Risk Management and Monty Python

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Thank you, Mr. Chairman, and my thanks to the Institute of Risk Management and all its members for asking me to share with you some thoughts about our discipline. They will be deliberately irreverent and masked with a bit of humor. I do want to emphasize that these are my views alone: they are not the views of IRM, its leadership or its members.

My comments are irreverent for several reasons. First, this has been a calamitous year. We've been shocked by four disasters, three natural—the Indonesian tsunami and Hurricanes Katrina and Rita—plus one thoroughly unnatural, the London bombings. Each of them remind us of the importance of trying to anticipate in some intelligent way the probable likelihood and possible consequences of unexpected events and of being prepared for the necessary short and long-term responses. In all these cases we were sadly unprepared. Too often we anticipate only those events that appear in databanks, not the outliers that appear to be remote contingencies. Yet these outliers are the most disruptive to our lives. Our apparent inability to prepare people for these events and the difficulty of restoring balance afterwards provokes some anger plus numerous irreverent thoughts.

Second, my comments are irreverent because I am descended from two generations of preachers. My grandfather, the oldest of eleven children, became an Episcopal (Anglican) minister, serving in parishes in Virginia, Maine, North Dakota, Maryland and North Carolina. My father, also an Episcopal minister with parishes in New York, Philadelphia and Washington, was ordained in St. Paul's Cathedral here in London while

studying tropical medicine preparatory to serving as a missionary in Liberia for three years. With all that reverend and multinational background I claim a right to express some occasional irreverence, especially to this audience in London.

I also plan to add some humor to my observations as I've found that a direct frontal attack full of righteous indignation only rouses an equally self-righteous counterattack. If I add just a few notes of disarming humor, others may be seduced to remember and consider my ideas. So, combining humor and my ecclesiastical background, this morning I plan to use as my lesson plan the Gospel According to Monty Python.

I have three serious concerns about our evolving and continuously intriguing discipline of risk management. My first is the proper focus of risk management. I maintain the primary goal *must* be that of building and maintaining *trust*, the confidence that various stakeholders have in any organization, be it governmental, nonprofit or corporate. We spend far too much time and energy thinking about costs, or profits, or shareholders, and thereby dilute our effectiveness even as we satisfy the number crunchers. Trust is in especially short supply in the area of financial services in which blatant and continued conflicts of interest have eroded the very condition that is essential to this marketplace. I intend to focus on these conflicts this morning not only because our trust in each other is minimal but also because the view of those outside financial services is even more jaundiced. Their perception is the reality with which we must deal.

My second concern is the growing fragmentation of risk management, as different practitioners define their narrow interests to the exclusion of others. Interdisciplinary dialogue and cooperation are critical to our future but few try to bridge the growing chasms that separate credit, market, operational, actuarial, audit, safety, insurance and public policy advocates. We are retreating to the very silos of selfishness that enterprise risk management is trying to undermine.

My third and final concern is that we continue to view risk itself too narrowly, focusing only on the downside consequences of unexpected events. In so doing we create a new and malicious form of risk aversion that will, in time, cripple innovation and creativity.

What, then, can the Gospel of Monty Python tell us about these issues? A great deal, I find.
Most of you, I trust, remember the lesson in these scriptures about the dead parrot. In it a customer played by John Cleese enters a pet shop holding a dead parrot in a cage, complaining that the bird, purchased only a half-hour earlier, is dead. The shop owner, played by Michael Palin, suggests that the creature is simply "resting," or "stunned," or "pining for the fjords", as it is, of course, a Norwegian bird. Cleese responds that the only reason that it is upright on its perch is because it was nailed there.

Let's reconsider this lesson in light of the recent disclosures of the Attorney General of the State of New York, Eliot Spitzer. Mr. Spitzer now plays the role of the angry buyer and Insurance Head One, plays the shop owner. Spitzer holds not a parrot but the business model of the insurance industry, the model that is riddled with inappropriate payments, conflicts of interest, bid rigging and other devious machinations. Huddled in the background, peeking around a door leading to the backroom are the heads of many major insurance firms, all with worried faces.

Spitzer: Look my lad, I've had just about enough of this. That business model is definitely deceased. When I bought it a while ago, you assured me that its lack of movement was due to the fact that it's been in use for more than fifty years.

Insurance head one: It's probably pining for the good old days.

Spitzer: Pining for the good old days, what kind of talk is that? Why did it fall flat on its back the minute that I looked at it?

Insurance head one: The insurance business model prefers quiet, no attention, and above all no questions from either customers or regulators.

Spitzer: The only reason that this business model is sitting on its perch is that you brokers and insurers nailed it there and hid the hammer from your customers.

Insurance head one: But the customers haven't complained in fifty years.

Spitzer: That's because you co-opted them. This business model has passed on. It is no more. It has ceased to be. It's expired and gone to meet its maker. This is a late business model. It's a stiff. Bereft of life, it rests in peace. It you hadn't nailed it up, it would be pushing up the daisies. It's rung down the curtain and joined the choir invisible. This is an ex-business model.

Insurance head one: Well, I'd better replace it then.

Insurance head two: Here's our brand new business model, with no contingent commissions, at least for a few of us, but we will still accept fees from insurance companies to compensate us for all the work we do for them, and reinsurance commissions, and interest income of fiduciary funds. This new model is called a slug.

Spitzer leaves in exasperation to run for governor.

That's what we face this October in London: a refurbished business model hurriedly put together by the brokers and insurers, one that is in reality no change at all. It is a slug!

Individual brokers are going to jail for bid rigging, but the larger firms avoid retribution by firing some staff, paying pay enormous fines, now over $1 billion, and avoiding any admission of guilt. They dump a few CEOs for effect. But no one acknowledges that the system is broken; no one is honest enough to say that it's time for a new model. Everyone, including I am sad to say, the majority of their customers, tries to paper over the adverse publicity and return to a semblance of the old system. The buyers' associations are equally complicit. Witness what the executive director of the Risk & Insurance Management Society said last year:

"Our members appreciate what the broker is doing. They don't care where the payments are coming from so long as they are disclosed." That's like saying, "I don't care how you rip me off; just tell me how you are doing it!" What else can RIMS say when more than half of its operating income is derived from the payments and contributions from the

many vendors, brokers being foremost, at its annual trade show. AIRMIC is hardly blameless: undeterred by all this adverse publicity, it proudly announced this spring a £400,000 "partnership agreement" with three brokers and seven insurers, most of which are involved in the Attorney General's complaints, to support "new research and services." These are the same organizations that have been steadily bilking AIRMIC's members.

At some point we have to draw the line on these sponsorships and relationships. Yet so long as the customers don't complain, how can we expect these organizations to help eliminate the conflicts and habits developed over so many years?

The problem of conflict of interest is "running rampant" in financial services (words from *The Economist*). Accounting firms sell patently illegal tax shelters. Mutual funds permit late trading by favored stockbrokers. Pension consultants take payments from the investment firms they recommend. Stockbrokers slant their research in favor of their large investment clients. A hedge fund pays a commission to a so-called "independent" advisory firm. And, of course, insurance brokers profess to serve their clients and yet take all manner of behind-the-scene contingent commissions, gratuities, reinsurance commissions, fees for "services" to insurers, interest income on fiduciary funds, and low-interest loans, plus owning or holding substantial interests in insurers and reinsurers. And all of this is in addition to the up-front commissions from these same insurers, payments that are and have been for more than 50 years a blatant compromise of their required integrity to customers. We've corrupted a system that mandates trust between client and advisor and "utmost good faith" between buyer and insurer! David Shirreff commented on this development in his book, *Dealing With Financial Risk* (*The Economist*/Profile Books, Ltd., London 2004): "The standards that crept in during the 1990s condoned rapacity on behalf of bankers and their institutions and rewarded it, whereas scruples about the client's best interests were seen as squeamish and weak."

It's time to stop being squeamish and weak!

I have no objection to any or all of these payments from insurers so long as the insurance intermediary correctly and honestly states that it is an "agent" of the insurer, a

sales representative, and a hawker of coverage, not an objective representative of the client. Then the buyer can properly beware sales pitches and twists. But to swallow the idea that these multiple payments do not, in fact, alter the objectivity of the placing broker is to accept the idea that the dead parrot is actually alive and well. They lead inevitably to corrupt behavior on the part of some brokers. In a recent paper entitled "The Economics of Insurance Intermediaries," David Cummins and Neil Doherty of the Wharton School at the University of Pennsylvania, conclude that contingency commissions may actually help all parties to the insurance transaction. But they also suggest that the "role of the intermediary should be aligned with that of the insurer." If that is true, the there is no such thing as a broker, only an agent. I grant that insurers always will have a problem with "adverse selection," one that the proximity of the broker to the customer can help alleviate, but reformatting the underwriting process to permit a much closer connection between underwriter and buyer will help the situation far more than outrageous incentive compensation to brokers. Note that the American Insurance Association actually commissioned the Cummins-Doherty paper, something that calls into question its objectivity, and that the magazine of the US insurance sales community, *Leading Edge,* promptly jumped on it as a justification for *all* contingent commissions! If contingent commissions can be misused, and they are by some, then how and when can a buyer trust a broker? Continuation is unacceptable and disclosure is a sham.

The problem isn't that the *buyers* don't know what is going on. That's the sad part of our story. They know but they don't seem to care. They are complicit in supporting this system of conflicts by not raising the hue and cry for change. They've sat on their hands and wallets, stuffed with the goodies handed out by brokers (theatre tickets, vacations, fancy dinners, lavish hospitality suites at annual conventions) and said not a word. Many of us on the periphery of the business have complained vociferously over the years: I registered my first complaint in 1971 and repeated it almost every year thereafter, but the force of cash and convention overwhelmed our few voices from the wilderness.

What is the solution? RIMS and several other organizations argue for simple disclosure, as if we are naïve enough to believe that any brokerage firm will willingly set forth on paper all the possible perks received from insurers. Even with full disclosure, the temptation remains to steer business to the insurer with the fattest perks. A more radical

change is necessary, one that AIRMIC and its members support. I argue that we must substitute client fees for *all* commissions, so that fees are the *sole* source of income to a broker. This is the first and mandatory step in creating a new business model. A broker should agree with its client that it will accept no income whatsoever other than directly negotiated fees from the client. Having said that, I acknowledge that there still will be brokers who will try and take payments behind the scenes: a fee system is not the ultimate panacea, but it is, I believe, the critical first step. As Ronald Reagan famously said, "Trust but verify." AIRMIC, in contrast to its counterpart in the United States, has shown leadership on this issue. Now let's see who follows. All of us, brokers, insurers, buyers, regulators, and commentators alike, have too long tolerated a system that creaks with conflicts, anachronisms, and inefficiencies. Much of this may not have been "illegal" in the strict sense of the law, but isn't it time we cleaned up the act? Change is the prevailing movement today in other financial services, as we change the way we work with stockbrokers, mutual funds, pension advisers, and accountants. It's time to dump the dead parrot of the insurance industry along with the slug proposed as its successor.

I've dwelt on this subject as an illustration of what I believe to be the proper goal of our discipline: re-creating a sense of trust and confidence in the working relationships with not only financial advisors but also all stakeholders. It's not just a problem of a safety or environmental record, premium costs, governmental expenditures or net profits, it is one of *trust*, as increased confidence in any organization enables it to present its perspectives and ideas to stakeholders with a greater potential for acceptance and understanding.

Now to my second concern. To illustrate it, I draw from another part of the Gospel According to Monty Python, the story about the Bruces. You remember it, I'm sure. The philosophy faculty of an Australian university gathers for a meeting. In spite of an enormous range of intellectual interests, from Socratic and Aristotelian to the theories of Kant, Hobbes and Hegel, these professors all share the same name, Bruce. Here's a modified and updated version of that discussion, in which the heads of the major global risk management associations play the Bruces:

First Bruce: G'day mates!

Other Bruces: *(in unison)* Bon jour, ohayo, 'morning, guten tag, buenos dias!

Second Bruce: I'm glad to see we have some sheilas here today. (*He motions to the leaders of the Risk & Insurance Management Society, the Institute of Internal Auditors and the International Federation of Risk and Insurance Management Associations.)*

Third Bruce: Do we see any differences among strategic, enterprise, integrated, holistic, qualitative or quantitative risk management?

All Bruces: No, they're all Bruce to me!

Fourth Bruce: What about the SRA, IRM, RIMS, IFRIMA, IIA, SOA, CAS, RMA, IOSH, GARP and PRMIA?

All Bruces: They're all Bruce to me!

Fifth Bruce: What about all these standards from New Zealand, Australia, Japan, UK, Canada, Norway, and COSO, and the Dey, Cadbury, and Hemphill committees?

All Bruces: They're all Bruce to me!

First Bruce: Right, as we're all in agreement, crack tubes! (*sounds of cans of Foster's beer being opened simultaneously)*

Would that this serendipitous scene is reality! Unfortunately today I see a growing failure of interdisciplinary discourse. In the words of John Adams and Michael Thompson, from a 2002 paper, this discourse ranges from "an unresponsive monologue" to a "shouting match amongst the totally deaf." Most members of the alphabet soup of associations I cited don't even know that the others exist. Over the past three years, when attending the annual meetings of these associations, I've often asked how many can even identify the other organizations. In every case the response is less than 10%! How is it that so many advocates of risk management are so ignorant of their fellow practitioners?

We must expand our knowledge of others who speak risk management. The oldest groups, including the Casualty Actuarial Society and the Risk Management Association (formerly Robert Morris Associates), go back to the early 1900s. The largest is the Institute of Internal Auditors, with 107,000 members worldwide, dwarfing both GARP and PRMIA, which claim over 20,000 members each. And if you don't think that the internal auditors are a risk management group, just take the time to study many of the risk management materials it has published. They are among the best and clearest to date. Age and size, of course, are not as important as influence, and here the Society of Risk Analysis, the smallest, probably exerts the greatest effect on governmental and public policies. That the topics of cost-benefit analyses, coupled with sophisticated risk assessments, rank high in governmental work in the United States is directly attributable to an ex-President of the Society for Risk Analysis serving in the Department of Management and Budget.

What should we do? The first step is to acknowledge that each of these organizations plays an important role in the development of the discipline of risk management. Next, each organization should create an *ad hoc* liaison committee to stimulate contact and cooperation with other groups. Our own IRM leads in this effort, along with the IIA, in trying to bring these organizations closer together. Third, why not reach out to our fellow groups by having plenary interdisciplinary sessions at our regular annual conferences? The SOA, CAS, and PRMIA, did just that last spring in Chicago, and RIMS is planning a similar interdisciplinary panel in Hawaii in 2006. Fourth, we students of risk management should subscribe to and read the publications of these other sub-disciplines. Nothing is better to help stimulate the ferment of new ideas. And fifth, we should invite our fellow students to attend our local meetings. As the Gospel says, we're all Bruces!

My third and final concern is our view of the nature of risk itself and the growing propensity for those involved with risk analysis and risk management to look only on the dark side of future events. It's a rather gloomy view from where I stand.

The financial risk managers, the quants and their allies, are so encumbered with the dictates of Basel 1 and 2 that their models for credit, market and operational risks are

focused only on possible losses and the effect of these losses on regulatory capital requirements. As Avinash Persaud pointed out in his lectures here in London a year ago, the growing bank aversion to risk may create a horde of lemmings, following each other instinctively for fear of being out of step with the herd, and, perversely, actually increase systemic risk even as they reduce individual downside risk for each financial institution. The internal auditors have now spent over a decade helping to create the mandates of COSO, whose recent paper on enterprise risk management is a perfect example of Babelian jargon, a work lacking clarity, cohesion and cogency. Their entire approach is to create new controls to prevent losses.

The safety engineers think only of reducing lost-time frequency and severity and justifying their importance within organizations. Similarly the security specialists want to protect both tangible and intangible property, such as information, from the depredations of hackers, thieves and an entire outside world bent on stealing us blind. The public policy gurus see nothing but disaster looming on the horizon: tsunamis, floods, hurricanes and typhoons, and even asteroids, bio-terrorism, global warming and strangelets, one of which could run rampant and reduce the earth to a diameter of less than one hundred meters. The uniform response to all these fears is that remarkable golden rule of all the Luddites before them, do nothing for fear of some adverse outcome. This is known as the "Precautionary Principle," an idea that freezes creativity and innovation. Finally, of course, the insurance world sees risk only as a negative outcome. It sits on its hands as the world economy expands, providing less and less coverage for
the growing costs of unexpected events. Its role as a financer of risk, like the grin of the Cheshire Cat, seems to be diminishing annually into the haze, until it finally disappears altogether.

Benjamin Hunt's *The Timid Corporation,* published in 2003, chronicles the effects of public policy, regulation, litigation, and human fears and, yes, even the tools of risk management, all of which force corporations into a "defensive mode." They dumb down innovation and avoid taking chances, in their obsession with preserving "shareholder value." They react too fearfully to the warnings of outsiders such as single-issue NGOs and create the fiasco of the Brent Spar decision of Royal/Dutch Shell. So we drift into

tacit adoption of the precautionary principle, fearful of any change. The Rector of my boarding school issued a similar warning over a decade ago. He argued that a leader who is too risk averse sends throughout an organization messages that affect every level of decision-making, making them miss opportunities. He concluded: we must avoid becoming creatures "afraid to risk what they have achieved for what they might achieve."

This mounting aversion to risk suggests, in the words of your own Prime Minister, in a paper delivered to University College London on May 26 that "something is seriously awry." He went on, "We are in danger of having a wholly disproportionate attitude to the risks we should expect to run as a normal part of life." His attack on this growing "compensation culture" is warranted, especially as we in the United States have brought it to a high level of idiocy. Mr. Blair called for a "more sensible debate." I agree, and I believe this debate should start with an acknowledgement that risk itself, the measure of the probable likelihood and consequences of an unexpected event, includes both favorable and unfavorable outcomes. John Adams calls it correctly: "risk management is a balancing act involving uncertainty about rewards and costs." He explicitly includes "rewards." Richard Posner, in his magnificent analysis of potential disasters, *Catastrophe: Risk and Response* (Oxford University Press, Oxford 2005), comes to the same conclusion: "Risk aversion implies an asymmetrical attitude towards gains and losses." When we include only downside results in our definition of risk we inevitably slip towards risk aversion. The Prime Minister summed it up in May: "Government cannot eliminate all risk. A risk-averse scientific community is no scientific community at all. A risk-averse business culture is no business culture at all. A risk-averse public sector will stifle creativity and deny to many the opportunities to be creative while supplying a few with compensation payments. . . . Sometimes we have to accept (that) no-one is to blame."

The current series of *Financial Times* articles on "Mastering Risk" is a breath of fresh air. Eamonn Kelly and Steve Weber's opening piece on September 8 puts risk in proper focus. We must return, they argue, to the original concept, born of "European seafaring adventurism," one that contains a "powerful sense of opportunity and reward as well as downside and danger." Our organizations require an entirely new attitude in dealing with internal, market and external environments. "When advantage lies mostly in the

unknown and the uncertain, the ability to sense and learn faster, to correct mistakes and drop losing bets, to tolerate ambiguity and live with, even embrace, ambivalence, becomes absolutely essential." As the authors conclude: "Loss aversion is not a way to win. . . . re-embrace risk as a source of advantage."

The aftermath of hurricanes Katrina and Rita, in which so many poor families were uprooted, prompted the right risk management response from Carlos Eire, a professor at Yale University. He wrote to them (*The New York Times,* Sept. 25, 2005): "Embrace your rage. It is utterly justified. Nature dealt you a low blow, and your government made it worse. Your city deserved to have better levees, and in the richest nation in the world, you could have easily had them. Your leaders failed you at every turn, especially if you were among the poor. But embrace your survival, too, along with all those surprising acts of kindness and all of the unexpected opportunities that came your way because of the disaster. Never forget that gain and loss are twins conjoined at the heart." His is a reminder that opportunity is omnipresent with loss: it only depends on how you look at it. And so I turn again to the Gospel of Monty Python for more light on this problem, finding it in that immortal film, *The Life of Brian.* At its conclusion, as Brian hangs crucified in Palestine, he and his fellow victims are encouraged to look on the bright side of life!

As the song goes:

> Cheer up, Brian. You know what they say.
> Some things in life are bad.
> They can really make you mad.
> Other things just make you swear and curse.
> When you're chewing on life's gristle,
> Don't grumble. Give a whistle.
> And this'll help turn things out for the best.
> And always look on the bright side of life.
>
> If life seems jolly rotten,
> There's something you've forgotten,
> And that's to laugh and smile and dance and sing.

When you're feeling in the dumps,
Don't be silly chumps.
Just purse your lips and whistle. That's the thing.
And always look on the bright side of life.

And so I reach the end of this morning's homily, one that combines a bit of irreverenceand a touch of humor to remind us all of three critical ingredients of our discipline. I learned my method from my reverend antecedents. In any homily, first tell your congregation what you intend to say. Then say it. And, finally, remind them at the end what you just said. So here's my summation. First, always work to build and maintain trust. Beware the dead parrot and its successor, the slug. Second, we are all named Bruce in our quest to develop risk management. Speak and listen to all your compatriots in the related sub-disciplines. And, finally, risk embodies both good and bad outcomes. Avoid risk aversion and "always look on the bright side of life."

Thank you for listening to my sermon.

(revised October 5, 2005)