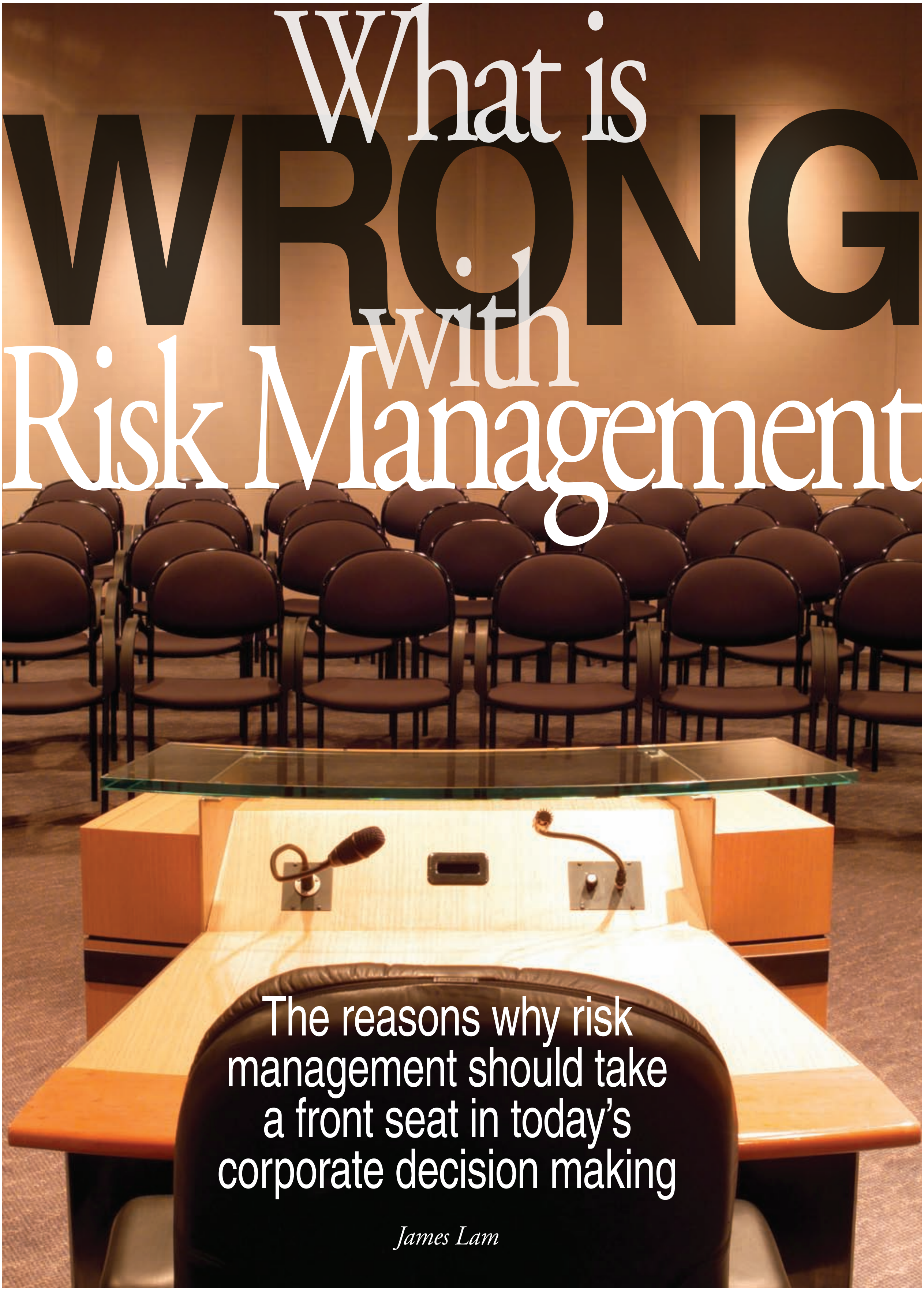

What is WRONG with Risk Management

The reasons why risk management should take a front seat in today's corporate decision making

James Lam

2008 was a year that most finance and risk professionals would rather forget, and 2009 promises to be equally, if not more, challenging. Global economies and businesses are facing one of the most difficult economic contractions that we have seen in our lifetimes. For many years to come, economists will argue about the root causes of the financial crisis: failed housing policies, lax regulatory oversight, complex structured products, inaccurate debt ratings and undisciplined lenders and borrowers. In my opinion, at the core of the financial crisis there has been a failure in risk management.

One can argue that the financial crisis could have been avoided if risk management worked effectively. What is wrong with risk management? I believe that there are seven fundamental issues with risk management, and that each one must be addressed in order for risk management to be truly effective. Otherwise, we will likely find ourselves in another severe financial mess a few years down the road. The seven fundamental issues are:

1. Compliance-driven risk management
2. Lack of active participation by the board
3. Lack of risk management independence
4. Ineffective enterprise risk management
5. Ineffective board and management reporting
6. Lack of an objective feedback loop
7. Ineffective incentive compensation systems

Issue #1: Compliance-driven risk management

Compliance with laws and regulations is an important objective in any risk management program, but we must remember that it is a necessary but insufficient condition for success. Regulations are blunt instruments that are designed to establish minimum standards for an industry, but they don't represent industry best practices. For example, banking regulators established Basel II to link regulatory capital requirements with a bank's risk profile. However, leading banks have developed more sophisticated economic capital models that better represent the risk-return economics of their businesses. Moreover, new regulations often overreact to past problems. Sarbanes-Oxley was enacted in the aftermath of accounting frauds at large corporations such as Enron and WorldCom. While accounting controls are important, they are only a subset of operational risk, and operational risk is a subset of enterprise-wide risks. In fact, one can argue that the emphasis on accounting controls over the past several years has been misguided given that risk is mainly driven by future events whereas accounting statements reflect past performance. In order to be effective, a risk management program must be forward-looking and driven by the organization's business objectives and risk profile, not by regulatory requirements.

Issue #2: Lack of active participation by the board

According to recent surveys, risk management has replaced accounting issues to become the top concern for corporate boards. However, boards were often seen as the "audience" with respect to risk management. At board committees, they approve risk policies, review risk reports, and get Powerpoint presentations designed mainly to assure them risks are well managed. In order to provide effective oversight, boards must be active "participants" in the risk management process. They must debate risk tolerance levels, challenge management on critical business and financial strategies, and hold

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management accountable for the risk-return performance of past decisions. To strengthen board oversight, boards should consider establishing a separate risk committee, especially at risk-intensive companies (e.g., banking, insurance, energy). At a minimum, boards must ensure that risk management is allocated sufficient time and attention. Boards should also consider adding risk experts to their ranks.

Issue #3: Lack of risk management independence

Where was the outcry? Why didn't we hear about chief risk officers going directly to the board, or quitting out of protest given what was going on under their watch? I believe a central issue is the continued lack of true independence of risk management. Since the trading losses suffered by Barings and Kidder in the mid-90s, companies have worked to ensure that the risk management function is independent relative to trading, investment, and other treasury functions. However, we must go further and ensure risk management is independent relative to corporate and business unit management. This is similar to, but not to the full extent of, the independence of internal audit. One organizational solution is to establish a dotted line reporting relationship between the chief risk officer and the board or board risk committee.

Under extreme circumstances (e.g., CEO/CFO fraud, major reputational or regulatory issues, excessive risk taking), that dotted line may become a solid line such that the chief risk officer can go directly to the board without concern about his or her job security or compensation. Ultimately, to be effective, risk management must have an independent voice. A direct communication channel to the board is one way to ensure that this voice is heard.

Issue #4: Ineffective enterprise risk management

One of the key lessons from the current financial crisis (and previous financial crises) is that major risk events are usually the consequence of not one risk, but a confluence of interrelated risks. Historically, companies managed risk by silos where different organization units managed different risks separately. There is ample evidence that the silo-approach to risk management has contributed to the ineffective management of interdependent risks in the current crisis. As an example, a recent front page Wall Street Journal article reported that the risk model used by AIG to manage the credit derivatives business only considered credit default risk, but not the mark-to-market or liquidity risks associated with the business.

Companies should implement ERM programs that will analyze multi-risk scenarios that may have significant financial impact. For banks, that would include the integrated analysis of credit, market, and liquidity risks. For insurance companies, that would include the integrated analysis of investment, liability, and interest rate risks. For all companies, there are critical interdependencies across business, financial, and operational risks that must be managed on an integrated basis.

Issue #5: Ineffective board and management reporting

What gets measured gets managed. It is difficult to implement ERM when companies continue to measure and report risks by silos. There is a general sense of dissatisfaction among board members and senior executives with respect to the timeliness, quality, and usefulness of risk reports. Currently, companies often analyze and report on individual risks separately. These reports tend to be either too qualitative (risk assessments) or quantitative (value-at-risk metrics). Risk reports also focus too much on past trends and current risk exposures. In order to establish more effective reporting, companies should develop forward-looking role-based dashboard reports.

These reports should be customized to support the decisions of the individual or group, whether that is the board, executive management, or line and operations management. These dashboard reports should integrate qualitative and quantitative data, internal risk exposures and external drivers, and key performance and risk indicators. Initially, companies should develop concise decision-based "paper dashboards." Over time, the databases, analytics, and reporting should be automated. These "electronic dashboards" would be the risk analog to the touch-screen "Magic Map" pioneered by CNN to show real-time voting trends by state, including drill-down capabilities into granular voter segments.

Issue #6: Lack of an objective feedback loop

How do we know if risk management is working effectively? This is perhaps one of the most important questions facing

boards, executives, regulators, and risk managers today. The common practice is to evaluate the effectiveness of risk management based on the achievement of development milestones, or the lack of policy violations, losses, or surprises. However, qualitative milestones or negative proofs should no longer be sufficient. We need to establish performance metrics and feedback loops for risk management. Other corporate and business functions have such measures and feedback loops. For example, business development has sales metrics, customer service has customer satisfaction scores, HR has turnover rates, etc.

In order to establish a feedback loop for risk management, its objective must first be defined in measurable terms. I believe the objective of risk management can be defined as to minimize unexpected earnings volatility. In other words, the objective of risk management is not to minimize absolute levels of risks or earnings volatility, but to minimize unknown sources of risks or earnings volatility. Based on this definition, companies can perform earnings-at-risk analysis at the beginning of each reporting period. This analysis would identify the key risk drivers and quantify potential earnings impact (e.g., a 1% increase in rates would reduce earnings by 5%, or a 2% decrease in market share would reduce earnings by 12%, etc.). At the end of each reporting period, companies can perform earnings-attribution analysis, in which they can identify the actual earnings drivers and sensitivities. Over time, the combination of these two analyses can provide a powerful performance measurement and feedback loop. Such a feedback loop can help the board and management to ensure that risk management is effective in terms of minimizing unexpected earnings volatility. Finally, I believe this type of analysis should be provided with the earnings guidance of publicly-traded companies. Relative to the current laundry-list approach of risk disclosure, earnings-at-risk and earnings-attribution analyses can provide much higher levels of risk transparency to investors.

Issue #7: Ineffective incentive compensation systems

The design of executive incentive compensation systems is one of the most powerful levers for effective risk management, yet insufficient attention has been paid to how incentive compensation systems influence risk-return decisions. For example, if executive compensation is driven by revenue or earnings growth, then corporate and business executives might be motivated to take on excessive risks in order to produce higher levels of revenue and earnings. If executive compensation is driven by stock price performance via stock options, executives might also be motivated to take on excessive risks to increase short-term stock price appreciation. Unethical executives might even manipulate accounting rules.

Traditional executive compensation systems do not provide the appropriate framework for risk management because they motivate excessive risk taking. Moreover, the corporate structure creates potential conflicts between management and investors. In essence, executives are betting with “other people’s money” and heads they win and tails the investors lose. To better align the interests of management and investors, incentive compensation systems must be driven by long-term, risk-adjusted financial performance. This can be achieved by incorporating risk management performance into the incentive compensation system; establishing long-term risk-adjusted profitability measurement; or using vesting schedules consistent with the duration of risk exposures and/or clawback provisions.

As companies work through the current financial crisis, they should evaluate the effectiveness of their risk management programs. This evaluation should consider the seven critical issues discussed above. I believe that a risk management program must address all seven areas in order to be effective. For example, to engage the board in the risk management process (Issue #2), the risk management function must provide useful risk information to the board (#5). And even if a company has addressed issues 1-5, it still needs to establish a feedback loop (#6) to ensure ongoing risk management effectiveness, as well as an incentive compensation system (#7) that aligns management and investor interests. Ten years from now, I will most likely be writing another article on risk management. However, instead of “what is wrong with risk management” I hope that title will be “how risk management has saved the day.”

James Lam is president of James Lam & Associates, a risk management consulting firm founded in 2002. It provides board advisory, consulting and executive training services. Lam is author of “Enterprise Risk Management: From Incentives to Controls”. With 20 years in experience in risk and business management he was an early advocate of enterprise risk management. He will be speaking at the AFP Corporate Risk Forum in ChampionsGate, FL., Feb. 22-24