

Chief Risk Officers: a case of Quadrophenia?

Many companies have recently announced the appointment of an executive level CRO. But it's a fine balancing act to get right. Mike Wilkinson, head of risk consulting at EMB, reviews the key factors for success.

The recent Société Générale case has again thrust the issue of risk management well into the limelight. Not surprisingly many companies are announcing the appointment of high profile Chief Risk Officers (CRO). Morgan Stanley and Swiss Re are two firms who have recently hired senior executives to provide strategic oversight for risk.

The significance attached to recruiting a CRO is no new surprise. Over the past five years the preponderance of the role has increased, with each corporate crisis creating its own spike of activity. Solvency II will generate a new wave of change for insurers and reinsurers across the EU, as Basel II previously did for banks. Firms must demonstrate that risk management and measurement are embedded throughout the organisation and establish a formal risk management function. Regulators and rating agencies echo this view globally, seeing good risk management as a necessary and indicative element of business strength within an overall Enterprise Risk Management (ERM) framework.

As the latest member of the 'C' suite, the CRO has been elevated to a senior management position alongside the CFO, CEO and COO. But it's a challenge since there is no generally accepted *modus operandi* as with, say a CFO, and the position can cut across established roles, such as Internal Audit.

On the other hand, increasingly companies see an opportunity to create a new role that can deliver genuine added value improving the effectiveness of their organisation.

What is the role all about?

Developed in the 1980s in response to various corporate crises and market issues, the initial role of a CRO was about control - putting a brake on activities that generated excess risk.

However, the role has matured, and it is becoming apparent that a CRO can bring real business value. This is perhaps best illustrated by the analogy of two racing cars, one with brakes, one without. Which goes faster? Answer: the one with brakes - the driver has the confidence of brakes for the corners so he can accelerate down the straights.

The point is that brakes are not just about stopping. Similarly the role of the CRO is not just about removing risk but taking a broader view across the organisation - Enterprise Risk Management. The crisis and regulatory driven approach can result in organisations having an overly narrow perspective: that all risk is 'bad'. But this is not necessarily so. All financial institutions - and particularly insurers - make their money from risk. The CRO's brief is to ensure risk is properly understood and translated into meaningful business requirements, objectives and metrics. This includes understanding 'good risk' leading to profits, and 'bad risk' leading to excessive cost.

So what does this mean for the role of the CRO?

I believe the modern day CRO has to combine four functions. In the words of The Who, it must be not schizophrenic, but 'quadrophenic' - part police officer, part teacher, part counsellor and part business leader.

CRO's must be flexible...

The police officer can be seen as the base function - the ability to apply the brake. This aspect of the role provides the assurance that the business is following good systems and controls with regards to identifying, assessing, mitigating and reporting its risks; and can react accordingly if these are being breached. However, it is reactive and lags behind adverse indicators or events.

The teacher role is about educating employees so that risk is properly understood across the organisation and that objectives, business procedures, controls, data and reporting reflect this understanding throughout the business. Good risk management is as much about culture as it is about systems and controls, and this education can proactively address cultural issues which may lead to unwanted risks.

As a counsellor, the CRO is an advisor to the Board and Management, regularly commenting on the key risks to the business. They will also advise across the organisation, overseeing and co-ordinating a consistent approach to support the day-to-day management of risk.

And the final function is that of business leader taking a commercial view of risk completely aligned to the business goals. The CRO needs to measure the impact of risk and how to balance cost and benefits. This is a key aspect of the CRO's role and the one that adds the most value to the organisation. A more effective approach to measuring risk and reward enables the business to make better investment decisions.

Where does the CRO fit in the organisation?

The CRO is in a peculiar position. Their role is not simply to 'tick boxes' but to add essential experience at a senior level. This demands a disciplined and clear approach with board level authority and commitment from the outset.

At the same time, while they are there to spearhead the drive to increase risk awareness within the company, they are not solely responsible. As Societe General demonstrated, any employee can expose a business to risk, and the responsibility needs to be shared by all. A number of different generic organisational models have emerged, incorporating one or more of the facets which make up the modern CRO. The three main generic models are outlined below.

In the first model, the CRO is a fully paid up member of the Executive Committee, reporting directly to the CEO. His role is to advise the board and operational business units on how to tackle risk. Within this model there are a number of variants and the CRO may also have other responsibilities such as compliance. He acts as both counsellor and police officer. His team typically comprises direct reports with specific responsibilities for group level risks, combined with representatives from other business units - especially for the elements of operational risk.

In this structure the organisation gives weight and focus to risk management with specific responsibilities defined for making it happen. The CRO needs to deploy all four roles although the business leader usually comes to the fore. This model is favoured by organisations that allow a significant degree of autonomy across the organisation requiring a proactive and flexible approach to risk management.

In the second model, the CRO reports to the CFO as part of a combined finance and risk function. The emphasis is on the police officer and teacher roles. This structure has been developed as a result of regulation such as Basel II, where risk needs to be integrated with financial data and processes. This can also help with forthcoming regulation like Solvency II.

...to implement Solvency II successfully

A benefit is that resources within the finance function are often considered the most suitable for the role within insurance companies. It is likely to be popular with businesses that have a more centralised control culture and whose approach to regulation focuses on compliance.

In the third model, the CRO focuses on the teacher and counsellor roles, advising not only the board but across the organisation. With few dedicated staff they must engage with resources within each business unit, using education and persuasion to achieve their objectives. With lower direct cost this model suits smaller, closer-knit organisations and has been adopted by a number of medium-sized insurers as a more flexible approach. However, it relies heavily on the influencing skills of the CRO themselves and requires a risk management culture to be firmly embedded effectively across the whole company.

Meeting the challenge

The CRO's role is a balancing act, affected by the company's corporate aims, strategy and structure, as well as the ERM strategy. The first challenge may be to establish exactly what the role is, what the jobholder is accountable for and how it fits into the rest of the organisation.

One key element is how the CRO interacts with other group functions such as finance, compliance, internal audit and actuarial. This needs to be articulated clearly and practical approaches established.

Structurally, an appropriate balance must be found within the risk management framework between group, business unit, territory and subsidiary levels. The models that exist are dependent upon the underlying culture of each organisation. For example, businesses with a strong centralised or 'command and control' culture tend to have risk frameworks biased towards group functions. Those that encourage more local autonomy tend to place responsibility for risk management at the local level.

The implementation of a new approach cannot be done overnight and it takes time to embed into the business and become an integral part of what the company does.

Appointing a CRO is a key step in providing leadership in risk management. It is a keystone in building an effective ERM strategy and maintaining the focus during the cultural change required by most insurers. It is also a wise business move, enabling firms to make better investment decisions through more informed measurement of risk and reward.

Mike Wilkinson leads EMB's Risk Management Consulting team.

Mike has over 20 years' experience of working with the insurance industry across a wide range of sectors, assisting clients to develop and implement strategic change initiatives. In recent years, he has focused on assisting clients to assess the impact an implementation of risk based regulatory change, such as ICAS, Basel II and Solvency II as well as dealing with the broader issue of Enterprise Risk Management. Mike works closely with both business and actuarial teams to address the increasingly important issue of integrating qualitative and quantitative risk approaches.



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