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Definition of Risk

What is risk? How it is defined drives everything else about enterprise risk management. As an individual, my current situation helps to determine how I look at risk. As a recent college graduate starting a new job I worried about the downside risks related to health and my ability to hold onto that income. As I got older, accumulated some assets and got married, the health of my family was primary and then I worried about asset diversification. Now that we have accumulated some assets, downside financial risk again becomes important. I don't want to be so aggressive with our investment strategy that we lose what we have, but I also worry about diversification, tax impacts and volatility.

There are several ways to think about risk. Frank Knight defined it in the last century as uncertainty. If an event were certain to occur, no matter how negative, it had no risk using his definition. This is interesting to consider but I find it of limited practical value. The two definitions I think should be included in this definition include downside risk and volatility risk. Downside risk considers events with negative outcomes. Note that this does not always mean you have fewer of something. If a company expects to sell 100 of a financial product and instead sells 1,000 the product is probably mispriced. This creates a negative event (sales always proves themselves worthy of finding these anomalies). Of course few will want to limit the opposite - upside risk. Volatility risk management became popular in the run-up to the financial crisis and showed how model risk should always be considered. Volatility is often measured using standard deviation or value at risk. Limited historical data, or a future unlike the past, are among the shortcomings of these methods. It doesn't mean you should not look at models, but being skeptical and using common sense should remain part of any analysis.

Companies today focus on regulatory compliance as they look at their risk management program. Do they have one that will allow their regulator to check the box on their form? This is driven by downside risk, which is appropriate from the regulatory stakeholder viewpoint. Internally this is considered a fixed cost and the goal is to minimize that cost. While this might seem short-sighted, it provides a base to leverage future efforts. ERM can be considered a multi-tiered process, with compliance efforts laying a base to integrate with strategic planning. A strong risk culture must be in place for strategic planning to combine with ERM and make better decisions.

How does your board look at risk? This discussion should occur first, before a risk appetite is determined, and is determined in part by the firm's risk culture. Are some risk conservatives, focused on limiting losses, or aggressive optimizers trying to maximize risk-return tradeoffs. A balance of both will lead to more honest discussions. How a group defines risk will change over time as the group turns over and evolves, living

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through various environments driven by economics, politics, and conflict. If a board desires a steady risk appetite it should consider the risk mix of its board when a new member search occurs.

Short and Sweet

One characteristic of a good CEO is one who welcomes those who share bad news, especially if they also share solutions to improve the situation going forward.

Beware of auditors leading ERM projects – it can become a checklist exercise that is auditable. This is useful but minimizes the benefits of an ERM process that builds a risk culture.

Why do academic papers get reviewed by the media but practitioner papers do not? Is it marketing? It seems like a truly novel idea will not make it through a peer review process. This silences outside opinions.

We are lucky that AIG Financial Products was not located inside an international reinsurer. The systemic risk discussion would have changed materially if that had occurred.

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