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FEDERAL HOME LOAN BANK OF CHICAGO*

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BREAKING THROUGH

The Rise of the RISK Executive

It's still rare to find risk managers running major corporations, but as risk becomes an increasingly urgent boardroom concern, the doors are opening.

BY L.A. WINOKUR

hen Matthew Feldman became chief executive officer of the Federal Home Loan Bank of Chicago last April, a barrier was breaking. Four years earlier, just

six months after joining the bank as a senior vice president, Feldman was named chief risk officer. His rise from there to executive vice president of operations and administration in 2006 and to CEO in 2008 represents a C-suite success story for the risk management profession, a signal of changing times and a higher profile for a set of skills and expertise in demand as never before.

“I always viewed risk as a business function, not just a risk function,” says Feldman.

His ascent illustrates both how strategic a function risk management has become in recent years, and how high risk professionals have climbed in terms of corporate stature. Just as the recent turmoil in financial markets has brought more scrutiny on the profession and its performance – whether for better or worse – amid the economic downturn, so has risk

The path is not well-worn. Feldman came to the FHLB, one of a network of government-sponsored housing finance agencies, in 2003 as operations manager for its mortgage purchase program. He brought an MBA degree from Northwestern University’s Kellogg School of Management; 15 years at the former Continental Illinois Bank (including time spent as president of its Continental Trust Co. unit and as a managing director for global trading and distribution for the bank); and eight years with Learning Insights, an e-learning startup he co-founded, financed and headed.

It wasn’t very long ago that risk managers had almost exclusively quantitative backgrounds, or were regarded within their organizations as back-office functionaries in audit- or compliance-related roles. In recent years, many risk professionals have become increasingly involved in decision making, and moving closer to, or, as Feldman demonstrates, all the way to the top. In many instances they have also been working to move their companies away from a siloed approach to risk management and toward more integrated, enterprise-wide models. That trend, too, has served to give risk managers more visibility.

The financial crisis was a compelling event of cataclysmic

management gained entry into the highest echelons of the business and financial world and its management consciousness. “It may sound like a cliché, but the CRO almost has to be the CEO,” says Richard Spillenkothen, a longtime Federal Reserve banking regulator who is currently director of Deloitte & Touche’s regulatory and capital markets practice.

It wasn’t always so. Consider the career path of one risk management pioneer, James Lam, head of Boston-area consulting firm James Lam & Associates. The University of California at Los Angeles MBA graduate is widely credited with having coined the title CRO when he went to work in this capacity for FGIC Capital Markets Services, a GE Capital company, in 1993. When asked what he wanted his title to be, Lam figured that a chief risk officer, or CRO, could do for risk management, what chief information officer, or CIO, was doing for technology: help to integrate the function across the company and elevate it to the C-level agenda.

In 1995, Lam moved to Fidelity Investments as its first CRO. Lam, who counsels major financial institutions and corporations on risk management, describes the FHLB’s Feldman as “one of the first examples” of a CRO becoming CEO.

The credit crisis that hit in 2007 thrust risk management and risk managers into the spotlight, where they remain. Financial services companies, regulators and others have been struggling throughout to understand how the risk discipline – and the credit risk component, in particular – got so terribly out of control. Look at the former giants that have gone bankrupt, got acquired or had to be bailed out: Lehman Brothers, Morgan Stanley, Merrill Lynch & Co., Bear Stearns, Citigroup and American International Group. And those are just the U.S.-based, A-list players. All had risk management programs and people in place. Not surprisingly, what happened to them caused an earthquake of such magnitude that the industry as a whole is still feeling the shocks, while fear, panic, anxiety and uncertainty pervade Wall Street.

All that has led to a lot of soul searching and, naturally, finger pointing. Blame has been assigned to everything from regulatory ineptitude to misguided public policy goals to unbridled personal greed. Another of those targets – a breakdown in risk management – points up a downside of the risk profession’s ascendancy: demoralization.

Being a CRO “is one of the toughest jobs on the execu-

tive team,” says McKinsey & Co.’s Kevin Buehler, a director in the firm’s New York offices and a co-leader of its global risk practice. “It’s very easy to blame the CRO when things go wrong.”

Maureen Miskovic, executive vice president and CRO of Boston’s State Street Corp. (see CRO Interview, page 4), recalls that during an eight and a half year stint with S.G. Warburg in London, she took on, in succession, responsibility for index derivatives, equity risk management, fixed-income market risk management, counterparty credit risk and liquidity risk. “I ended up with the title group treasurer, while also retaining market and credit risk responsibility,” she says. “If it could go wrong, it was always on my watch.”

Consultant Lam concludes that there has indeed been a “failure in risk management:” in its systems, functions and the way it was – and was not – carried out. Distilling a very



Companies that stumbled were either “risk ignorant” or “risk incompetent,” says consultant and enterprise risk management pioneer James Lam.

proportions. The industry response was insufficient.

complex set of circumstances, Lam says that companies that fell short were either “risk ignorant” or “risk incompetent.” The ignorant “didn’t know what they didn’t know,” such as how much exposure they had, or they didn’t ask the right questions, or they relied on outside rating agencies or financial models that used bad data. The incompetent, for reasons that could have been rooted in a governance problem, misdirected financial incentives or executives turning a blind eye, “had the information but didn’t act on it appropriately,” says Lam.

As people try to make sense of all that went wrong, how it happened and, most important, what to do to prevent recurrences, risk management has become even more of a priority. Risk managers, too, are said to be in greater demand, though the irony is inescapable: On the one hand, risk management is seen as partly to blame for what happened, which could jeopardize risk managers’ standing if not their jobs. On the other, it’s precisely because it may be to blame that risk management – and risk managers – is said to be needed more than ever before.

The financial crisis was a “compelling event of cataclysmic proportions,” says Tim Holt, a partner in the New York

offices of executive search firm Heidrick & Struggles. Holt, who specializes in financial services, including the firm’s risk-related practice, sees “heightened attention” now being paid to risk management across the board, and particularly by financial firms. The conversations are “unprecedented,” he says, and the search activity is also “fairly unprecedented.” Holt estimates that the activity is running at three to four times the rate of a year or two ago, while a “dramatic increase in demand” at the senior levels of risk management is being driven by a “redefinition of what risk means across the industry.”

“What we’ve been doing in the past as an industry was insufficient,” Holt states. “It’s broadly acknowledged that managing risk as an isolated element did not work. Risk is a cultural and systemic issue.”

“Every client is interested in what the other firms are

doing,” he continues. “They’re rethinking their strategies, and how best to mobilize.” Less attention is being paid to technical skill sets, and more to executive-level skill sets, and talent-seeking clients are willing to pay up for it. Without giving specific numbers or ranges, Holt reckons that compensation is at an “all-time high,” 20 to 25 percent above where it was only a couple of years ago.

Michael Woodrow, president of New York-based recruiting firm Risk Talent Associates, describes mid- to senior-level managers as the “sweet spot” for his business. His clients run the gamut from banks, investment banks and asset management firms, to global corporate clients, energy companies, consulting firms and technology and software analytics companies. Woodrow says he sees “an incredible amount of firefighting going on” in the aftermath of the market meltdown. There is some hiring going on, by companies with an international footprint and by commercial banks, he notes, while many others have put things on hold.

Woodrow says one area where there is a decent amount of search activity is credit risk management. He is involved with a number of companies wanting to build out their credit risk functions and looking to hire mid-level risk managers

in the \$200,000 to \$400,000 compensation range. Companies more and more are looking for candidates who have not only quantitative skills, but who are also market-savvy (trading experience, for instance) with front-office experience, and who are forward-looking and can communicate complex concepts to senior management.

The recruiter contends that instead of being paid like people in back-office control and accounting functions, as they historically have been, these risk managers are now compensated more in line with what front-office personnel earn per year: anywhere from a couple of hundred thousand dollars to a million or more. Woodrow adds that the ranks of risk managers remain overwhelmingly, perhaps as much as 90 percent, male.

According to Buehler at McKinsey, which has tracked the growth and penetration of CROs by industry, "within [U.S.] banks and securities firms, the CRO role first made its ap-



Risk is an integral part of the "Market-Based Management" philosophy at privately held Koch Industries, says Michael Hofmann.

modity and financial trading and services; and forest and consumer products.

After studying engineering in Germany, Hofmann received both his undergraduate degree and MBA from Wichita State University. He worked as an auditor for KPMG Peat Marwick for seven years before joining Koch in 1991. He was the chief market risk officer from 1999 to 2000, when he helped develop and start up trading ventures.

"We deal with a diverse set of business issues and a broad set of financial risks," the CRO says, noting that his role has similarities to that of a financial institution CRO. But while Koch Industries deals with some of the same operational risks – in trading,

clearing and the like – it also faces a different set. Consider that, as Hofmann puts it, "the same week that Lehman went bankrupt, we had to deal with a major hurricane."

Koch says it takes advantage of its private status by thinking like an investor and focusing on long-term value, which

In organizations that get it right, the CRO has the ear of

publicly held companies are often criticized for not doing. Chairman and CEO Charles Koch, also the principal owner, was very involved with senior management in developing the vision for the risk management program, which was motivated by a desire to "protect our financial strength and improve decision-making."

appearance in the early 1990s, reached roughly 49 percent of firms by 2002, and is now present at more than 80 percent of firms." It's becoming a regulatory expectation "to see one person thinking of risk on a full-time basis," Buehler says. The CRO position is gaining traction outside banking and securities: 19 percent of insurance companies had a CRO in 2002, rising to 43 percent now. Adds Buehler: "Other industries with significant penetration include energy and utilities, at 50 percent, and health care, and metals and mining, which are both at roughly 20 to 25 percent." For corporates overall, roughly 4 percent had a CRO in 2002, while more than 10 percent do today.

Koch Industries, because it is privately held, is under no external pressure or regulatory mandate to do risk management. Yet it has a CRO, Michael Hofmann, who oversees all global, market, credit and hazard risk management. Headquartered in Wichita, Kansas, Koch is one of the world's largest private companies, with annual revenues of around \$100 billion, over 70,000 employees in more than 60 countries, and a portfolio of businesses that includes refining and chemicals; process and pollution control equipment and technologies; minerals; fertilizers; polymers and fibers; com-

It has three guiding concepts, consistent with the company's "Market-Based Management" philosophy. First: "The future is unknown and unknowable," or, in other words, "think about what could happen rather than trying to predict what will happen," Hofmann says. Second: "Reward and risk are inseparable," or, "the role of risk management is to ensure you understand the risks you're taking and avoid the risks that are never acceptable," he adds. Third: "We are all human beings," meaning, "we are all subject to biases that affect our judgment and cloud our decision-making."

The philosophy has been "very helpful in making risk management a part of our culture, our DNA," Hofmann explains. "It's not an add-on and not an afterthought. It's integrated." Being privately held allows for "a different mind set," Hofmann says. "It's not funny money or Monopoly money. It's [our] own money. We know our shareholders,

and they know us.”

Koch is no different from any company, private or not, financial or other, that must define a risk appetite that fits its business mix and strategy. Says McKinsey’s Buchler, “You don’t want a ‘Dr. No,’ but just as bad is having a CRO who never says ‘no’. Both lead to poor outcomes.”

“How do senior risk officers strike a balance between the twin roles of ‘compliance champion’ and ‘business partner?’” asks Harvard Business School post-doctoral fellow Anette Mikes in research published in the *Journal of Risk Management in Financial Institutions* last August. Mikes, also co-author of “Beyond Compliance: The Maturation of CROs and Other Senior Risk Executives” in the November/December 2007 *GARP Risk Review*, tracked senior risk officers at 15 international banks from June 2006 to June 2007, a period that provides, as she puts it, “a snapshot of the calm before the storm.”



A typical board doesn’t understand the extremely complex risks financial institutions are taking, says RiskMetrics’ Gregg Berman.

the CEO and is more an adviser than a policeman.

Mikes found that “the role of CRO’s had expanded dramatically, with more than half of them frequently involved in firm-level strategic decisions.” However, she goes on, “in the majority of these banks . . . various compliance and risk modeling initiatives were still works in progress at the onset of the market turmoil. CROs voiced divergent views on the uses, benefits and limitations of risk models,” she wrote, adding, “strategically involved CRO’s interpreted the ‘business partner’ role of their function differently. Some risk functions aspired for an influential expert voice in key business decisions, while others strived for the formal integration of risk management with performance management.”

Risk management programs and CROs, like financial risk models, clearly aren’t of the one-size-fits-all variety. So, with the benefit of hindsight, and insights gathered during these very challenging times, what are some of the things companies can and should do to either get or keep their risk management programs on track and to support their risk professionals?

Deloitte’s Edward Hida, global leader for risk and capital management and a partner in the regulatory and capital markets area in New York, lists four main areas companies

need to address: governance and risk oversight; balancing risk and reward; building risk capabilities; and transparency and disclosure.

With regard to governance, corporate boards need to “clarify” their oversight roles, Hida suggests. A number of industry experts agree. They say boards need to have more of a presence when it comes to risk expertise, setting up risk committees if they don’t have them already.

Many boards are “not well organized to provide effective risk oversight,” Lam says, when it comes to governance structure and risk management expertise. They might not have a dedicated risk committee, or don’t spend enough time on risk management issues. They are often not well served, he says, with respect to the right risk policies, defined risk tolerance levels and useful reporting. Lam advocates that boards add risk management expertise to their ranks, which he stressed is

different than financial expertise.

“The types of risks that financial institutions are taking are extremely complex,” points out Gregg Berman, a co-head of the risk management unit of New York-based RiskMetrics Group, which was spun out from JPMorgan & Co. in 1998 and went public last year. “A typical board of directors doesn’t understand them,” says Berman.

For the most part, experts are in agreement that CROs should report directly to CEOs, with a so-called dotted line to the board.

Lam notes, however, that there is another, controversial conversation taking place on this subject: Should CROs have a straight line of reporting directly to the board? This would be for cases where companies are taking on too much risk, or that involve reputational or regulatory risks. Adds Lam, who has written in detail on this issue in a white paper, “Where was the outcry? Why didn’t we hear about chief risk officers going directly to the board, or quitting out of protest given what was happening on their watch? I believe a central issue is the continued lack of true independence of risk management.”

Many industry players single out the old JPMorgan as a

place that had established a strong risk management culture. Goldman Sachs & Co. shares that reputation. So it makes sense that boards looking for risk expertise – and companies looking to hire risk executives – would look to them as fertile recruiting grounds. Examples: Bank of Montreal appointed Don Wilson III, the former CRO at JPMorgan Chase & Co., to its board last March, and JPMorgan Chase named former Goldman Sachs executive Barry Zubrow CRO in November 2007. A recent independent addition to Feldman's FHLB of Chicago board is Diane M. Aigotti, who held the titles of senior vice president, chief risk officer and treasurer at insurance brokerage and consulting firm Aon Corp. from 2000 to 2008.

The regulatory and consulting arenas are other sources of expertise. For instance, reinsurer RenaissanceRe Holdings named Anthony Santomero, a former president of the Federal Reserve Bank of Philadelphia and a McKinsey risk practice adviser, to its board last February. Today it's not so easy, however, to get people to leave the regulatory world for corporate risk jobs, according to Risk Talent's Woodrow. One reason, he says, is that it's an exciting time to be in the

You don't want a 'Dr. No', but just as bad is having a

regulatory arena. Many ambitious and talented people, who in years past typically would have eagerly made the jump, are often opting to stay put; others are even moving into the regulatory sphere.

The other major piece of this governance issue that needs to be addressed has to do with the CEO. "It's important for the CEO to set the overall tone," says Deloitte's Hida, adding that this demonstrates that "risk management has a seat at the table in the decision-making."

Lam knows firsthand from his CRO days just how critical this is. GE Capital had hired a bunch of traders from a foreign bank for its capital markets start-up. But according to Lam, they didn't pay attention to the risk management systems that had been set up. Lam reported it to top management; they shut down the business for two days and conducted an internal workshop on how risk must be managed. This was a big deal, he notes, especially for a start-up where every day counted. It showed that GE Capital "took risk management very seriously," Lam says. "Clearly, they got it."

However, Lam says when he joined the privately owned Fidelity investments in 1995, he faced a different challenge. Unlike GE Capital and its hands-on approach, Fidelity was

more decentralized. "People felt risk management was everyone's job," says Lam. He found it necessary to lay out a clear vision for a more integrated risk management program, and for what his role was at the firm. Getting people to understand and accept these things took time, he says.

"You cannot have effective risk management without it coming from the top down," Lam explains. Otherwise, he notes, CRO's end up spending half their time persuading people to do the right thing, which doesn't leave them much time for getting their jobs done. "It's an uphill battle and doesn't do anyone any good," he says.

The FHLB's Feldman recalls that in 2004, when he was first named CRO, his role wasn't clearly defined, and his peers on the management committee didn't understand it. But times have changed. Feldman can now provide leadership on risk management to his CRO, Michael Ericson, who had previously overseen Securities and Exchange Commission reporting and accounting policy, and who had formerly worked at PricewaterhouseCoopers, Bank One Corp. and JPMorgan Chase. Feldman makes it clear that he not only did the CRO job, he "respects it."

Balancing risk and reward means looking at them together and making decisions from a business standpoint, Deloitte's Hida explains. One way companies have been doing this is by moving toward integrated enterprise risk management, or ERM, and away from silos, with their various chosen models, processes and oversight committees.

Breaking down risk silos can be time-consuming. The FHLB's Feldman says he spent "a significant part" of his two years as CRO doing just that. (He made a simple but strategic impact on the culture and cohesiveness of the organization by arranging, as one of his first orders of business when he became CRO, the purchase of BlackBerry handheld devices for most of the bank's 450 employees.) Even with only six months at the FHLB under his belt before becoming CRO, Feldman says he was seen as somewhat of an insider, which helped his cause. An insider has a "better understanding of the values of a culture, and has developed a respect for how to change it," he says. "An insider also has more credibility."

"Culture change is an idiosyncratic thing," Feldman notes.

When advising other companies about the kind of candidate he thinks would make for a good CRO, Feldman recom-

mends that it be someone who is “bright; somewhat dissatisfied with the organization and culture as it is; understands a significant part of the organization and how it operates; and has a vision as to how to change it.” That person does not necessarily need a risk background, he points out.

The third requirement on Deloitte’s list is building risk capabilities. Hida notes that developing valuation systems requires integration of multiple models. Says RiskMetrics’ Berman, the historic separation of credit and market risk is “inappropriate for the strategies of today.” Companies also can’t afford to rely “blindly,” on these tools, he says, adding, “You can’t press a button and say, ‘predict the future,’ but you can allow a qualified professional to use judgment to come up with estimates for the future.”

A manager is only as good as the tools he or she has to work with. “These are “sophisticated and complex models,” says McKinsey’s Buehler. “But if you use models with historical data generated over a reasonably benign economic environment, you will come to the wrong conclusions.”

Lam is an advocate of dashboard reporting, or reporting that integrates qualitative and quantitative data; internal

CRO who never says no. Both lead to poor outcomes.

risk exposures and external drivers, and key performance and risk indicators. He has written about this, saying, “Over time, the databases, analytics, and reporting should be automated. These ‘electronic dashboards’ would be the risk analog to the touch-screen ‘Magic Map’ pioneered by CNN to show real-time voting trends by state”

“What gets measured, gets managed,” Lam notes.

Additionally, many agree that the credit crisis reinforced the need to account for the worst case scenario, the extreme, “black swan” type of rarity that options trader-turned-business school professor Nassim Nicholas Taleb has written and warned about. It’s shocking, in hindsight, that Wall Street models didn’t take into account the possibility that home prices could decline. As FHLB’s Feldman puts it, “We’re now living in the world of the improbable.”

On the fourth item on Deloitte’s recommended checklist, the need for transparency and disclosure, RiskMetrics’ Berman believes that “everyone should understand how a company views and manages risk.” Companies need to start discussing this at every level of the organization, a “constant” dialogue on the question, “what are the risks we are taking?”

People also need to understand where compensation and concerns about job security – particularly for risk managers – fit into this equation, and to determine if there are potential conflicts of interest among risk managers who wear the hats of “compliance champion” and “business partner, as Harvard’s Mikes frames it.

Both transparency and disclosure can be a tough sell on Wall Street because many of its business models are considered proprietary. “If you look at other industries,” Berman says, “transparency comes from consumer pressure, not regulation. Investors need to ask for this.”

An important question for boards, regulators and others is, “How does anyone know if a risk management program is working?” says Lam. “You can’t have a good performance function, or risk management, without good performance measurements and good feedback.” The industry, he says, has never really had that. Implementing these, he adds, would go a long way toward reestablishing trust in enterprises and their risk management capabilities, not to mention helping to restore the financial industry’s damaged reputation.

Stepping back and looking at the big risk picture, and where risk professionals fit into it, McKinsey’s Buehler says he has observed that “in organizations that get it right, the CRO has a seat at the table; reports directly to the CEO; has the ear of the CEO and is more of an adviser to the line organization than a policeman.” But this individual also has to have “the stature, authority and influence to make his or her will felt in the organization.”

Compliance -- once a driver of risk management programs – “is not risk management,” Lam is careful to point out. “It’s a small subset of operational risk.” He warns that if risk managers “spend the bulk of their time on this, they will end up missing the next credit crisis.

“Risk management is about the future, not about the past,” he says.

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