Enterprise Risk, Enterprise Risk Reward

By Dennis Barry

Risk is opportunity.

So says the Society of Actuaries. On its website. In its correspondence. Seemingly everywhere.

If that sentiment is, in fact, the way we want to perceive risk, then both enterprise risk management and its related component within incentive compensation plans seem unclouded in their applications. Note that here we're separating general management of enterprise risks from the more formal "Enterprise Risk Management." They are not the same.

Lower case enterprise risk management should be an effort to optimize risk acceptance or avoidance for the betterment of the business and its stakeholders. An example of success in that context might be Apple. It's hard to quantify risk of products that are entirely new but if Apple bet the company on the success of the iPod followed by the other i-products, someone in the organization judged that to be an appropriate risk to be taken. It's unlikely that any set of calculations based on demonstrable facts would have led to a conclusion that even came close to the actual success Apple has had, but here we are. On the other side we need only remember the New Coke debacle. As with Apple, this was a major change to an established business, but it didn't work. Again, no set of calculations based on facts would have revealed the result that ensued. Luckily Coca Cola hadn't bet the entire company on the new product and was able to roll things back before it got completely eaten up by the competition.

But competition is where the rubber really meets the road in the world of risk management. Whether it's competition for product market share or competition in the capital markets or competition for governmental favor or some other form of competition, where there is competition there is always risk, and opportunity. A company, like a predator, can run all day and all night in an attempt to catch prey or it can, like an antelope, run all day and night to avoid being eaten. Even though a given company can be in either role at any time, it surely must run constantly. Risk is the chance that in its role as either predator or prey a company runs the wrong way, and risk management ought to be devoted to minimizing the effects of those occasions. But it needs to be clearly recognized that completely avoiding all adverse effects of risk gone wrong is impossible. All that can be done is to recognize that risk is present and manage the effects.

If we want incentive compensation for managing risk perhaps the road to happiness for all comes from one of the new metrics used in baseball: WAR—Wins Above Replacement. The idea is to put a value on a player versus a theoretical replacement. The higher the value, the more valuable the player. If we buy into the idea that risk is opportunity, the same concept can be applied to alternatives in terms of the risk/reward they bring to an organization. In fact, in many insurance companies that's how decisions regarding capital allocations are made. But not all risk choices can be made based only on calculations, or protocols, or SOP manuals. Think again about Apple. They could have stayed the course, continuing to successfully make and market a variety of very useful and unique computers, or they could branch out into a new world involving new technologies. Whether they already saw potential connections of the iPod technology to all the other things that have come along since, they made a choice based not on calculations relying on models populated with vast assumptions (which, with apologies to Fred Kilbourne, often lead to half-vast conclusions) but based on someone's belief in what was best for the business. Success was not inevitable, no matter what anyone believed, but they went ahead anyway.

Rewarding people for turning risk into success ought not to be difficult either in concept or execution, but there is one serious potential snag, and that is time frame. No incentive

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compensation should be paid to anyone until it is fully known how things turned out. The 2007-08 financial crisis points this need out in spades. People at AIG, to pick one example in our industry, were offered enormous amounts of money for executing a highly risky strategy, and then were rewarded before the final results were actually known. The company took advantage of the opportunity for growth—market share—but didn't factor the long-term financial health of the organization into the incentive equation. By the time the real risk reared its ugly head, bringing lethal consequences with it, huge incentive compensation had already been paid and it wasn't likely to be coming back. The company was lost because of what had earlier been seen as a success but really wasn't.

There are a lot of lessons from this and other similar events surrounding the financial crisis when it comes to risk and reward. As noted above, prime among them is that incentive compensation for accepting risk shouldn't be paid too soon. Another is that while blessings of either auditors or ratings agencies or both may be necessary conditions for accepting a risk, they are in no way sufficient. For demonstration of that truism, we need only look at the catastrophe that was Enron/Arthur Anderson. Of course Enron was an exercise, at least in large part, of deception and dishonesty whereas AIG was more one of failure to know what they were doing, but the outcome was the same. In both cases, though, a strong ERM function may well have ferreted out the truth before rather than after the fall. But even had appropriate ERM analyses been done and conclusions reached, in both cases it was the role of the two Boards to say either "No," or "No more."

An upper case ERM function is, in significant part, a complex form of internal audit with a heavy focus on compliance. It seeks to first codify and then, when possible, quantify a variety of risks, both ongoing and related to proposed changes in the business, always with an eye toward avoidance of "catastrophe" by whatever definition. Having quantified risks, ERM then seeks to drive the organization toward acting in accordance with the results. It is primarily defensive in nature and, as stated so succinctly in the call for these essays, it claims as one of its major roles the saying of "no" when appropriate, a role for which there is no reward under current compensation systems. Nor should there be. Compliance is required for an organization's survival but it cannot be the sole, or primary, driver. The ultimate saying of "no" to major risks, as noted above in the AIG and Enron cases, is a Board function, not one for the ERM area alone. Certainly the Board should be armed with as much salient information as it can get. There must be clear, unencumbered, and unfiltered channels of communication between the risk evaluators and the Board, but ultimately the Board must decide. Think again of Apple. Had the Apple ERM function been able to say "no" to the iPod based on its best, state-of-the-art, fully robust analyses, your phone today mightn't be nearly as cool, or as small, but the Apple Board chose to go forward, presumably eyes open. That's why Boards are there.

In the ERM realm, one of the primary actuarial functions is to construct models. That's natural. It's what we as a profession have been doing for a long time, and we're good at it. But we're not perfect. No one is. We should heed Nate Silver's words in his 2012 book, *The Signal and the Noise*. While discussing the 2007-08 financial meltdown, he wrote, "We forget—or we willfully ignore—that our models are simplifications of the world. We figure if we make a mistake it will be at the margin. In complex models, however, mistakes are not measured in degrees but in whole orders of magnitude. S&P and Moody's underestimated the default risk associated with CDOs by a factor of 200. Economists thought there was just a 1 in 500 chance of a recession as severe as what actually occurred."

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ERM, with its structures and its calculations and its COSOs is still subject, at its core, to the same model problems as all other complex financial analyses. It is not infallible, no matter how diligent our efforts or pure our intentions. We should recognize ERM for what it is—an important and valuable tool—and not for what it isn't—the key to success for an organization. Incentive compensation isn't appropriate for ERM, except in very small doses, any more than for other internal audit functions. More important, when it comes to applying ERM, a company should comply where compliance is required and use the ERM tools to best effect, but it should not count on ERM to save the organization. That's the role of competent management and the Board.

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