The ERM Rainbow

By Alice Underwood and David Ingram

WHAT IF THERE WAS A LAW THAT EVERYONE MUST HAVE THE SAME FAVORITE COLOR?

It would be so much more efficient! We would only need one color of paint for cars, for houses, even for furniture and toys. Clothing stores would take up much less space. Society could save huge amounts of wasted money and put it to more productive purposes. The single-color system would make the world a more peaceful place: fewer arguments between parents and children about what to wear in the morning, between couples over how to decorate the living room … everyone's stress level would be reduced with a best color pre-determined for all of us.

Something along these lines was once tried. Henry Ford famously declared, "Any customer can have a car painted any color that he wants so long as it is black." This strategy simplified production—and black paint dried faster than other colors, reducing time on Ford's assembly lines. The monochrome approach was wholly aligned with Ford's focus on efficiency. But the situation didn't last. People wanted cars in different colors and eventually Ford had to start providing them.

Even if somehow a law were passed decreeing a universal favorite color, it wouldn't change people's individual preferences. Those whose true favorite color was something else might go along; *pretending* to change their preference to avoid penalties, but most would seek out their real favorite whenever the color police weren't looking.

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Lately, risk management authorities have been trying to tell firms how they should think about and manage risk. People who have labored in risk management through the boom period before the crisis—a period when risk managers were largely ignored—are very happy that those authorities may finally be empowered to force firms to get with the program. But, such decrees are not working and will not work, because individuals and companies have risk perspectives that cannot be changed by fiat—any more than mandating a favorite color for everyone would change anyone's *real* favorite color.

Corporations and the human beings who run them have their own views of risk and risk management. These perspectives have formed over time, in response to personal experiences and the changing business environment, influenced by watching various strategies succeed or fail. Studies show that risk perspectives fall into four broad groups with almost wholly incompatible views—and only one of those four perspectives is totally compatible with the current paradigm of enterprise risk management (ERM). If proponents of ERM do not offer approaches that make sense for each of the four risk perspectives, ERM could become as obsolete as the Model T.

FOUR DIFFERENT PERSPECTIVES ON RISK

The four basic risk perspectives were first discovered in the context of research that was not originally seeking to study risk attitudes. But clear patterns emerged in the data and have proved quite resilient over time. Most people tend to identify with one of the following perspectives:

- **Profit Maximization.** This perspective does not consider risk very important—*profits* are important. Businesses managed according to this perspective will accept large risks, so long as they are well compensated. Managers who hold this perspective believe that risk is mean reverting—gains will always follow losses—and the best companies will have larger gains and smaller losses over time.
- **Conservation.** According to this perspective, increasing profit is not as important as avoiding loss. Holders of this view often feel that the world is filled with many, many dangerous risks that they must be very careful to avoid.
- **Risk Reward.** Careful balancing of risks and rewards is the heart of this perspective. Firms that hold this view employ experts to help them find risks offering the best rewards, while at the same time

managing these risks to keep the firm safe. They believe that they can balance the concerns of the first two groups, plotting a very careful course between them.

- **Pragmatism.** This perspective is not based on a specific theory of risk. Pragmatists do not believe that the future is very predictable—so, to the greatest extent possible, they avoid commitments and keep their options open. They do not think that strategic planning is especially valuable, but rather seek freedom to react to changing conditions.

Each of the different perspectives leads to a strategy for dealing with risk. Firms led by Profit Maximizers seek out risk, believing that no risk is inherently unacceptable—every risk presents an opportunity, and the trick is to negotiate appropriate compensation. Conservation-oriented firms shun risk of all sorts. Risk reward firms carefully manage and calibrate both the amount and type of risk. Pragmatist firms seek diversification but otherwise have no overarching strategy—they operate tactically, reacting to each new development.

RESISTANCE TO THE CURRENT ERM PARADIGM IS INEVITABLE

The ERM paradigm currently touted as the solution to all risk problems comes straight out of the risk reward (RR) playbook. ERM helps firms with a RR orientation to do a better job at what they were trying to do anyway.

But, given the four fundamental risk perspectives (and various hybrids thereof), it's hardly surprising that adoption of ERM has been less than universal and often less than enthusiastic. No matter how reasonable ERM sounds to its RR-oriented proponents, it does not align as well with other risk perspectives. In many cases, managers are only pretending that ERM is their new favorite color.

Profit maximization (PM) firms see ERM as an unnecessary restriction. Why should a limited risk appetite be enforced, when any risk can be accepted for the proper price? That means turning away potential profit! If a PM firm bows to outside demands for ERM—such as those imposed by a rating agency or regulator—this may be largely a charade, a sop to the unrealistic pessimists and worrywarts.

For conservation (CO) firms, ERM is a dangerous strategy because it encourages taking more risk. Establishing a risk appetite would only give permission to the cowboys in the ranks to expand risks to fill that risk budget. While such a firm may—with trepidation—adopt an ERM program, CO managers remain convinced that risk assessments can never be comprehensive enough; risk quantification cannot be trusted because the result is always too low.

Pragmatic (PR) firms do not trust risk assessments either. But they are not sure whether the existing assessments are too optimistic or too pessimistic. Adherents of the PR perspective think that ERM takes too constant a view of an ever-changing world. In their minds, ERM means letting a model run the company. And a fixed set of rules and metrics hamper their ability to react to changing circumstances.

In a world of multiple risk perspectives, an RR-only approach to ERM is as self-limiting as an auto manufacturer that offers "any color you want, as long as it's black."

ERM NEEDS A BIGGER TENT

The truth is, risk management in one form or another has been practiced since the dawn of time—by adherents of *all* of the four basic risk perspectives. And it would be difficult to argue that adding an enterprise-wide view to any risk management strategy is not beneficial. A broader and more flexible definition of ERM would bring more managers and more firms "into the tent," enabling the benefits of an enterprise-wide view of risk to be realized more broadly.

A review of the literature suggests that there are four different strategies that fall under the general heading of risk management:

- **Loss controlling.** This is the most traditional form of risk management; it seeks to identify and mitigate the firm's most significant risks. Commonly practiced by non-financial firms, loss controlling also applies to financial risk; examples include the careful underwriting of loans or insurance policies, as well as the

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practice of claims management. Risk management of this sort is not new—but the inclusion of an aggregate, firm-wide view of risk is a relatively new development that could be termed loss-controlling ERM. This type of ERM is favored by CO firms.

- **Risk trading.** A newer form of risk management, this approach arose from bank trading desks and the insurance industry. Risk trading focuses on getting the price of risk correct—which leads to sometimes complicated models of risk, reward, and economic capital. While a risk trading strategy can be applied on a transaction-by-transaction or other "siloed" basis, establishment of a consistent risk valuation on a firm-wide level is risk trading ERM. This type of ERM is favored by PM firms.
- **Risk steering.** Under this strategy, the ideas of risk trading are applied at a macro level to the major strategic decisions of the firm. Here, rather than focusing on the proper price of risk, the question becomes one of how much risk the firm *should* take—and how to steer the firm in that ideal direction. By its very nature, this is an enterprise-wide approach. Perhaps this is why some seem to think that only risk steering ERM is "real" ERM. Risk steering ERM is highly favored by academics and consultants; RR firms find it appealing, but firms that hold any of the other three strategies do not.
- **Diversification.** Spreading risk exposures among a variety of different classes of risks, and avoiding large risk concentrations, is another traditional form of risk management. Formal diversification programs will have targets for the spread of risk with maximums and minimums for various classes of risks. The newer ERM discipline adds the idea of interdependencies across classes, providing better quantification of the benefits of risk spreading. Pragmatists tend to favor diversification because it maximizes their tactical flexibility, but they avoid reliance on any particular risk mitigation process and often mistrust quantitative measurement of diversification benefits.

We believe that limiting the field of ERM to risk steering ERM alone would be a serious error. Such a restrictive definition of ERM would alienate firms and practitioners holding any of the other three risk perspectives. Moreover, such a limited view is inherently incomplete, for reasons that the pragmatists know all too well.

Simply put, the world does not stand still.

CHANGING RISK ENVIRONMENTS

Why do different people prefer different colors? That's a difficult question, influenced no doubt by personality, individual differences in color perception, and early experiences and associations. The existence of the four different risk perspectives may be easier to explain—and clearly a key factor is that, over time, the risk environment changes.

A simplistic model of changes in the risk environment might posit that either things are "normal" or they are "broken." But people do not necessarily agree about what is "normal." An observer viewing the world through the lens of conservation might say that extreme hazard and danger are the "normal" state of affairs—while a profit maximizer, finding this view timid and overly pessimistic, might argue that profitability is "normal" and hazardous conditions prevail only when the market is "broken."

Expanding the model to allow more than two states allows for the possibility that both the conservation view and the profit maximization view can make sense. Consider a model with four risk regimes:

- **Boom times.** Risk is low and profits are going up.
- **Recession.** Risk is high and profits are going down.
- **Uncertain.** Risk is very unpredictable; profits might go up or down.
- **Moderate.** Both risk and profit fall within a predictable range.

Such a model seems to be a reasonable description of economic cycles—whether in the banking world, the insurance sector, or the broader economy. As the cycle moves through these four different states, external conditions match the worldview of each of the four different risk perspectives. Each perspective has been right part of the time—and will be again, at some point in the future. But none of the risk perspectives is perfectly adapted to external conditions all of the time.

> "In any given risk environment, companies holding a risk perspective and following an ERM program aligned with external circumstances will fare best."

RR purists may object that their view takes into account the full range of the cycle. But, economic cycles are not sine curves; the period and amplitude are irregular, unexpected "black swan" events do occur, and there are always "unknown unknowns." Model risk can never be eliminated, and restricting ERM to a RR-only view obscures this important fact.

A risk-steering ERM program works especially well in the moderate risk environment when risks are fairly predictable. But in a boom times environment, firms following such a program will unduly restrict their business—not as much as conservation firms, but certainly more than profit maximizing firms—and more aggressive competitors will be much more successful. In the recession environment, a risk steering ERM program again advocates a middle path; this may mean the firm sustains too much damage to be positioned to take full advantage of the market when it turns. When times are uncertain, a firm following a risk steering ERM program will be frustrated by frequent surprises and a world that does not quite fit the model. Competitors not tied to a particular view of risk will fare better, making decisions in the moment with maximum flexibility.

Why do corporations adhere to a particular risk perspective? The firm may have been formed during an environment aligned with their perspective. Alternatively, the company may have suffered traumatic damage during a period of dissonance between an old perspective and the risk environment and then made a shift, perhaps under the direction of new leadership. The firm may have been wildly successful at some point in the past, and now cling stubbornly to the strategy that worked for them then. Corporate culture tends to be self-perpetuating: individuals are drawn to employers with a perspective that makes sense to them—and those in a position to make hiring decisions typically prefer to hire staff whose views mesh with their own.

In any given risk environment, companies holding a risk perspective and following an ERM program aligned with external circumstances will fare best:

Table 1

Risk Environment	Boom	Recession	Uncertain	Moderate
Risk Attitude	Profit Maximizer	Conservator	Pragmatist	Risk Reward Manager
Risk Management Strategy	Risk Trading	Loss Controlling	Diversification	Risk Steering

Yet in each risk regime, there are companies following strategies that are not well aligned with the environment. Some of these firms muddle along with indifferent results and survive until their preferred environment comes back. Others sustain enough damage that they do not survive; some change their risk perspective and ERM program to take advantage of the new environment. Meanwhile, new firms enter the market with risk perspectives and ERM programs that are aligned with the current environment.

Since many of the poorly aligned firms shrink, die out, or change perspective—and since new firms tend to be well-aligned with the current risk regime—the market as a whole adjusts to greater alignment with the risk environment via a process of "natural selection."

RATIONAL ADAPTABILITY

In order to thrive under *all* future risk regimes, a firm ideally would follow a strategy of rational adaptability. This involves three key steps:

- Discernment of changes in risk regime.
- Willingness to shift risk perspective
- Ability to modify ERM program

The difference between rational adaptability and the process of "natural selection" described above is conscious recognition of the validity of differing risk perspectives and proactive implementation of changes in strategy.

Individuals often find it difficult to change their risk perspective. Therefore, a company that wishes to adopt

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rational adaptability must ensure that its key decision-makers represent a diversity of risk perspectives. Furthermore, the corporate culture and the managers themselves must value each of the risk perspectives for its contributions to the firm's continued success.

An insurance company is best served by drawing on the respective expertise of underwriters, actuaries, accountants, contract attorneys, and claims experts—and members of one discipline should not feel slighted when the expertise of another discipline is called upon. Similarly, any firm that wishes to optimize its success under each of the various risk regimes should have profit maximizers, conservators, risk reward managers, and pragmatists among its senior management; and those who hold any one of these risk perspectives should acknowledge that there are times when another perspective should take the lead. The CEO must exercise judgment and restraint, shifting among strategies as needed and shifting responsibilities among the management team as required.

Rational adaptability recognizes that during boom times, risk really does present significant opportunities—and it is appropriate to empower the profit maximizers, focusing ERM efforts on risk trading to ensure that risks are correctly priced using a consistent firm-wide metric. When the environment is moderate, the firm employing rational adaptability will give additional authority to its risk reward managers, examining the results of their modeling and using these to reevaluate long-term strategies. And in times of recession, a firm following rational adaptability shifts its focus to conservation: tightening underwriting standards and placing special emphasis on firm-wide risk identification and risk control. Resisting the pull of his or her own personal risk perspective, the CEO must be willing to listen —and act—when others in the firm warn that the company's risk management strategy is getting a little too monochromatic.

HARMONY

Although rational adaptability may well be an ideal solution, it requires the accomplishment of two very difficult tasks at the same time. The firm must recognize the change in risk environment at the earliest possible time, and be willing to change risk attitude and risk strategy quickly. Achievement of either of those tasks is not easy or common.

An alternative is to seek to find harmony from the discordant voices within the firm that represent the four risk attitudes. And all four voices will exist within most firms. To achieve harmony, the risk committees must provide seats not just for the managers in the firm who believe fervently in the risk models and the risk steering programs that are based upon those models, but also for those who distrust such models. Most risk committees are populated by managers and maximizers. An unsteady coalition between those two perspectives forms the core of most businesses, and experienced business people can often tell stories of classic battles between the two points of view.

Conservators and pragmatists are usually present as well, but their views are not always welcomed in discussions about major corporate decisions. They may have learned to keep their ideas to themselves. However, they should also be represented in the risk management process because their views of risk will sometimes be more appropriate to the risk environment than the views of the maximizers and managers. The trick to creating harmony from these various points of view is to get all members of the risk committee to acknowledge that each of the four perspectives offers value to the organization, and to encourage each of the four to speak out.

Every harmonious firm will create its own unique compromises among the four views. Different firms will choose different times and ways to honor the inherent caution of the conservators, to heed the pragmatists' call for diversification, to follow the models of the risk reward managers, or to give the profit maximizers greater scope to grow. The resulting strategy will never seem perfectly "right" to any of the four groups. But as the environment shifts among moderate, boom, recession and uncertain regimes, the harmonious firm will be able to show reasonable success in each environment and avoid unreasonable failure.

CONCLUSION

In the open market for goods and services, the firms that are best able to adapt to the market's changing demands will enjoy the greatest success. No firm can be all things to all customers, all of the time; but a firm that too severely limits its offering, focusing on too

narrow a market segment, may wind up making itself irrelevant. Philosophies of risk management face much the same situation.

A recent study by Kay, Goldspink, and Dyson sought to explore attitudes towards ERM by assessing the predominant risk perspective exhibited by various professional groups. Their results show that "[k]ey aspects of the Hyper-Rational approach favoured by the actuaries were often seen as irrelevant to, or explicitly rejected by, the Operational and Strategic sub-groups." While resistance to ERM is sometimes blamed on poor communication, this study suggests that "any communication issues are symptomatic of the broader paradigm issues described above, not the cause … the issue is that stakeholders don't believe the validity of the message."

In order to gain traction across the full spectrum of human risk perspectives, the discipline of ERM must include approaches that fit the profit maximizing, conservation, and pragmatic risk perspectives as well as the risk reward perspective. And, in order to remain relevant and help firms flourish in all risk environments, ERM must embrace a Harmonious approach, drawing from the entire palette of strategies to suit the changing environment. ■

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