To Whom Should the Risk Manager Report?

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New priorities in risk management after the crisis

Improve risk management

"… recognize the need for better coordination between risk functions and other areas of the business."

Elevate risk manager's role

"The issue for the risk officer is to be as independent as possible and not to be a line function within a business unit that has commercial pressures on that role."

However, these may constitute conflicting goals in organizational design of the risk function

Source: KPMG (2009), "Insurance – Getting the Balance Right", p. 7 and p. 25.

To whom should the risk manager report?

Risk manager reports to ...	**Principal** (e.g., Board, Group)	**Business manager** (e.g., CEO, CFO, BU CEO)
Benefits	Independence of risk manager without pressure from business	Coordination fosters communication and improves decisions-making
Drawbacks	Informational barriers may lead to rejection of value-creating projects	Risk manager may rubber stamp value-destroying projects

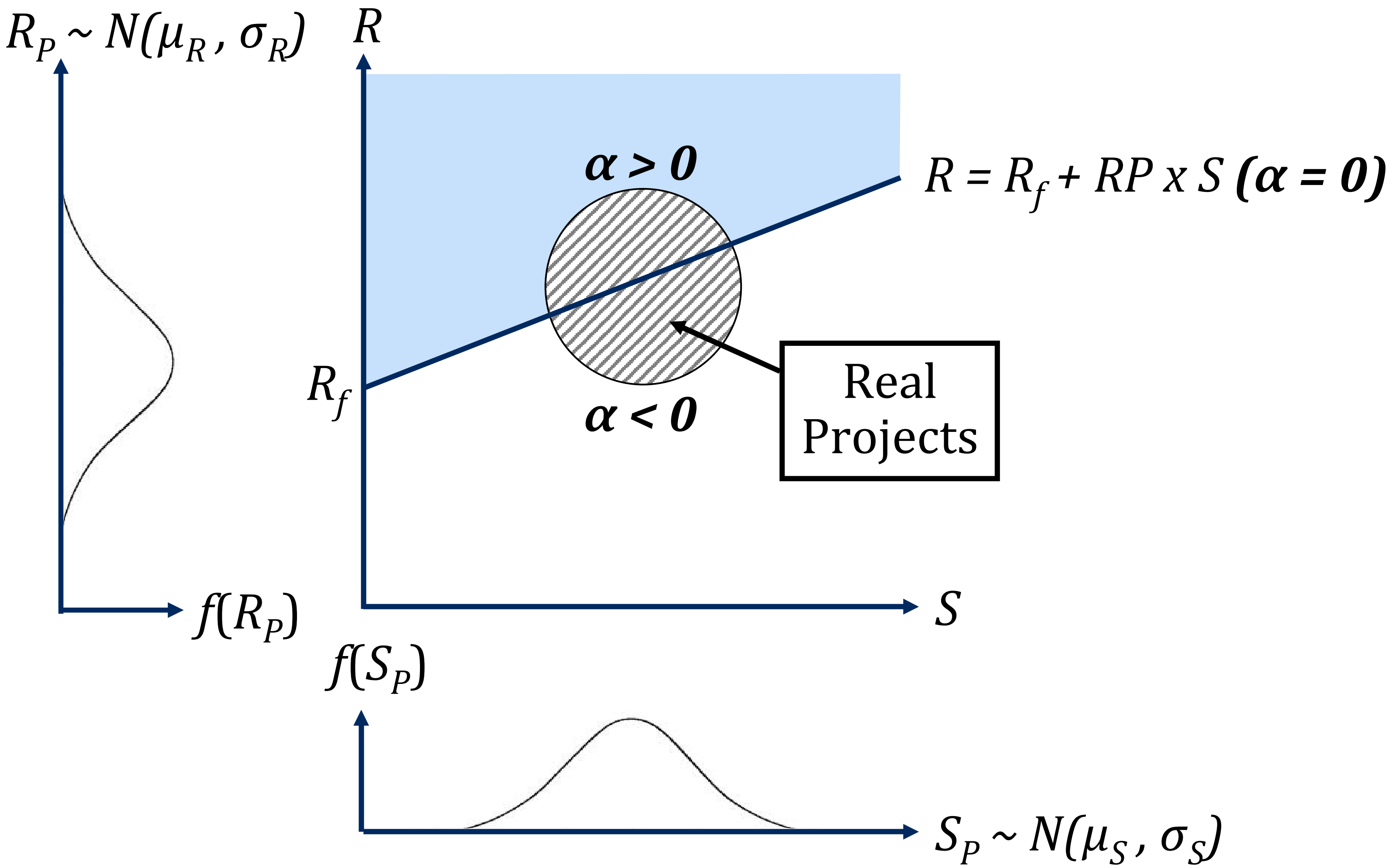
? **How to embed risk management in a firm's hierarchy if the cost of coordination is loss of its independence?**

Literature review

	Risk management	Information economics
Benefits of coordination	Mehr and Forbes (1973)	Aghion and Tirole (1997)
	Froot and Stein (1998)	Bolton and Farell (1990)
	Boyer et al. (2005)	Desseins (2002)
(Agency) costs of risk mgmt.	Tufano (1998)	Harris and Raviv (2006)
	Fatemi and Luft (2002)	Melumad et al. (1992)
	Roy (2008)	Villadsen (1995)
	Bloos (2009)	Alonso et al. (2008)

!!! We analysing the trade-off between the benefits and costs of co-ordination between the risk and the business function

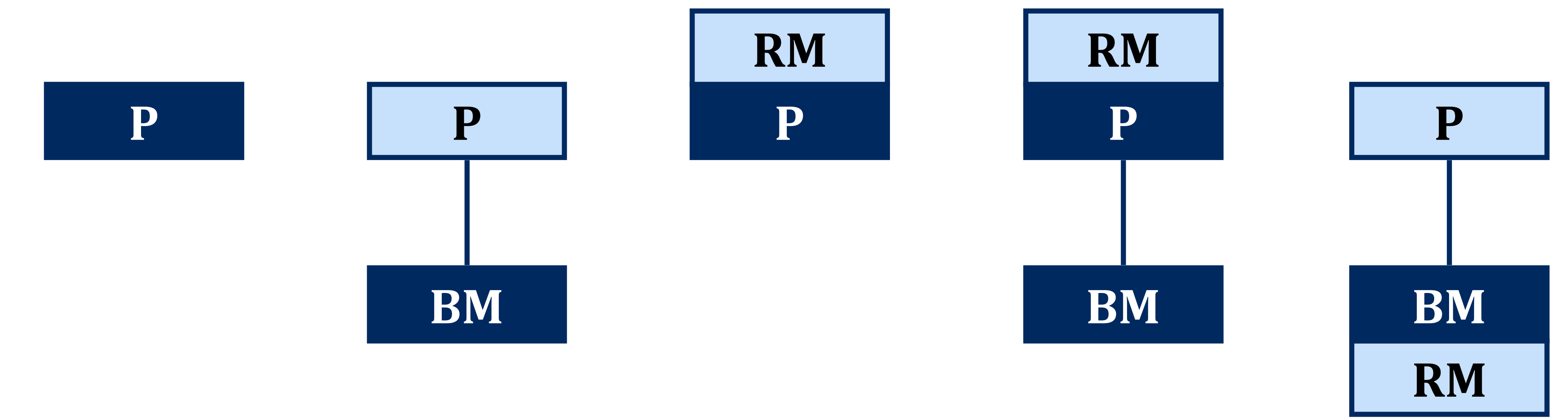
Environment is comprised of the CAPM principles



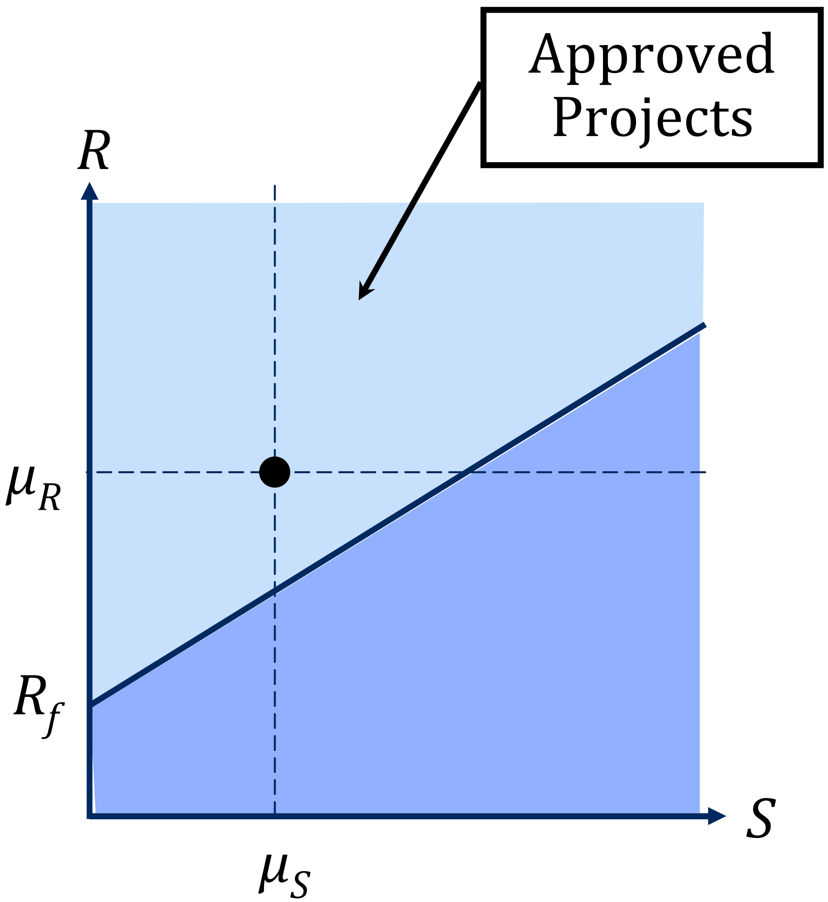
Investment decision setup choices of the principal

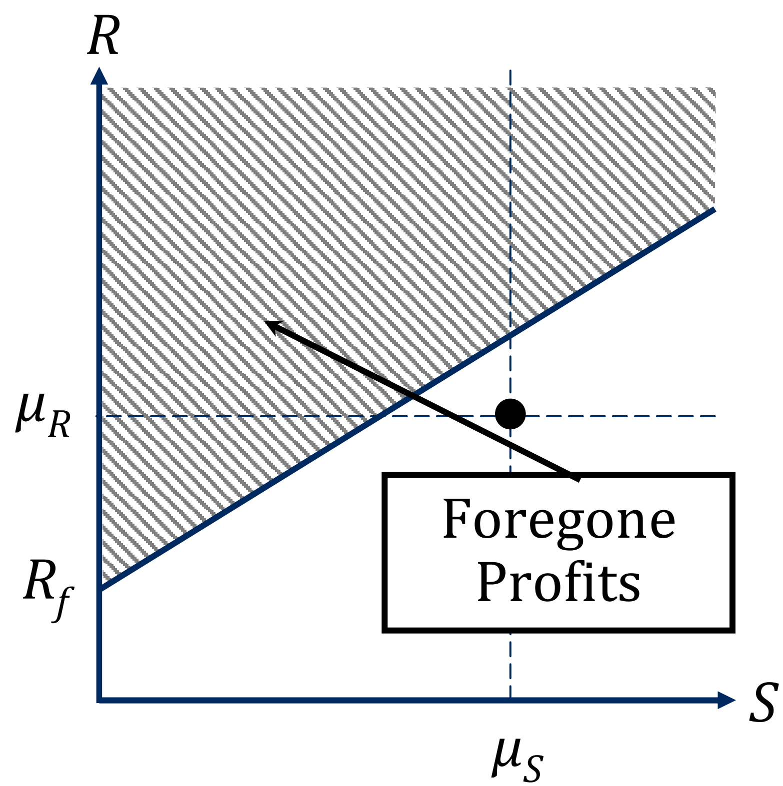
Party with decision-making power

1	2	3	4	5
Uninformed Decision	**Return-Based Decision**	**Risk-Based Decision**	**Independent Decision**	**Coordinated Decision**

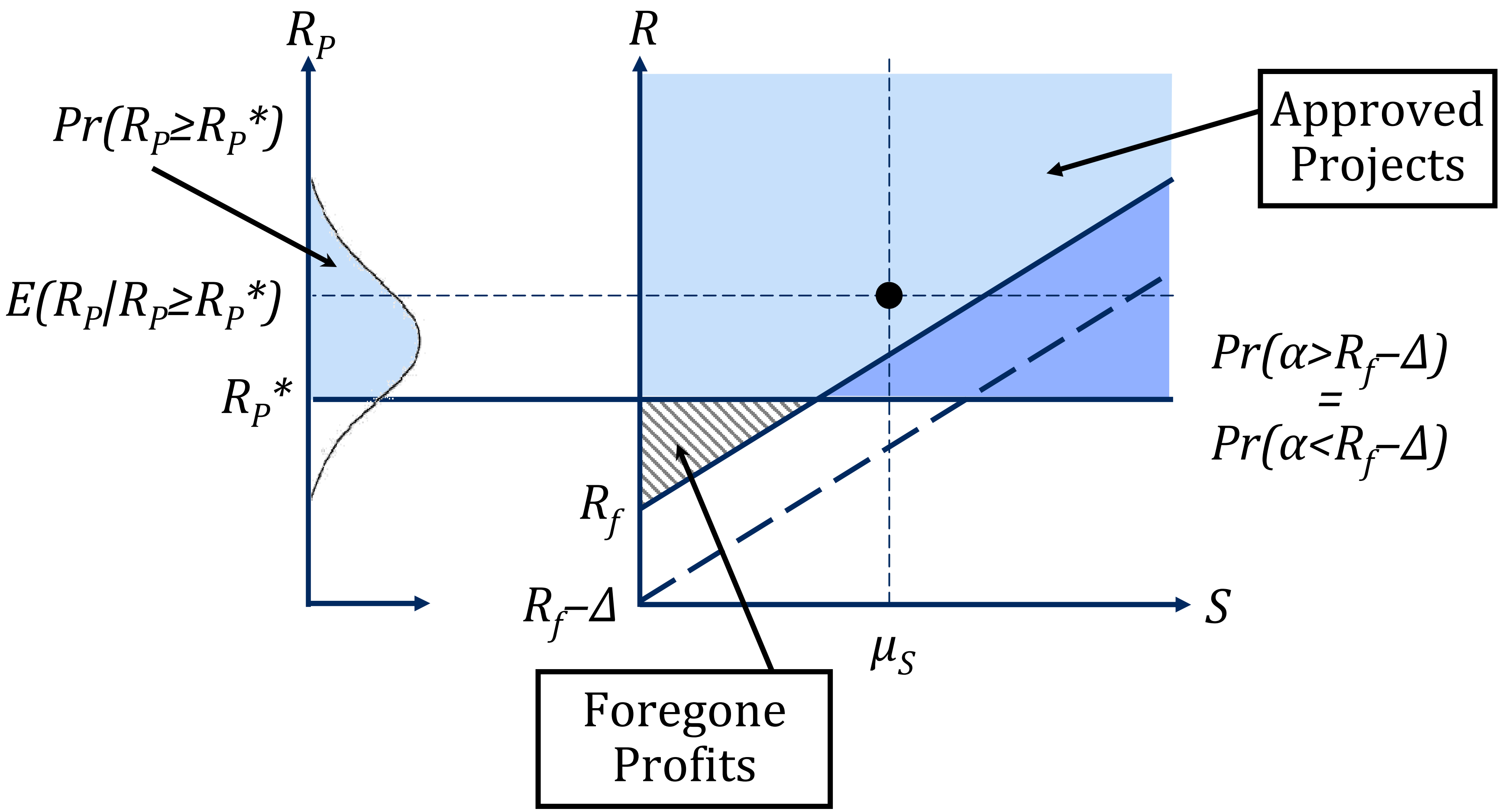


1 Principal takes an uninformed decision

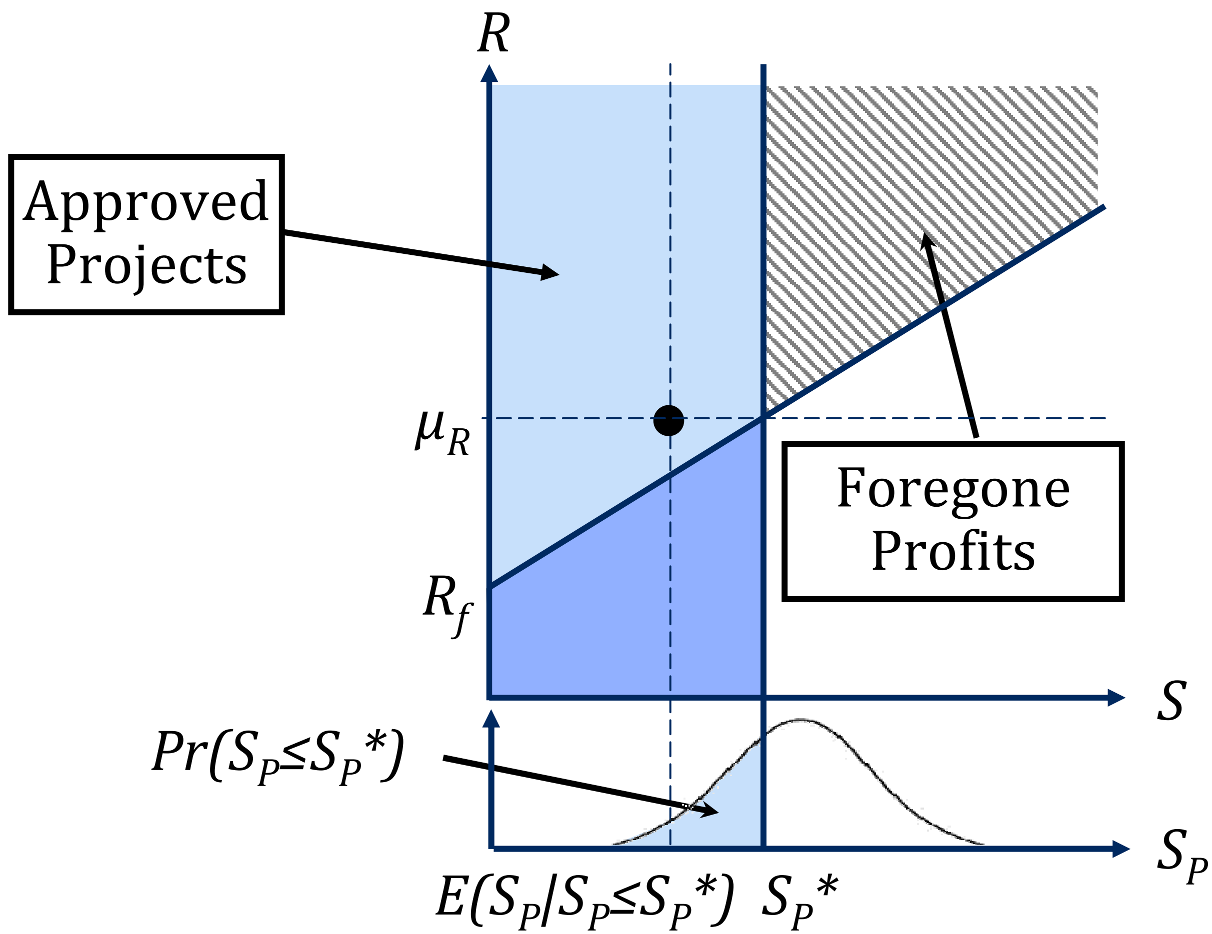




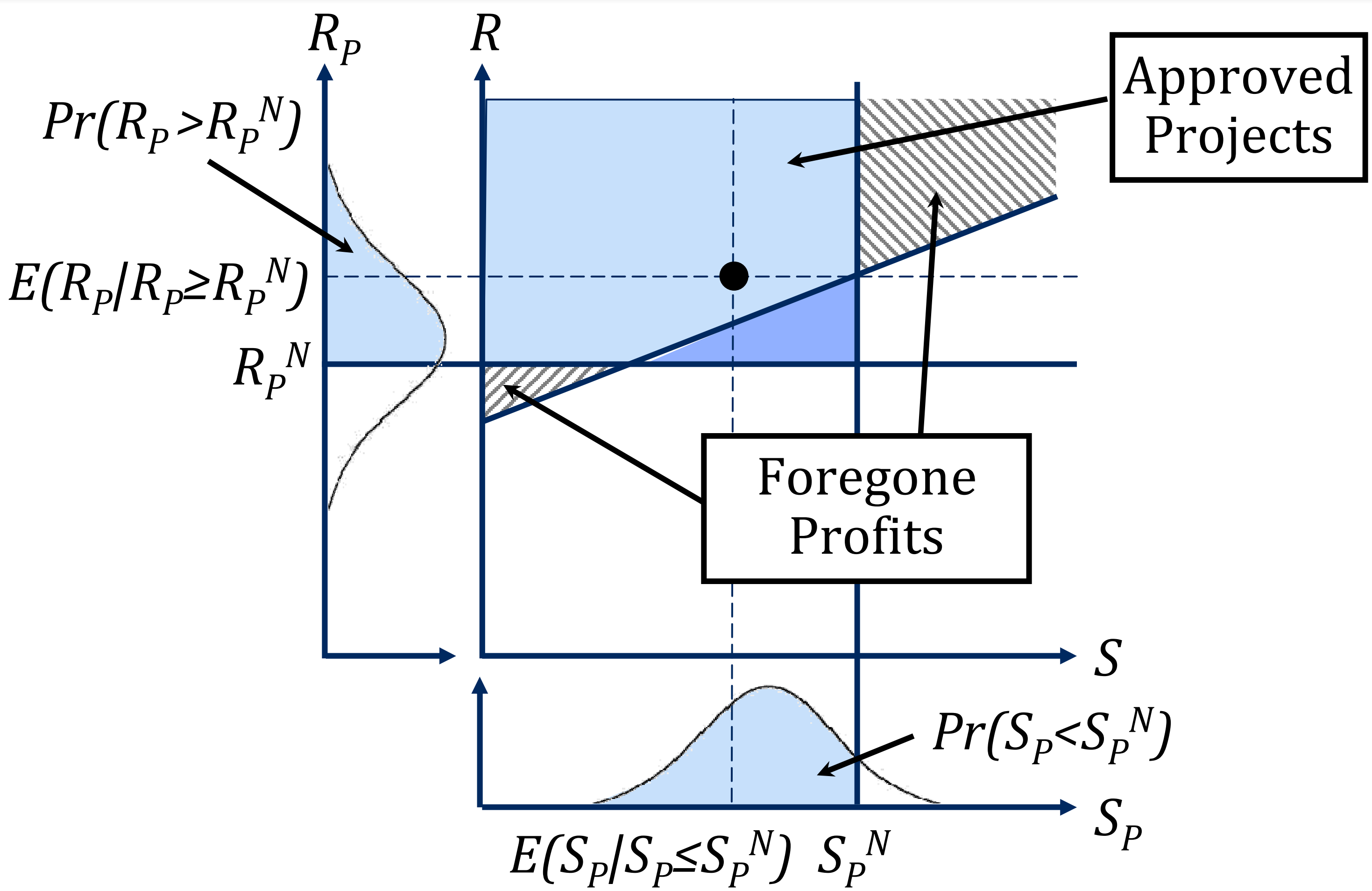
2 Business manager takes a return-based decision



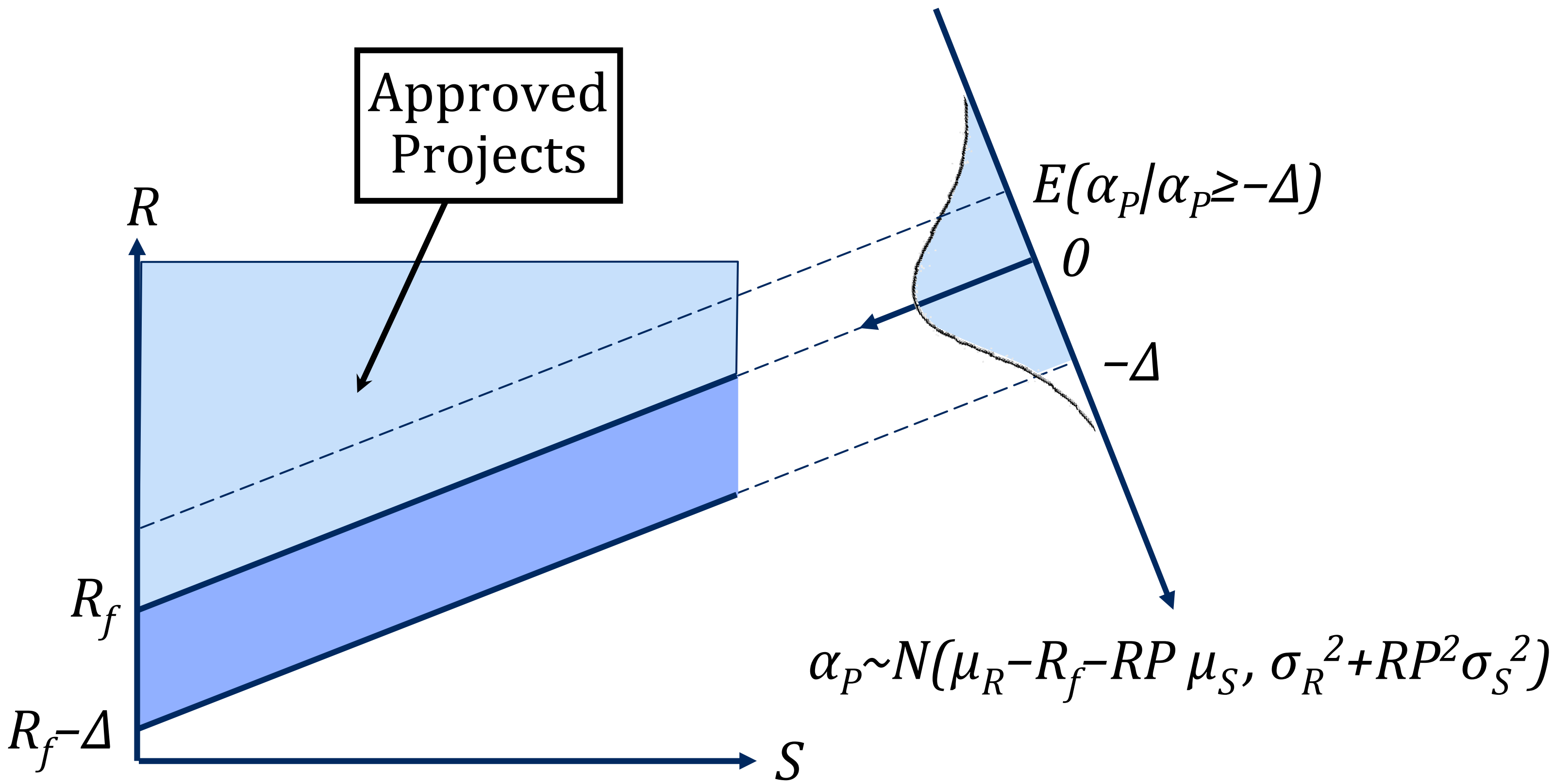
3 Principal takes a risk-based decision



4 Nash equilibrium of independent decision-making



5 Business manager takes coordinated decision



First findings

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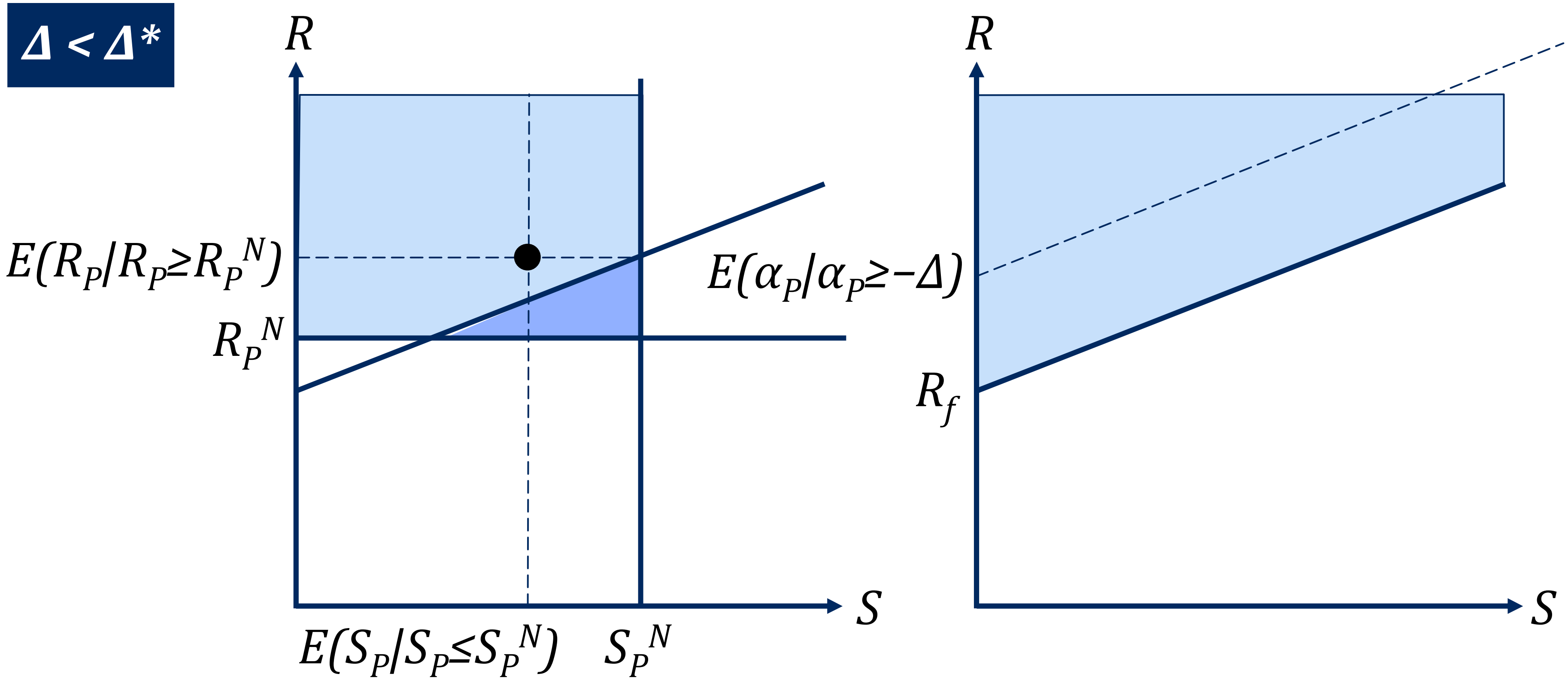
- Value of private information is largest when the principal is most uncertain about whether to implement projects
- Ambiguity as to the project's return and risk increases the value of the business and the risk manager respectively
- If the cost of hiring a business manager and a risk manager is sufficiently low, ambiguity about the project's return and risk is sufficiently high, and the principal is very uncertain about the expected excess returns the independent decision or the coordinated decision will always dominate other investment decision setups

Delegate if you have trust

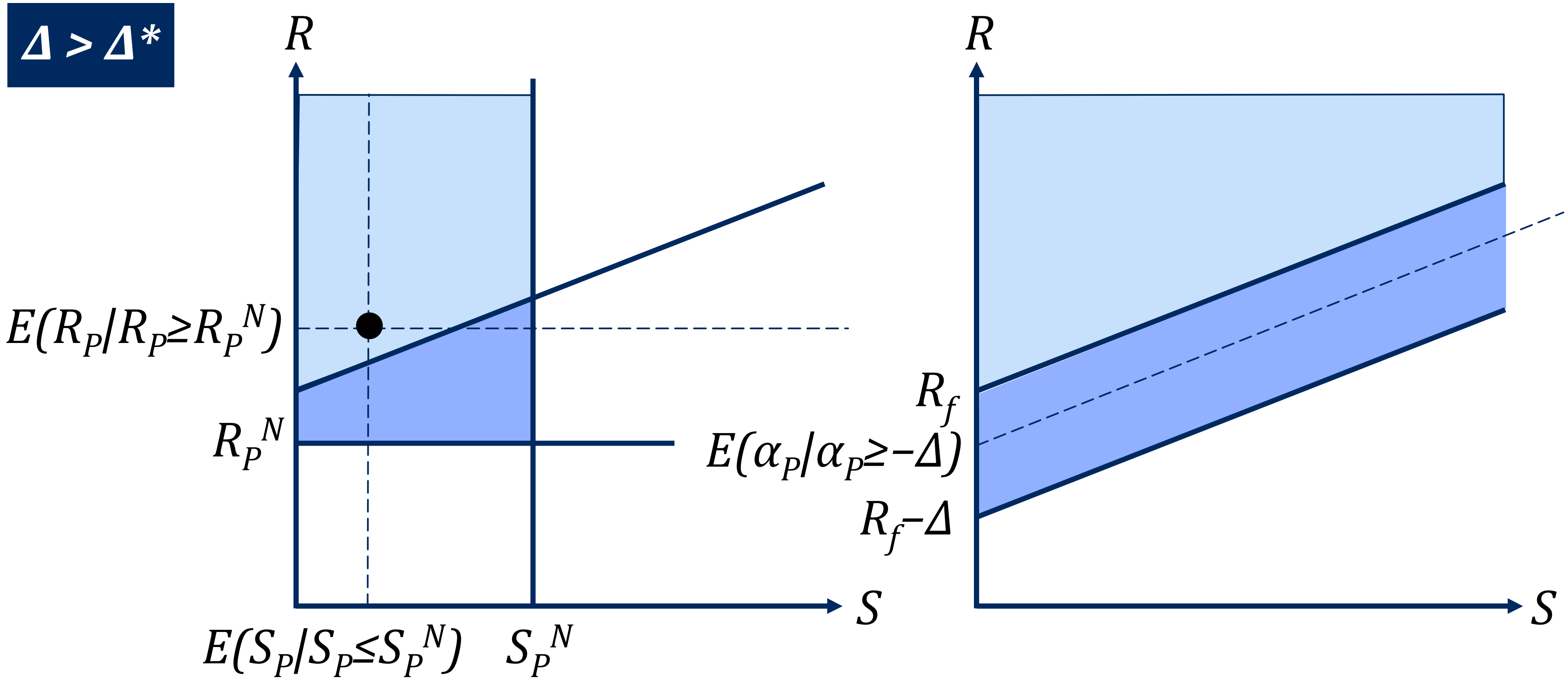
$\Delta < \Delta^*$



!!! If the business manager has a low bias the organization benefits from coordinated decision-making

Don’t delegate if you can’t trust

$\Delta > \Delta^*$



!!! However, there exists a positive Δ^* for which the principal implements independent decision-making

Conclusion

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- Delegate if you can trust the business manager or proper incentive contracts and governance mechanism exist
- Align the incentives of the business manager and the risk manager in order to foster communication
- Monitoring of the business activities is more effective if the informational disadvantage of the risk manager is low
- Industries in more competitive, saturated or declining markets have greater need for independent decision-making
- Emphasize and establish a risk culture in order to improve sharing of risk and return information without giving up the independence of the risk management