, of course, sometimes outright dishonesty.

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A recent worldwide survey of 950 business executives⁴ suggested that 63% of a company's market value is attributed to reputation, and the leading triggers of reputation crises included financial irregularities (72%), unethical behaviour (68%) and executive misconduct (64%). While there are established tools and mechanisms to deal with most of these challenges, they are not commonly recognised as being part of the process of crisis prevention. In order to secure optimal protection against crises, organisations need to establish four key foundation strengths.

(1) Effective processes for identifying issues and problems early

In the aftermath of any crisis, the most common questions are 'Why didn't you see this coming?' and 'What steps were in place to prevent it happening?'

Research across more than 100 leading companies by the insurance broker AON found that, after business interruption, reputation loss was considered to be the greatest hazard these companies faced. However only 22% of those interviewed had implemented a formal strategy to identify and proactively manage potential reputation risks.

An effective process needs to be in place to identify issues and problems in all areas, not just the obvious ones. Organisations tend to have a good understanding of potential issues in their own areas of expertise, but experience shows that this level of preparedness often does not extend to the non industry-specific risks, which can be equally damaging.

In addition, it is not enough to simply identify problems that could potentially lead to a crisis. The process should lead to explicit action and there are proven tools and templates to prioritise issues, then plan and set goals.

(2) Open channels for upward communication

The American crisis expert Ian Mitroff claims that in every organisational crisis he has studied, someone inside the organisation was well aware of the problem in advance, but information was either blocked or ignored. Indeed Kurt Stocker (a US expert on corporate governance and reputation, and a member of the New York Stock Exchange Regulation Board of Directors) believes top management, by definition, is the least informed group in the company when it comes to bad news. 'Nothing,' he once quipped, 'moves more slowly than bad news running up a hill'.

Several major financial crises in Australia in recent years have highlighted the fact that responsibility for reputation, share price and profitability ultimately lies at the top of the organisation, regardless of shortcomings and failures at lower levels. Organisations and individual executives have been fatally damaged by crises and it is clear that proactive management requires open channels for upward communication from within the organisation and from external stakeholders, especially upward communication of bad news and dissenting opinions.

(3) Systematic learning from past issues and crises

When a major crisis is resolved, it is very convenient to say 'Thank goodness that's over, let's move on' or 'Thank goodness that happened to someone else, but anyway we would have handled it much better'.

Either reaction is a sure recipe for history repeating itself. For example, the Société Générale rogue trading scandal came only 12 years after the startlingly similar collapse of Barings Bank, when a 200-year-old financial institution was destroyed by the actions of a single rogue trader. There too, repeated warning signs were ignored.

To help prevent future organisational crises, organisations should learn from their own issues and crises, and also crises that affect other organisations, especially those in the same field. This should be done using a systematic process, and the outcome should be honest benchmarking and recognition of best-practice procedures.

(4) Integration of issue management and crisis prevention with strategic planning

The fourth and final key foundation for effective crisis prevention is to ensure integration or full alignment of issue management and crisis management with the organisation's strategic planning. Virtually no organisational strategy is capable of surviving a major crisis intact, and crisis prevention requires management involvement at the highest level, along with genuine commitment of resources and effort.

Many of the tools and processes needed to implement a crisis prevention approach will already exist within the organisation, though they often lack integrated oversight and implementation. By contrast, a systematised preventive process helps ensure:

- effective prioritisation of effort, cost and resources;
- avoidance of duplication;
- consistent messaging to all stakeholders;
- ease of measurement and evaluation;
- consolidation of reporting, both internal and external;
- transparency and unambiguous responsibility;
- alignment with broad strategy; and
- executive involvement and accountability for good governance.

Few major business sectors outside financial services are more vulnerable to loss of reputation and customer confidence, which adversely affect organisational success. That fact alone should be reason enough to accelerate the move from conventional crisis response to strategic crisis prevention. ●

1 www.crisisexperts.com

2 The study was undertaken by Dr Les Coleman, currently a Senior Lecturer in Finance at the University of Melbourne. L. Coleman 2004, 'The frequency and cost of corporate crises', *Journal of contingencies and crisis management*, vol. 12, no. 1, pp. 2-13.

3 Tim Griffiths 2009, 'Defamation risk in the banking industry'. *JASSA*, issue 2, pp. 20-24.

4 Weber Shandwick, 2006.