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Enterprise Risk Management Symposium: Notes on a Conference

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Another year, another terrific event. And this year, it was timelier than ever. We hope that the remarks below will give those unable to attend a good overview of the insightful discussions that occurred at this year's ERM Symposium.

Executive Summary

- ***The quality of conversation about risk management among directors and managers is still below par.*** Tough questions about project proposals and business operations are hard to ask particularly when profits are strong. A weak risk management culture and lack of organizational power for Chief Risk Officers (CROs) exacerbate this outcome.[1] Significant numbers of ERM Symposium participants reported that they experienced problems communicating risk management principles between different professional groups and levels of management within the firm.

- ***Risk appetite adjusts to the quality of risk management.*** Studies show that people driving safe cars drive faster and have similar numbers of accidents and injuries to other drivers. This outcome implies two things that are not necessarily intuitive. First, loss outcomes are not a direct measure of the quality of risk management. Second, temporary lapses in risk management or changes in the risk environment can have disastrous effects as managers practice brinkmanship with their perceptions of the state of firm risk management and actual practice changes without their knowledge. Pipeline risk apparently led, for example, to the failure of Northern Rock Bank in the United Kingdom after loans were made that could not be resold.

- ***The model risk contribution to the sub prime crisis is still not understood.*** Numerous speakers reported no problem with modeling in the crisis in spite of not anticipating valuation problems (see HPI chart on next page). Actuaries understand the issues in the inadequate housing loss data and model specification problems and follow the implications. But often, their managers cannot. Before the crisis, weaknesses in the subprime lending and marketing channels were not anticipated. After the crisis, some managers reported that stressing existing models with standard scenarios would have allowed them to anticipate the problems that emerged.

- ***Other observations:***

  - Insurance firms experienced relatively few losses in the subprime crisis relative to banks, investment firms, and hedge funds.
  - Reputation risk was a significant factor in the failure of Bear Stearns. The firm was not liked on Wall Street and it refused to participate in previous bailouts, such as Long-Term Capital Management.
  - The ***broken glass*** theory: crime is contagious. Allowing small crimes to go unchecked may signal it is okay to commit big crimes.[2] A similar principle may be at work in corporate cultures. Participants commented that broken corporate cultures, such as that at Bear Stearns, are a significant factor in operational risk and are asso-

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[1] They are not invited to director planning retreats, they are underpaid relative to business line officers, and risk management is frequently not a viable career path in the firm.
[2] James Emory White. 2004. Serious Times: Making Your Life Matter in an Urgent Day. InterVarsity Press. pp. 158.

ciated with the rogue trader problem. This problem also affects nation states.[3]

- Focus on policy issues was small. Recognition of sub prime losses, financial policy, and liquidity concerns, which were the focus of a recent Basle study[4] and other recent conversations in Washington, were not discussed in depth. Is this an opportunity to enhance the event discussions next year?
- The gold standard for crisis management certification: ***Standard on Disaster/ Emergency Management and Business Continuity Programs 2007 Edition***.[5]

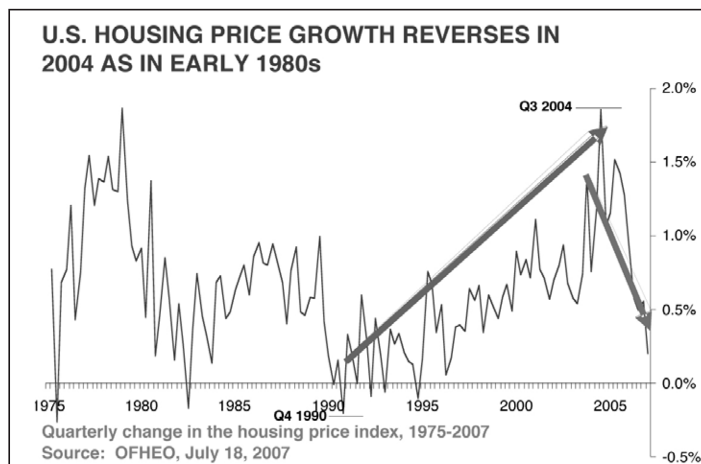
This year was a year of a record attendance (circa 600). Good Chief Risk Officer (CRO) participation and successful roll out of a new director's workshop suggest that the conference was an organizational success. However, an increasing non-insurance body of the participants cited a greater need for presenter and topic diversification.

Below we provide highlights from some of the selected sessions.

General Session: Is ERM Still Relevant—a Chief Risk Officer Perspective

Tuesday, April 15, 2008, 8:10 a.m.

Speakers: Marcello Cruz, AVIVA Randy Frietag, CRO, Lincoln Financial Tim Patria, Vice President and Director, Hartford Financial Services Group Anurag Saksena, CERO, Freddie Mac **Moderator:** Paul L. Horgan, Partner, PricewaterhouseCoopers



Anurag Saksena:

- Two basic CRO operating strategies exist:
  - ***Partnership approach***—where you have skin in the game. Are you respected enough to participate in decisions and have access to the Board?
  - ***Watcher approach***—where you observe those with "skin in the game."
- Can you communicate the risk story without resorting to jargon? What is the quality of the returns being earned?
- Everyone wants the same talent, but does not pay the same (e.g., market risk is less critical from a failure standpoint than credit risk, but the market risk managers get paid more).
- Is risk management a career track in your firm?
  - One firm required that all senior vice presidents spend at least two years in a risk management position.
- Observations:
  - Regulators now want more detail than they wanted 14 months ago.
  - The CRO's job is to reduce friction in the system.
  - Freddie Mac tracks nine categories of risks.

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[3]See, for example, Asharf Ghani and Clare Lockhart. 2008. Fixing Failed States: A Framework for Rebuilding a Fractured World. Oxford University Press.
[4]Senior Supervisors Group, Observations on Risk newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf. Basle, Switzerland. March 6, 2008. Management Practices during the Recent Market Turbulence. www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf. Basle, Switzerland. March 6, 2008.
[5]www.nfpa.org/assets/files/PDF/NFPA1600.pdf

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- Current sub prime crisis has its roots in corporate governance problems.
  - Board of directors may be too far removed from the best practice risk principles partially because of a generational lag. Consequently, they may be unable to ask the right questions and understand the significance of the reports they hear. Director education is one solution to this problem.
  - Who do CROs report to? They need a double reporting line to allow them access both to senior management (e.g., CEO, CFO) and the Board.

Luncheon Speaker: Lord John Eatwell, President, Queens' College, Cambridge

EU Regulatory Changes in the Light of Recent Events

Tuesday, April 15, 2008, 1:00 – 2:15 p.m.

- Lord John Eatwell was one of the best presenters at the Symposium. He was clear, precise and very insightful. This presentation alone was worth the Symposium attendance.
- Much of the discussion focused on the recent credit crisis and how it should be shaping the regulatory activities.
- He proposed a new role of the regulator:
  - Assure that the firm has incentives to management risk properly.
  - Enforce best practices management.
  - Focus specifically on systemic risk.
  - Develop countercyclical bank regulatory incentives, such as a required capital cushion during economic booms that could be dipped into during the downtimes.
  - Make sure financial firms have "skin in the game"—no off-balance transactions should be allowed.
- Northern Rock bank in the United Kingdom failed because of ***market gridlock***—the chain of counterparties froze. Loans were made that could not be sold.
- Comments on the U.S. regulations
  - They are too cumbersome.
  - When too many groups are overseeing the economy, things are bound to "fall through the cracks."
  - Simplification of the regulations could be a positive change.

General Session: In the Pursuit of Return, Have We Lost Sight of Risk?

Tuesday, April 15, 2008, 2:15 p.m.

Speakers: James C. Allison, Regional Risk Manager NA, Conoco Phillips Leo Tilman, Chief Institutional Strategist, Bear Stearns Larry Moews, Vice President and Chief Risk Officer, Allstate Insurance Company **Moderator:** Jorge Montepeque, Global Director, Marketing Reporting McGraw-Hill Platts

Jorge Montepeque:

- Life styles are converging worldwide. An inflationary environment is evolving out of the Federal Reserve actions.
- Problems with rogue traders may arise when high-energy individuals make mistakes and prevent oversight due to their force of personality.

James C. Allison:

- What went wrong?
  - ***Risk appetite adjusts to the quality of risk management***. Losses were higher because of our successes in risk management, not our failures. People with safe cars drive faster.
  - Risk transference created couplings not previously observed. Tension exists between product innovation (product differentiation) and market transparency. Firms make money being different, not uniform.
  - Stress testing—everyone talks about it; no one does it properly.

- Risk managers, directors, and buyers have an obligation to ask tougher questions about the business. We need to make sure that all disciplines and professions are talking the same language and engaged in decisions.
- Nearly all of the largest bankruptcies were due to preventable management failures—integrity problems and competencies.

Source: ***www.bankruptcydata.com/Research/15_Largest.htm***

Larry Moews:

- Segmentation of duties makes it unlikely that there is such a thing as a rogue trader—too many (30+) people have to be involved. When bad news is disclosed, managers pile on all the bad news they know about so as to purge the system.

Leo Tilman:

- Nothing focuses your attention like the failure of a firm (LTCM) just like your own (Bear Stearns, for example).
- What went wrong?
  - ***If firm risk appetite adjusts and is a problem, then hire more policemen.*** In the case of the autobahn road deaths, fatalities were reduced through driver education.
  - ***We did not ask the right questions. Risk managers continue to be called <u>after</u> decisions are made and are not invited to participate in planning retreats.***
  - Risk management did not fail. Nor was there a modeling failure.

General Session: View from the Top

Wednesday, April 16, 2008, 7:45 a.m.

Speakers: Dennis Chookaszian, Director, CME Holdings Branko Terzic, Global & U.S. Regulatory Policy Leader in Energy & Resources, Deloitte Services LP John Wengler, Chief Risk Officer, Entergy Services, Inc. (ESI)

Moderator: Matt Feldman, EVP, Operations, Chicago FHLB

Matt Feldman:

- A bad corporate culture can kill a firm. Risk officers used to be lone wolves.
- What we are frequently missing is good interaction between the company, the regulator and the customer. In that sense, the CRO plays a role like that of Henry Kissinger in the Nixon administration, getting everyone to talk constructively even when they do not get along on all issues.

Dennis Chookaszian:

- National Fire Protection Association (NFPA) 1600—the gold standard for crisis management certification: Standard on Disaster/Emergency Management and Business Continuity Programs 2007 Edition.[6] SOX requires a risk review: an out of the box process for out of the box risks.
- After 80 years of playing the "bad boy" on Wall Street, Bear Stearns ended up friendless.
- CRO role: If you cannot change things, what are you doing here?
- The big corporate failures could mostly have been prevented.

John Wengler:

- What is frequently missing in risk management is ***cultural competence***. Risk needs to be examined from a multidisciplinary perspective. We cannot be ***married to our numbers*** or use a lot of jargon. Phrases, like "six sigma losses," do not communicate to most audiences.
- ***The model for avoiding turf wars is to require that managers concur (not approve) that each proposal adequately describes risk management implications.*** By requiring only concurrence, concerns can be

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[6] www.nfpa.org/assets/files/PDF/NFPA1600.pdf

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expressed without offering a direct challenge to the proposing manager. Illustration is given of not looking a child in the eye (simian male challenge)—a sideways glance is preferred and less threatening.

- ***Does your secondary staff feel secondary?*** (They should not).
- ***Question:*** Did Bear Stearns executives know they were rolling the dice or was it an honest mistake that led to their failure? We may never know.

Branko Terzic:

- Does the CRO ask the right questions and have the support from senior management to do so?
- Reputational risk examples:
  - Schlitz Brewing Company failed from reputational problems after introducing a new brewing process that cut costs dramatically but left the beer maker with a dramatically reduced employee head count. Customers fled when the story was leaked because the company tried to position itself as a "traditional" brewer.
  - Arthur Andersen failed after playing a brinkmanship game with federal prosecutors who failed to realize that even filling an indictment of the firm would ruin their reputation and drive them out of business.
  - Tylenol enhanced the reputation of their firm by acting promptly and prudently when faced with a problem of poisoned product.

Luncheon Speaker: Dr. William Freund, Chief Economist Emeritus, The New York Stock Exchange

What Is Ahead for Business and Investors?

Wednesday, April 16, 12:30 p.m.

- Overall summary—great jokes, great insights. Some samples:
  - "Of the many introductions that I have received, this one was the most recent!"
  - "As Henry the Eighth told his wives—I won't keep you long!"
  - "An economist is someone who can make love 16 ways, but doesn't know a girl."
  - "Greenspan: constructive ambiguity. Congressman, if you understood what I just said, I misspoke."
  - "Will Rogers: If the world comes to an end, I want to be in Cincinnati, Ohio because everything happens in Cincinnati 10 years later."
  - "Winston Churchill: In the end, Americans always do the right thing—after exhausting all the other alternatives."

General Session: Strategic Risk—Making Models Relevant in Executiv e Decisions

Wednesday, April 16, 2008, 1:50 p.m.
Speakers: Scott M. Polakoff, Senior Deputy Director and Chief Operating Officer, Office of Thrift Supervision, Myron S. Scholes, Chairman, Platinum Grove Asset Management, L.P., Charlie Shamieh, Executive Vice President, AIG
Moderator: Thomas S. Y. Ho, President and Founder, Thomas Ho Company

Myron S. Scholes:

- Is there a difference between good management and good luck?
  - Good management is a marriage between good theory, experience, and luck.
- Was Bear Stearns insolvent or illiquid? We may never know.
- More information does not necessarily provide more value. Sometime we need to use ***mushware*** (our brains).

See you in Chicago in 2009! ✦