Trusting the Wrong Compass – Lessons from Risk Management Failures

Imran Zia – MSc., CPA, CA, FCCA, CIA, CISA, CFE, CRMA

Director, Internal Audit – Abu Dhabi Ports Group


5:56
OUTSIDE 15℃
Brake Malfunction
Stop the vehicle in a safe place immediately, and contact a dealer

Failures in Personal Risk Management

Red Flags Ignored – The unusual sound was the first warning. But I downplayed it.

False Assurance Accepted – The owner gave an offhand explanation, which I accepted without evidence.

Strategy Overrode Risk Reality – I didn't want to disrupt my plans. Risk became an inconvenience.

Positive Bias – I assumed things would be okay because they had been okay so far.

Lack of Risk Re-assessment – Once the issue was reported, I didn't reassess or escalate.

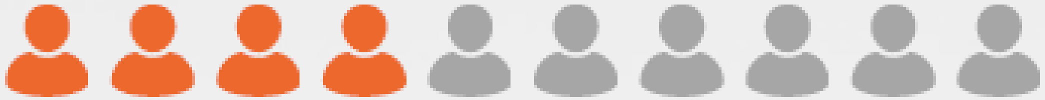
No Contingency Plan – I had no plan if the car failed mid-trip. I wasn't prepared for the worst.

Failures in Personal Risk Management

What nearly left my family stranded in a smoky SUV on a rainy mountain road is the same mindset that can leave organizations exposed to catastrophic failure.

- **Risk isn’t static;**
- **It doesn’t wait for you to update the risk register; and**
- **It certainly doesn’t care about your strategic plan**

State of Risk Management



44% indicated that the integration of risk management across different departments/functions was the biggest challenge in 2024.

"There needs to be more effective communication at board level of the intrinsic value of risk management in the business decision-making processes"

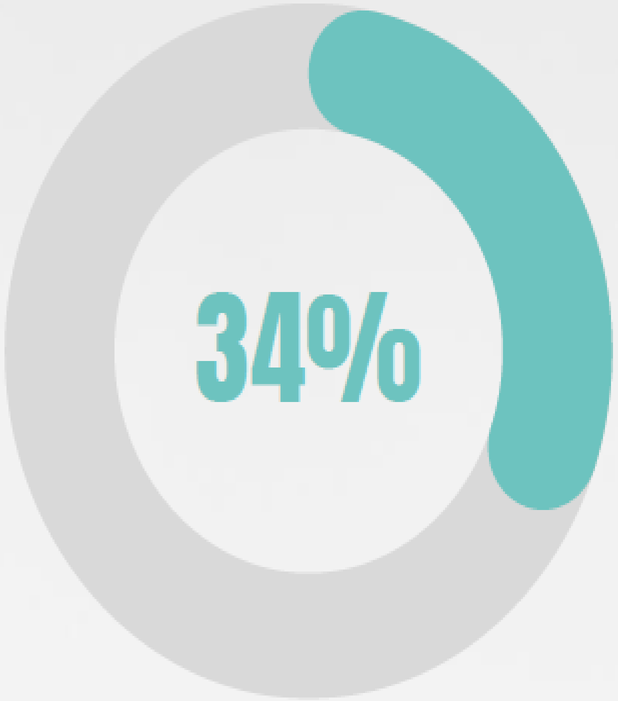
Only 51% currently view their risk management initiatives as effective

– Nationwide's 2025 Survey

TOP PRIORITIES OVER THE NEXT 12 MONTHS

69%	Cybersecurity
48%	Enterprise risk management
37%	Finance and internal audit talent
36%	Compliance with laws and regulations
33%	Finance transformation

Top Priorities of Audit Committee Members Over the Next 12 Months – Deloitte's Audit Committee Practices Report



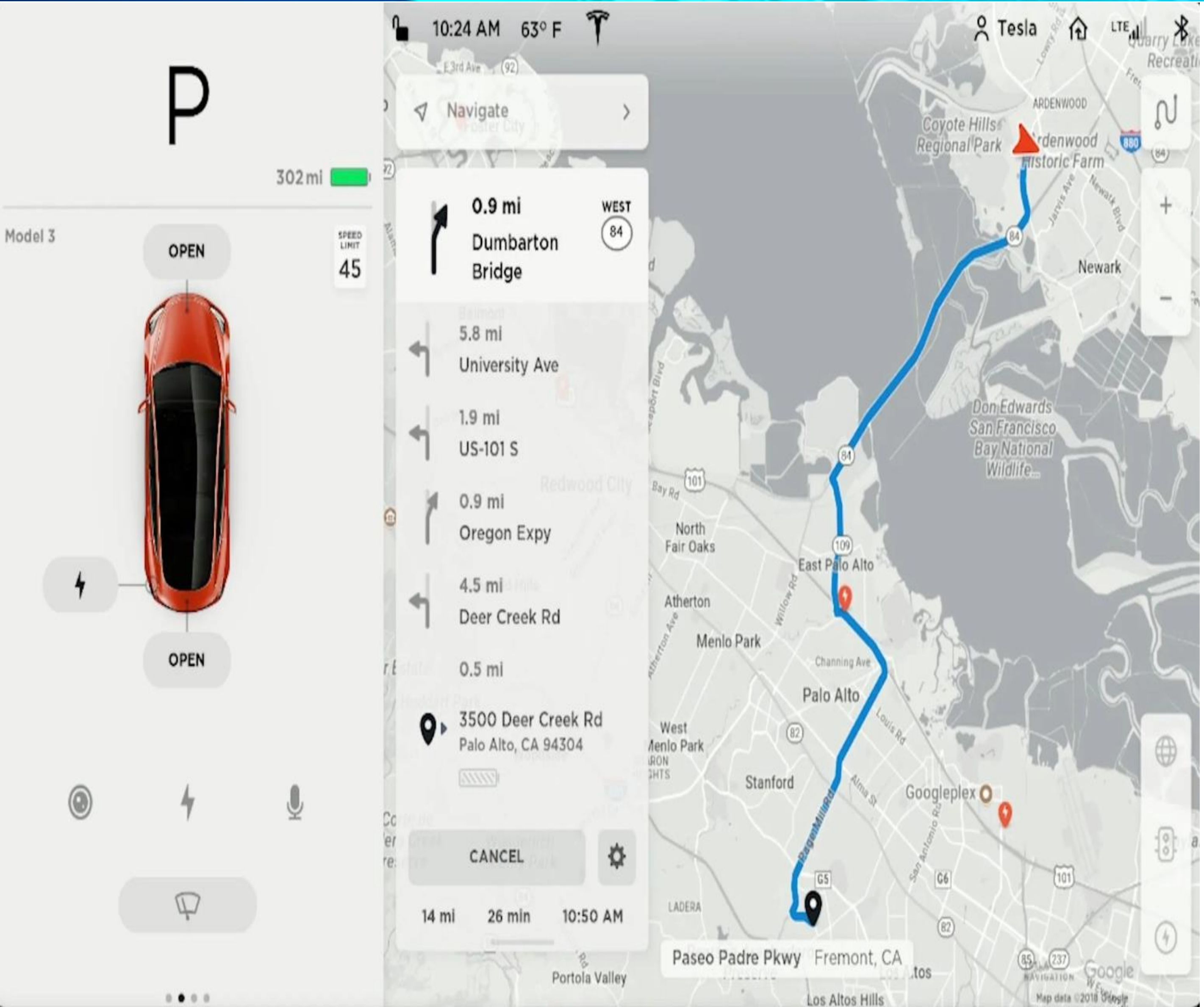
of risk managers feel their organisation does not prioritise risk management in their strategic decision making process


When the winds of change blow, some build walls, others build windmills
What are we building?

Understanding Risk Management – The Spicy Salsa Story

So, in the game of salsa and risk management, it's all about being smart, prepared, adaptable; and having a glass of milk handy when things get too spicy!

How Does Effective Risk Management Look Like?



- It shows us the options and informs us which is the best route
- It indicates traffic problems ahead and suggests alternative routes
- It warns us of upcoming turns
- It alerts us when we have made a wrong turn; and recommends how to get back on track
- It predicts our arrival time
- It also predicts how much resources (battery) will be consumed to reach our destination
- It keeps us on track and **increases the probability of us reaching our destination**

How Does Effective Risk Management Look Like?

Effective Risk Management is about

- Increasing the likelihood of achieving our objectives; and not just about avoiding harm
  - What could go wrong; **and what needs to go right**
- Effective management for success – every manager is a risk manager
- Making informed and intelligent decisions; and taking the "**right amount of right risks**"
- Alignment of risk analysis / reporting with the speed of decision-making

But What About The Risks We Can’t Foresee?

Recognizing a novel risk requires people to suppress their instincts, question their assumptions, and think deeply about the situation

- **The triggering event is outside the risk bearer’s realm of imagination** or experience – fire in a Philips semiconductor plant in March 2000
- **Multiple routine breakdowns combine to trigger a major failure** – Boeing’s development of the 787 Dreamliner
- **The risk materializes rapidly and on an enormous scale** – COVID-19 (*tsunami risks*)
- **The function trap of risk management** – compartmentalizing risks into functional areas
- **Biases reinforced by standard procedures and normalization of deviance** – high-speed train derailment in Germany in 1998

The Problem of Bias

- **Overconfidence about the accuracy of our forecasts** – studies have found that people overestimate their ability to influence events that, in fact, are heavily determined by chance

- **Anchoring our estimates to readily available evidence** – despite the known danger of making linear extrapolations from recent history to a highly uncertain and variable future. (2008 financial crises)

- **Confirmation bias** – drives us to favor information that supports our positions (typically successes) and suppress information that contradicts them (typically failures)

- **Group-think** – Once a course of action has gathered support within a group, those not yet on board tend to suppress their objections, however valid, and fall in line

The Leadership Challenge

We don't live in the world for which conventional risk-management textbooks prepare us

- **Managing risk is very different from managing strategy** – It runs exactly counter to the "can do" culture most leadership teams try to foster when implementing strategy

- **Managing risk by predicting extreme events** – we have abysmal record of predicting black swans; and by focusing our attention to few extreme scenarios, we neglect other possibilities
  - Less than 0.25% of all the companies listed in the world represent around half the market capitalization
  - Less than 0.2% of books account for approximately half the book sales world-wide
  - Less than 0.1% of drugs generate a little more than half the pharmaceutical industry's sales; and
  - **Less than 0.1% of risky events will cause at least half your losses**

The Leadership Challenge

We don’t live in the world for which conventional risk-management textbooks prepare us

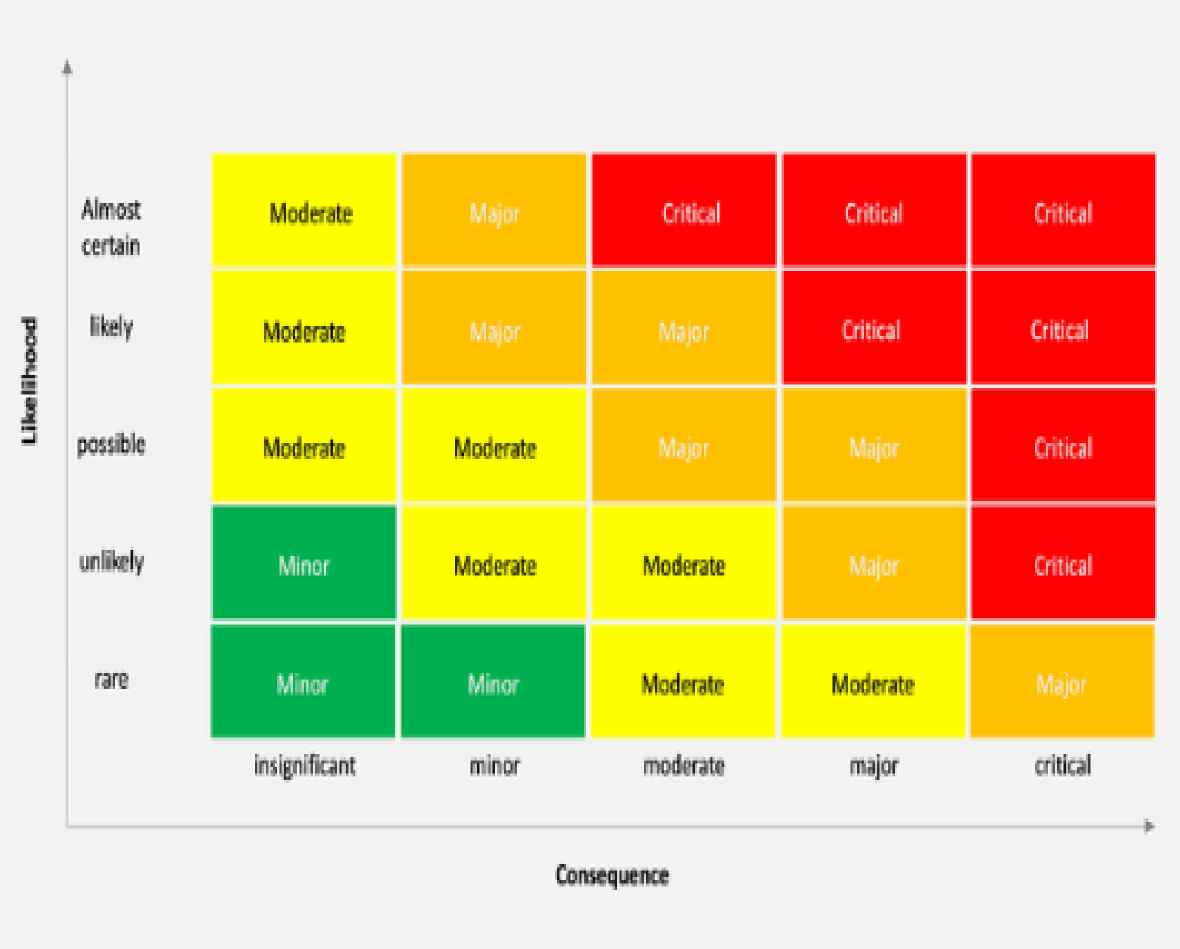
- **Studying the Past will help us manage risk** – risk leaders mistakenly use hindsight as foresight.
  - Black Swan events don’t have precedents
  - Until the late 1980s, the worst decline in stock prices in a single day had been around 10%. Yet prices tumbled by 23% on October 19, 1987

- **We don’t appreciate what is mathematically equal isn’t psychologically so** – the way a risk is framed, influences people’s understanding of it.
  - Investors losing all their money only every 30 years; VS 3.3% chance of losing a certain amount each year
  - One crash every 1,000 years Vs one in 1,000 flights on this airline has crashed

The Heat Map Trap

Executives Don’t Think in Colors, Why Should Risk Managers?

- Should a CEO be more concerned about one “red” risk or three “amber” risk?
- Does a 5x1 risk (high likelihood, low impact) pose the same threat as a 1x5 risk (low likelihood, high impact)?
- Should a CFO always prioritize an “amber” risk over a “green” risk?
- Can an executive safely ignore a “green” risk simply because it is categorized as “low”?



The Heat Map Trap

If Risk Management is about making risk-informed better decisions, then risk heat maps don’t make the cut

- **CEO:** “OK, I see this risk matrix. What does it mean? What am I supposed to do with it?”
- **CFO:** “Why do you have currency fluctuations marked as a high risk when you have already agreed that we are doing what we can to hedge it? Does the Treasurer agree with you?”
- **COO:** “I manage by exception, as I think all executives should. What are the exceptions that require my attention?”
- **CIO:** “What does high Cyber Security risk mean? How much we should invest to bring the risk down?”
- **Business SVP:** “How am I supposed to use this?”

Risk Management meets the Real World – ROI, Capital and Trade-offs

Risk Mitigation isn’t free – it competes for limited capital and operating budget like any other business initiative

The level of risk alone isn’t enough; ask; what is the ROI of treating it?

Key questions to consider:

- By how much will the risk be reduced? (or the opportunity increased?) Will the treatment result in the risk being returned to desired levels?
- How certain is that risk improvement? (a point most miss)
- What is the ROI on the investment?
- Is that ROI at the desired level? (most organizations require the ROI to exceed a certain threshold)
- Can the treatment be modified to improve the ROI?
- Is that ROI better than those for other investment opportunities?
- Can we afford not to treat the risk, even if the ROI is poor?

Risk Appetite – The Problem with Setting it and Forgetting it

Risk Appetite Must Support Decision-making, Not Confuse It

Static risk appetite doesn't tell you where to go, when the weather changes

Risk appetite is the amount of risk, on a board level, an organization is willing to accept in pursuit of value (COSO's ERM Framework)

Here are some considerations:

1) Risk appetite, defined as a single number (usually expressed in monetary terms)
2) A separate risk appetite statement for each of the sources of risk (e.g., finance, safety, compliance)
3) Consider the following risk appetite statements (especially for financial institutes):
   - We have no tolerance for ……
   - We have a modest appetite for …..

Risk Appetite – The Problem with Setting it and Forgetting it

Risk Appetite Must Support Decision-making, Not Confuse It

Does A Static Risk Appetite Serve the Purpose?

- How do such risk appetite statements influence let alone change a business decision?

- How do these risk appetite statements capture the concept or **risk and reward**?

As conditions change, your priorities change, the potential rewards change, and your willingness to take risk changes as well

Auditing The Elephant in the Room

How do you eat an elephant?

- One bite at a time

How do you audit the entire system of internal controls (i.e., for all objectives)?

- One audit of high source of risks at a time

How do you audit the processes and practices of risk management?

- One audit of high source of risks at a time

Auditing The Elephant in the Room

But which pieces ?

- Audit those pieces where a failure in process or practice would represent the greatest “source of risk” to the organization
- i.e., take a risk-based approach to the audit of risk management

Why Should You Audit Risk Management?

Effective risk management helps you anticipate what might happen, both good (opportunities) and bad (risks)

Without reliable information about what might happen, people will likely:

- Set the wrong objectives
- Select strategies to achieve their objectives that are sub-optimal
- Make poor decisions, both strategic and tactical
- Fail to understand current, and likely future performance (the likelihood of achieving objectives)

Risk Management Policies and Culture

When Culture and Policy Clash, Which One Wins in Your Organization?

- What happens when policy says “no”, but culture says “yes”?
  - It’s not just tone at the top; it is also about mood in the middle and buzz at the bottom
  - It is sometimes hard for companies to build a culture where people are comfortable thinking and talking about what could go wrong with their excellent strategies
  - You don’t manage risk through documents - you manage it through behavior

Risk Management That Connects the Dots - and the Decisions

Panoramic View

Embedding leading indicators to provide early warning signs

Systems & Processes

Leverage a singular risk assessment approach to drive consistency

Early Engagement

Engage early and get risk insights at the point of decision

Risk Appetite

Setting and employing dynamic risk appetite to take advantage of the upside of risk

Focus on Top Risks

Assessing Interconnectivity of Top Risks

Building Strategic Risk Management Capabilities

1. <u>Engage early and get risk insights at the point of decision</u>

Risk management capabilities provide the greatest value when they are embedded within the organization's strategic planning and decision-making processes

Key considerations for engaging early and getting risk insights at the point of decisions include:

- Embedding risk management into the strategic planning, business decision-making processes, and large-scale transformation initiatives
- Applying strong scenario planning and analytics techniques to address key enterprise risks

Building Strategic Risk Management Capabilities

2. Taking a panoramic view of risk

The ability to utilize and interrogate data is a key tool in the arsenal to detect changes in the risk landscape

Key considerations for taking a panoramic view of risk include:

- **Focusing on where the risk is going to be, not where it has been**
- Mining KRIs from internal and external data for real-time risk intelligence
- Leveraging data and risk tools for a more panoramic view across all functional areas

Building Strategic Risk Management Capabilities

3. Set and employ risk appetite to take advantage of the upside of risk

Risk appetite is a critical tool to understand where we're able to take more risk in pursuit of new opportunities and growth.

When strategy, risk appetite and risk culture are aligned, business leaders can take better and informed decisions

Key considerations for employing risk appetite to take advantage of upside risk include:

- Establishing a dynamic risk appetite (not a static one) to articulate how much risk the organization is willing to take for achieving or exceeding objectives
- Educating risk owners on how to leverage risk appetite as they make business decisions
- Enhancing risk culture by embedding risk management practices in day-to-day operations

Building Strategic Risk Management Capabilities

4. Double down efforts on top risks

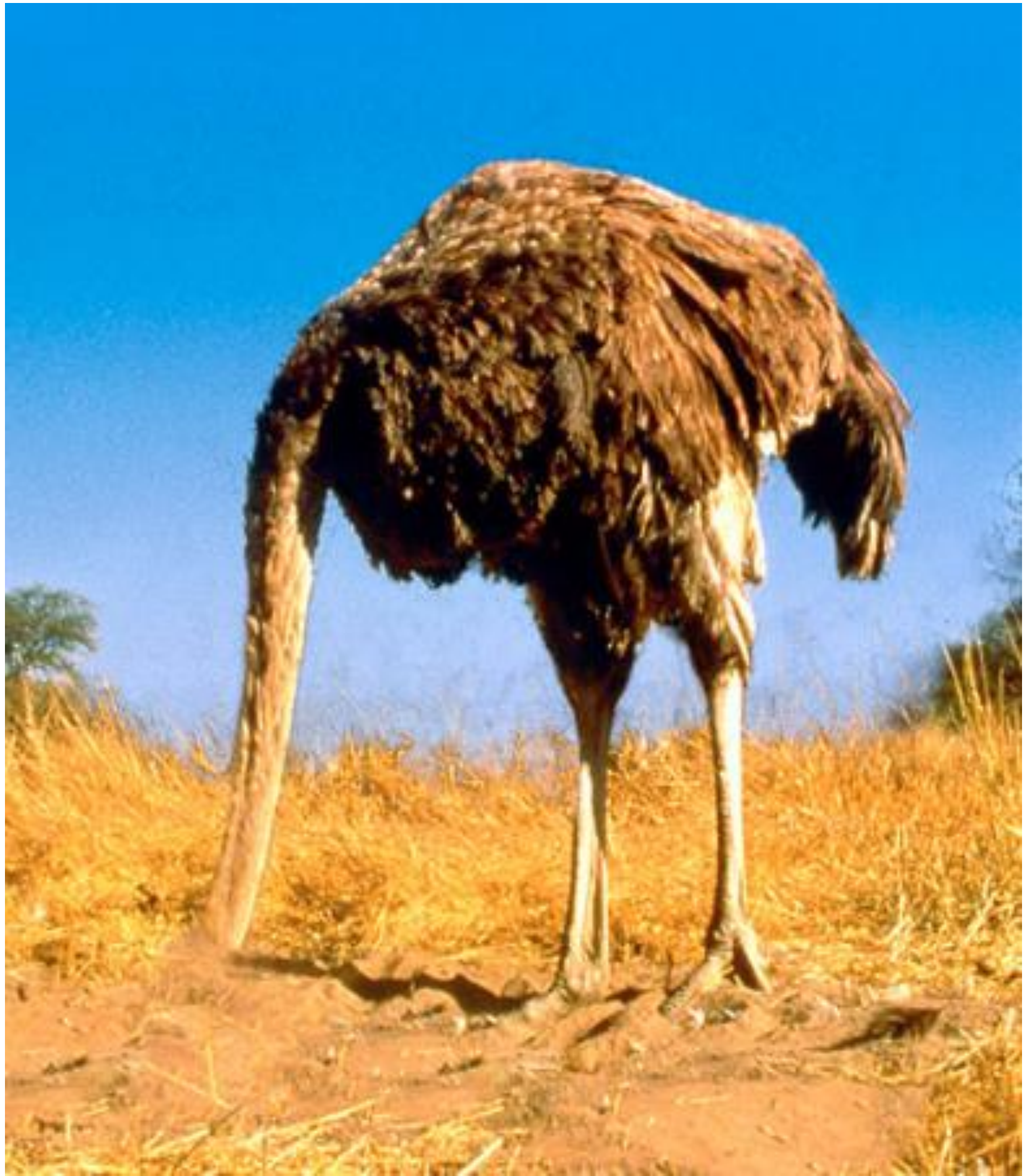
Our high-priority risks are tightly interconnected, which means one can amplify others and impacts can be far reaching

Key considerations for doubling down efforts on top risks include:

- Performing an interconnectivity assessment over key business risks
- Facilitating deep dives into mitigating activities over key risks

Predict the Weather, Don’t Just Report It

Meercat or Ostrich



Thank you!