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# GROUP BEHAVIOUR IN UNFAMILIAR PROBLEM DOMAINS

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# ABSTRACT

This research explores the determinants of risk behaviour when an organization operates outside its normal operational domain, the operational “comfort zone”. Organisations are being forced outside their normal operational domains with ever-increasing frequency due to commercial or regulatory factors and in response to “one off” events such as climatic events and acts of terrorism. Through studying a banking acquisition and focusing on the change of control, an area which has not been significantly studied before, the research identifies:

- The risks faced by the organisation
- The apparent irrational management of the risks; and
- The reasons for this behaviour.

The programme of research applies multiple research methods, which include reviews of company documentation, interviews with key managers and external experts, a modified Delphi technique, case studies and statistical analysis. By combining these methods, the risks are identified and evaluated in terms of probability, impact, and degree of mitigation. Six propositions are put forward, four of which are support by statistical tests.

This research finds that where the organisation had a successful outcome history in managing a given risk, or could manage the risk using normal management controls, the risk tended to be managed disproportionately well compared to its significance. Where these conditions do not apply the management of the risk tends to be proportionately weak. There is also evidence to suggest that the existence of industry-specific regulation in relation to a risk results in the risk being better mitigated. This is important as it suggests that regulators can use their regulatory framework to improve the risk management across a given industry.

Organisations wishing to improve their risk response in unfamiliar operational domains should therefore consider day-to-day controls as one route to improvement. Also, where possible, they should try to create a history of successful outcomes in dealing with the risk types they are likely to face in unfamiliar problem domains, this is obviously a potentially difficult challenge. Regulatory bodies need to consider the impact that their regulations will have in order to help organisations exhibit better behaviours in unfamiliar problem domains. This is a “two way street” regulations that can create improved environments could also alter the environment in a manner that is detrimental to successful risk management.

# INTRODUCTION

This paper examines group decision making in the face of unfamiliar problems, the unfamiliar problem domain. By unfamiliar problem domain the paper is referring to risk decision making that the organisation does not deal with in its normal course of business, the familiar problem domain. Specifically, it examines the behaviour of a senior team and their staff managing the acquisition of one bank by another. This is an activity which is outside the bank's normal problem domain.

The paper will examine research into the determinants of risk behaviour, looking first at individual "single determinants" and then at theories that encapsulate multiple risk determinants. It also touches upon the concept of group versus individual decision making behaviour. The paper examines the context under which the research is undertaken. Finally, the findings and conclusion are presented.

# DETERMINANTS OF RISK BEHAVIOUR

The concern of this paper and its underlying research is the determinants of risk behaviour and what that behaviour means for organisational management and control. Risk behaviour is the behaviour exhibited when decision making takes place under uncertainty. This assumes that every decision leads to two or more distinct outcomes, some of which are “better” than others.

When we think of risk decision making it is tempting to think in very classical terms and consider it to be a highly rational process. Since earliest times it was understood that risk decision making could be apparently irrational, and even be counter to self interest (Catullus, 58 BC). Bernoulli (1783) discovered what he termed the “utility of money”; most people, if given the choice, would elect not to play a 50/50 game of chance for the same prize (gain) or loss. This is born out by later research conducted by Neumann and Morgenstern (1945).

They also identified that politics, for example, played a factor in risk decision making. They showed that all other factors being the same the decision (the behaviour) would be different, depending on who was impacted i.e. the political element. This is one of the first theories in modern research to identify a single determinant and demonstrate its impact upon the risk decision process and outcome. Their work demonstrates that the risk quantities factors (impact and probability) are complemented by other factors which do not necessarily relate to the risk itself. Therefore, the risk decision making process is composed of the evaluation of the risk, which is impacted by other factors. Generally, these fall into two broad categories, risk propensity, the appetite for risk and risk perception, the manner in which the risk and its “riskiness” is seen. These determinants are discussed in the following section.

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## SINGLE DETERMINANT THEORIES

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It is necessary to briefly cover a number of important single determinants because they are the building block of multi-determinant behaviour and also because they illustrate a very important point. Organisational risk behaviour can be explained in terms of many factors. It can not be exhaustively explained by any, it is inherently complex. To understand and explain it requires the consideration of many factors, which can operate in a contradictory manner. For example prospect theory (Kahneman and Tversky, 1979) suggests that individuals who protect their gains tend to be risk averse. Both Osborn and Jackson (1988) and Thaler and Johnson (1990) found the opposite to be true. Each of these theories are equally valid, the point is that to consider a single determinant on its own is to over simplify the understanding of the risk behaviour.

### RISK PROPENSITY

One factor to determine risk behaviour is “risk propensity”, the desire to seek or avoid risk. Kogan and Wallach (1964) showed there is a difference in risk seeking behaviour from person to person. Factors that determine this include achievement orientation (McClelland, 1961), managerial position (Brockhaus, 1980; Sitkin and Weingart,

1995), gender (Siegrist et al. 2002), personal experience (Wildavsky, 1988; Slovic, 1972) and cultural background (Douglas and Wildavsky, 1982).

Risk propensity also tends to be consistent over time (Heath, 1998; Rowe, 1977). It can, nonetheless, be altered by outcome history (Thaler and Johnson, 1990).

At a group or organisational level Douglas and Wildavsky (1982) suggested that organisations prefer certainty to uncertainty. This avoidance of risk may be quite a sensible strategy, it can be demonstrated that low risk companies actually perform better (Brown 1993).

### **RISK PERCEPTION**

The perception of the risk can also alter the risk decision process and thus the action. The size of outcomes (Vlek and Stallen, 1980) will change the willingness to accept risk. We tend toward perceiving large losses/gains as changes in wealth, while small losses/gains cause us less concern (Tversky and Kahneman, 1973; Kachelmeier and Shehata, 1992), this illustrates the effect of “risk consequence”. Some risks are more acceptable, for example living close to nuclear power plant is statistically much safer than smoking, yet most smokers are happy to accept the smoking risk than the living close to a nuclear power plant risk (Health and Safety Executive, 1989).

Organisation culture can also influence what is perceived as “safe”, Rochin (1999) found “safe” to be a social abstraction. The manner in which the risk is presented, or presents itself, called prospect theory (Kahneman and Tversky, 1979) will influence risk perception.

Much of this research has been undertaken as individual risk perception; some theories of group or organisational risk perception have been put forward. The degree of homogeneity among the senior management team impacts the organisational ability to perceive risk (Sitkin and Pablo, 1992). At the same time the leader’s own experience can influence group risk perception (Jacofsky, et al., 1988).

National culture (Hofstede, 1980; Douglas and Wildavsky, 1982; Trompenaars, 1993) and organisational culture, the risk reward and punishment environment (Ouchi, 1977) and organisational controls (Flint, 1981) all contribute to the organisation’s perception and propensity to risk.

Finally, the history or risk taking and familiarity with the problem domain (March and Shapira, 1987) and availability theory, the belief that we evaluate options in the order they “come to mind” (Tversky and Kahneman, 1973) have also demonstrated to be factors.

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### **MULTIPLE DETERMINANT THEORIES**

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Each of the determinants of risk behaviour presented in the above sections are single determinants. They identify a single factor that can alter how a given risk is perceived or the propensity to accept the risk. Each has been subjected to rigorous academic testing. Since each is demonstrated to be a valid determinant, clearly it follows that each if is valid it is necessary consider various risk determinants and their interaction operating in concert, rather than trying the behaviour by just one factor. The view of organisations as having multiple strands working and interrelating concurrently (Koot, 2002) offers an almost organic model with which to understand this interaction.

Sitkin and Pablo (1992) address this with the “Reconceptualized Model”. This states that risk behaviour is influenced by both the propensity and the perception of the risk. Risk propensity and perception, in turn, are composed of a number of factors (single determinants). This is illustrated in Figure 1 - Reconceptualized model of risk determinants (Sitkin and Pablo, 1992) which follows:

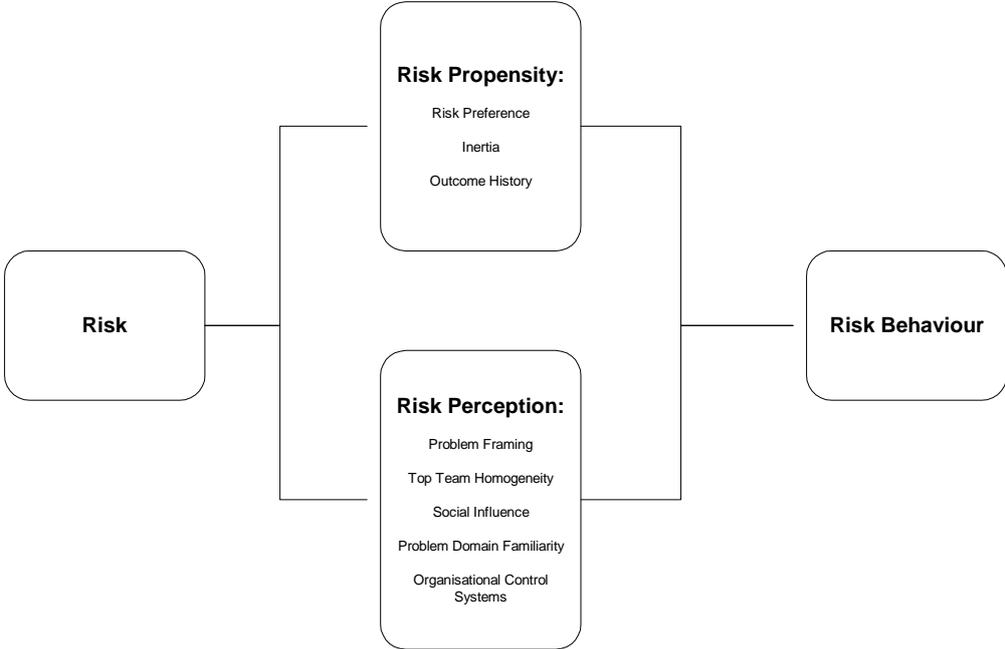


Figure 1 - Reconceptualized model of risk determinants (Sitkin and Pablo, 1992)

This was enhanced by Das and Teng with their “Temporal Model” (2001) which added the extra complexity of near or distant future orientation. This considered the risk propensity and risk context (positive or negative) with the near or future decision context. Their model is summarised in the table Table 1 - Temporal impacts on risk behaviour (Das and Teng, 2001):

Table 1 - Temporal impacts on risk behaviour (Das and Teng, 2001)

<b>Future orientation</b>	<b>Near-future orientation</b>	<b>Distant-future orientation</b>
<b>Risk propensity and decision context</b>		
Risk averter and positive context	Low-risk behaviour	Low risk behaviour
Risk averter and negative context	High-risk behaviour	Low-risk behaviour
Risk seeker and positive context	Low-risk behaviour	High-risk behaviour
Risk seeker and negative context	High-risk behaviour	High-risk behaviour

# RESEARCH CONTEXT

This section briefly describes the context, the financial services industry, in which the research was undertaken and discusses the risks associated with M&A activity.

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## UNIQUE REGULATORY REQUIREMENT

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In the United Kingdom a number of statutory bodies supervise the regulation of mergers and acquisitions. The general regulations separate the acquiring and target company to protect the shareholders' interests and to ensure the two firms can operate independently should the merger not progress. These regulations also operate to ensure that the merger is allowable (i.e. not against the public interest) and that it is conducted in a fair and appropriate manner. The main bodies which are interested in protecting the public interest are the Office of Fair Trading (OFT) and the Monopoly and Mergers Commission (MMC). The City Panel on Takeovers and Mergers ("the Panel"), which has implemented the City Code on Takeovers and Mergers ("the Code" – also known as "the Blue Book" because of the colour of its cover) to oversee the conduct of a merger. In addition, there is also European Union regulation, and most countries will have their own specific merger legislation, which is important in the case of trans-national and cross-border M&A. This means that international or cross-border mergers may be subject to many different regulations and regulatory bodies. The broad aim of this all this regulation is to protect the public and shareholders by assessing the validity of the merger or acquisition and making sure that it is undertaken correctly. In practice this results in the two parties to a merger being required to keep a certain distance until the merger is transacted, and the Change of Control (CoC) is completed.

This research is conducted in the financial services industry. In the UK a single statutory body, the Financial Services Authority (FSA), regulates the industry. Like other financial regulators, it requires detailed daily reporting. This reporting can cover many areas depending on the specific business activities of the firm in question. Typically, the FSA requires reporting on capital adequacy (the amount of cash and liquid assets held to cover any outflows or risks that may occur), large equity positions (typical, greater than 5% in a public company), anti-terrorism and money laundering (activities to "hide" money gained from illegal activities, or used to fund) and exposure to credit (risk of not being paid) and market (losses resulting from movement in market prices) risk.

This is complicated further by the need to conduct the reporting across the two enterprises as one immediately after the CoC. In order to meet these sorts of regulatory requirements straight after a merger, advanced preparation, and integration and co-ordination of business controls are required. On the face of it this is completely at odds with the intent of the basic M&A regulatory requirement for organisational distance. This potential source of conflict does not appear to exist in any other regulated industry, because other regulated industries do not have a regulatory requirement for daily business reporting for the whole of the enterprise.

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## MERGER AND ACQUISITION RISK

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The target organisation had experienced two acquisitions which failed. This is not unusual considering the considerable practitioner evidence to suggest that failure rates for M&As are in the 70% - 80% range .

Failure occurs when a deal is attempted and is not legally agreed, when transfer of ownership is not completed, or when the deal is completed but in the period following completion, the acquirer or the new merged organisation does not attain the goals which were expected of the deal in the first instance. Research into practitioner attitudes across a number of industries conducted by A.T. Kearney cited in “After the Merger” (Habeck et al, 2000:4), suggests that the risk of failure is most likely in the “post-merger” phase, but that the likelihood of failure is only slightly higher than in the preceding due diligence and execution of the change of control (CoC) of the deal. Their findings are shown in Table 2 - Risk of merger failure.

Phase	Probability of failure
Strategy development, candidate screening and due diligence	30%
Negotiation and closing (including the CoC)	17%
Post-merger integration	53%

*Table 2 - Risk of merger failure*

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## MOTIVATION

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While research has been focused on understanding the merger process in general, it has tended to focus either on the total merger process , or pre-CoC (Johnson, 1999; Sudarsanam, 1995; Bradley and Myers, 2000) or post-CoC (Chevriere, 1999); . None of these focus on the change of control period itself or the procedures and controls around it. This even applies to those investigating the technology integration (Robbins and Stylianou, 1999; Robb, 2003), the technology security impact (Tuesday, 2003) or the reward and motivation aspects .

M&A activity, let alone CoC in this specific circumstance, is not well researched. An example of this is to examine the number of articles published in the *Academy of Management Journal* and the *Academy of Management Review* during the period January 1995 – February 2003, in which there were twenty-four articles relating to merger, acquisition or takeover activity. Of these three referenced banking mergers. There were no published articles on investment banking specifically, and consequently, none addressed the control issues surrounding the merger that result from the regulatory reporting requirements in an investment bank, which are the subject of this research.

In addition to a personal interest there are important commercial reasons for undertaking the research. Over the last twenty years there has been a move towards consolidation in the banking industry, driven in part by globalisation, and in part by the piece-by-piece removal of the 1933 Glass-Steagall Act, which was fully

repealed in 1998 (Harrison, 1997; Henriques, 1998). Secondly mergers are organisationally complexity and very expensive, with a number exceeding the US\$10 billion level.

The f reason is that for all the importance of the industry, M&A activity, and the risk involved, it is hard to identify any academic research or practitioner work relevant to investment banking change of control. There is a gap in our collective knowledge, which this research could address. For these reasons, I decided to undertake the research.

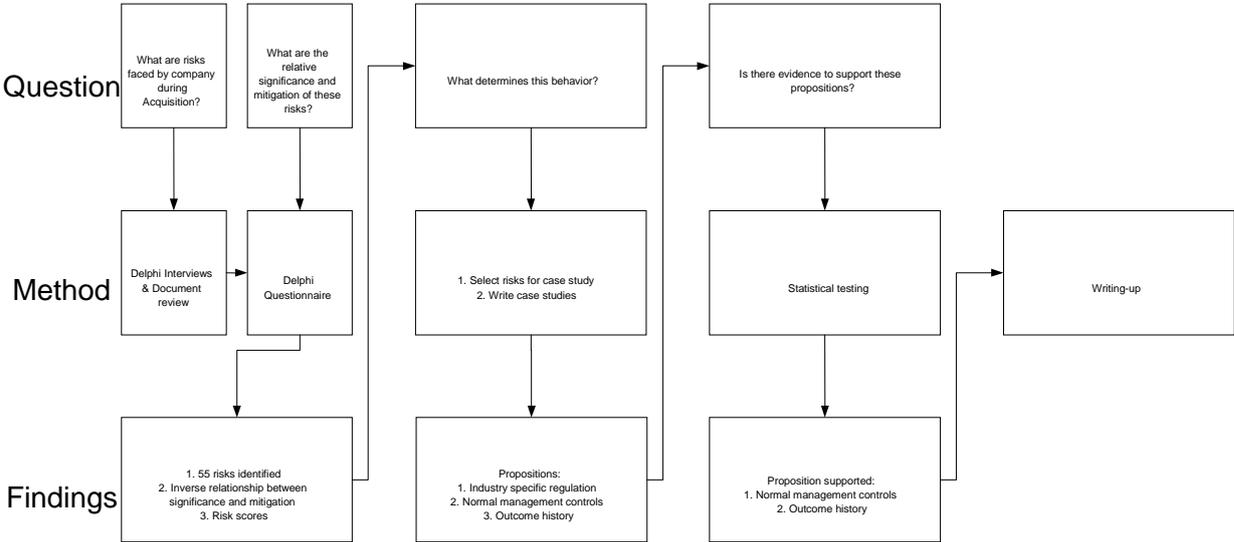


Figure 2 – Project overview

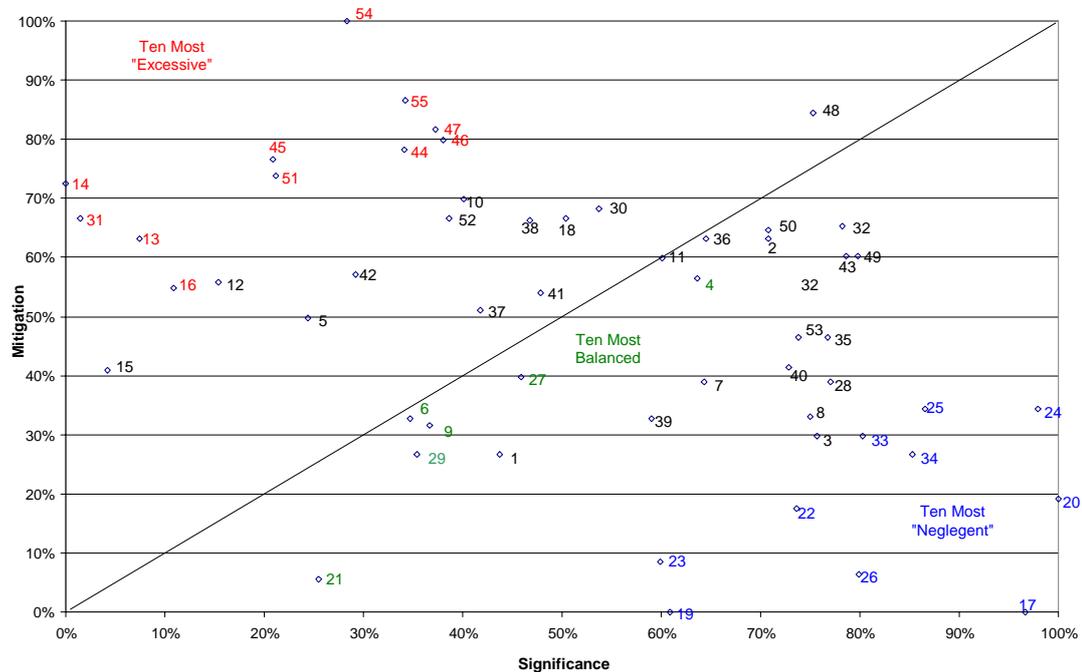
# METHOD

This section provides a brief overview of the research method followed. The research was divided into three projects. This section presents an overview of the research projects. The section describes the three projects in terms of how they are linked, the research question that each answers, the methods followed, results found, limitations of the research and findings

# FINDINGS

The projects produced a series of detailed findings. In summary;

- Risks identified – from the various sources, reduced to 55 risks for a Delphi style evaluation
- The risk impact, probability and level of risk mitigation are assessed, see Figure 3 - Significance V mitigation scores below
- The inverse relationship between the risk significance (probability and impact) and the level of mitigation.
- Three pairs of propositions are identified
- Two pairs of propositions supported



**Figure 3 - Significance V mitigation scores**

**Proposition 1** – When a risk is addressed by industry-specific regulation, the organisation will tend towards excessive risk management behaviour.

**Proposition 2** – When a risk has a successful outcome history under normal business conditions, the organisation will tend towards excessive risk management behaviour.

**Proposition 3** – When a risk is managed using effective organisational controls in normal business operation, the organisation will tend towards excessive risk management behaviour.

**Proposition 4** – When a risk is not addressed by industry-specific regulation, the organisation will tend towards negligent risk management behaviour.

**Proposition 5** – When a risk does not have a successful outcome history under normal business conditions, the organisation will tend towards negligent risk management behaviour.

**Proposition 6** – When a risk is not normally managed using effective organisational controls in normal business operation, the organisation will tend towards negligent risk management behaviour.

Propositions 2,3,5 and 6 were found to be statistically significant,

# CONCLUSIONS

Based on these findings, a number of conclusions can be drawn.

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## THE ROLE OF OUTCOME HISTORY

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Propositions 2 and 5 relate to the organisation's outcome history in terms of the type of risk faced. Proposition 2 suggests that where there is a successful outcome history, the risk is likely to be well managed, tending towards excessive management. Proposition 5 suggests that where there is not a successful outcome history, the organisation will not manage risk well; in fact it will tend towards negligent management. Both these propositions were supported to a high level of confidence ( $> 0.025$ ). This suggests that outcome history will impact on risk behaviour.

This is clearly important from a number of perspectives. It indicates how well an organisation will operate when faced with new risks that are in some way similar to previous risks that it has faced. This would indicate support for the existing research relating to outcome theory (Tversky and Kahneman, 1973; March and Shapira Z., 1987; March, 1988; Thaler and Johnson, 1990). Of course, an organisation may not always know in advance the nature of events that will place it outside the familiar problem domain. However in some circumstances it may be possible to create the necessary outcome history if it does already exist.

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## NORMAL MANAGEMENT CONTROL

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Propositions 3 and 6 relate to the organisation's management of risks which can be handled using regular management controls. Proposition 3 suggests that where the risks can be managed with regular controls they are likely to be well managed, tending towards excessive management. Proposition 6 suggests that where normal controls are not in place the organisation will not manage the risk well. The management of this risk will be poor, tending towards negligent management. Both of these propositions were supported to a high level of confidence ( $> 0.025$ ).

The findings support earlier work by March and Shapira (1987) and Tversky and Kahneman (1973) on problem domain familiarity. The higher the degree of familiarity, the greater the tendency toward better risk management. I believe this is the first time such theories have been tested in unfamiliar problem domains.

This also raises questions about the role of sense-making. Weick (1988) shows that sense-making in an organisation during a crisis can often be in the context of the normal environment, which can in extreme circumstances lead to people making incorrect decisions and taking detrimental actions as the members of the organisation are either unable to develop creative solutions or are unable to follow unorthodox solutions (Weick, 1993).

These findings show that outcome history and normal operational controls play a particularly important role in determining risk behaviour in the unfamiliar problem domain. The challenge for organisations is either to take

steps to make the organisation more creative (Weick, 1993) or to put more robust controls in place which can deal with the unexpected, or failing that, keep the organisation functioning well enough to give it time to come up with the appropriate risk management behaviour.

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Michael McGrath is founder of Hibernia Consulting, a project delivery and risk management consulting firm serving major investment banking clients. He is a former regional CTO at Merrill Lynch and Project Delivery Director at both Bankers Trust and Deutsche Bank. He holds an MBA from the Smurfit School of Business and his Masters thesis won the Institute of Accountant's in Ireland gold medal for research in 1996. His doctoral research examines risk behaviour in unfamiliar problem domains.

He has published previously and presented at the British Academy of Management and presented internally at Cranfield colloquia.

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