

# The Risk Management Paradox

## Survey Demographics

Navigant has partnered with the Economist Intelligence Unit to conduct a series of three surveys targeting over 500 financial executives globally. The first survey focused on risk management effectiveness and below is a summary of the key findings. Of the 180 financial executives surveyed, 37% are based in North America and 33% in Europe; 30% are from firms with global assets of more than \$250 billion; 41% are senior corporate executives (including chief executive, financial, and risk officers, as well as board members); and for 42%, risk is a major functional responsibility.

A clear contradiction emerges when evaluating the results of a recent survey conducted by the Economist Intelligence Unit on behalf of Navigant Consulting. While financial services companies indicated that they have “adequate risk management practices and philosophies”, many of those same companies are now facing significant economic loss, and in some cases, demise, as a result of their inability to correctly assess and manage risk. How could both be simultaneously true? Attempts to provide the answer to this question may yield valuable insights into the current state of risk management systems employed in today’s financial firms.

The ever-evolving credit crisis has highlighted the need for financial services companies to continue the process of integrating risk management, monitoring and reporting capabilities, and more closely align these programs with business activities and decision requirements. Going forward, risk measurement is not likely to change dramatically, but an evolution in how financial professionals use this data is almost certain. Future risk assessments may involve more frequent and sustained input from heretofore under-represented stakeholders, and focus will more likely be on changes in risk management governance

and execution than on an overhaul of existing risk systems.

## Confidence in risk systems prevails, but monitoring must improve

At first glance, many financial services professionals seem almost overly confident of their firms’ existing risk management practices; however, this conclusion seems to contradict the widespread assertions that risk-management breakdowns have contributed to the current credit crisis. Seventy-one percent of respondents say the risk management function plays an integral part in their firm’s business decisions, and about 65% say their firm has clearly stated and widely understood risk practices and philosophies, and clearly articulates its appetite for risk (see Figure 1).

Moreover, while many executives concede their firms need to improve monitoring of almost all risk types, a surprisingly large number are neutral, or outright disagree, that risk monitoring needs to be improved. (see Figure 2).

FIGURE 1

### Most say their firm’s risk management practices and philosophy are robust and transparent

To what extent do you agree/disagree with the following statements about your firm’s approach to risk management?

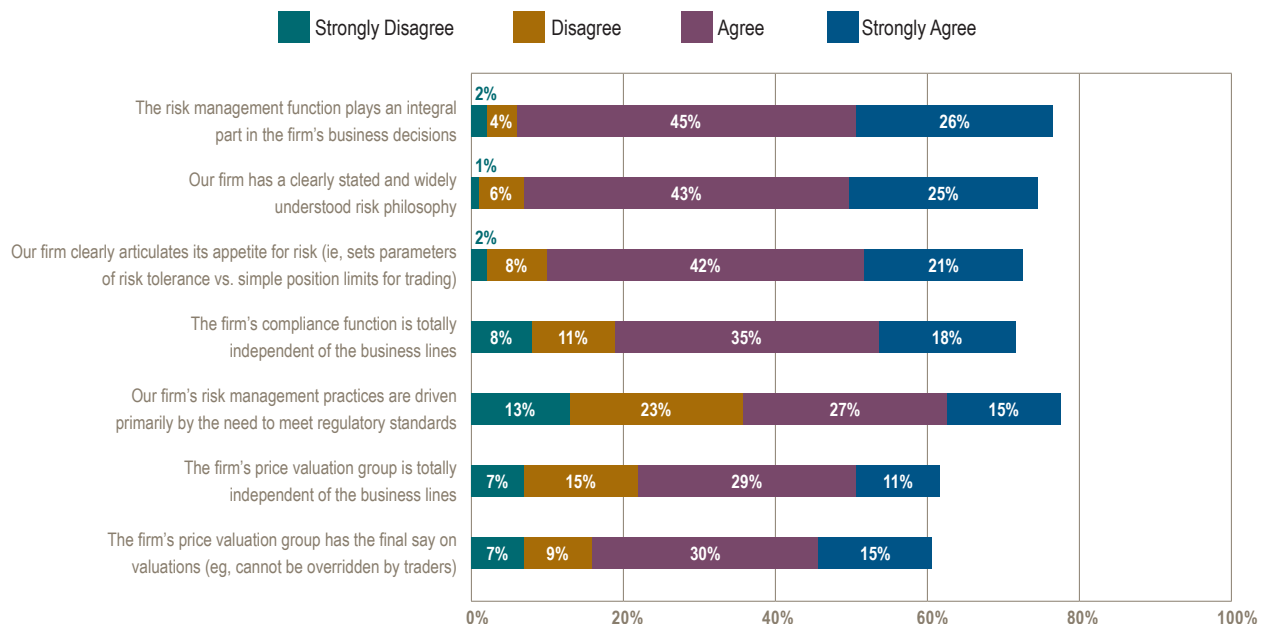
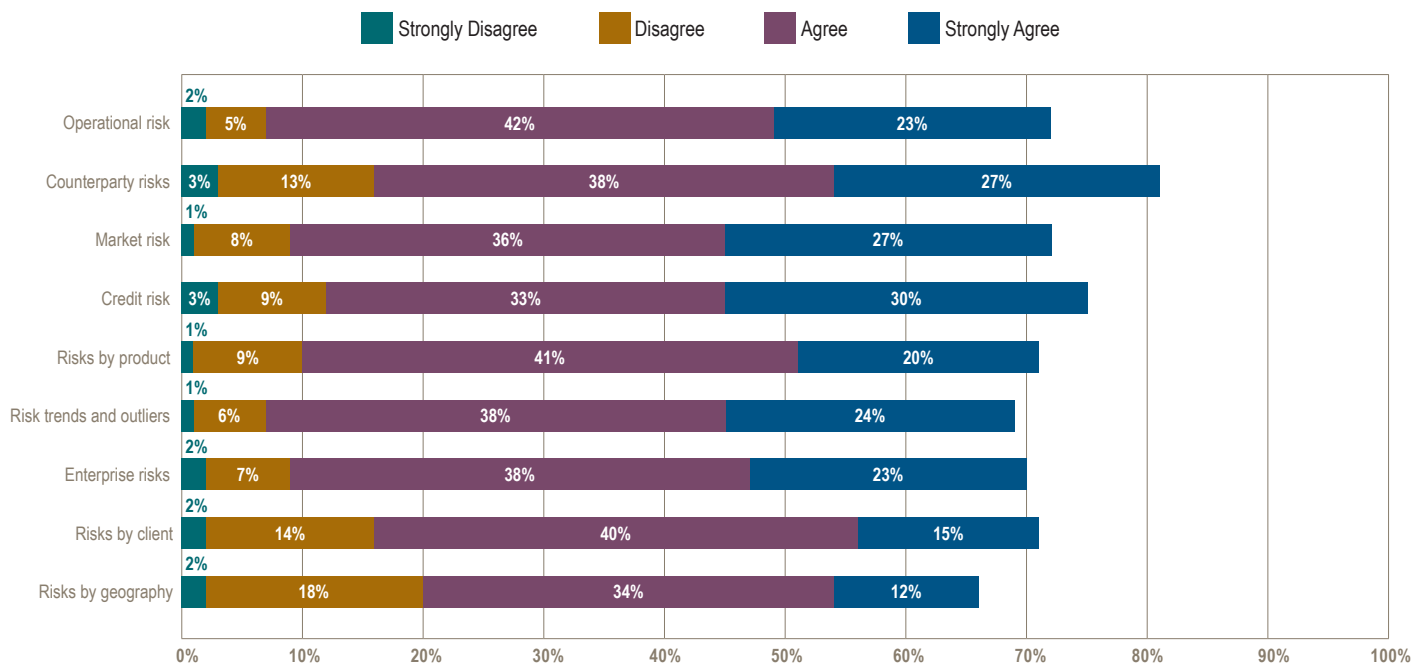


FIGURE 2

**Crisis has persuaded many financial services firms they need to monitor risks better, but some are still not convinced**  
 To what extent do you agree that your firm needs to improve its monitoring of each of the following types of risk?



## Risk “ownership” will evolve to improve integrity of business decisions

While risk systems themselves may not require significant change, survey respondents are convinced a change in risk governance is in the cards. Not only is the risk function expected to grow in size (according to 52% of respondents), risk functions are expected to be more closely integrated into business activities than in the past. For example, 88% of respondents say it will be critical or important to broaden the discussion of risk issues across functions, business lines, underwriting and trading, and 80% say risk management must be cast as a business enabler rather than a “loss avoidance” tool (see Figure 3).

The chief risk and compliance officers, in particular, are more likely in the future to have unilateral authority to curtail specific transactions or business activities because of the risks, giving them more business clout than in the past (see Figure 4). By further injecting the voice of these executives into discussions previously dominated (and

in some cases monopolized) by CEOs and CFOs, firms could help close any gaps that exist between the risk strategy advocated by senior management and the execution by the front lines of the business.

## Risk assessments should involve more input, more often, from more stakeholders

Another imperative for financial services firms going forward will be making sure to account better for the evolution of risk profiles over time, as the business portfolio, market and economic circumstances change. This will require deliberate attempts to preserve the power and integrity of independent teams, and to make sure that a variety of stakeholders remain formally responsible for monitoring risks long after the initial assessments of those risks are made. Stakeholders should include those who advocate assuming the risks and those who value them for accounting purposes, as well as those who operate directly in the markets from which the risks originate and players in the secondary markets for those risks.

For example, among survey respondents from larger institutions (those with more than \$50 billion in global assets), more expect price verification, business unit/regional risk officers and accounting officers to play a role going forward in evaluating the potential risk impact of new products, especially after their launch (see Figure 5). Those same stakeholders are also likely to be more involved in assessing the risk of new products before their launch. Corporate counsel and the CFO are expected to have a more active pre-launch role as well (see Figure 6).

At larger firms, 30% also say price verification groups will have the unilateral authority going forward to curtail a specific transaction or business activity because of the risks. That is up from the 19% who say those groups had that authority before the credit crisis. More than 60% of those respondents say their firm’s price verification groups are already totally independent of the business lines and have the final say on valuations (i.e., their assessment cannot be overridden by internal groups such as traders).

## Risk intelligence and communications will also need to improve

The survey also suggests there is significant room to improve risk intelligence – making it more current, comprehensive and consistent – and to make risk reports more intuitive for the reader to understand.

This is consistent with the growing realization that reporting on risk, even using widely advocated gauges like value at risk, does not necessarily provide different business stakeholders with the broader context and insight they need to make sound business decisions. Notably, if stakeholders lack a uniform prism through which to view risk, it will be very difficult for them to discuss or police it effectively – or to identify param-

eters of risk that everyone can recognise as signs of danger or opportunity.

The survey shows that the need for prime risk intelligence is also likely to grow from a compliance perspective. Most respondents (72%) cite risk disclosures as a likely plank in regulatory reforms going forward.

### Prepared, Yet Vulnerable?

Many of our survey respondents felt confident in their ability to measure risk, so where was the systemic breakdown that led to the credit crisis? One thought is that many risk assessment programs are “point-in-time” processes that provide definitions and parameters for measurement. When the risk tools are not updated in real time, the outputs may not be up-to-date, and so

the risks that are being measured may not allow for adequate or timely decisions. Another possibility is that risk measurement is working; yet triggers that are designed to identify potential risks that require attention (e.g., significant market events, compliance, and valuation changes) have not been developed or implemented. Without well designed triggers, the risks that are being measured will not provide context for decision-makers, or even more importantly, signal the need for escalation. A final thought is that individuals within the decision process have not been delegated the appropriate authority to make the difficult but necessary decisions to mitigate risk. As with all organizational roles and responsibilities, risk processes must be constantly tested and re-evaluated to remain effective.

FIGURE 3

### Majority say crisis has made changes to risk management philosophy important going forward

Given the lessons learned already from the financial crisis, how important is each of the following aspects of the firm’s risk management philosophy going forward?

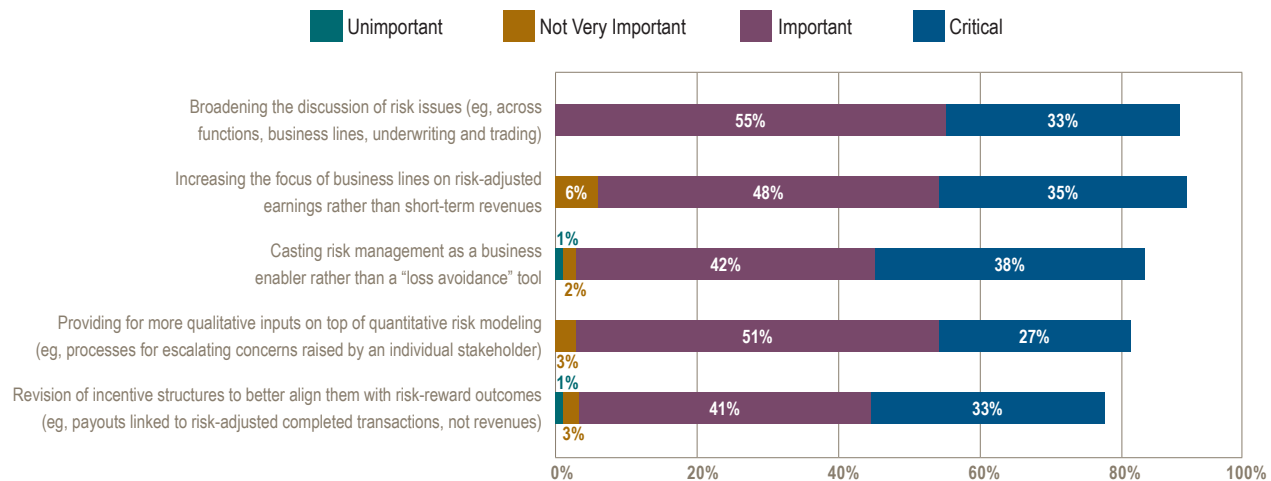


FIGURE 4

### MORE SEE RISK, COMPLIANCE OFFICERS VETTING BUSINESS ACTIVITIES GOING FORWARD

Before the financial crisis, which of the following stakeholders had the unilateral authority to curtail a specific transaction or business activity, because of the risks? Which are likely to have that unilateral authority going forward in light of lessons learned from the financial crisis?

Winners	Gain*	Losers	Loss*
Chief compliance officer	11%	Chief executive officer	4%
Chief risk officer	9%	Customer relationship managers	3%
Corporate counsel	5%	Board of directors	1%
Price verification group	5%	Marketing/Sales	1%

\* Percent change from pre-crisis status

FIGURE 5

**In future, more are likely to have price verification, business unit/regional risk officers watch new products post-launch**  
 Whose participation was required in evaluating the risk impact of new products after their launch?

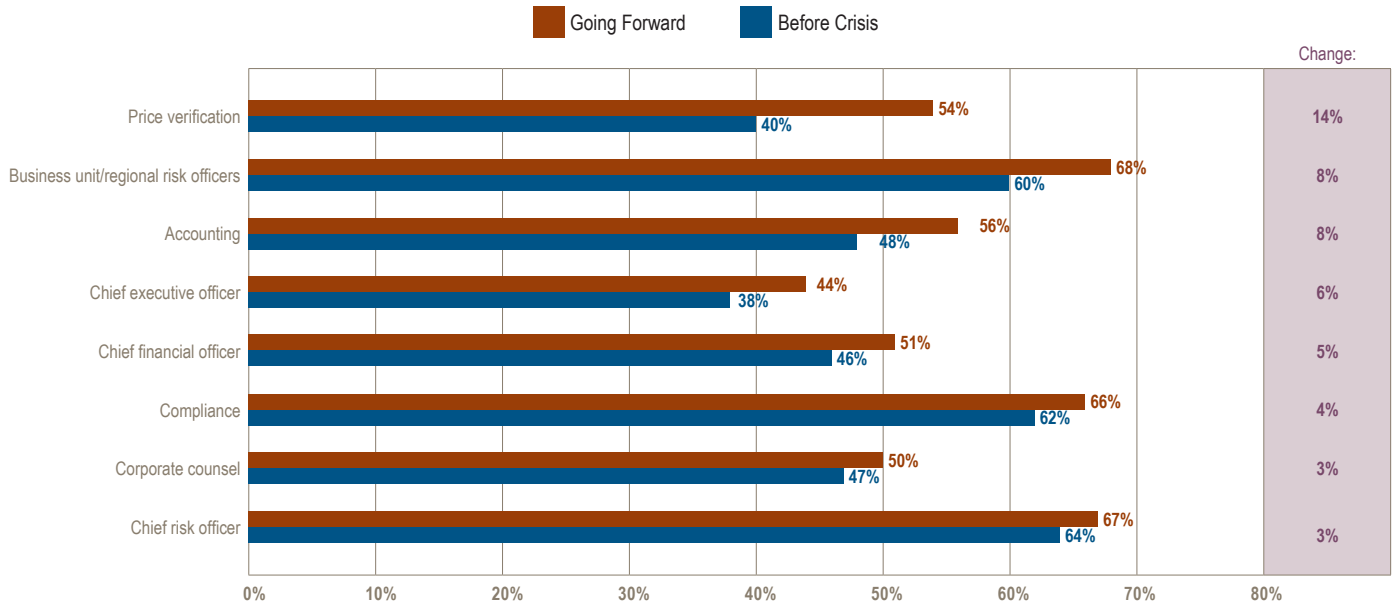


FIGURE 6

**In future, more are likely to have CFO, business unit/regional risk and legal officers approve new products pre-launch**  
 Whose participation was required in evaluating the risk impact of new products before their launch?

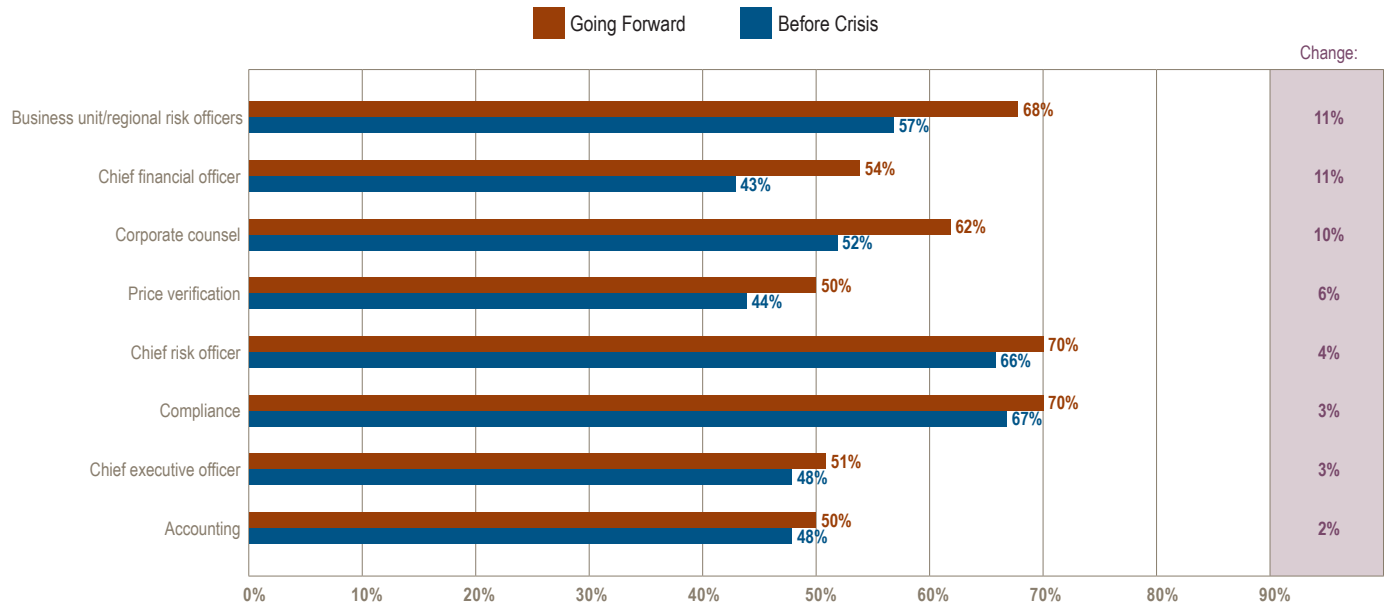
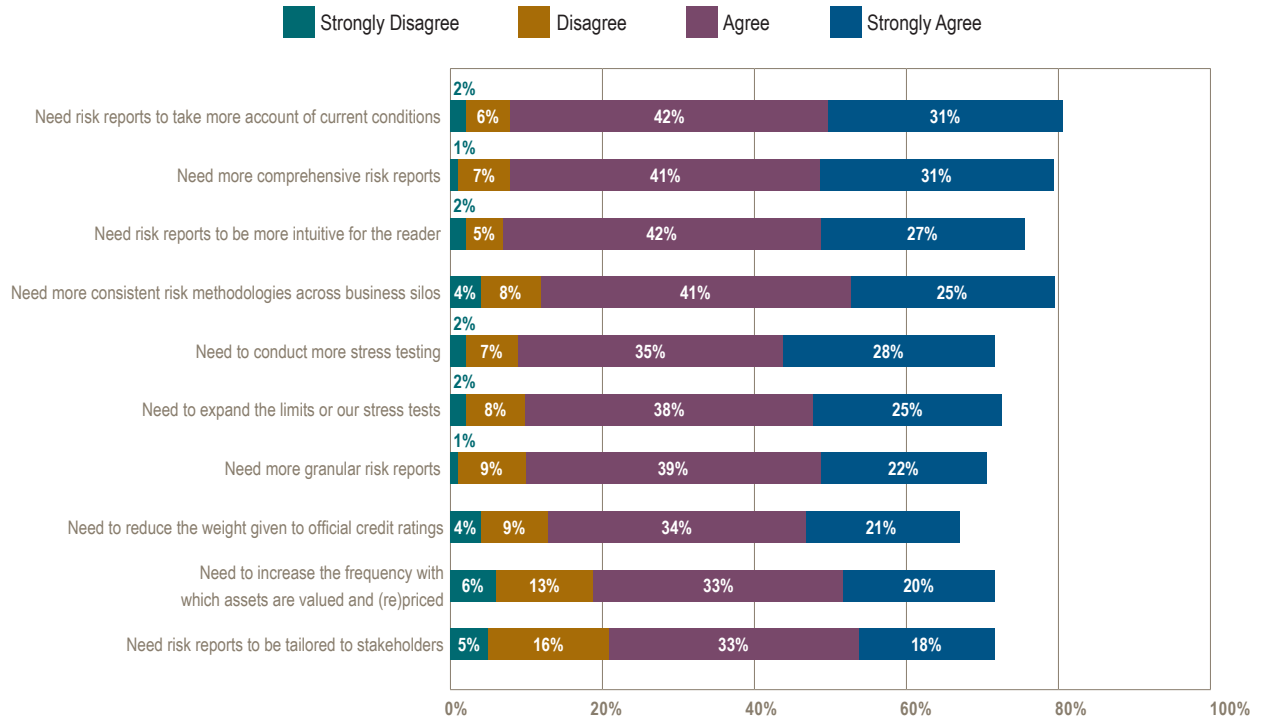


FIGURE 7

**Many see room for improvement on risk intelligence**

To what extent do you agree with each of the following imperatives in light of lessons learned from the financial crisis?



The financial crisis has radically changed the entire operating environment: Industry segments are consolidating, competition is growing, balance sheets are shrinking, and margins are being squeezed. Going forward, the survey suggests, a key enabler of success will be the firm’s ability to ap-

portion risk governance in a more granular but dynamic and cooperative structure. It will also be imperative for financial services firms to get the right risk information to the right people, in the right form, at the right time, so the enterprise can make better and timelier business decisions.

John J. Schneider is a Managing Director in Navigant Consulting’s Financial Services practice. For more information, or further detail on this survey, please contact John at [jjschneider@navigantconsulting.com](mailto:jjschneider@navigantconsulting.com).