

Foreword



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Risk management and governance are in vogue. Some of those who missed this trend are in jail. We are now wondering if the serious attention given to these critical elements will continue or if corporate focus will somehow shift away, relegating value-adding governance to a role of diminished and perfunctory process. It is essential that this not be allowed to happen.

In virtually every region of the world, legislation has been written to prescribe governance and the penalties for lack of engagement. In 2004, a collaborative effort of accounting and audit professionals, acting under the acronym COSO, made a well-intentioned, but somewhat misguided attempt to turn risk management into damage prevention. They have even gone so far as to define enterprise risk management, a subset of good corporate governance, as primarily a control function.

Risk management and good governance go hand in hand; one is not possible without the other. Yet, prescriptions, controls and punishment are not as effective in stimulating good governance as is the creation of an internal culture that understands and supports intelligent risk-taking and further engrains an appreciation of risk in those who are its originators. The advancement of risk management practices and the derivative tools to mitigate and transfer risks makes

such intelligent risk taking ever more possible today. Their joint advancement means that enterprise risk management can add significant value when defined and employed properly.

We note that the first business decision made, that to open, is in fact, each firm's first risk management decision. The entrepreneurs who start companies are generally engrained with an appreciation of risk. Like them, we need not fear risk. We also need not punish those who take risks in an ethical and well-intended fashion simply because some risks are realised. Not every business works and not every business decision is a good one.

So what is it that differentiates good risk management and governance from that which fails its role? It is clear from the scandalous episodes of this decade that the simple presence of a risk management function is not a sufficient condition to ensure good governance. What differentiates good risk management from not-so-good is

a focus on creating a culture of intelligent risk-taking, where every employee is a 'risk professional'; free to make good business decisions. It is an environment of openness and disclosure and one in which the risk professional, particularly the newly emerging Chief Risk Officer, can add tremendous value to a firm.

The organisations with the best risk management and best governance practices have a strong, reinforced, culture of:

- knowledge sharing;
- openness;
- collaboration;
- aligned incentives with risk management objectives; and
- freed decision-making within the established boundaries.

A culture of knowledge-sharing is one in which the enterprise risk management infrastructure and business leaders are in continuous communication regarding the existence, make-up, best uses and best mitigants of risk.

A culture of openness and collaboration is one that allows for risk to be realised in a non-threatening environment. It encourages escalation of events and the partnership of risk originators and enterprise risk managers in the identification of potential problems and the address of developing ones. It is most clearly not a culture that first looks to assign ex-post blame for the realisation of risk.

A culture that matches incentives to risk management goals is one where compensation and non-financial reward are continually reviewed for consistency with corporate, stakeholder and regulatory expectations; where long-term compensation is matched with long-term corporate success.

A culture of freedom to make decisions is a bi-product of the cultures of knowledge-sharing, openness, collaboration and alignment of rewards to expectations. Parameters are established, communicated and understood. Within those parameters, those who have been employed to attempt to make good business decisions can do so without jeopardising the larger

organisation. It is the true culture of best practice enterprise risk management.

Over time, free markets have demonstrated their superior ability to create wealth. There is no point to engaging in wealth-creating activities without the willingness to take risk. The freer the markets, the more easily risks can be taken that potentially create wealth.

Good governance and enterprise risk management create freedom. Freedom creates greater wealth and thus the ability to survive greater risk realisation. Greater ability to survive the realisation of risk makes the organisation, its stakeholders and the system in which they operate safer.

Note that freedom is hardly what is created by heavy-handed legislative intervention or documents that over emphasise controls to the detriment of good business operations.

As an example of impending writ, the Basel II banking capital accord has some excellent principles at its core. Basel II uses three pillars in its approach to regulation. Through pillar I, it encourages banks to use their internally developed models to measure risk. Through its second and third pillars, it seeks to encourage transparency and resultant market discipline that rewards the best risk-takers with more wealth and to position the regulatory role as one that ensures the market is being informed honestly and openly. Basel II has the potential to help create freedom and that is one of its strongest points.

Basel II, or for that matter, any legislative intervention, also faces the danger that if it is overly prescriptive on rules, or overly bent on punishment for the realisation of risk, it will ultimately take away freedom and increase the impact of risk realisation. Such may even exacerbate the impact of normal economic cycles, harming everyone: the rule of unintended consequences.

In a 2003 forum, Eliot Spitzer, Attorney General for the State of New York and R. Glenn Hubbard, former Chair of the White House Council of Economic Advisory and now Dean of the Columbia Business School, both spoke of corporate governance and their thoughts of the impact of recent corporate scandals. Even though neither one might

agree to such a statement, their beliefs overlapped substantially. Mr. Spitzer is not prescribing legislation, but is rooting out the risk taking that was neither ethical nor well intended. Dr. Hubbard argues that people should not be punished when the process of good-business-decision-making yields bad results and worries that the fear created by collective actions of attorneys-general might be a negative for the economy. They are both correct.

Good governance and enterprise risk management come from the culture that is present at an organisation, and is encouraged by regulatory bodies through open discussion and examination of that culture. Some broad parameters that protect our systems are essential and unethical behaviour should be meted with consequences. For the near totality of workers, who never cross a line warranting punishment

and the near totality of realised risks that do not jeopardise the system, the freedom to make sound business decisions, in a culture like that described, is the best form of governance and risk management.

Regulators and internal risk managers have very similar roles to play. The best enterprise risk managers focus on cultural bias towards risk professionalism and that same focus should be embedded in legislation and regulation. It is the job of risk professionals, and the power that should be given to every Chief Risk Officer, to help create the environment that begets such freedom. In turn, we also encourage legislators to resist prescriptive entanglement that in the end makes the realisation of risk more costly for all and we encourage the continued development of the risk management profession and the derivative tools that make it possible.