Should You Have a Chief Skeptical Officer?

by Max J. Rudolph

What a roller coaster ride the past year has been! Occasionally we had respites as the financial markets gained altitude. This made the next day's drop even deeper and scarier. Volatility in the system has increased, not only between months and days but from morning to afternoon. Are we at the bottom now? Who knows? But unless we think the world economy is completely falling apart and we are switching back to a barter system, we should look for learnings that could help prevent future problems. This will also provide a competitive advantage during an inevitable rebound.

The current financial cycle has been particularly harsh. Risk managers at financial firms have not proven effective. They have either not had the authority to address their concerns or have gotten caught up in the excitement of the "new paradigm." Common sense has sometimes seemed in short supply, but this is not entirely fair. As with any crisis, hindsight will be 20/20. The economy has many moving parts. Actions by government and management often lead to unintended consequences.

Many of the reasons for the current crisis are not new. History truly does repeat itself. "It's different this time!" and "You don't understand the new economics" are mantras that have been repeatedly proven false. Some people truly recognize when they create a scheme to rip people off, while others buy into the excitement and sustain the momentum. No one wants to slow down the bus as it rolls downhill.

Many call this the sub-prime crisis, but risky mortgages were simply symptomatic of the underlying excesses building throughout the financial system. Some Wall Street firms used low interest rates driven by government policies to take on high amounts of leverage. Many firms borrowed more than $30 for each $1 of their own capital, with neither investors nor bankers knowing the total extent. Private equity firms, investment banks and hedge funds were ringleaders, but were joined by many other willing participants. Sometimes investments were entered into based entirely on a rating agency opinion of an asset, with no due diligence performed despite the obvious conflict where the issuer paid for the opinion.

Where was the due diligence? Where was the discipline? Analysts were considered lacking if an investment opportunity made no sense to them. Putting some PowerPoint slides together and giving a presentation created a supposed expert. Large egos ruled.

Investors, government, lenders and borrowers were all at fault. Where did the skeptics go? Where was someone asking the pointed questions? Why didn't chief risk officers identify and mitigate this situation? Why have they been so quiet? Some did identify the growing problem. Those who tried to slow down the "good times" were neutered or ignored. Options included quitting, being fired or being the fall guy.

Risk and return are key components to creating an optimal position, and there needs to be a healthy balance while managing against goals and constraints. Building models is useful as much for what is discovered from extreme scenarios as from the average results.

When a modeler communicates complex results to a lay audience, this helps everyone to better understand the risk/return relationship. Risk management, especially when applied holistically to the enterprise, combines the best of quantitative and qualitative methods. Quantitative models provide an immense amount of information, but can mislead without proper context. Scenario planning, where specific concerns and assumptions are investigated, can provide knowledge to the strategic planning process and a story to accompany the recommendations. Qualitative methods, built from common sense and an effective risk culture, lead to superior results. But these can't work unless the culture encourages challenges to assumptions, models and strategic thinking. Better decisions can be made. There is no free lunch.

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When a firm's culture is driven by growth and manager incentives ignore risks taken, it is only a matter of time until the process implodes. People will naturally gravitate to practices that enhance their pay. That's why it is called incentive pay. A company with a review team available and encouraged to challenge assumptions for both new and old products provides a competitive advantage for that firm. Alternative perspectives are healthy. Their task is to ask tough questions and maintain a consistent company-wide framework. The review team could consist of a combination of internal staff with broad exposure to a company's products and existing balance sheet, external consultants with knowledge of best practices and academics. Broad financial skills developed through the credentialing process make actuaries natural members of such a team. This team should not be viewed as a cost, but rather as an enabler. Better decisions are made by those who think about how a product impacts the firm's existing balance sheet on a marginal basis, not just its standalone effect.

The leader of such a team should have the CEO's ear and be aware of all corporate initiatives. This devil's advocate should be part of the C-suite, and have ownership of the strategic planning process. While internal audit has a role to play, the need here is for a broader role that challenges the risk culture and develops best practices in addition to checking processes. This leader should be prepared to state strong opinions so that improved decisions can be made. It is important for the board to have full access to this person, but the primary focus should be on educating and advising the CEO. This person acts as the firm's "chief skeptical officer." When a business line brings a new idea to the CEO, he should be able to ask, "Have you run this past the chief skeptical officer and does she concur with this proposal?" The CSO (could also be referred to as the common sense officer) might not always be popular, but the improved decisions made will allow the CEO to more confidently execute the company's strategic plans.

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