Organisational balance

Do financial risk managers need their own specialised organisation? Despite recent upheavals at the Global Association of Risk Professionals, David Rowe argues the answer is definitely yes

In mid-July, Peter Martin wrote an insightful essay on the career contributions of Jack Welch at General Electric.[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".

Most of us have seen how difficult it is to maintain this 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. Many approaches are used to approximate this alignment of incentives in large corporations. Stock options and tying bonuses to the performance of a small unit are two examples.

In my experience, a similar challenge arises in maintaining the proper balance of risk and return relative both to strategic and tactical decisions. To paraphrase Martin: "A company cannot succeed without proper risk controls, but a totally risk-averse company will fail." To cite another ironic quip: "Risk is not a four-letter word." It is not risk as such that threatens an institution's long-term success. Only excessive and uncontrolled risk or insufficient risk awareness presents such a threat.

The key strategy 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 make every effort to seek new profit opportunities, even though this generally leads to higher levels of risk. Obviously, risk managers are primarily charged with ensuring 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.

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.

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Generally, there are important psychological differences that predispose individuals to one role or the other. Instinctive line managers 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 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 just '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.

Deliberations

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 levels of scepticism 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.

Organised risk professionals can play a similar role in public policy debates such as that surrounding the Basel II proposals. There is certainly a place for the institutional voice of the business and trading side of financial markets. Risk managers as a profession, however, are recognised as coming from a different perspective with different priorities. As a result, their views can often carry more weight than those of an organisation composed primarily of line managers.

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 even today, my sense is that a better balance and greater respect have emerged in recent years. Surely this is the result of financial risk management having emerged as a self-consciously distinct professional discipline. As in other cases, the risk of excessive bureaucratisation is very real. I believe, however, that the significant decline in the number of large unexpected losses since 1996 is attributable in no small part to the strengthened quality of risk management personnel.

The important point is that trading and risk management are distinct and complementary professions. Purely technical skills in financial engineering and market conventions are only part of the repertoire of tools needed by the risk professional. An organisation explicitly for risk managers, as distinct from traders, is essential to maintaining the appropriate balance between these functions. ■

[1] *Martin P, Life after the myth, Financial Times, July 17, 2001*