# Street-Smart Risk Management

*by David Koegel*

The current financial turmoil has revealed an absence of the sensible and fundamental application of risk management practices. Many corporations failed to exercise sufficient internal controls resulting in projections and reported outcomes based on defective assumptions or manipulated facts. Financial statements were materially misstated because of failure to write down impaired assets.

There has also been insufficient linkage between performance and financial incentives. Risk-taking authority levels have been disproportionately high, relative to the levels of accountability for poor results. Failure to properly adjust incentive compensation for risks undertaken has been irresponsible and has created public outrage.

Sensible risk management practices can help resolve the current financial crisis. Sustainable business in the current environment requires corporate management to be street-smart by using practical wisdom above and beyond theoretical knowledge to identify, measure, monitor and control risk.

Street-smart risk management emphasizes a more balanced approach between realistic assessment of uncertainty and the alignment of interests—a balance that the financial services industry has so far failed to achieve. But with more rigorous credit risk due diligence and oversight rather than primary reliance on assessments of rating agencies, certain company downfalls in the financial services industry may have been averted.

Both Wall Street and Main Street have revealed a tendency to underestimate risk. Improving risk assessment will require the acknowledgment of uncertainty in projections based on data that may not be fully credible or predictive of the future; stress testing of crucial input assumptions; and speculation about correlation of variables and volatility around expectations.

One practical method of measuring uncertainty and modeling sensitivity is to monitor financial leverage as determined by the ratio of total invested assets or other risk exposure to total shareholders equity. Impartial assessments of leverage can often be quite revealing about a company's risk profile.

Another area of focus needs to be on better alignment of interests between company shareholders and management, and between counterparties to financial transactions.

Aligning interests between shareholders and management can be achieved by more closely linking incentive compensation payments to risk-adjusted profitability of business written, rather than primarily to current reported earnings; empowering internal control and audit functions to bring managers' actions coherent with business strategies; and verifying the consistency of risk taking decisions to approved documented guidelines and processes.

Aligning interests between transaction counterparties, though challenging, could be achieved by inducing originators and servicers to have some "skin in the game" through risk sharing. In the property/casualty insurance industry, interests of managing general agents and third party claims administrators can be aligned with interests of insurers through loss-sensitive commission structures or risk retention via captive insurance vehicles.

In addition to pursuing the optimal blend of practical risk assessment and incentive alignment, the insurance industry should continue the pursuit of diversification strategies to keep the cost of capital reasonable and help manage the risk of cyclicity.

Other than diversifying business by broadening products, classes of business and geographic reach, insurers may be well positioned to offer value-added services for a fee. Insurers can capture such opportunities by developing and marketing services to commercial customers in areas of loss control, claims handling, actuarial analyses, asset management, etc. For insurers, such activities could provide a counterbalance to the periodic softening of insurance prices and create new opportunities to participate in the excess insurance programs of these clients.

For the customer, expanding its relationship with an insurer in this way could result in cost savings in its overall risk management and insurance purchases. And as insurers would need to only allocate a very small amount of risk capital to support the fee-for-service segment of the business, any related earned income could at least somewhat improve the insurers' return to shareholders. ■