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Turning risk management into a true competitive advantage

Lessons from the recent crisis

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Executive summary

Chief executives, chief risk officers and board members alike are asking the same questions these days. How is it possible that an entire league of institutions has had record write-offs and suffered the results of risk surprises, even though many of these firms have generally been viewed as good risk managers or “best practice” institutions? What does the range of losses, whether from fraud or instruments such as mortgages and CDOs, signify about the state of the industry, and what can be done about it? Could any more of the problems experienced by some of the world’s biggest banks happen to us? Is the impossible possible? At the same time, these executives are wondering “do we truly understand and effectively manage our risks?”

While there are important lessons to be learned from the recent turmoil, the core message of this working paper is that banks also have an opportunity to turn good risk management into a true competitive advantage. To this end, the paper describes potential risk-related actions available to banks that can make them far more resilient in the face of future uncertainties. The paper also sets out some big questions to which CEOs and boards should ensure their institutions have robust answers.

Lessons of the recent events

Our work and recent discussions with clients suggest a few recurrent themes in risk management breakdowns, and that most of the large surprises, in principle, could have been avoided.

Good risk management is based on getting four basic disciplines right:

1. Ensuring full transparency across all risks and across the organization
2. Putting in place vigorous risk governance structures
3. Clearly defining (and ensuring compliance with) the firm’s risk appetite
4. Instilling a consistent, strong risk culture focused on optimizing well-understood risk-return trade-offs within the defined risk strategy.

The central theme here is that many of the recent surprises are the result of specific failures in one or even several of these key disciplines. Banks should be focusing their attention on each of these areas in the months and years ahead.

Ensuring full risk transparency

A key lesson of the events of the past 18 months is that banks’ biggest risk exposures are often not sufficiently transparent. A number of root causes have been observed:

- Risk metrics generated by complex mathematical models are clearly important and indispensable tools, but they often give a fallacious picture of actual risk profiles. Existing risk tools (e.g., VaR models) have proved largely inadequate for assessing the impact of

market dislocations, or have failed to account for “fat tails.” Management often relies on a few numbers that are the result of multitude assumptions, which are in turn not well understood.

- Organizations often do not pay sufficient attention to problems that arise and develop gradually. A recent example of the harmful effects of this inattention can be seen in banks’ hopes that a rising housing market would let them grow out of mortgage credit problems, perhaps falsely relying on pricing patterns from the recent past.
- Not all frontline executives in charge of complex capital markets businesses take the time truly to understand the risk and return drivers of these businesses. This form of inattention leads to excessive growth of these businesses in good times and higher-than-expected volatility or significant losses in bad times. By contrast, effective frontline managers look at extraordinary returns and ask “how exactly did we make this kind of money? What risks are we getting paid for?”
- Risk reports are often rich in data, but poor in synthesis and actionable insight. For example, businesses manage partially “by intuition,” without full comprehension of the risk-return profile at higher levels of the organization. Boards are spending more time reviewing single transactions vs. focusing on emerging risks or portfolio issues.

Making risk governance robust

Our experience with leading banks across the world has demonstrated that there is no single right governance model. Both centralized and decentralized models have, for example, both succeeded and failed. A few basic principles, however, do need to be in place, such as central oversight, clearly defined roles and accountabilities, and true ownership of risk by the originating businesses. A few challenges furthermore commonly appear across a large number of institutions:

- **Accountabilities are not often clearly defined**, nor are they properly enforced through the use of incentives and management of consequences.
- **Significant investment in resources, but under-investment in top talent.** Most banks have added resources to their risk management departments over the past decade as a result of ever-growing regulations, including Basel II requirements, privacy rules, or new compliance rules, such as those against money laundering. At many banks, however, a talent gap has opened between Risk and the businesses, which has the potential to exacerbate the problem of the function’s effectiveness. Consider Goldman Sachs as a counterpoint. Successful business executives there become risk managers and vice versa – risk management is encouraged as an essential top management task, not a staff function.
- **Insufficient or unproductive dialogue at the board level** has caused frustration in many boardrooms. As one board member puts it, “it’s hard to even know what questions to ask. . . . We are not seeing what management doesn’t proactively bring forward.”

Clearly defining and enforcing the risk appetite

Particularly in today's complex organizations, embracing many quite different businesses in different geographies, risk strategy must be laid down by the top management. The company's top people must be deciding questions like, which risks are we willing to take? how much of them? and for what return?

This idea must be operationalized, which is not a trivial matter. Our clients report that risk management capabilities and infrastructure are often unable to keep pace with fast-evolving businesses. In the quest for growth, business leaders constantly look for new product, client or trading opportunities. Sometimes they embark on new ventures, even when the risk management infrastructure is a long way from being able to manage the resulting risks. Although the risk appetite in the short term should have been constrained by the bank's current risk capabilities, desire for growth and profit dictated the course.

Looking at the recent losses in mortgage-related businesses, some executives are wondering whether different decisions would have been made had there been a deeper and truer understanding of the potential losses. For those who believe the decisions would not have been much different, the argument runs that the liquidity crisis came on with too great a severity, was extremely difficult to predict, and indeed appeared to many experts as highly improbable. Taking these factors into account, they furthermore reason that the profits from mortgage businesses were so high that banks would in any case have chosen to continue growing these businesses. Our response to this well-reasoned argument is that if an institution made a conscious bet based on a full understanding of the risk-return trade-offs, then our confidence that the institution will succeed in the long run would be commensurately higher. Banks that give careful thought in advance to their risk appetite put themselves in a position to make informed choices.

Instilling a robust risk culture

Financial markets are so dynamic that it is simply unrealistic to assume that every risk can be controlled by policies, limits, etc. The most successful firms seem to have a strong and consistent risk culture, but often a partnership culture as well, in which individuals feel that they are committing their own capital, and important decisions are widely syndicated and intensely discussed. Companies with recent experience of losses clearly thought that a lack of risk culture contributed to the losses, and cite a few common themes.

- **More attention needs to be given to the “soft” aspects of risk management.** The soft aspects include the willingness across entire organizations to have frank and open debate about perceived risks, with no penalty for escalating the debate to the next layer of management and the layer after that. Models, policies and controls tend to follow quickly evolving businesses (in particular in capital markets businesses), rather than lead them. A cohesive risk culture is a much more powerful offensive and defensive tool (witness the case study on Goldman Sachs in McKinsey Working Papers on Risk No.1). Clearly, getting incentive structures right is vital if this is to be achieved.
- **The relationship between the businesses and Risk Management (and other control and finance functions) is not working well.** In some cases, revenue producers are clearly in charge and tend not to involve the Risk Management function in their

decisions. In best-in-class organizations, businesses are the best risk managers (“first line of defense”) and the Risk Management function is seen as a key enabler of profitable growth. Problems can arise when the Risk function is viewed by the quickly evolving businesses as a cop or a goalie trying to catch the bad shots. This approach often leads traders (or lenders) to act with little compunction to take as much risk as they can within the risk constraints that have been set, even though this may not be optimal for the business as a whole. The complaints we have heard are, “Risk is incentivized to minimize, not optimize risk”; “traders rely on risk management to control and manage risks, and feel they can do whatever is allowed within limits.”

In our experience, significant risk disasters are usually the result of a failure of more than one of the basic disciplines of a vigorous risk culture. As an example, consider the following constellation of factors. Complex trading risks are really only understood by the key individuals running the desk. The executives overseeing these businesses don’t have the habit of truly managing the details of such operations, but in times of growing profits are keen to demand faster growth. At the same time the relationship between the Risk Management function and the businesses is ineffective. In such an environment, where multiple dimensions of good risk management fail, there is clearly the potential for a significant surprise.

How to proceed? Today’s priorities, tomorrow’s competitive advantage

Banks are already taking a variety of steps to upgrade their risk management practices and address today’s challenges. An obvious way for top managers to reassure themselves and stakeholders alike is to undergo a short- to medium-term due diligence, whilst also developing a targeted action plan for improving risk management in the longer term. This approach would be served by several initiatives running in parallel. In this part of the paper we look in detail at some elements of a short-term risk management due diligence, to take 3 to 6 months. Reference is also made to other measures that might be equally important depending on an individual bank’s findings. There is no single action plan: rather each institution must create an appropriate set of prescriptions for itself by applying the different elements laid out above.

Strengthening those core functions which are particularly relevant in today’s turbulent markets

An obvious starting point for an action plan is to address those functions in the bank that are in the front line of current risk management interest and scrutiny, and at the same time are extremely important to keeping the bank in business, increasing its profitability and supporting its growth. The box below summarizes some of the key questions that might arise in a selection of these areas (liquidity risk, credit portfolio management, capital management and Board level perspective) and highlights some possible answers and action points. The challenge for top managers is to assess frankly whether they have good answers to these questions and whether the action points make sense for their institution. (Obviously this list will vary depending on each bank’s make up.)

STRENGTHENING CORE RISK MANAGEMENT FUNCTIONS

Liquidity risk management

Key questions

- Do you have a full understanding of your contingent liabilities like guaranteed lines to SIVs, and have back-up liquidity for a crisis?
- Do you know how much liquidity is required for key businesses to survive possible bad case scenarios or your worst-case scenario and are they incentivized correctly?
- Do you know if you are exposed to a key liquidity market becoming illiquid, for instance the Repo market or interbank money market?
- Are you utilizing all liquidity sources – especially sufficiently leveraging the client base for generating rating insensitive funding?
- How can you leverage your liquidity surplus vs. more stressed competitors?

Potential answers and recommendations for action

1. **Refine tools to optimize usage of liquidity and improve transparency.** To ensure prudent use of liquidity, banks need to upgrade the Funds Transfer Pricing system, especially for their trading and structuring business, so that they appropriately charge users of liquidity. The liquidity premia used in the transfer pricing should be reviewed to ensure consistency with today's fast-evolving realities.
2. **Strategic readjustment of liquidity intensive businesses.** Liquidity/funding remains at the core of bank activities, and the current environment offers an opportunity to make the business more profitable by increasing margins and focusing on higher yielding business. This will significantly change the way banks engage in hedge fund financing, Repo/Securities Lending and structured finance. For banks with excess liquidity, the resource can be used to gain market share and create add on business.
3. **Review limit structures and limit utilizations.** Banks should ensure they have a transparent view on their availability and that usage of liquidity is relative to well-defined limits. Limits should not just include core liquidity ratios and liquidity gap measures, but also a robust set of stress scenarios (which often require updating to reflect recent experiences).

Credit portfolio management

Key questions

- What scenarios would lead to significant losses? Are there still hidden concentrations of credit risk that have not yet surfaced?

- What are the implications of reduced liquidity for your portfolio of credit risk? Does the "buy, structure, sell" model have a future for your institution?
- In what way do you need to change your origination approach in terms of product structuring, pricing, and risk appetite?
- How prepared are you for dealing with warehousing risk – that is, a full syndication pipeline due to dried-up liquidity?
- Could you develop new distribution channels such as private banking that might replace CDOs? How would these placement transactions differ from the traditional CDO model?

Potential answers and recommendations for action

1. Strategically decide what positions to hold in credit, market and liquidity risk inherent in credit, and which ones to sell off in the new market environment.
2. Adjust credit policies, including underwriting guidelines, and revise mandates and incentive system of origination and portfolio management, for example by creating stronger incentives for origination to apply risk-adjusted pricing and stringent account planning and by developing clear guidelines for dealing with pipeline risks (conditions for holding exposures on balance sheet vs. selling them off at lower price).
3. Start building up alternative investor franchises and placement options, taking into account changes in investor preferences, e.g. for simplicity, less of a risk appetite; develop mechanisms to mitigate conflicts of interest between credit originators and investors.
4. Strengthen "internal information markets" to make information available to decision makers on credit and liquidity risks.

Capital management

Key questions

- Do you know how your capital ratios will behave under various market scenarios?
- Do you know the returns on regulatory, economic, and rating agency capital? Have you fully optimized your balance sheet to maximize returns?
- Have you done everything to free up capital in your current business model?
- How can you build up access to and relationships with new sources of capital, e.g., the Middle East, Government funds?

Potential answers and recommendations for action

1. **Create transparency on the usage of and returns on capital.** Identify which businesses, customer segments and products are the “worst offenders” from a capital perspective (e.g., regulatory capital – undrawn committed lines). Simultaneously optimize across regulatory, economic, leverage ratio and rating agency capital.
2. **Further strengthen internal capital efficiency,** e.g., invigorate internal capital markets with robust transfer prices to balance capital demand and supply, strengthen balance sheet optimization processes.
3. **Launch a targeted program to reduce RWA and capital wastage,** by, for example, improving mitigation and netting practices and improving risk modeling and processing to minimize capital safety buffers.
4. **Strengthen capital planning for the coming 3 years** to reflect potential market scenarios, especially a cycle downturn.

Improving risk management at the board level

Key questions

- How comfortable is the board with its understanding of the key risk concentrations, including which circumstances would lead to losses?
- Does the board have full transparency on the quality of the bank’s risk management relative to the level and complexity of the risks the bank is taking? Does the board understand where talent gaps exist?
- Does the bank have a clearly defined risk appetite and can the board track the risk profile relative to the defined risk strategy?
- Has the board explicitly determined the method for reviewing risk? In a separate committee? By the full board? Is a “risk expert” needed on the board?
- Does the board understand the incentive structures of key capital markets staff and how they influence risk-taking?

Potential answers and recommendations for action

1. Obtain an independent assessment of the company’s level of risk management
2. Explicitly discuss whether board has the required risk expertise
3. Explicitly discuss whether the governance structures at the board level are adequate and decide whether the board needs a separate risk committee.
4. Spend real time in executive sessions with management – the CRO, and key line executives running risky/volatile businesses.

Improve transparency by undertaking a quick review of the main areas of concern.

The second area for immediate management attention is the specific business lines where exposures are, or might be, concentrated, not well understood, unattractive from a risk-return perspective or potentially misaligned with the bank's risk appetite. Individual banks will have different exposures depending on their business mix and relative strengths and weaknesses, but for most banks at present these would probably include structured credit, leveraged lending, mortgage businesses, and proprietary trading activities.

The “3 M’s” of risk governance: is your front line managing risk with sufficient vigor?

Are your line managers really managing the risks in their businesses? Determine whether they are assessing risk within a culture of the “3 M’s”:

1. **Micro:** basic granular knowledge of typical transactions and the risks attending them;
2. **Macro:** an understanding of what portfolio of risks is created by the sum of these transactions; and
3. **Model:** an understanding of how in this business model we make money, and what happens if critical underlying assumptions are wrong.

If your managers are not going out and getting this kind of knowledge, then there may be scope for a major initiative to strengthen the front line.

Ensure that strategic decision making is truly “risk-adjusted” and that the strategy is aligned with your risk appetite

Taking a risk-adjusted view and avoiding the biases that mislead decision makers at times of stress can help banks to make correct strategic decisions. Transparency on risk as well as return is a key factor, but requires sound data infrastructure, appropriate risk metrics, a clear synthesis of data-rich risk reports, and top-level commitment from managers to understanding the risk-return drivers of their businesses. In some cases, banks may decide that the risk-return profiles of certain activities are no longer attractive, or they may decide to change their business model. One institution once active in sub-prime has shifted resources towards distressed debt investment activities and some of its servicing operations towards managing assets for third-party investors such as life insurers or pension funds looking to originate new, carefully selected high-yielding assets.

Align your risk appetite and your strategy

Taking a systematic look at the profitability of businesses, especially at a difficult point in the business/credit cycle, can lead to surprising opportunities for new and profitable activities.

Enhance your risk culture by improving stakeholder management

Improving the quality and timeliness of your stakeholder information and interaction can prove tremendously beneficial, especially at times of crisis when fast actions require trust and support from key stakeholders, e.g., necessary capital infusions are by their nature transactions that need a quick understanding and consensus from the main stakeholders.

Strengthen the risk management function by ensuring the risk-business interface is truly effective

If the interface is not working well, then consider talent upgrades. Asking your leaders to articulate what behavior is desired and then define these behaviors. Risk management organizations are often large, but have less than their rightful share of top talent, and the degree of centralization versus decentralization of risk functions is hotly debated. Evaluate whether business units consciously evade the risk management function, or whether they have a culture of not bringing up potential issues until problems arise. Equally important is to ensure that the risk function supports areas of sustainable growth even when times are tough. Simply freeing up capital by reducing its wastage has proven to be a powerful, vastly underestimated lever. Growth could be encouraged, for example, in the front-line by offering incentives on collateral and netting agreements, in middle-office processes by matching exposures to risk mitigation elements, and in the risk office by properly calibrating regulatory capital calculations.

* * *

As recent events have shown, there is never a "right time" to undertake set of processes designed to invigorate risk culture. In an ideal world, companies would continually and consciously manage their risks. In the real world, however, it is rare that a moment arises, brought about by a combination of unexpected events wherein banks can take stock of their position and regroup. Now is just such a moment.

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