Organisational aspects of risk management

*In this last of a four-part series, **David Rowe** looks at organisational issues and argues the chief executive and board must accept responsibility for strategic risk management decisions*

One of my earliest columns for *Risk* pointed to a fundamental conundrum of corporate life: a firm cannot succeed without proper risk controls, but a totally risk-averse company will fail. It is not risk as such that threatens the long-term success of an institution – only excessive and uncontrolled or insufficient risks present such a threat.[1]

Most of us have seen how difficult it is to maintain the right balance in a large company. 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 – and many approaches are used to approximate this alignment of incentives in large corporations. Stock options represent one important example; tying bonuses to small-unit performance is another. As the financial crisis demonstrated, however, the long-term nature of many exposures meant traditional incentive structures were frequently ineffective in keeping risks under control.

In public corporations, a key requirement for maintaining a 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 concerned with ensuring 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.

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, while instinctive risk managers gravitate naturally to the opposite perspective. Neither position is right or wrong. A successful organisation 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 'the risk police'. While oversight and control is a necessary part of the role, the most successful risk managers recognise the importance of supporting and facilitating line management's ability to operate profitably.

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Where the buck stops

A lesson to be learned from the subprime mortgage crisis is the overwhelming difficulty of making strategic risk decisions. When a profitable market appears to be experiencing unsustainable growth, the managers of that business are unlikely to propose calling a halt or even pulling back significantly – their job is to make the business as successful as possible. On the other hand, only the bravest (or most foolhardy) risk manager will take the career threatening step of insisting on a retrenchment. Such a risk manager may well be vindicated in the end, but if competitors continue to make significant profits for two or more years, that vindication may have to be savoured from afar.[2]

At every level of an organisation, controlling risk cannot be the sole responsibility of risk management staff – it needs to be the responsibility of everyone. At the highest strategic level, however, responsibility must lie with the board and the chief executive. If the only thing a chief executive can do is insist on a 20% higher operating income than last year, then the long-term success of that company is in serious doubt. A chief executive should not try to take on all the responsibilities of a chief risk officer. For major strategic risk decisions, however, the chief executive, in consultation with the board, is the only one in a position to make the call. ■

[1] Students of American history will recall the lesson of General George McClellan, first commander of the union army during the American Civil War. While a dashing personality, McClellan was plagued by a debilitating degree of caution. Despite inferior numbers, Robert E Lee, general of the army of Northern Virginia, ran rings around McClellan time and again by taking carefully calculated risks

[2] Most of us remember Alan Greenspan coined the phrase 'irrational exuberance' in reference to an apparent stock market bubble. What we often forget is that he did so in December 1996, over three years before the Nasdaq composite index peaked on March 10, 2000

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