

Risk Management KPIs: Efficiency Tool or Formality?

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2011 Enterprise Risk Management Symposium
Society of Actuaries
March 14-16, 2011

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Key Ideas

1. The need to ensure the responsibility for managing risks
2. The link between managing risks and managing business processes
3. Possible ways of setting KPIs in risk management
 - a. KPIs on formal process
 - b. KPIs on effective and efficient risk management
 - c. Problems of (b): the difficulty of taking all risks into account, new emerging risks, external risks that cannot be directly managed
4. Our proposal: To keep formal compliance KPIs to support RM system implementation and to have a business plan based on risk assessment
5. Conclusion

People have always managed risks, starting with a caveman trying to run faster to escape wild animals and ending with ourselves looking left and right before crossing the street. Risk management always has been and will be a part of doing business, and it does not matter whether a company has a sophisticated risk management system or risks are managed informally by all employees without their even knowing the term “risk management.” However, nowadays a formalized risk management system is not only the requirement of regulators but is often seen as an effective management response to a highly competitive business environment, acceleration of technological development and shortened product lifecycle. This tool is a part of an entire corporate management system and therefore should be regulated by certain rules clear to everyone in the organization.

At the same time, when risk managers first introduce a formal risk management (RM) system in a company, they come across the same basic problem: an RM system is viewed by most employees and managers as just an additional reporting process and extra burden to their responsibilities. The initial perception is often negative, and a risk manager may face latent opposition and even sabotage from managers. This is especially true with regard to middle and low middle management as top management and the board usually act as process sponsors and therefore more actively support RM system implementation. It is clear the first essential step of any RM implementation is establishment of training and coaching courses, supported by top managers, that will clarify the ideas and aims of the RM system to all employees. The next “easy” step aimed at avoiding resistance is to include risk management elements into the managers’ key performance indicators (KPIs). Linking employees’ motivation, i.e., the amount of compensation received, to effective and efficient functioning of the RM system appears at first sight to be the best way to make the system work immediately. Such an approach not only forces managers to manage their risks in a prescribed and approved way but also secures the formal aspects of the RM system, such as timely reporting and compliance with risk management policies and procedures.

Unfortunately, this does not work as well as it was designed to. First, the idea of introducing an RM system is far from mere compliance with following reporting deadlines and filling in risk registers only as is often required by company’s risk management policy. The aim is to make risk management a company’s business philosophy, to make people think and plan in terms of risks, the consequences and

their ability to manage those risks. This has little to do with a minimal number of risk factors listed in the risk profile or exact quantification of risk. Secondly, the speed of changes happening daily in the external environment and the internal processes of the company is really incredible. That inevitably leads to new risks as well as the dissolution of previously identified issues. One can imagine how many risks and unforeseen issues may arise during a year that make key risks identified at the beginning of the period much less significant. The passage of time alone may easily convert the most effective and efficient mitigation plan into a waste of time and resources. Therefore, the targets on risk mitigation (both on time and resources) will also become meaningless. And these are only two examples from the endless list of what might happen. That is why setting performance indicators on managing specific risks in the same way as is done for other business processes (for example, using a balanced score card system or one-year budgeting period) is almost impossible. This is because managers trying to reach a risk mitigating KPI set in the beginning of the year might completely miss any new risks or just spend resources on risks that are no longer significant.

But still, some of such indicators—those related to the formal part of setting up and running an RM system—will work. As we have mentioned above, it is common to have some employees oppose RM systems at the initial stages. And, in this case, inclusion of RM indicators into managements' KPIs will work well. In such a situation, linking compliance with the risk policy's requirements to a manager's motivation makes the system work at least from a formal point of view. For example, including compliance with reporting deadlines and completing risk data will ensure at least initial information about the company's risk profile is available when needed. Another example of a formal indicator is the requirement to have mitigation plans on every identified risk. This undoubtedly will ensure the development of those plans.

Another useful indicator that also relates mostly to the formal side of an RM system is a number of realized risks under manager's responsibility that were not identified before. By introducing such an index, the completeness of risks identification and corresponding analysis can be measured. At the same time, this will stimulate managers to identify risks more carefully and will minimize the cases of management concealing risk information, thereby securing the accuracy of the RM system. At the same time, questions on the completeness and adequacy of mitigation plans and risk evaluation are still there.

According to the Committee of Sponsoring Organizations (COSO), other well-known standards and just common sense, risk management is a process, and, as any process, it is changing every day. The trick is that risk management cannot be separated from management itself. It is not a breakthrough that managing business means managing risks inherent to the business and each and every manager is a risk manager mitigating risks inherent to the business process under his/her responsibility on a day-to-day basis. And the ultimate risk manager of a company is the chief executive officer. So, effective and efficient risk management is by definition the responsibility of any manager whether or not an RM system is in place. The question here is how to identify the share of effective and efficient risk management from general effectiveness and efficiency of a manager. And another even more complicated question is whether risk mitigation depends only on the manager/risk owner. Often a risk owner is unable to do anything to decrease the risk. The most evident example is the recent financial crisis. To our mind, almost any company in the world had a liquidity risk at that time. Did managers

mitigate it? Sure. Everybody in the company worked to decrease the liquidity risks, and now, after almost two years, the risks are still there in some of the companies. Does this mean managers mitigated the risk in the wrong way? Were they ineffective and inefficient managers? Didn't they fulfill their KPIs? The answer in most cases is no. The companies are still on the market and that is the most convincing argument for the managers' effectiveness and efficiency. The point is that there are risks mostly influenced by external factors such as the world financial crisis and managers inside the company can do little or even nothing to decrease the risk to an acceptable level. That is why setting KPIs on mitigating liquidity risk in, let's say, half a year or one year under crisis conditions is absolutely meaningless and even dangerous, as it leads to the diminution of the KPI system's significance and decreases the level of confidence in it.

So, in the end, the question is how to motivate managers to mitigate risks in an efficient and effective way and at the same time make the entire system work in accordance with transparent rules known to everybody. The answer lays again in the risk management definition. As it is a process performed daily by everybody in the company, it should not be in any way separated from general operational activities, i.e., a risk management system should not be another torn-off system. It must be part of operational management. Because this statement is acknowledged by every risk manager around the world, there is no need to develop additional specific risk management KPIs (except for those mentioned above). Complete, effective and efficient achievement of a business plan's target is the only KPI here. And any target cannot be achieved in the desired way—efficiently and effectively—if the related risks are not taken into consideration.

Any business plan, budget or project should incorporate risks as basic assumptions and corresponding mitigation plans as part of the expenses. This is a simple equation: Either you take risks into account and incorporate related costs in your budget or you do not consider any risks and cannot bear any additional costs accordingly. In the case of the former, you have lower, but guaranteed, income. In the case of the latter, your plan will show much higher income because of fewer expenses. But the possibility of getting the income at the end of the financial year is quite questionable because of a lack of resources dedicated to managing risks.

Therefore, it is obvious the KPIs on achievement of the business plan's targets are to a large extent based on successful risk management during the planning period. Combining the risk-based business planning with some supporting RM compliance KPIs, the CEO and board can be sure (of course, with the same reasonable guarantee) that to achieve his/her KPIs, a manager has developed necessary mitigation procedures as part of the business plan and will control their execution, taking additional and urgent measures if needed. At the same time, this process is not viewed by managers and employees as an additional burden or another tricky system invented by the board. The idea is that the manager will manage risks not even perceiving them as such, thus no contradictions or obscurities will arise. The manager understands his/her goals, has a clear vision of ways to achieve them and has appropriate resources to do that. Regardless of any changes in the risk portfolio while working to achieve those goals, risks are managed in the same way.

In conclusion, we understand there is no single RM system implementation recipe for any company in the world; however, we strongly believe no one should separate the RM system from the corporate management system of any company and therefore there is no need to develop a comprehensive set of KPIs related to RM effectiveness and efficiency. The company should enforce the RM implementation in the beginning with some RM policy compliance KPIs and simultaneously implement risk-based business planning activities where risks are analyzed on all organizational levels and risk mitigation plans are included in the company's budgets. However, the major KPI of any manager should stay the same: Reach the business plan's goals. We also believe that in advanced RM implementations where the risk management culture becomes widely accepted by employees and managers of the organization, the need for any RM compliance KPIs will become less significant and finally will become useless, leaving only business plan-related goals.

The authors call the risk managers society into discussion on this topic as we believe it has a strategic importance to any risk manager in the world and stands as one of the key success factors for any RM system implementation.

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December 2010