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Risk Intelligence

A Bedrock of Dynamism and Lasting Value Creation

By Leo M. Tilman

In finance, a desire for leadership, ideas, and action has emerged in response to the unsatisfactory "new normal." Increasingly, leadership teams are determined to spend productive energy on long-term solutions. To chart a bold vision and new value proposition, financial institutions and investors must develop a new competence – risk intelligence. As the organizational ability to think holistically about risk and uncertainty, speak a common language, and effectively use forward-looking tools in making better decisions, risk intelligence has become a key determinant of survival, success, and relevance. It equips boards and executives with new ways of seeing. Viable business models, better decisions, effective communication and rigorous governance follow as a result, helping financial firms contribute to what societies need the most: sustainable economic performance, new measures of success, and economic dynamism that drives growth, inclusion, and real prosperity.

New Ways of Seeing

An inflection point is upon us. Amidst the anxiety and pessimism of the post-crisis world, a desire for leadership, ideas, and bold action has emerged in response to profound dissatisfaction with the "new normal." Increasingly, boards and leadership teams are determined to spend productive energy on long-term solutions that go beyond the next quarter's earnings, the next regulatory rule, or the next landmine.

In the financial industry, this desire for new value propositions and broader societal relevance is set against a backdrop of one of the most complex and difficult environments in memory. Fiscal and debt crises are sending real economies and markets into chaos on a seemingly regular basis, paralyzing decision-making and economic activity. Global imbalances remain intact – and some continue to grow. Real economies and financial markets are more interconnected than ever before, and the pace of change – along with the global competition for returns, customers, jobs, and resources – is intensifying.

To chart a bold vision and new value proposition, financial institutions and investors must develop a new competence – risk intelligence.

These global trends translate into significant challenges for financial firms and institutional investors. Amidst lackluster global growth, a low return environment in developed countries is expected to persist for many years, with compensation for risk remaining low. Deleveraging of consumers, financial institutions, and alternative investors is continuing, impairing transaction volumes and demand for credit. Higher capital requirements, new regulatory prohibitions, and higher compliance costs are all diminishing profitability and morale.

Such an environment makes envisioning uncontested new markets[1], creating innovative products, or enacting bold initiatives designed to create lasting value exceptionally difficult. Confronting these challenges on the board and executive management level entails asking fundamental (perhaps even existential) questions:

- What is our vision for relevance and profitability in the changed world?
- What returns will make us attractive to shareholders – and can such returns be generated without excessive risks?

- **Are we equipped to effectively respond to the next "once-in a life-time" crisis around the corner?**

By their very nature, responses to these questions shape the firm's strategic vision, business model, organizational structures, communication, and culture.

The presence of risk – and the critical importance of effective decision making under uncertainty – permeate strategy, business models, leadership, and cultures across the financial industry. To chart a bold vision for relevance and lasting success, financial firms and institutional investors must foster a new type of competence – risk intelligence – that we define as[2]:

> **The organizational ability to think holistically about risk and uncertainty, speak a common risk language, and effectively use forward-looking risk concepts and tools in making better decisions, alleviating threats, capitalizing on opportunities, and creating lasting value.**

Risk intelligence represents both a strategic imperative and a powerful adaptive advantage. It equips boards and executive teams with new ways of seeing "the future that has already happened,"[3] empowering sustainable growth, effective communication, and organizational change.

From Risk Management to Risk Intelligence

The historical origins and language of **risk management** have largely shaped its perceptions and uses among executives and risk-takers, as it became a fully developed and institutionalized discipline over the past two decades. A common definition – "identification, analysis, assessment, control and avoidance, minimization or elimination of unacceptable risks"[4] – is both telling and consequential. First, it presents risk as undesirable and harmful – to be avoided or mitigated. Second, it creates a perception of a policing and enforcement activity, generally not conducive to a collaborative environment. Last, it instills an "after the fact" mentality with profound organizational and cultural implications: the role of risk management is to perform a safety-and-soundness check **after** critical business and investment decisions have already been made.

How do you turn a traffic cop into an invaluable contributor to growth, profitability, and societal relevance? Taking a look at key organizational competencies – **competitive** and **business intelligence** – is useful in repositioning risk management as a strategic resource and fostering an effective partnership between risk managers and executives, risk-takers, and boards of directors.

Competitive intelligence involves systematically gathering, analyzing, managing, and deploying information related to the firm's competitors and operating environments, which often includes products, customers, business plans, and operations. By understanding competitors' strengths and weaknesses, continuously evaluating the evolving needs of customers, and detecting changes in competitive landscapes, companies become better positioned to make informed decisions and improve investments in R&D, resource allocation, branding, marketing, and business strategies.[5]

Similarly, **business intelligence** helps companies extract value from data related to products, costs, processes, operations, and revenues, providing historical insights and driving predictive analyses. Extending far beyond reporting tools, business intelligence systems improve decision-making and resource allocation, reduce costs, and identify new opportunities and "inefficient business processes ripe for re-engineering."[6]

Competitive and business intelligence could have emerged as **defensive** or **policing** tools, focused on remediating operational inefficiencies, avoiding strategic risks, or reducing operational risks. Instead, a proactive, forward-looking focus was adopted: **enabling better decision-making** through the use of advanced tools and systems able to translate vast amounts of data into actionable information. The same proactive approach can and should be taken with risk.

Risk taking has always been a core business of financial institutions and investors. Globalization, technological advancements and increased competition have made the role of risk even more important in the recent decades. As argued in *Financial Darwinism*, an increasing proportion of earnings of financial institutions is driven by risk-taking rather than feebased activities. Needless to say, organizations whose business models are centered on risk-taking – particularly systematic risk taking – must be equipped and organized accordingly.

> **The dominance of risk taking in financial business models suggests that possessing risk intelligence – thinking holistically about risk and uncertainty, speaking a common risk language, and effectively using forward-looking tools to make better decisions – has become a critical determinant of survival, success, and relevance.**

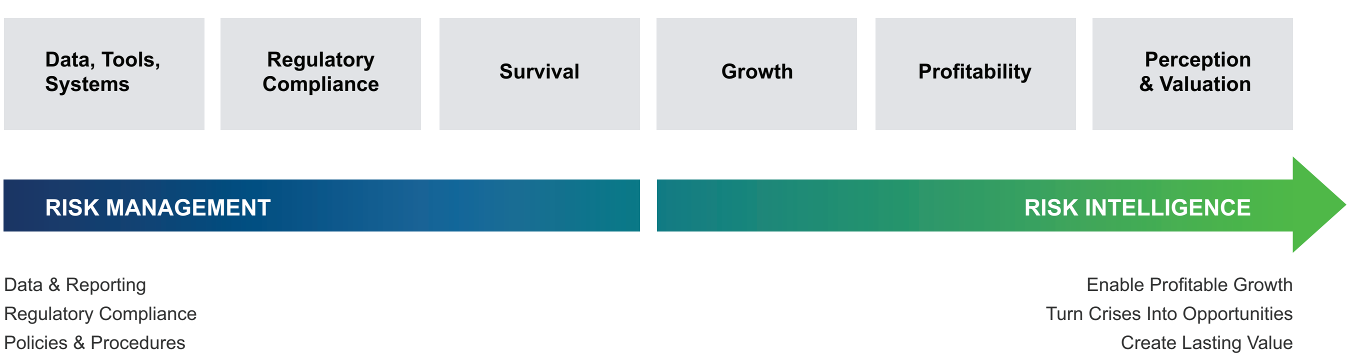
Here lies a unique opportunity. After decades of extensive development and practical application, risk management has accumulated a wealth of frameworks, tools, experience, and lessons learned. To be ultimately effective and useful, they need to be **repositioned** – by bridging the linguistic, analytical, and cultural gaps between risk management and executive decision-making. Further, they need to be **complemented** with new tools, information, and technology to facilitate new thinking and uses.

Organizational repositioning of risk management starts by posing two fundamental questions to senior executives and boards of directors – as they relate to top corporate priorities, such as robust data and systems, regulatory compliance, survival, growth, profitability, and favorable external perception:

- **What is the desired role of risk thinking in achieving our objectives?**
- **What is the desired role of the risk management organization in achieving these objectives?**

Traditionally, risk management involved mostly defensive activities: providing reporting tools and systems, fostering regulatory compliance, and mitigating catastrophic risks (Exhibit 1). Leadership teams now desire to employ risk thinking and risk professionals proactively in value-creating, strategic activities as a way of improving the firm's competitiveness, assets under management, and relevance. For each of the top corporate objectives – such as growth, profitability, or

Exhibit 1: Organizational Vision and Role of Risk Intelligence



Source: L.M. Tilman & Co.

favorable external perception – a specific set of risk-related initiatives can be developed and custom-tailored to the firm's strategic vision. For instance, building robust "risk intelligent" systems – that unify data across the firm and turn it into reliable and actionable information – improves resource allocation and allows senior people to spend more time on value-added activities, thus improving profitability. Meanwhile, risk intelligence helps enhance long-term economic performance by fostering organizational dynamism across strategic planning, capital allocation, balance sheet management, and rebalancing of the firm-wide portfolio of risks. This, in turn, helps reduce the cyclicality and volatility of earnings and garner favorable external perception among equity and debt investors, credit rating agencies, politicians, and regulators.

In building a dynamic risk-intelligent organization, the following tasks have proven essential:

- **Directly linking risk, strategic vision, value proposition, and business model – where the desired role of risk as a driver of earnings is explicitly defined on an ongoing basis.**
- **Identifying, measuring, managing, and governing all relevant dimensions of risk. Even apart from "unknown unknowns," many companies continue to fly blind in the face of invisible risks that can and should be measured.**
- **"Connecting the dots" within an integrated framework and a common language, thus creating a holistic picture of risk conducive to effective decision-making.**
- **Eliminating business model and cultural deficiencies, where companies respond to earnings and market pressures by leveraging up.[7]**
- **Fostering a strong risk culture, where professionals at all levels are empowered and incented to detect threats, manage risks, and contribute to lasting value creation.**

The role of executive leadership – including setting the firm's ethical stance, voice, and culture – is critical in building an organization's risk intelligence. The failures to adapt, flying blind, or playing a game of musical chairs have all led to corporate ruin, and these were as much failures of leadership as they were signs of unviable business models.[8]

The Grand Alignment

> **"While my days are consumed by meetings and fire fighting, the plane that I am entrusted with is flying through extreme turbulence."**

This statement by a chief executive of a leading financial company aptly summarizes the state of affairs and the acute need for risk intelligence. In the past, favorable operating environments, informational advantages, and plentiful compensation for basic financial activities did not necessitate that boards and executive teams perceive themselves as pilots of a complex airliner. New realities demand adaptation, which applies to how boards and management teams consume information, how resources (including executive time) are allocated, how organizations communicate internally and externally, and how decisions flow through organizational structures.

Transforming a boardroom into a state-of-the-art cockpit equipped with essential knowledge, information, and tools is a fascinating and energizing endeavor, particularly because requisite capabilities quickly become self-evident:

- **Situational awareness and systemic knowledge.** Have we systematically identified emerging trends, threats, and opportunities? Who is responsible for continuous monitoring and are they adequately equipped to do their job? Will we be informed of important developments and changes in a timely fashion?

- **Strategic vision and action plan.** What is our vision for relevance and profitability – and value proposition for different stakeholders – today and going forward? Is this vision aligned with external realities and trends? How dynamically do we adjust our vision in response to changing environments?

- **Dashboards.** What performance metrics, measures of success, and risk dashboards and radars reflect the external environment and are specifically tailored to our vision, business model, and strategy? Are we seeing everything that is relevant?

- **Levers, Communication, and Culture.** Which business and risk levers are we using to navigate and achieve objectives? Are we effectively communicating our vision and strategy internally and externally? Do we have the right culture to achieve and sustain our strategic vision?

Navigating turbulence takes the right strategy, risk intelligence, and capabilities. Equally importantly, it takes **firm-wide alignment** in the broadest sense – spanning vision, risk, culture, and communication.

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- An organization's **business model** **must be aligned with its** **strategic vision**, **particularly with respect to the desired role of risk.** For instance, if the overarching strategy is to be the best provider of fee-based products or services – yet a significant portion of earnings is driven by risk exposures on the balance sheet – this misalignment is likely to result in earnings surprises, sub-par equity valuation, and impairment of business objectives.

- **In turn, performance metrics and measures of success must be aligned with the business model and role of risk.** If creating stakeholder value by delivering superior risk-adjusted returns is a priority, then organizations need to think beyond sales volumes or accounting metrics.

- **The institution's risk exposures must be aligned with its risk-bearing capacity.** This encompasses not only capital, insurance, and contingent sources of funding but also expected behaviors and contingency plans, such as hedging, balance sheet restructuring, and other means of rebalancing the firm-wide portfolio of risks.

- **The firm's business model and risk must be aligned with organizational design, communication, and culture.** For instance, experience has shown that if an institution's profitability is driven by macroeconomic risk taking, its organization should not be structured as a conglomeration of silos.

- **Equally important, expectations of external stakeholders must be aligned with the firm's business model via proactive, risk-conscious communication to maintain staying power in achieving growth and profitability objectives.**

Risk intelligence is the unifying language and framework that helps create firm-wide alignment in the broadest sense.

Risk Intelligence and the New Normal

The pressures of the **new normal** – with its low growth and low return environment, higher costs of doing business, higher capital requirements, regulatory restrictions, and ongoing deleveraging – will continue putting leadership teams and business models to the test. The firm's ability to thrive in this environment depends on continually adapting and redefining its value proposition. Outdated buy-and-hold business models will need to be improved upon via other forms of value creation, such as dynamic asset management on the balance sheet. Boards and executives will also need to bridge the persisting gap between the language of risk and the parlance of decision-making.

Of special relevance to the current environment, risk intelligence will help financial institutions address one of the most important lessons learned: how to respond to competitive and market pressures in effective and financially sound ways (Exhibit 2). Changes in the environment will be detected and conceptualized. Boards and senior executives will be able to examine and dynamically adjust key measures of success – across accounting, economics, and regulatory dimensions. When a proactive response to external changes is required, the arsenal of business levers – such as expenses, products, and business mixes – will be deployed simultaneously, while risk appetite and risk allocation will be readjusted. "Optimized" long-term economic performance custom-tailored to the operating environment will follow, with informed and prudent risk taking hard-wired into the culture on all organizational levels.

> *The more complex and global a company, the more critical the crisis management roles of risk intelligence, organizational coordination, and ongoing communication become.*

By articulating the direct connection between risk and dominant aspects of performance – including growth, profitability, and equity valuation – risk intelligence naturally becomes an important decision-support tool in strategic planning, M&A, new product and customer strategies, organizational development, and communication, helping align the organization for the challenges ahead.

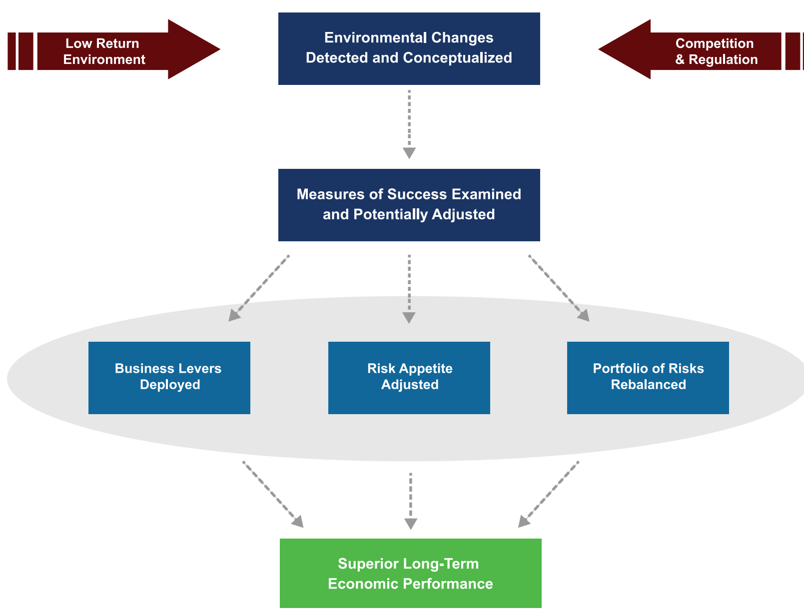
Sustainable Performance Through Crisis Management

Inner workings of large and complex organizations reveal a striking diversity of practices and attitudes related to crisis management. At some firms, crisis management is a surge of activities that *follows* an incident, breakdown, or loss. Resources are mobilized to contain damage, and a reactive public relations campaign is typically launched.

To others, crisis management is a **forward-looking** and **ongoing** activity. The need to integrate crisis management into strategic planning, new business development, M&A, or board governance often stems from a philosophical belief on the part of boards and executives:

The ability to effectively manage crises is a core competence essential to lasting value creation.

Exhibit 2: Response to Pressures: Risk-Intelligent, Dynamic Organizations



Source: L.M. Tilman & Co.

The more complex and global a company, the more critical the crisis management roles of risk intelligence, organizational coordination, and ongoing communication become.

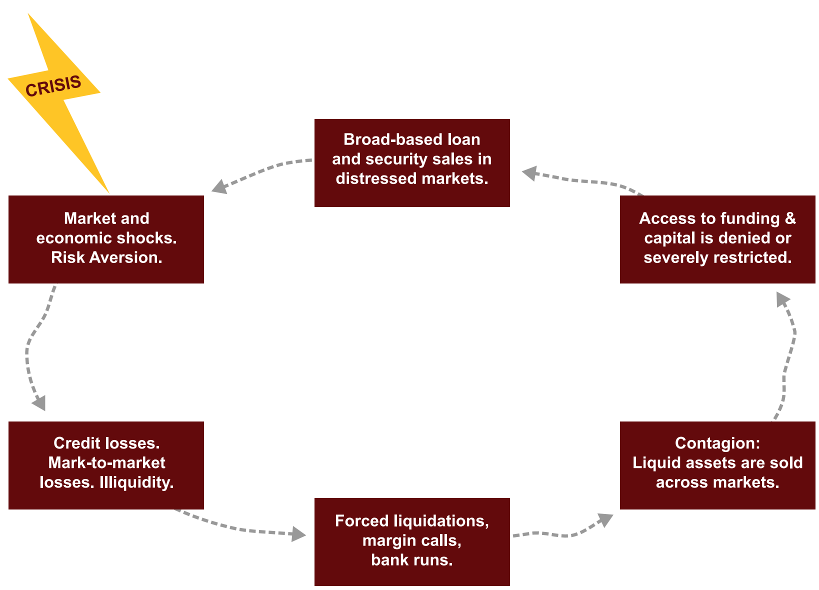
The financial industry provides an instructive case study in crisis management. In finance, it all starts with understanding the vicious circles of modern financial crises. These crises are typically sparked by catalysts with previously unknowable likelihoods, such as a government default (1998), fiscal imbalances (1997, 2011), or asset bubbles bursting (2000-2001, 2007-2009). Market and economic shocks follow, significantly increasing risk aversion. Borrower defaults result in credit losses, while market dislocations lead to significant unrealized losses on portfolios and balance sheets. Forced selling – spurred by margin calls and deleveraging – begins, piling up losses. Via contagion, losses and selling spill over into unrelated asset classes. Companies and investors are denied access to capital and funding for their operations, which hampers economic activity and causes further selling and losses. In the process, every imaginable type of risk – market, credit, counterparty, funding, liquidity, operational, reputational, etc. – comes into play (Exhibit 3).

Effectiveness of early warning systems lies with the right leadership and culture where open communication is encouraged and it becomes everyone's responsibility to be on alert.

Systemic financial crises reflect the very nature of the global financial and economic environment – a complex, adaptive, self-learning system that instantaneously transmits information and shocks. This system has many opaque links and feedback loops and operates without robust buffers or circuit breakers. Some have argued that it is constantly "teetering on the edge of chaos"[9] and that any attempt to suppress its natural functioning (be it via monetary policy, corporate bailouts, or political regimes) eventually results in even greater dislocations.[10]

Which brings us to Yogi Berra, who has famously observed – "It's tough to make predictions, especially about the future." This timeless insight – along with understanding of global systemic crises – suggests that instead of devoting resources to estimating likelihoods of various adverse events, investors and companies would be better off by fostering their **crisis detection capabilities**. As the first pillar of compressive crisis management, **early warning systems** – where predefined indicators and risks that are systematically monitored, managed, and governed – are most effective when they build upon the reconnaissance inherent in investment processes, enterprise risk management, as well as customer and strategic activities. Ultimately, however, the effectiveness of early warning systems lies with the right leadership and culture where open communication is encouraged, bearers of unwelcome news are rewarded, and it becomes everyone's responsibility to be on alert.

Exhibit 3: Vicious Cycles of Global Systemic Crises



Source: Financial Darwinism.

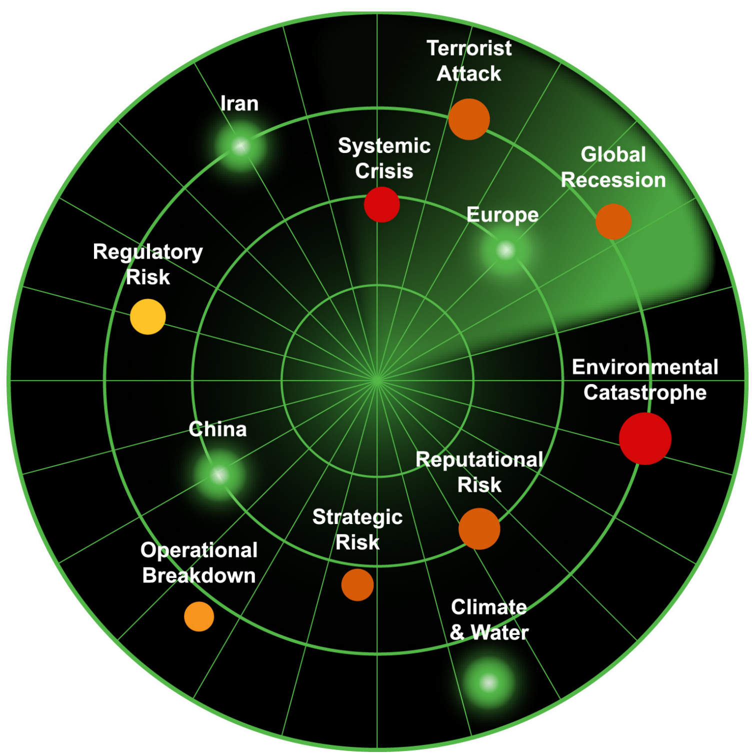
Once a threat (or, to that matter, an opportunity) is detected, organizations must be in a position to measure corresponding risk exposures and potential impact in real time. This is where **risk dashboards** – employing scenario analyses, stress tests, and other risk measures – become critical, forming the second pillar of effective crisis management. As a prerequisite to an organization's ability to measure the potential impact of upcoming crises, all relevant risks must be identified and measured in isolation (Exhibit 3). Moreover, the institution must possess an analytical and technological ability to "connect the dots" within a comprehensive framework, arriving at a holistic picture of risk that lends itself onto effective action.

Risk intelligence equips boards and leadership teams with new ways of seeing, out of which emerge new ways of thinking about strategy, communication, and organizational design.

The organizational ability to **effectively act** in the face of an internally and externally-driven breakdown constitutes the third pillar of crisis management. This ability is predicated on comprehensive contingency plans, where loss mitigation strategies, strategic and crisis communications, as well as roles and responsibilities are determined and rehearsed in advance. It is important that crisis management approaches be uniquely tailored to the institution's business model and organizational structure: a contingency plan for a centralized, top-down organization is very different from that of a siloed, decentralized company. Equally important, the institution must be equipped to use the entire arsenal of loss mitigation tools. As an example, financial firms that were successful and withstanding the 2007-2009 financial crisis, shrunk balance sheets, rebalanced assets and liabilities, put on derivatives hedges, bought insurance, and fortified capital structures as the crisis intensified. They also effectively employed strategic communications and public relations strategies alongside financial activities.

Crisis management is an opportunity to unify strategic vision, risk appetite, strategic planning, enterprise risk management, reputation and brand, communications, and organizational development (Exhibit 4). A wide range of potential risks, some quantified and others simply monitored (green), can be depicted and highlighted according to their likelihood (distance to center), negative financial impact (size), and organizational preparedness (color). This thirty thousand foot view forms the basis for productive dialogue and strategy setting. In this respect, three pillars of crisis management – early warning systems, risk dashboards, and the organizational ability to effectively act – apply to both financial and non-financial companies that face operational risks, environmental catastrophes, and geopolitical disruptions.

Exhibit 4: Risk Intelligence Radar: The Corporate Command Center



Source: L.M. Tilman & Co.

Every board of directors and executive team determined to position their organization for sustainable performance must be asking the following fundamental questions:

- **What is on our firm's radar screen?**
- **Which risks and events are identified and monitored?**
- **What contingency plans are in place?**
- **Are we positioned to endure crises and capitalize on the opportunities they present?**

Thriving, Dynamic Organizations – For the Greater Good

When firms holistically unite their most critical activities – executive decision-making, corporate governance, risk management, and strategic communications – they position themselves to effectively navigate the profound complexity and uncertainty confronting them. By embracing risk intelligence as an integral part of a firm-wide language and toolkit, financial institutions and investors not only become more dynamic and adaptive, they also achieve organizational alignment vital to creating lasting value.

Risk intelligence equips boards and leadership teams with **new ways of seeing**, out of which emerge new ways of thinking about strategy, communication, and organizational design. Alongside business strategy, investment management, and management science, risk intelligence empowers better decisions, viable business models, effective communication, and rigorous governance. Strategic vision becomes comprehensive, coherent, and clearly articulated. Business models, day-to-day decision-making, and communication become aligned. And from the cultural perspective, an environment of inspiration and energy emerges.

Risk intelligence is essential to the survival and success of financial institutions and investors in the changed world. The biggest opportunity, however, extends beyond growth, profitability, and stock prices. By making risk intelligence an integral part of corporate DNA, the financial industry can become a **part of the solution**: allocate resources to useful activities; finance small companies and entrepreneurial ventures; help consumers solve their financing, insurance, and retirement needs; and foster a smooth functioning of real economies and markets – all without posing danger to real economies. This, in turn, makes it ultimately relevant to what societies need the most: sustainable economic performance, new measures of success, and economic dynamism that drives growth, inclusion, and real prosperity.[11]

About the Author

Leo M. Tilman is President of L.M. Tilman & Co., a strategic advisory firm that serves financial institutions, corporations, governments, and investors worldwide. Through thought leadership and actionable solutions, LMTC helps clients create lasting value for the benefit of all stakeholders. Mr. Tilman, who previously held senior positions with leading financial firms, teaches finance at Columbia University and is the author of three books: *Financial Darwinism*, *Asset/Liability Management*, and *Risk Management*. He is a co-author, with Nobel economist Edmund Phelps, of a *Harvard Business Review* proposal to create the First National Bank of Innovation. Mr. Tilman has been profiled as a *Business Visionary* by Forbes and honored by the World Economic Forum.

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