WALKING THE WALK OF RISK

Charles Orton-Jones asks Mike Power, professor of accounting at the London School of Economics, what businesses and regulators could do better to manage risk

London School of Economics' Professor Mike Power

Q&A

What is wrong with the current model of risk management?

There are three things wrong. The first is that risk management has become too bureaucratic. It emphasises a controls-based approach, characterised by excessive box-ticking. The second is in the financial arena, where banks and other financial institutions became reliant on value-at-risk models. Those models were dependent on a range of assumptions, not least an implicit assumption about liquidity and the real availability of interbank funding. In hindsight, we can see there was insensitivity to the limitations of those models. And the third thing to go horribly wrong was focusing on entities in isolation, rather than the relationship between entities. Banks and insurers all used the same risk management model. But they didn't consider what would happen if they all acted in the same way and how that would create a systemic problem.

How is it possible to be rigorous and systematic, without box-ticking?

That is a fair question. Let's face it, box-ticking is very functional in many circumstances. When a pilot goes through the process for take-off, you want them to tick the boxes in sequence. The key is to understand the difference between necessary and sufficient.

The controls-based approach of risk management was necessary, but not sufficient. And it tends to have its own logic which crowds out other methods. It even crowds out the time people have to think about risk.

So what's the answer?

If I knew that I'd be a rich man. Everybody knows this is a pathology of the risk management arena. You can't get out of it. So part of the solution is down to the regulators. They should trust a little more and need evidence a little less. The second part of the solution is to have courageous leadership in organisations which says, yes, we are going to do the process stuff, but we are also going to make sure risk is part of the organisational conversation.

What practical steps can businesses take to make those changes?

The chief risk officer needs to be the first among equals. This means they get the full trust of the board and chief executive. And businesses need to take a long view of their relationship with clients. We are seeing this in the banking sector, where firms such as Barclays are attempting an ethical renewal. When businesses derive their philosophy from an understanding of the relationship they want to have with their clients, they can change their risk management profile. But I'm afraid there isn't a magic bullet. Organisations are experimenting with ways to re-orient their ethical compass to improve the quality of their risk management.

How can firms tell if they are on the right road?

One indicator is how often the risk management function is approached for advice. Some organisations see risk management as a partner and adviser, others as a compliance department. If people aren't talking to the risk managers often enough, that's a bad sign. The truth is that change is hard. People feel comfortable with due process. It makes them feel safe. It gives them the illusion of certainty in an uncertain world.

COMMERCIAL FEATURE

Insight ver oversight

Risk management is a way of de "insights" into emerging uncer within a business, to adapt and resilience, says Milliman

Neil Cantle, principal, Milliman

At 9:18am the manager gets an e-mail... the management information system has spotted a problem. Production is 1.75 per cent under target. A few more clicks and the manager can see one of the machines seems to be malfunctioning. A quick call to the production team and by 9:27am it is all looking good again.

This vision of management as an "observation and correction" oversight task has been at the heart of business school mantra for nearly a hundred years. But the problem is that most companies are not production lines and simply adding "touchy feely" culture work around that underlying premise simply does not work.

Most companies are a lot more like a group of people trying to achieve a common set of goals and facing dynamic conditions while trying to do so. And the managers are part of that group of people, not abstract observers.

Modern thinking about how "management" sho reflects on the fact th longer possible for m to choose the outcome like – they can simply c next action. Of course is that a particular ou result, but this canno anteed due to the man interactions going on b different elements of m ness. Even if your busin tively simple within the ing walls, it interacts w complex environment and supply chains.

The classic cyberne management as a contr loop can ultimately lead fire-fighting and ineffic tion of resource. Much o from the impossibility the current state of th in sufficient detail to p actions will play out. So not control our destiny, point of risk managemen

In fact, the answer lie thing that has been par life since the start – st The best way to achie come when the path is dynamic and unce ensure that everyone w there, and then regul about how it might be means that people who comfortable with unce take a key role in helpi tate discussion and c narratives in which the ronment makes sense.

Small corrections to t made naturally and au as people go about their with immediate feedba agers are part of the

The need to facilitate 'insight' offers a persp