

A New Position On Risk

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In case you haven't noticed, the new risk management paradigm of the 1990s was a failure in the early 2000s. It should have precluded the numerous corporate scandals that now shape the corporate landscape, but it didn't. Aspects of risk management need to be rethought, but this is a matter of fine tuning. The real problem has been implementation. There has been—and continues to be—a widening gap between risk management theory and risk management practice. Exhibit A is the issue of independence.

In the **Group of 30's** groundbreaking 1993 report on financial risk management, Recommendation 8 is titled **Independent Market Risk Management**. It reads

Dealers should have a market risk management function, with clear independence and authority ...

Recommendation 12 is titled **Independent Credit Risk Management**. It reads

Dealers should have a credit risk management function, with clear independence and authority ...

Ten years later, few people speak of independence anymore. Perusing the latest books on financial risk management, independence is hardly mentioned. Last year, the energy industry's Committee of Chief Risk Officers released a series of white papers on risk management. Amidst the discussions of policies and procedures, independence didn't come up.

Perhaps the need for risk management independence is so obvious that no one sees a need to point it out anymore. Based on my own experience, the issue is not so obvious. Earlier today, I was approached by an energy merchant about running a training session for their risk management team. When I inquired more about the team, I learned that it comprised mostly traders!

Here is what independence means:

1. Risk managers have reporting lines that are independent from those of risk taking functions.
2. Except at the highest levels, risk takers have no input on the performance reviews, compensation or promotion of risk managers, and conversely.
3. Employees cannot switch from one role to the other. Those hired into risk management stay in risk management; those hired as risk takers stay as risk takers.
4. Risk managers do not take risks on the firm's behalf. They do not advise on which risks to take. They express no opinions about the desirability of any particular risks.

The first three items are straightforward. The fourth is more subtle—or perhaps, controversial. It speaks to the very heart of what constitutes risk management. Let's

briefly address the first three items and then proceed to the question: what is the role of risk management, anyway?

Enron's experience with risk management is instructive. The firm maintained a risk management function staffed with capable employees. Lines of reporting were reasonably independent in theory, but less so in practice. The group's mark-to-market valuations were subject to adjustment by management. The group had few career risk managers. Enron maintained a fluid workforce. Employees were constantly on the lookout for their next internal transfer. Those who rotated through risk management were no different. A trader or structurer whose deal a risk manager scrutinized one day might be in a position to offer that risk manager a new position the next. Astute risk managers were careful to not burn bridges. Even worse, risk managers were subject to Enron's "rank and yank" system of performance review. Under that system, anyone could contribute feedback on anyone, and the consequences of a bad review were draconian. Risk managers who blocked deals could expect to suffer in "rank and yank."

Of the above four criteria for independence, Enron was weak on the first but utterly failed to satisfy the second two. Despite the sophistication of individual employees, risk management at Enron was hollow.

Proceeding now to the fourth criteria for independence, we want to distinguish between risk taking and risk management. Within firms, there are strategic and tactical risk takers. The CEO and other senior managers are strategic risk takers. They formulate a strategy for the firm that entails taking certain risks. They communicate the strategy to tactical risk takers—including traders, structurers, and asset managers—whose job it is to implement that strategy. This is how businesses have operated for hundreds of years, so where do risk managers fit in? While not typically acknowledged, there are two competing models.

According to one model, strategic and tactical risk takers need help taking risk. Under this theory, super risk takers—risk managers—are required to intervene. They identify risks that should be avoided and, in doing so, risks that should be taken. In this manner, risk managers help the less qualified strategic and tactical risk takers do their jobs.

There is much wrong with this model. First, it is redundant. If strategic or tactical risk takers are not capable of doing their jobs, the answer is not to hire a super risk taker to do it for them. Rather, it is to replace them with strategic and tactical risk takers who are up to the task. Second, it undermines accountability. If a trade turns sour, is the trader at fault, or is the risk manager who failed to block the deal? Third, it leads to conflict. While strategic risk takers will never feel threatened that a super risk taker might usurp their prerogatives, tactical risk takers often do. At some firms, the result has been a cold war between the front and middle offices. Finally, risk managers are positioned to be used as scapegoats. With corporate scandals fresh in memory, we can understand why some senior executives may be all too happy ascribing full responsibility for risk taking to a chief risk officer (CRO). With this model, risk management can become a device for executives to manage career risk as opposed to a device for managing corporate risk.

Do you know any risk managers who, despite tremendous dedication, hate their jobs? Are they spurned by the front office and ignored by senior management? If so, they are probably working at firms that embrace the risk-managers-as-super-risk-takers model.

The alternative model is that risk managers are facilitators. Strategic and tactical risk takers are responsible for deciding what risks to take. Risk managers facilitate the process by ensuring effective communication between the two groups. They help strategic risk takers communicate through policies, procedures and risk limits. They help tactical risk takers communicate by preparing risk reports. To avoid the pitfalls of the risk-managers-as-super-risk-takers model, risk managers must have no authority to take risk on the firm's behalf. They do not advise on risk taking issues because, if their advice is routinely followed, they will become de facto risk takers. To avoid the semblance of giving advice, they express no opinions about the desirability of taking any particular risks. It is one thing for a risk manager to measure risk. It is entirely another for the risk manager to express an opinion that the risk is too large or otherwise not worth taking. With risk managers not expressing opinions, tactical risk takers don't feel threatened ... so there is no cold war. With risk managers not responsible for taking risks, there is little possibility of shifting blame to them when things go wrong.

In light of the merits of the risk-managers-as-facilitators model, the very term "risk manager" seems unfortunate. Wouldn't it be more appropriate to describe them as "risk facilitators?"

In its 1993 report, the **Group of 30** made risk management independence a priority. Today, we have two unacknowledged competing models for risk management. The risk-managers-as-facilitators model embraces independence. The risk-managers-as-super-risk-takers model repudiates it.

Few firms follow either model in a pure form. Most follow a blending of the two, perhaps emphasizing one more than the other. By placing the issue of independence back on the table and *talking about it*, we can move firms towards the right model and away from the wrong model.

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