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Summary With all the attention for the credit crisis by government agencies and regulators, the risk management discipline appears to be keeping a low profile. And yet, the expectations for risk management are increasing. Time to set a few targets for risk managers.

Dear reader,
Four major developments spring to attention when we examine the initiatives that are being proposed to tackle today's downturn.

First of all, the G20 Economic Summit of November 15/16. This summit achieved as much as could be expected of a hastily assembled group with different objectives. Apart from the facile call to 'work together to combat the global economic crisis' they also called for a potentially far reaching initiative to create 'colleges of supervisors' for global banks. While this policy re-alignment and global programme is encouraging, it will take time to implement and can not be expected to influence a bank's day to day decisions.

Secondly, and on a more detailed level, the President's Working Group on Financial Markets on 14 November proposed measures to increase oversight in the CDS market by creating central counterparties, an initiative endorsed by ISDA. This initiative has wide support since it is expected to increase transparency and accountability without limiting the price discovery inherent in the CDS market. This will lead to less uncertainty, but not necessarily to lower exposures.

The assorted initiatives of national governments, ranging from barely disguised protectionism to outright nationalisation count as a third type of development. These initiatives depend on the economic strength of the nation and the intellectual strength of programme. Either of these can severely limit the effect. A case in point in the US TARP, which despite a whopping 700 billion USD funding has made an about turn even before being implemented. Turning the tide is beyond any nations' capability, and the national programmes are not likely to make a lasting dent in the world economy. Also, bank's and investor's decisions regarding risk may be adversely affected if bail outs remain on the cards. This is witnessed by the early scramble to become 'too big to fail', a coveted status for some.

The final notable development has been the near absence of the risk management community in the recent discussions. What is puzzling is that the sharp increase in risk aversion among banks and investors has not lead to a comparable increase in risk management. If anything, it seems that risk aversion has spilled over into risk *management* aversion. It is time for risk managers to come out of the closet and take a seat among the finance ministers, regulators, rating agencies and even hedge funds managers to help shape prudential banking practices.

Let's investigate what avenues risk managers can pursue by looking at a recent speech from the international regulator. On 17 November 2008, the chairman of the Basel Committee on Banking

Supervision[1] stated that "Supervisors are reviewing the need to supplement risk-based prudential and risk management approaches with simple, transparent gross measures of risk. In combination, such risk-based and gross measures may provide a further check on the build-up of leverage at financial institutions and the underestimation of risk during rapid periods of credit growth or in new business lines that have not experienced a downturn. Moreover, in periods of stress a large gap may open between what the risk-based metric requires, and what the market expects through simpler metrics. I hasten to add that simple metrics alone can and will be gamed […]. "

Five improvement programmes suggest themselves, which should occupy risk managers:

a. **Integrated Risk Management**. Many banks still organise their Risk Management in silo's, with little or no interaction between the various risks types. The lack of an integrated Risk Management function has unwittingly been reinforced by Basel II through the wholly artificial separation between risks covered under Pillar 1 and Pillar 2. A programme to make earnest steps in Integrated Risk Management is urgently needed. Note that IRM must be governed by a proper methodology. It should not degenerate into mere integrated reporting, such as the largely failed Enterprise Risk Management.

b. **Treatment of Assumptions**. The way assumptions are treated that underlie the risk models must be improved. Since all models necessarily rely on assumptions, it pays to have a methodology that examines these assumptions explicitly. One way would be to develop broad scenario analysis as a requirement for any modelling activities in addition to the customary stress tests.

c. **Re-evaluation of Risk.** In well run banks, the introduction of new processes and products is subject to extensive evaluations. Approvals following such evaluations should be subject to a time limit and a compulsory re-examination. In the re-evaluation, the treatment of the assumptions must be explicitly examined for applicability.

d. **The position of Risk Management**. The roles of the business and Risk Management have become blurred and need redefining. A strong Risks Management requires more than clear methods, knowledgeable staff and transparent reporting. It also requires a level of objectivity which is fundamentally beyond business owners. Over the past years, it has been a trend to accuse Risk Management of distancing itself from the business. This has lead to far too cosy relationships. Risk Management needs to redefine itself to add its independent perspective and thus safeguard the financial stability of the institution.

[1] Keynote address by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the High Level Meeting "The Role of Banking and Banking Supervision in Financial Stability", Beijing, 17 November 2008.
http://www.bis.org/review/r081117a.pdf

e. **Disclosure**. The Risk Management function should issue its own (annual) report outlining their methodologies, assumptions, scenarios in use and limits to the applicability of their models. This disclosure should take the form of an industry wide template to facilitate market transparency.

Some of these programmes may seem fanciful, e.g. the programme on Disclosure. However, risk managers have a duty to think of ways to improve their contribution to the firm. There seem to be plenty of avenues which risk management can pursue. Shareholders will start demanding them soon.