ORGANIZATIONAL BALANCE

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Abstract. Organizational balance is an essential requirement for successful risk management. The prospective requirement in the United States for independent Board-level Risk Committees may support improvement in this area at the very top of major financial institutions.

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It seems hard to believe that ten years have passed since Jack Welch retired from General Electric. At the time of his retirement, the distinguished *Financial Times* journalist Peter Martin wrote an insightful essay on his career contributions.[1] He argued that Welch was uniquely adept at coping with the central contradiction of corporate life. That contradiction, according to Martin, is that "individual managers cannot succeed without conforming; but a company composed solely of conformists will fail." The path to continued success, Martin says later, is "to combine the advantages of incumbency with the energies of an insurgent."

Ten years later, it remains as difficult as ever to maintain this balance in large companies. The central problem is the separation of ownership from management control. In a partnership, where the top managers are also the owners, corporate and personal incentives are closely aligned. Many approaches are used to approximate this alignment of incentives in large corporations. Stock options represent one important example and tying bonuses to small unit performance is another.

In my experience, a similar challenge arises in maintaining the proper balance between risk and return relative both to strategic and tactical decisions. To paraphrase Peter Martin, "a company cannot succeed without proper risk controls, but a totally risk averse company will fail." It is not risk as such that threatens an institution's long-term success. Only excessive and uncontrolled risk *or* insufficient risk presents such a threat.

THE TENSION OF ROLES

The key strategy for maintaining proper balance between risk and return is an appropriate degree of institutional tension between the business units and risk managers. Line managers can and should push the envelope in seeking new profit opportunities, even though this generally leads to higher levels of risk. Obviously risk managers are primarily charged with assuring that aggregate risk levels are not dangerously excessive. That said, the process works best when each side understands the need for both roles, reinforced by mutual professional respect.

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Some institutions have tried to develop this mutual understanding and respect by shifting individuals between the two roles. While this may be successful in some cases, I tend to think these are exceptions. Generally there are important psychological differences that predispose individuals to one role or the other. Instinctive line executives tend to focus naturally on upside rewards, viewing the downside risks as speculative and remote. Instinctive risk managers gravitate naturally to the opposite perspective. Neither position is "right" or "wrong." A successful organization must include both perspectives and maintain an effective balance of authority and influence between them.

One implication of this for professional risk managers is to avoid being pigeonholed as just "the risk police." While oversight and control is a necessary part of the role, the most successful risk managers recognize the importance of supporting and facilitating line management's ability to operate profitably.

OPINION DISCOUNTING

One area where risk managers can play a valuable role in this regard is in corporate policy deliberations. We all quite naturally and properly apply different rates of discount to any given viewpoint based on its source. We look for conflicts of interest, examine the past track record, and make a subjective evaluation of the reliability of the source in deciding how much credence to give to any given claim. This often places line managers at a disadvantage when arguing for higher limits or for development of a new product or service. Clearly they have a vested interest in the decision and this tends to raise the implicit discount applied to the arguments they present. Well-informed risk managers can provide an objective viewpoint. Senior executives understand that they do not have the same conflict of interest as line management. Hence, insofar as they can confirm and support the business case, their views tend to carry more weight than those of the line managers themselves.

PROFESSIONALIZATION OF FINANCIAL RISK MANAGEMENT

In the mid-1980s, risk managers were often viewed with thinly veiled contempt by the staff of trading units. In part this was a result of the rapid development of complex derivatives and a lag in attracting qualified staff into the risk management field. While such views persist in some organizations even today, a better balance and greater respect have developed in recent years. Surely this is the result of financial risk management having emerged as a self-consciously distinct professional discipline. Day-to-day risk in financial institutions is far better managed today than it was from the mid-1990s to the mid-1990s. In no small measure this is attributable to the improved training, greater independence, and strengthened role of risk management.

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SO WHAT WENT WRONG?

If risk management has improved so much, many will ask, how was the global financial crisis allowed to develop? One big reason is that the advances in risk management created an unwarranted complacency among many executives.[2] This was especially common among those not familiar with the technical details of statistical risk analysis and its inherent limitations. Statistical techniques are necessary components of risk assessment but they are not sufficient for a full understanding of the uncertainty every company faces. In late 2009, Roger Bootle, a London economist, was asked what he thought risk managers should have done differently. His insightful answer was, "I think they should read less mathematics and more history and literature."

REASON FOR HOPE

One reason to hope for a move in this direction, at least in the United States, is a provision of the Dodd-Frank financial reform bill that is to go into effect over the next year.

Section 165 (g)–Risk Committee states that:

> [165 (g) (2) (A)] the Board of Governors of the Federal Reserve shall require that all bank holding companies with consolidated assets of not less than $10 billion establish a formal Risk Committee of the Board of Directors.
>
> This committee shall [165 (g) (3) (A)] "be responsible for the oversight of the enterprise-wide risk management practices" of the institution.
>
> It also must [165 (g) (3) (B)] "include such number of independent directors as the Board of Governors may determine appropriate, based on the nature of operations, size of assets, and other appropriate criteria."
>
> It also must [165 (g) (3) (C)] "include at least 1 risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms."

Undoubtedly some institutions will meet this requirement in form but not in spirit. Passive aggressive behavior is an all too predictable response to regulatory mandates. The best run institutions, however, will use this requirement to establish a far more effective forum for discussing strategic risk considerations at the highest management levels, up to and including the Board.

Only a willingness by senior management to grapple with risk in all its messy multi-dimensional complexity will result in financial institutions performing more effectively in the face of the next major upheaval. If the Risk Committee requirement of Dodd-Frank brings greater organizational balance at the top of major financial institutions, it will have made a valuable contribution.

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