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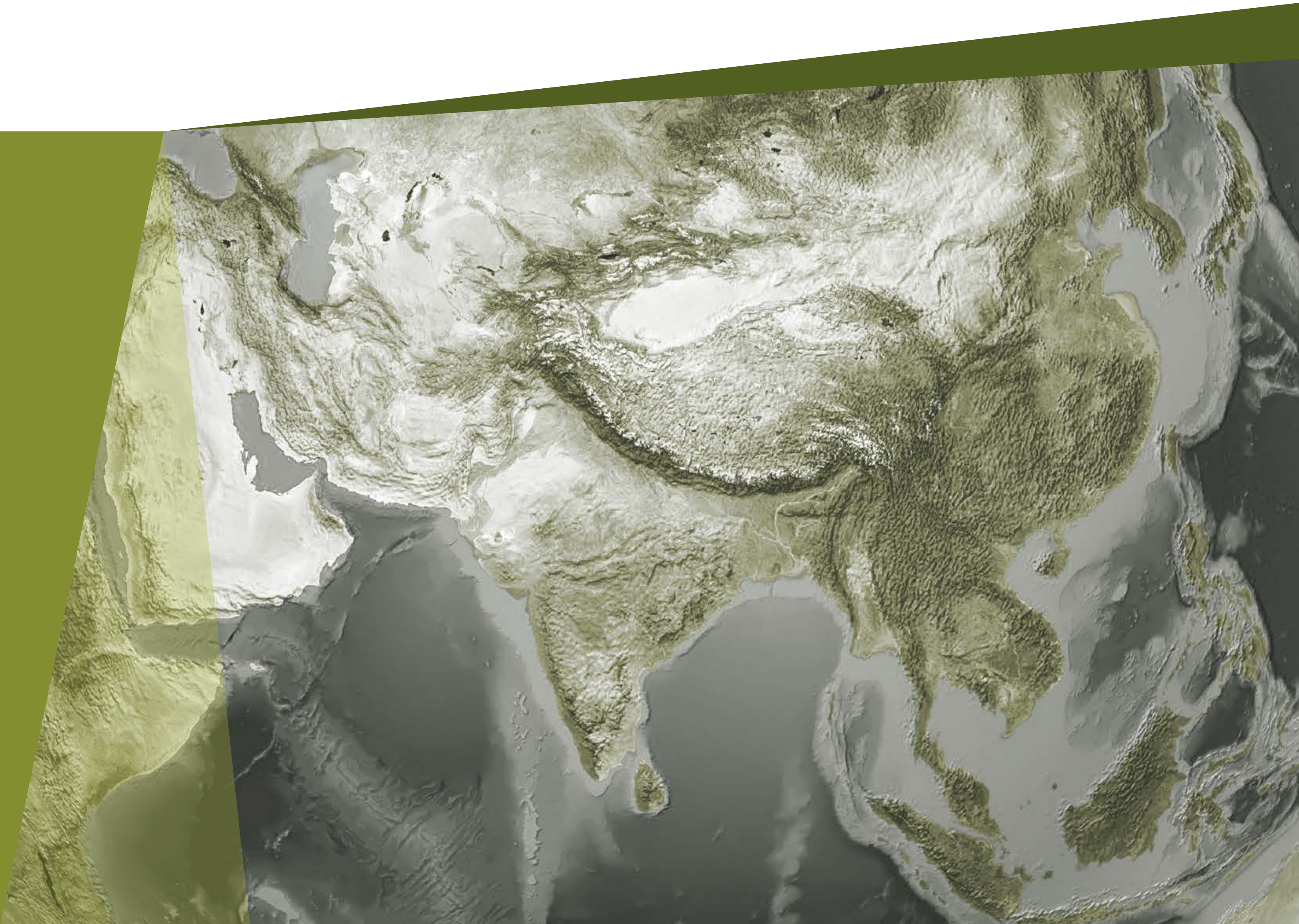

ASIA PACIFIC FINANCE AND RISK SERIES

MAKING RISK PERFORM

MARSH & McLENNAN COMPANIES

INTRODUCTION

Banks are in the business of taking risk. If a bank overestimates the risk of its lending and other activities, it will over-price or reject valuable opportunities. If it underestimates risk, unexpected losses could make it insolvent. The performance of a bank's risk function is therefore critical to its fortunes.

The risk function assesses and monitors the risks taken, and gives advice about the risks of complex transactions. Over the long run, if the risk function underperforms, only luck can save the entire bank from underperforming.

Yet managing the performance of the risk function is difficult because its performance cannot be readily observed. Banks must instead rely on indicators that should correlate with performance. And they must employ incentive schemes that encourage this unobservable good performance.

The trick is to avoid creating perverse incentives. A performance management framework can easily make risk managers overly cautious and inclined to stifle the business. Or it can move in the opposite direction: pre-crisis, some banks adopted incentive schemes that made it difficult for risk managers to say no or, sometimes, overly enthusiastic about saying yes.

In the rest of this short article we explain why the performance of risk staff cannot be observed directly and then suggest ways that their performance can nevertheless be measured and rewarded to incentivise good performance.

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RISK PERFORMANCE CANNOT BE OBSERVED

Risk functions are supposed to improve decision-making by assessing, monitoring and providing advice on the risks involved in doing business. The more accurate the risk evaluation, the better the risk function's performance. Alas, the accuracy of risk assessments is impossible to fully observe.

Suppose that the risk function is asked to evaluate a particular corporate loan. If risk assesses and approves the loan, we can eventually see whether or not the loan is repaid and therefore whether the risk team made the right call. However, if the risk function evaluates and then declines the loan, it is difficult to track whether this was the correct decision, because the bank cannot observe what would have happened if they had approved the deal. The decline may have prevented a loss but it might have forgone revenues.

Thus tracking and rewarding the performance of the risk function cannot be based purely on their "yes" decisions while ignoring the consequences of their "no" decisions. That could result in the risk function declining many profitable deals.

Over the long run, if the risk function underperforms, only luck can save the bank.

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MEASURING RISK PERFORMANCE WITHOUT OBSERVING IT

Although the performance of risk staff cannot always be directly observed, we can track things that should correlate with it. Many firms seek to do this by using a set of specific Key Performance Indicators (KPIs) that differentiate "factory" and "advisory" tasks.

Good performance for many "factory" risk processes, such as reporting, can be readily quantified by simple metrics. However, measuring the quality of outputs, advice and guidance is more difficult and more important. Risk must ensure that risk-taking remains within appetite but without stifling growth and innovation. It must support the business lines, but in part by challenging and constraining them.

The best approaches assess risk's "advisory" performance against multi-year and peer-benchmarked targets. These might include comparisons of non-performing loan ratios, stock betas or return volatility. These can be extremely useful measures so long as the context of such comparisons is understood. For example, market comparisons cannot be meaningfully assessed without also considering the institution's risk appetite relative to peers. Many banks also use qualitative input, such as three hundred and sixty degree feedback. Again, this again needs to be interpreted with care given the importance of protecting the risk function's independence.

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LINKING PERFORMANCE AND REWARD

Given the difficulty in measuring the risk function's performance, how should rewards for risk staff be determined? Three principles should be followed:

PRINCIPLE 1

ALLOW FOR THE USE OF MANAGEMENT JUDGEMENT IN THE PERFORMANCE ASSESSMENT

Since inaccuracy and asymmetry are unavoidable characteristics of quantitative performance metrics for risk management, most banks supplement them with the judgement of senior management (and the Board Risk Committee). Performance targets are expressed in terms of KPIs, and performance is assessed against them during the annual review. The link to bonus assessments is qualitative or judgement-based rather than formulaic to enable the incorporation of context and non-quantitative aspects. Nevertheless, the rationale for the reward should be documented and defensible.

PRINCIPLE 2

RETAIN THE FLEXIBILITY TO MOVE HIGH-CALIBRE STAFF BETWEEN RISK AND THE FRONT OFFICE

Many firms favour a relatively low bonus component for senior risk managers' compensation, in line with regulatory guidance. However, setting pay structures for staff in risk that differ dramatically from those in the front office may reduce staff mobility between the two. This can be an impediment to attracting talent from the front office into the risk function (and vice versa).

Some organisations have managed this by maintaining relatively high ratios of variable to fixed pay in the risk function. In such schemes, because performance metrics for the risk function are less volatile than those for the front office, the volatility of bonuses within risk have also been lower, with reduced upside relative to front-office schemes and incentivising long-term stewardship of the business.

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PRINCIPLE 3

ENSURE THAT PAYOUT STRUCTURES SUPPORT LONG-TERM PERFORMANCE

In most developed markets, bonus deferrals are now standard practice for senior banking staff (and usually required by regulation). The deferral is typically three years and 40-60% of variable compensation. However, deferrals will only have an impact on employee behavior if three conditions are met:

- A meaningful amount of total compensation must be placed at risk. This is another argument for material variable pay within risk functions
- Payment of deferred amounts should be put at risk contingent on the continued performance of the business and individual. The pay-out conditions for deferrals are typically set at group, business unit and individual level. The business unit level is especially important for senior risk staff because high levels of unexpected loss may be an indicator that risk models are ineffective, and may only be realised several years down the line. In those cases however, it will also be important to assess the firm's relative performance to peers in order to ensure fair interpretation of Risk's performance, as high unexpected losses are most often driven by market forces
- Contingent conditions must have "bite". Thresholds for payment must be set at levels that have a realistic chance of being triggered, must have a solid legal basis in employment contracts, and a track record of acting on these conditions must be established

Approaches for assessing and rewarding performance in risk functions vary across the industry. However, good practices are emerging and advanced institutions have many elements in place. If risk is everyone's business, incentivising risk managers the right way is critical. Our experience suggests there is still significant opportunity to improve.

Risk function performance cannot be readily observed. Banks must instead rely on indicators that correlate with good performance.

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