Overhead or value-added?

Many argue that risk management professionals must break out of the role of being the 'risk police' and become value-added contributors. David Rowe wholeheartedly agrees, but warns that it is important to distinguish the nature of a risk manager's role from that of traditional line managers

At a recent Professional Risk Managers' International Association meeting in Athens, risk management veteran Constantine Thanassoulas, of Eilon & Associates, argued with some passion that risk managers must break the stereotype of being the 'risk police' and become active value-added contributors. If this does not happen, he argued, risk management will always be viewed as nothing but an overhead. Such costs are accepted as an unfortunate necessity to be tolerated but also carefully restricted.

I wholeheartedly agree with this sentiment. Very often, line managers are considered the heart of a business whereas risk managers are there to make sure nothing too bad happens and to help clean up the mess when it does. In many ways this is a product of the circumstances in which formal financial risk management was born.

David Rowe is group executive vice-president for risk management at SunGard Trading and Risk Systems
Email: david.rowe@risk.sungard.com

Experience is a harsh teacher

An old cynical saying holds that "experience is a harsh teacher, but some will learn from none other". Sadly, like all cynical sayings, this one contains a significant element of truth. Those whose experience in capital markets extends back to the mid-1980s will remember the recurring string of embarrassing losses that plagued the emergence of derivatives as mainstream financial instruments. Most of us can still rattle off names and events such as:

- Andy Krieger of Bankers Trust and the $80 million restatement due to mis-valuation of long-dated forex options;
- Howie Rubin of Merrill Lynch and the $180 million loss from trading of interest-only mortgage contracts;
- Robert Citron and the Orange County loss of $1.7 billion on structured US government agency securities;
- and, most famous of all, Nick Leeson and the $1.4 billion loss from hidden speculation in Nikkei futures that brought down the 230-year-old Baring Brothers Bank.

Such losses were fairly effective at concentrating the minds of senior management. These very public embarrassments prompted the creation of risk management departments in nearly all major financial market-makers. In general, the primary mandate for these departments was to prevent the future occurrence of such major losses. In this environment, it is no surprise that risk management became viewed as the 'risk police'.

Independence remains important

Looking back, an important trend since the early 1990s has been the emergence of financial risk management as a self-conscience profession similar to accountants or security analysts. In the process, a broader conception of the appropriate role of professional risk managers has begun to emerge. While some of the characteristics of this role reflect the necessity for oversight and control, more is required if risk managers are to achieve their full potential contribution. Risk management can and should be viewed as a key contributor to maximising shareholder value.

Having said this, clarity on the nature of risk management's contribution is essential. One aspect of this is embodied in another old saying that "you don't buy a dog and then bark yourself". It is not the proper role of risk managers to countermand or offset traders' positions provided they are within the approved risk tolerance of the firm. Traders are paid to evaluate and 'wear' the risk of their chosen positions. If risk managers get into the middle of these decisions, they become part of the risk-taking rather than the risk management process, and their independence is compromised.

There is no reason, however, why risk managers should not voice concern both to traders and senior management. This is especially important when several desks are taking similar positions and the enterprise-wide risk management system is the one place that this concentration of exposure to a single market event becomes visible. Senior management may choose to scale back these positions based on input from risk management staff, but this is a senior management, not a risk management, prerogative.

Risk management and shareholder value

So what is the proper contribution of risk management to shareholder value? In this context, it is important to remember that equity valuation is the result of two competing forces:

- the expected long-term growth rate in earnings, and
- the market-determined discount rate applied to those earnings.

Line management is responsible for pursuing profit opportunities and seeking to increase the expected long-term growth rate of earnings. Risk managers should be responsible for constraining the volatility of earnings and thereby reducing the discount rate applied by the market to expected earnings.

Of course, the division of labour cannot be quite as distinct as this. Line managers must be conscious of and responsible for many aspects of risk management, and risk managers must appreciate the need to take calculated risks in pursuit of earnings growth. Proper balance is the key, but the most successful firms will be those that recognise the central contribution risk management can and should play in maximising long-term shareholder value. ■