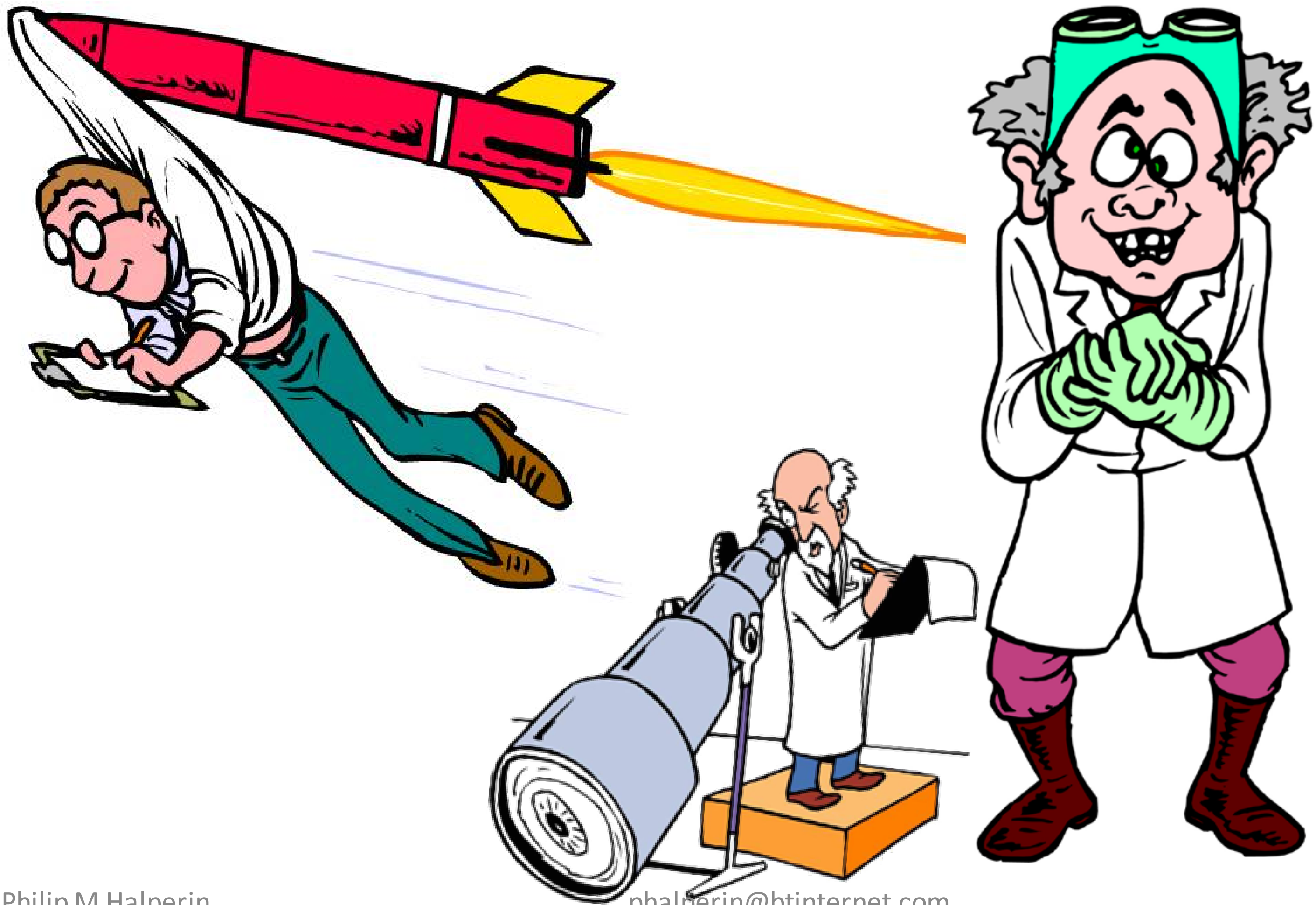
The CRO's View of RM---
History, Risk Governance, Culture

Masterclass –
Perm Winter University

Philip M Halperin – January 2014

Role Perception The way we see them:

Role Perception The way they see us:



"I get **nothing** of use from the Risk Management department"

"I *do not understand* what they are doing"

!

Agenda

I. History – The Genesis of Risk Management, or How did it get this way?

II. Risk Management Governance – Introduction

III. Culture

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In the Beginning Въ началѣ…

Financial firms
were organized as

PARTNERSHIPS

PARTNERSHIPS

Partnerships

There were no risk managers in the 1960s, when most investment firms were **partnerships**

- Business leaders had equity stake, hence
- Were concerned with preserving and growing equity.

- Risk and reward for a given business were balanced in a single director

COMPUTERS

Computers

- Computers were big, expensive and rare
  - Calculations were performed by hand
  - Systems included many "2nd pair of eyes", perforce (we come back to this point with the new regulatory paradigm of "3 lines of defence"
  - Human cognitive limitations were understood and accounted for.

Computers

- Manual computation constrained adventurism, trading books were small. Daily cash settlements provided automatic monitoring.

Computers

- The World Changes
- 1960s – 1970s: Silicon microchip computing
- 1970s – Handheld calculators
- 1970s – Black and Scholes papers.
- → *The RISE OF THE "QUANTS"*

But Partnerships became Corporations

1980s: Corporations become dominant, owners sell out.

Note as well that capital seeks return, and the increase in capitalization resulted on pressure for ever increasing yields.

Beginning of “**<u>agency”:</u>**

Beginning of *dichotomy* between

Head of Business Line,

and

“Risk Manager”.

Recall the equation for a synthetic:

$$C - P = \text{Stock}$$

We can apply this to the rational motivations of the now agent-actors: Business, and Risk Management

Recall the equation for a synthetic:

C – P = Stock

Business heads, traders, etc.:
--- base salary + % bonus tied to profit after some point

Recall the equation for a synthetic:

C – P = Stock

RM – much higher base salary, with the naïve mandate to constrain losses, possibility of getting fired below some point, or (!) if the business does not grow.

Recall the equation for a synthetic:

C – P = Stock

Note that the business payoff is similar in response surface to a “long call” , and the Risk Management payoff to a “short put”. One of the ways of increasing value of long option is to *increase volatility,* hence it is natural for front office to increase risk. The way to increase value of short option is to *decrease volatility*, hence it is natural for RM to decrease risk. Both are wrong.

RISK MANAGEMENT
(Short a put)

BUSINESS
(Long a call)

but

Risk Management

$$\neq$$

Risk Minimisation!

управление

рисками

$$\neq$$

минимизация

рисков

!

Modelling

RM became *defensively myopic*:

- modeling,

Modelling

1990s: Philippe Jorion Value at Risk published

1990s: European Capital Adequacy Directive – 95% Confidence Interval with a Safety factor of 3x or 4x

- This worked well
- Not intellectually neat enough for theoretical types.

Modelling

1990s: Begin Basel II ->

- Standards set to **absurd** levels: 99.9% etc. not testable, but satisfied continental theoreticians desire for “rigour”.
- Enormous demands for computing power and staff

➢ First <u>quantitative</u> justification of Risk Management function.

Quantitative Justification of Risk Mgt Function…

- Reg capital! Devil's bargain with the regulators – in return for higher budgets, more staff, Risk Management sold out objectivity function – justified their value in reducing regulatory capital, in effect becoming complicit in the increased gearing of their employers. – this is beginning to happen in Russia.
- Procyclical
- Set the seeds for the crisis of '08
- Distracted from Real Risk Management

Modelling

Quantitative overkill – the modeller became king

"When models turn on, brains turn off."
Til Schuermann --- this is extreme

"Risk management is about people and processes and not about models and technology." Trevor Levine – the RiskCzar blog -- well, it should be.

Another way to “play it safe” besides modelling, became the definition of Risk Managent to be Risk Reporting and Analysis…

Risk Manager is not just a risk reporter.

What, then, *is* Risk Management?

Models for Risk Management:

Reporter and measurer of risk.

Regulatory accountant.

New Paradigm --- partner with business

-> Reporting is the first step in establishing a partnership dialogue with business.

Risk Management Goals:

- No Surprises!

Risk Management Goals:

- Appropriate Risk/Reward Level

Reward…

vs.

…Risk!

Biblio for this first part

Philippe Jorion, *“Value at Risk”*

Nassim Taleb, “*The Black Swan: The Impact of the Highly Probable”*

Benoit Mandelbrot, *“The (Mis)Behaviour of Markets”*

Riccardo Rebonato, *“The Plight of the Fortune Tellers”*

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Risk Governance

Recall… Partnerships became Corporations

- The Risk Management Function appeared…
- as a Corporate Governance Response
- To the changed form of enterprise ownership
- From partner / business head
  - to a Corporate Form of Business governance
  - without owner-managers

➢ This “agency” solution became Risk Management.

- Функция Риск-менеджмента проявилась
- Как ответ корпоративного управления
- к изменению формы управления предприятием
- От долевого партнера – владельца бизнеса
  - к корпоративной форме управляющего делами
  - Без доли учередительнай

➢ в «агентской» предложенным решением является риск-менеджер

Siloing

Initially, as usual, business got it wrong. The risk manager was appointed and generally subordinate to the newly freed business manager.

Siloing

Silos evolved, with RMs handling just one type of risk or even line of business. RM became myopic, increasingly focused on modeling, and later on, essentially, regulatory accounting.

Basel 2

One antidote to this mess is the Basel 2 Pillar Structure:

Pillar 1 – Primary risks --- Market, Credit, Operational Risk

Pillar 2 – Governance and enterprise level risks. Formally expressed in the "Supervisory Review Process:

- Capital Adequacy
- **Corporate governance**
- **Documentation**
- Other risks, including:
  - Interest Rate Risk
  - Concentration Risk
  - Reputational Risk

➢ The Corporate governance and Documentation were occasioned by the nature of the agency problem, and siloing

Basel 2

Capital Adequacy and inclusion of other risks in a single framework has led to increasing centralisation of Risk Management, and the adoption of some capital framework, “regulatory” or “economic” capital.

- One downside to this was the *further* quantification of the unquantifiable --- enterprise level risk.

- Another downside was the diversion of attention from true exogenous systemic risks…In this manner, the Crisis crept up on the Basel-builders.

Risk Governance

Positive developments for a **Blueprint of Corporate Risk Governance**.

First is the role of the CRO:

•Started with the trend toward "Enterprise Risk Management" (James Lam)

•Supported by Pillar 2 and ICAAP

•Buttressed by passage of post-crisis legislation such as Dodd Frank, etc.

Risk Governance

CRO

- Represents all the risks to the governing Board
- Serves to focus and represent risk/reward

In previous (benighted) times, CROs reported to the CFO

- Now increasinglyCRO reports to CEO
- No single model has uniform acceptance:
    - German model has CFO reporting to CRO!

Risk Governance

Definition of Risk Governance:

- Risk governance is the **architecture** within which risk management operates in a firm.

If **we accept that risk management** is fundamental to running any business, then risk governance is a **fundamental part of corporate governance**. It **will** reflect the firm's risk culture.

A Common Blueprint (not always implemented)…

Совет Директоров
(или НабСовет)

Комитет по УР
(или Комитет по политика УР)

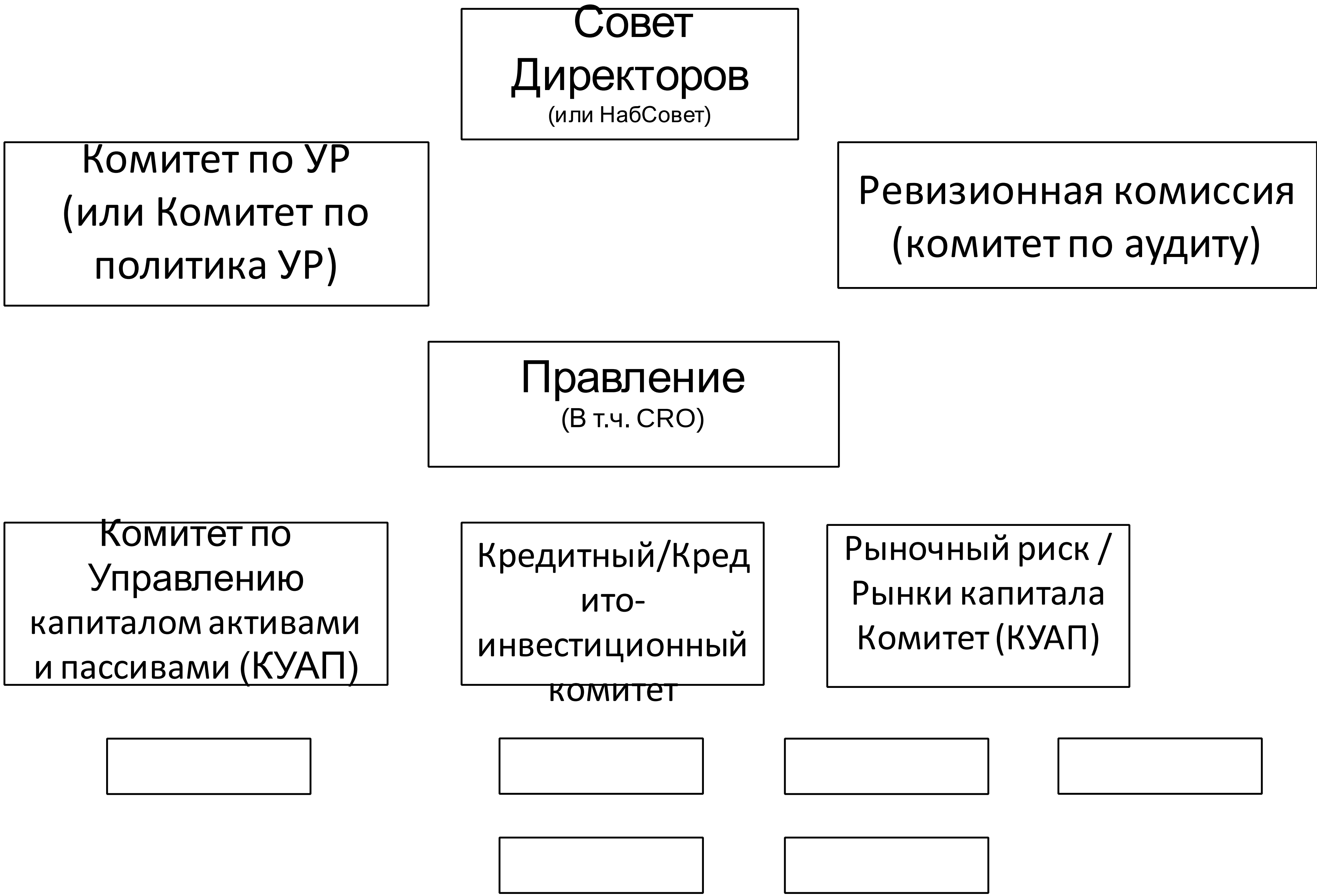
Ревизионная комиссия
(комитет по аудиту)

Правление
(В т.ч. CRO)

Комитет по Управлению капиталом активами и пассивами (КУАП)

Кредитный/Кредито-инвестиционный комитет

Рыночный риск / Рынки капитала Комитет (КУАП)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“Заявление аппетита к риску”

Primary “Risk Governance Instrument”

to be the

“Risk Appetite Statement”

“Заявление аппетита к риску”

Specifies goals (rating maintenance, % of defaults, and the like)

May specify appetite in terms of acceptable losses

May specify appetite in terms of

“allocated *economic* capital”

or

“*regulatory* capital”

View from the Board

Three major ingredients of good corporate Risk Governance

Subsidiarity and communication

Motivation

Culture

Subsidiarity

The principle of management, where goals are decided at the level where they are maximally effective.

Коммуникация

Субсидиарность

принцип управления, где задачи решаются на том уровне, где это наиболее эффективно

Communication

SUBSIDIARITY and COMMUNICATION:

The risk dialogue can be seen as both a top-down and a bottom-up phenomenon:

Upper board sets **risk appetite**, and strategic committees enact **real policies** (not just for the regulators).

Policies and supporting methodologies work their way down, and

Reports of compliance or noncompliance, of portfolio quality of risk undertaken, find their way up to the next level of risk governance

This all must be done in a transparent, verified, and timely manner.

Risk processes are ensured by healthy and robust practice of

Data Governance

Data review

Cleaning

When are points removed

When and how are points inserted

Model Governance

How is the model documented

Who reviews

Who approves

Who tests, and who updates

(review generally done by Internal Audit – bad practice)

Methodology Governance

Where does the policy/methodology originate

Who initiates

Who revises

Who verifies

MOTIVATION:

Conflict in the CRO-CEO reporting paradigm

МОТИВАЦИЯ:

Conflict in the CRO-CEO reporting paradigm

Counterbalance:

determination of the CRO compensation, and in the funding for the RM department

By upper board

dual-reporting line to the upper board.

MOTIVATION:

Mitigate the business risk-positivity:

•Delayed payouts, clawbacks, risk-adjusted bonuses

Mitigate the risk management minimisation:

Rewards for goals? Counterproductive and leads to profanation

Best with KPIs that emphasise partnering with the business.

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III. Culture – a special subset of Governance

Culture:

Both the CRO and the Board are responsible for the establishment and maintenance of a *healthy risk culture*,.

A Strong independent CRO at executive level,
A Qualified Risk Director at Board level,

But mostly… it is about *CULTURE*

Some ingredients:

Culture:

Responsibility follows authority. Responsibility flows up, not down.

Culture:

Transparency and quantitative goals are sought. Risk is neither overemphasized nor underreported, but rather reported objectively.
Policy is clear and followed,
Breaches punished equally and objectively.
Processes and economic risks are evaluated at the outset of each venture.

Culture *within* a RM department is also vital

Avoid profanation at all costs

Also avoid the tendency to err on the side of restriction.

КУЛЬТУРА:

Freedom of speech!– this must be cultivated, but is often suborned by collegial tradition, or presence of commissars.

Risk Manager is not just a risk reporter.

Ideally, there exists **a partnership role between RM and business** in modeling, launching, and revising the course of ventures, processes, products, and portfolios.

Appropriate level of Risk vs Reward involves assessment and much more discussion…
With the business.

Integrated with Risk Appetite & Business, Capital & Liquidity Planning

Managemen
t actions

Regular monitoring

Amendments to
business plan

Structure is important, and all that goes with it,

but…

Vitally …

The three major ingredients of good corporate Risk Governance

✓Subsidiarity and communication

✓Motivation

✓Culture

!

Biblio for this last part

James Lam *“Enterprise Risk Management”*

David Koenig *“ Governance Reimagined: Organisational Design, Risk, and Value Creation” (curiously more expensive in Kindle than in Hardcover!)*

Daniel Kahneman “Thinking Fast and Slow”.

Thanks for your patience!

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Благодарю за терпение!

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(Ну, всё)