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GLOBAL RISK POLICY QUESTION: SHOULD RISK MANAGEMENT BE MANDATED?

A small number of Black Swans explain almost everything in our world from the success of ideas and religions, to the dynamics of historical events, to elements of our own personal lives.

- Nassim Nicholas Taleb – “The Black Swans”
2007

Today I intend to set out the case for mandating risk management as we see it in the Australian Risk Policy Institute (ARPI). As Patron of the Australian Risk Policy Institute I am delighted to see that the program has included a number of elements of the key issues of concerning risk management and policy as these contribute to good governance. As well other colleagues from ARPI have already had their say. This is no surprise to me since, in the view of all in ARPI, effective risk management is a “sine qua non” in any significant enterprise – public or private.

Let me begin with a brief explanation about ARPI. The Australian Risk Policy Institute was established over two years ago **to promote and encourage a greater focus on risk policy in leadership, decision-making and management** across all sectors in Australia. ARPI members see risk policy as the driver and pinnacle of risk management and we expect it to be clearly articulated by Governments, Policy Makers, Boards and Executive Committees to ensure integrated risk management is optimized – for best-practice performance and sound corporate governance. We concern ourselves with matters of risk and dealing in uncertainties across all walks of life.

The Australian Risk Policy Institute is a world leader. We have now discovered so much international interest in the work that we do – across all spectrums of

Australian life. So, we are about to launch a global network on risk policy that will seek to make risk policy an international priority for action.

Finally let me re-emphasize ARPI's intent - to concern ourselves with **effective, high quality decision-making** across all walks of life.

We happen to believe that the most fundamental requirement of leadership, when everything is stripped down or out of it, is decision making. And it flows I think that effective, high quality, decision making is what we expect our leaders to deliver on our behalf. Let me say it once more – **effective, high quality decision-making!**

For me this is the fascinating part of the good governance question – the personal involvement of people across a range of activities and interests who are trying to deliver the best outcomes for the people they represent – whether we are thinking of military organizations, NGOs, other arms of Government, the International community, and countries. We are dealing in the nature of organisations at the top levels in our countries as well as the personal relationships that develop between the various decision makers leading those organisations.

Now, I would like to establish a basis for ARPI's view that risk management must be mandated.

I want to begin with ARPI's first winter seminar, back in 2008, where I presented my views on a world where something had gone seriously wrong, based on two case studies. An examination of these case studies is compelling evidence on the need for change.

At that time I purposely addressed the intersection between risk policy and leader behaviour - in particular, leader decision making. My hypothesis was that evidence over recent years had shown too many instances where we had held our leaders insufficiently accountable for the things that go wrong, when there are available suitable means for dealing with uncertainty and risk.

My perspective, drawn from my own experience and work in the field of strategic leadership, is that leaders who are ultimately responsible for all that goes on within the organization may believe that they have a sufficient

enterprise risk management profile when a Chief Risk Officer, or the like, is appointed. But that is not nearly enough as I shall show!

I believe that in considering leader behaviour what we are discussing is leader decision making. It is the decision that the leader makes that leads to action. Sometimes it is also the case that a decision not to make a decision is also a decision! So the core question for leadership is to describe the extent and nature of top level participation in the process of analysing and evaluating risk, even thinking the unthinkable, within the organization and then taking appropriate action to deter or avoid or mitigate the consequences of risk. In other words I am seeking to promote the adoption by our leaders of appropriate risk policies throughout public and private organizations in Australia.

Our concern is that, all too often, risk policy is inadequately implemented within most organizations. Indeed, I believe that in some organizations there has been no effort to deal seriously with risk issues in the insane belief that “she will be all right, mate”. But, as we know all too often, when structures and processes collapse unexpectedly many people get hurt. We have seen this happening most spectacularly within the financial system. When a sudden collapse like the Global Financial Crisis occurs we hear plenty about it because in nearly all cases many greedy, as well as some innocent, people get hurt. But, I assert that many non-financial organizations also work with the same shortcomings.

To illustrate my points on the case for change I want to use two case studies.

The first case study concerns a now infamous organization that purposely adopted a particular strategy to improve its bottom-line earnings and it was that strategy that had led directly to its collapse. In my view the case study reveals that while there had been an apparently serious effort by the company to integrate risk analysis and risk management within the organization, this turned out to be inadequate – a case for examining standards I believe. For mitigating the identified risks involved through the rigorous testing of the implicit assumptions that underpinned the strategy that was adopted should have prevented Bear Stearns from being sold to J.P. Morgan for a fire sale price!

So what happened?

In November 2006 the Bear Stearns Chief Institutional Strategist and Senior Managing Director gave a public presentation on a range of perspectives on “Making Pro-active Use of Risk Management an Integral Part of Strategic Decisions” at a CAP Conference at Columbia University.¹

In that presentation he outlined, presumably on an acceptable risk basis, the need for Bear Stearns to improve its margins by adding higher risk/margin products through subprime loans leveraging up to ten percent of total assets in order to offset low earnings that were coming from more conventional low interest earnings and Federal Reserve policies designed to keep U.S. interest rates low.

Underpinning the judgments made in that presentation was the critical assumption that no significant changes to market trends would occur especially to the underlying interest rate, and the housing investment market. We all know don't we that housing prices will always rise?

As well I have not been able to find any evidence that there was any serious testing of whether “up to ten percent of total assets” was an acceptable level of risk at the time, or not. But I did observe the judgement in the Bear Stearns presentation that “large amounts of investment capital remain available worldwide, ready to be deployed in a large dislocation, potentially constraining losses”! This also turned out to be a critical assumption. But, even worse, it seems that the internal structure of the products used to generate the additional income was such that the risk became more concentrated, and the chance of failure multiplied by several factors, - as opposed to the optimal strategy of higher risk products being mitigated by diversification of the “true” risk involved.

We know that Bear Stearns ceased to exist in June 2007.

The second case study concerns events at about the same time in the Australian financial market. These events highlighted the potential risk to banks and other financial entities coming from entrepreneurial, and in some

¹ Leo M. Tilman in power point Presentation “Making Pro-active Use of Risk Management an Integral Part of Strategic Decisions” presented 3 November 2006. Available at www.bearstearns.com

cases potentially criminal, behaviour by employees of large financial institutions and other operators within the Australian financial system.

What made this case remarkable was that after the National Australia Bank's difficulties of a few years beforehand the reports of certain behaviours in this case should have been the sort of thing that kept senior leaders and top level management awake at night.

I am referring, of course, to the complexities of the Opes Prime debacle of April 2008. It drew the following headlines in the Sydney Morning Herald² that month:

“Collateral damage - The Opes debacle has eroded the foundations of ANZ's reputation, but there were already problems lurking in the bank that John built”.

The article that under that headline went on to point out that the initial approach of the previous CEO of ANZ Bank to its institutional banking business had been to de-risk it, but this policy had been changed when the de-risking had apparently resulted in a substantial drag on profit growth in 2004.

The article also went on to ask some critical questions about the Bank's risk management procedures at that time. For example, it pointed out that the ANZ Bank had in place a credit and trading risk committee with responsibility for making key credit-related decisions. But the article went on to ask:

“Just how effective the credit committee was in coming to terms with the dangers represented by Tricom, Opes and the Melbourne based securities firm Chimaera Capital will be a matter for an internal inquiry...But where was the credit committee - or any other kind of risk management – when the original loans were being written?”

It may be that that these were simple “oversights” or perhaps “negligence”. But, then you read:

“The first loan on Tricom's books from ANZ was a \$10 million facility made in 2001, at a time when Laurie Emini and Julian Smith were working with Tricom on establishing their now - infamous business

² Sydney Morning Herald Weekend Edition 25-27 April 2008. Business and Financial Section.

model. The pair went on to found Opes...And ANZ's exposure to the businesses grew and grew, with little or no oversight from ANZ's vaunted risk-management policies."

As a consequence of leadership's past failure to become properly involved with its own risk policies and decision-making, the reputation of the ANZ Bank was put at serious risk.

Both case studies are food for thought. They prompt us to ask questions about the adequacy of current policies and risk management and what needs to be done? On one hand we see a case in which the testing of risk was grossly inadequate and on the other hand a case in which leaders disregarded the processes and systems put in place to protect the enterprise from a potential disaster. One is a case about standards and the other is a case about poor behaviour and possibly negligence.

So where does ARPI consider we should go from here?

In a special report on international banking in May 2008, The Economist³ focused on risk managers⁴ and their profession after looking at the extent of write downs by large international banks from January to April 2008 totalling US\$38 billion.

The special report observed that "(W)hatever the type of institution, it is clear that the quality of risk management can make a very big difference to its performance...The (recent) crisis has underlined not just their importance but also their weaknesses."

The special report went on to deal with various difficulties that had to be faced in assessing risk in a complicated and fast-moving financial world that involves very complex structures. These difficulties were summarized as:

"Bad decision-making does not respect sectoral boundaries;

Risk managers are aware that that they are trying to base their decisions on imperfect information;

³ The Economist 17th May 2008. "Paradise Lost" A special report on international banking.

⁴ Ibid p 11 "Professionally Gloomy – Risk Managers take a Hard Look at Themselves"

There is likely to be more emphasis placed on non-statistical ways of thinking about risk (and) that means being more rigorous about imagining what could go wrong and thinking through the effects;

Another big challenge for risk managers lies in the treatment of innovative products...that lack historic data ...and also sit outside banks' central risk management machinery; and

Keeping risks to a size that does not inflict intolerable damage if things go awry is a fundamental lesson...It is not acceptable for a division to have a position that wipes out its own earnings, let alone those of the entire firm."

But the final conclusion of this article draws our attention to the behaviour of leaders and our own appetite for optimism. It states:

"There is an even bigger concern. Everyone is ready to listen to risk managers now, but the message is harder to transmit when the going is good...To improve risk management through the cycle, deeper change is needed."

So on reflection we ask the question: Where do we stand now? Have we really averted the likelihood of a repeat performance? How can we elevate risk policy to put risk management on a solid footing?

Last year, ARPI's winter seminar debated the question of mandating risk management in the belief that something really had to be done to provide some assurance that we would not see a repeat of the Global Financial Crisis.

The case was put that as a consequence of the need to improve governance it is time to look carefully at the regulatory environment and risk management standards to ensure that the needs of internal and external stakeholders are properly addressed. The focus had to be on the restoration of trust in our community, which is vital if the normal mechanisms of a market capitalist economy are to function properly. From a policy perspective ARPI thinks this can be done only through mandating risk management in all significant enterprises throughout Australia and New Zealand.

We are not blind to the cases put against regulation by those who do not want to contemplate the kinds of changes we advocate, especially in big business. We have seen significant campaigning to head off calls by lawmakers and the general community for greater regulation. Some people are doing this even against the recent background of the manifest failure of market mechanisms and light handed regulation to safeguard the value of the community's assets and investments.

In addressing this question on mandating, most people are likely to focus naturally on the financial world. Most of us remember what has happened to our super funds and other investments. But we think that there is good evidence that a number of other areas in public and private enterprise also need an overhaul because there has been a demonstrable lack of effective risk management in linking risk and return in a truly transparent way designed to provide leadership and engender confidence. Look at the crisis of confidence in the State of NSW, for example.

We also believe in the value of managing risk appropriately as a means of fostering progress and entrepreneurship. It is an important point that ARPI is not advocating risk minimisation. Rather we are advocating that risk must be properly identified and its consequences managed comprehensively. But whereas in recent times there was considerable evidence that risk was undisclosed to important stakeholders, and the greedy often did not seek to find out what risk was attached to earning those high returns on offer, such unethical practices must be made illegal.

There is also the need to cycle proof by setting aside thinking that just because things have been bad it is now time to act. Rather what we need are solutions that are comprehensive, contingent and cost-effective but at same time doing our best to ensure that these solutions are cycle-proof. To be cycle proof means that whatever risk management approaches we mandate they must work at the top of the cycle as well as at the bottom.

It is the lack of trust that has undermined our financial system and thereby destroyed investment opportunities and employment prospects for many people. Doing whatever it takes to restore trust is an imperative for leadership at all levels.

We want to mandate the management of specific risks, for example those risks that corrupt trust, without trying to minimise risk. Indeed we think that risk taking should be encouraged and in so doing seek we would like to see a values debate about things like trust that frames what risks we must make the subject of mandatory risk management including what risks we want to be more risk-taking about. The paradox is that that we cannot clarify what the latter are without doing the former, without clearly mandating those risks that must be managed.

A focus, therefore, on risk identification as the basis for compliance, along with penalties for liability for non-disclosure of identified risk does seem like a good place to start.

In addressing the cycle proofing of risk management regulations we must look carefully at the Australian standard. Here we think that mandating a "principles approach", as with principles-based standards, would foster informed risk-taking without undue risk avoidance. The emphasis is on risk management not risk minimisation. The mandating issue should be about the major stakeholders clearly indicating their requirements, including priorities, and those responsible ensuring that they are accountable for meeting them. Our concern is about ensuring accountability and required performance rather than just relying on personal judgement in areas central to good governance and effective management.

We have looked at the current risk management standard. We think it needs an overhaul as it is now out-of-date following the events of the last few years. An important outcome of our work has to be a revision of the current standard to see that it satisfies the needs of external stakeholders, such as investors, as well as supporting internal decision making processes and accountabilities even to board and government level. As one example of what we mean we think that product disclosure statements for any investment product must contain explicitly transparent clauses as to the nature of the risk and its relationship to the reward on offer.

We would also argue that, while in an ideal world voluntary good practice is desirable, the case studies show that more must be done in the interests of restoring and building up trust. It is a fact that espousing voluntary good

practice to busy people often gets cursory attention - except from the very committed. Good practice has to be soundly based in terms of concept, standards and practicality, and kept up to date; it must be mandated.

At the very least proper risk management procedures have to be seen to work. They have to be explained and promoted to the uncommitted. No longer can we permit them to be discretionary. There ought to be penalties for the non-disclosure of identified risks, which have to serve as the basis for compliance. Adoption and ownership of good risk practices ultimately depends on the attitudes of other stakeholders and their demands for such practices. This is why evaluation is a useful example of what it may involve to be accepted and committed, including being made mandatory.

ARPI is confident that effective risk management demands a comprehensive regulatory framework that contains appropriate incentives and penalties to build up public trust in our market capitalist system. This demands urgent action by our political leaders. To fail in this regard is to sweep away much of the basis of Australia's positioning in Asia-Pacific, and globally, that has been built up since federation.

Accordingly ARPI has gone public to promote debate and action and has put the case that⁵:

'Risk management needs to be regulated not by mandatory methods, guidelines and practices based on the existing Australian or draft International Standards but by performance-based principles with the force and sanction of law.'

'This means that governments and industry leaders must apply a set of risk policy principles to ensure that businesses and governments exercise their 'duty of care' to regain and maintain the trust of society in corporate and government decision-making. The Global Financial Crisis was probably avoidable through better risk-informed decision-making and must not be allowed to recur.'

The Institute proposes the following risk policy principles be the subject of uniform global approach:

⁵ ARPI Press Release 14 October 2009

- ❖ Risk (impacts that might happen) must be part of corporate and government decision-making
- ❖ Boards, leaders and executives must be required by law to take into account risk management
- ❖ Personal legal sanctions must apply to Board, leader and executive negligence in failing to consider risks
- ❖ Disclosure of material risks to a business or government to become a legal obligation
- ❖ Regulatory authorities to have investigative naming and prosecutorial powers
- ❖ Boards, leaders and executives to be responsible for promoting a demonstrable culture of risk management through sound 'enterprise' or 'integrated' risk management practices visibly operating across organisations.

If this is done, 'risk' becomes an automatic and informed component of decision-making for global benefit — 'compliance' becomes real-time assurance that due processes are operating — and 'audit' becomes a management tool of continuous improvement rather than a 'shock and discovery' process after the horse has bolted.

Governments, leaders and executives around the world have tried for decades to make risk management work — but it has remained discretionary and hasn't worked. Now is the time to take a strategic and positive approach to improve global decision-making, trust and accountability — in the least interventionist way possible. This way, businesses, governments and the public all win — global trust can be rebuilt.

Moreover, the Institute has declared that it is time for an informed public debate to take place, led by the Government, on mandating risk management in the public interest. This is because we believe that sound risk management is essential for decision-making, accountability and good governance.

Governance reform across the world has improved the integrity of professional advisory services and audit independence but has stopped short of mandating risk management. As the examples I have used in this presentation show,

unfortunately leaving risk management to a voluntary compliance arrangement has failed too many people to be disregarded.

The effect of the Global Financial Crisis on every Australian has proved beyond doubt that effective risk management could have prevented, or at least reduced, the impact of the financial crisis if risk management had been formally incorporated into decision-making processes. That is why ARPI calls for risk management to be made legally compulsory.

But, in addition to the Global Financial Crisis there are a range of other national policies affecting every Australian where mandatory risk management would improve public and private sector leadership, decision-making, services, governance, reporting, transparency, accountability and public confidence.

Examples of activities include:

- Investment schemes
- Insurance Companies
- Superannuation schemes
- Governmental responsibilities such as:

National security

Major Infrastructure and equipment purchase projects

Air Safety

Environmental protection and impact statements

Health planning and delivery

Education – school curriculum outcomes and student safety

Transport planning

We do not see much difficulty in mandating through legislation in Australia a requirement for medium-to-large public and private sector companies, agencies and entities to comply with sound risk management practices in the public interest. ARPI recognizes that we live in a world of networks and that any workable solution will require collaboration. Accordingly, ARPI is ready to work within a Government group formed to mandate risk management in

Australia. To this end ARPI has begun developing a range of regulatory options that could be considered by Government.