

Victory at All Costs

by Jin Li and Tim Cardinal¹

“Upon this battle depends the survival ... If we can stand ... all ... may move forward into broad, sunlit uplands. But if we fail, then the whole world, ... will sink into the abyss ... Let us therefore brace ourselves to our duties, and so bear ourselves that, if ... {we} last ... men will say, “This was their finest hour.” Winston Churchill on the advent of the Battle of Britain in his famous “Their Finest Hour” speech on June 18, 1940.

Today our financial and market systems are beset by challenges. The second *Risk Management Call for Essays* asks many questions. In general the answers are yes. However, historical experience suggests there are significant obstacles. A fundamental obstacle is one that has been around for a long time – we are human. The second *Risk Management Call for Essays* seeks “thought leadership on the ERM discipline and the essential elements needed ...” and previously comments, “Ultimately, it becomes a story of risk that manifests itself through the decisions and behavior of people.” We could not agree more.

A quintessential element is integrity—trust in doing the right thing. The fundamental foundation of a sovereigns’ financial and risk systems and corporations’ insurance products is trust in delivering on long-term promises. Long-term implies a process (ERM) to balance and manage risks and economic growth. Decisions are not made by governments, institutions, corporations or policies. Decisions are made by people. Laws, policies and regulations attempt to legislate moral behavior, but common knowledge states, “You can’t legislate morality.” Even if permissible, it might be okay to do but might not be the right thing to do or may be the wrong thing.

The financial crisis had a dramatic impact on many individuals, companies and institutions that all responded in some

fashion. Governments passed legislation. Regulators found overlaps and omissions in oversight and also revisited and/or accelerated regulations. In the insurance sector, the NAIC’s Solvency Modernization Initiative and EU’s Solvency II have extensive requirements including embedding ERM into culture, decision making and business activities.

Government institutions and regulators face similar ERM challenges as corporations: integration of silos (jurisdiction, regulatory, etc.), acquisition of (risk) intelligence, behavior/culture, and decision making. The crisis has illustrated that embedding ERM is difficult to effectively implement in reality for both corporations and governments as does recent experience: Madoff, Toyota and BP. Behavioral hindsight critiques remind us of Steven Kerr’s classic management article, “The Folly of Rewarding A While Hoping for B.”²

The first *Risk Management Call for Essays* called for lessons learned. We pose four questions for the reader. Did we learn our lesson? Would post-crisis actions and developments, while worthy endeavors, have made a difference? Was government intervention or non-intervention appropriate—was it proactive, disciplined, well-thought-out and well-executed? Was the crisis severe enough?

¹ In this essay, the authors incorporated material from two forthcoming articles: Cardinal, T. and Li, J., *ERM & BI – Lessons From WWII Codebreakers*, forthcoming Contingencies 2011 Issue and Cardinal, T. and Li, J., *The Softer Side of ERM*, forthcoming *The Actuary* 2011 Issue

² Kerr, S. *The Academy of Management Executive*, 1995 Vol. 9 No. 1 7-14.

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Convergence is a theme that has been gaining momentum. Supervision, reporting, solvency and capital standards are converging within and across jurisdictions world-wide as well as becoming less rules-based and more principle-based. Convergence has and will unleash a Pandora's box. The *hope* saving us from *panic* is encapsulated by collaboration, wisdom and judgment. ERM acquires and implements business intelligence (BI) in making business and regulatory decisions in the face of ambiguity. These become useful when put into action resulting from collaborative choices made by an organization's decision makers exercising judgment. Thus ERM is inexorably tied to strategic organizational behavior (SOB).³

SOB is people and process centric: it studies how people, processes, teams and organizations behave, collaborate and make decisions to obtain sustainable competitive advantages resulting in performance. The hard sciences focus on things, mostly quantitative, and rules/policies and are necessary but not sufficient for successful ERM implementation and execution. Much attention is given to the acquisition of (risk) intelligence, such as the second *Risk Management Call for Essays'* question, "is it possible to effectively develop early warning indicators." We must also consider how intelligence is put into action. There are five stages to formulate and make intelligence useful⁴: 1) acquisition, 2) delivery, 3) acceptance, 4) interpretation and 5) implementation.

We can learn lessons by the responses to perhaps the most severe crisis, WWII. The Allies' early effort in ac-

quiring and using intelligence has the same plot as ERM and the financial crisis. Initially, the degree of collaboration between Intelligence Decryption and Interpretation departments and commanders (end users) and between the Allies was neither extensive nor effective. Various departments and military branches operated in silos each with inadequate resources and staffing. They learned that silos were ineffective and that intelligence was only as good as its interpretation and the use made of it.

The British included all who needed to know, shared best practices, varied techniques, invoked new technologies, and had an impressive degree of unification, communication and collaboration—an extraordinary singleness of purpose. In contrast the Japanese and Germans withheld information, were not as flexible or adaptable, confined direction to a small group and fixated on ideas and strategies made obsolete by events.

The Allies' response during WWII was multi-faceted. In addition to investing heavily in technologies, they recruited non-military people and industries to utilize resources and ingenuity from manufacturing, logistics, and transportation, etc. They changed work culture, facilitated an unprecedented coordination of silos, fostered transparency, and created collaborative high involvement cross-functional teams. They exemplified adaptation, flexibility, responsiveness and being learning organizations. We can learn from and apply all these lessons today.

³ The SOB material is derived from Hitt, M., Miller, C. and Colella, A. *Organizational Behavior: A Strategic Approach*, 2nd edn. Hoboken NJ: Wiley, 2008.

⁴ The military material is derived from Keegan, J. *Intelligence In War*, New York: Knopf, 2003.

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Supervisory agencies, like modern intelligence agencies, have become formidable bureaucracies staffed with full-time professionals. They often operate in silos not sharing what they know from their companion agencies. During Hurricane Katrina, various federal, state and local agencies were ineffective—disaster emergency plans were nice in appearance but ugly in substance. Before and during the financial crisis, regulatory supervisors operated in silos. Conventional wisdom says knowledge is power. However, foreknowledge is no protection against disaster. ERM indicators, supervision and frameworks are necessary but not sufficient for efficacy. Intelligence needs to be accepted, interpreted, and implemented, and implemented with force.

Centralized networks such as traditional command-and-control hierarchal management are appropriate for simple tasks requiring efficiency, speed and accuracy. Decentralized networks such as high-involvement management that integrates within and across organizational units and hierarchies are appropriate for solving complex problems and are better at timely and reliable intelligence and response time.

Supervisory ERM implementation and execution obstacles include communication barriers, decision-making pitfalls and conflicts. Organizational communication barriers include information overload, noise, time pressure, information distortion and cross-cultural barriers which include time zones, different languages and different regulatory jurisdictions. Intelligence distortion such as withholding or filtering intelligence vertically and horizontally severely limits the use of BI and ERM. Single node connections between silos, hierarchies and

BI stages exacerbate distortion. In contrast, transparency incorporates the process of enlarging internal circles of engagement and information sharing.

Decision-making pitfalls include individual biases such as cognitive, confirmation, anchoring, ease of recall and sunk-costs and organizational pitfalls such as group-think, common information-bias, diversity-based infighting, and risky shifts (group decisions tend to shift toward increased risk more often than toward increased cautiousness). Appropriate responses to conflict, which can be dysfunctional or functional, are situational. Rules and policies have limits. Effectiveness relies on people, processes, collaboration and judgment.

Historical experience teaches us the odds are stacked against us to avoid repeating mistakes resulting in crises. Globalization and the power information and decisions made by individuals via the internet have increased speed and correlations. Risk profiles and appropriate measures and indicators can rapidly change, reducing time and complicating responses. New issues and situations will arise. Creation of risk indicators, new agencies or supervisor CROs could be in vain or self-inflict problems. Done right, it could result in quickly bringing the right people together at the right time, sharing the right intelligence, asking the right questions, having the right dialogue, making the right decision, applying the right resources and taking the right actions.

Our advice is to focus on characteristics of a commitment organization encapsulated by the table below. In

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building an effective Supervisory ERM framework, in addition to what and why focus on the how. How will the indicators and other intelligence be robust, adaptable, timely, understandable, useable, relevant, timely, tangible and actionable? Political pressure will be intense.

Respond and/or intervene too slow, too fast, too heavy or too light and pressure will intensify. How will there be transparency, collaboration, checks and balances, and what will be the decision-making process and with what authority?

Control ERM & BI

- Silos
- Centralized communication networks
- Single points of connectivity
- Power resides in positions
- Need to know; secretive
- Club member only
- Separation/Partition
- Exclusive
- Withhold intel downstream
- Filter/censor up
- Top dictates solutions; bottom carries out orders
- Reports far-removed from source
- Non- & Miscommunication
- Single perspective/measures
- Delays
- Fixated beliefs
- Limits sharing
- Cost minimization

High Involvement ERM & BI

- Enterprise/global
- Decentralized communication networks
- Multiple connectivity points
- Power resides in interactions
- Transparent
- Wide circles of engagement/delegation
- Collaboration
- Inclusive
- Take in confidence/information sharing
- Inform, Alert
- All levels engaged; top receptive to bottom-up ideas
- Reports from/close to the source
- Dialogue
- Multiple perspectives/measures
- Speed
- Receives & explores alternatives
- Promotes sharing best practices
- Investment maximization

It is possible to have strong leaders in a decentralized, high-involvement, high-commitment, high-performance organization. Lincoln and Churchill come to mind as individuals we would choose as Supervisory CROs. In the

end it is victory that matters. As Churchill said, “Victory at all costs ... victory however long and hard the road may be; for without victory, there is no survival.”

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