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Summary: The recent credit crunch and liquidity crises has not been the happiest time for risk managers. Accused of not preventing the downturn, risk managers may appear weak. In fact, the time to show our mettle is now, and risk managers have plenty to look forward to in 2009, not least an increase in influence if they play their cards right. This newsletter outlines what they should focus on.

Dear reader,
At the closing of the year, it is time to take stock and to look ahead. Many people will use this time to sit back and decide how they want to behave in the new year. They will ponder which habits to discard or amend and what activities they would like to take up. The Financial Times editorial of Dec 22 noted "Eighteen months of financial surprises have served to remind us of the risks of a seductive journey: from thinking about the future, which is essential; to forecasting the future, which is something of a parlour game; to believing that one has truly understood what the future holds, which is dangerous." This certainly rings true for risk management.

For financial institutions, it is safe to say that 2008 will be looked at as a legendary year. It is commonly believed that it will prove to be a watershed. Although attractive and spectacular, there is no need to rehash the annihilation of grand institution's and respected individual's reputations. They have been thoroughly thrashed and the stories are well known. Rather, let's sit back and look at the habits to discard or amend and the activities that could be taken up for risk managers.

Habits to lose or amend
The first observation must be that risk managers should consider what to discard. Three areas stand out: Ratings, VaR and the notion of the Unifying Risk Measurement.

The predictive capabilities of Risk Management techniques (especially ratings) have been shown to be less than satisfactory. Thus, a clear candidate for the scrap heap is the overreliance on ratings. There is only so much that can be learned from a rating, and excessive modelling does not make the basic information any better. Rather than taking the ratings at face value, more effort should be put in the evaluation of the uncertainty surrounding the ratings.

A second candidate is the belief in the usefulness of VaR, now much maligned. As a predictive instrument, it has long had a loud opposition[1], but it is now sometimes portrayed as the ultimate villain in the play. As with ratings, it is more the overreliance on the measure than the measure itself. If we accept the underlying assumptions (normality being the most extreme of these), it is still an interesting measure. But no more than that. With the decline in the status of VaR, the approach to ICAAP also needs close re-examination. Many had pinned their hopes on computing VaR-like measures for other risk types, such as Operational Risk. Since Market Risk and Credit Risk, that both can boast data quality Operational Risk managers can only dream about, have deeply flawed VaR results, this is not a fruitful area to pursue. It should be scrapped.

[1] Although Taleb's "The Black Swan" is most commonly referenced, Benoît Mandelbrot's "The (Mis)behavior of Markets" predates it and is intellectually more stimulating.

Another item to be amended heavily is the chase for the Unifying Risk Measurement. Sometimes disguised as ICAAP and sometimes captured in the idea of risk appetite, this is yet another manifestation of the notion that risk can be captured in a single numerical measure (as with VaR), which can be added, compared across time and businesses, diversified etcetera at will. Risk information that consists only of a number should not be taken seriously. A host of assumptions, circumstances, environmental peculiarities, time-related information and information about the data collection process need to be made explicit for the number to be useful. It is therefore extremely rare for risk numbers to be compatible across risk types, businesses, market conditions, product life cycles or the maturity of departments.

Activities to be taken up
The initiatives that are worthwhile pursuing with renewed vigour are all concerned with getting a better understanding of the risk environment. Two avenues should be explored: Causal Analysis and Scenario Analysis.

Both kinds of analysis allow for a broader range of information to be included in risk assessments than in the ‘hard wired models’. This also forces banks to step away from a one-dimensional notion of risk, which masks many of the real issues.

By focusing on causal analysis the attention of risk managers can shift to prevention. Although prevention is known to be better than a cure, preventative measures in general suffer from a great lack of appeal. Nobody ever got promoted for preventing a bad investment or a bad loan. In risk management as in real life, it is the fire fighters who get all the glamour. The cleaning up process is showered with funds, to obscene amounts with few questions asked. If a fraction of that money had been spent to do some scenario analysis and causal analysis of the risks involved, the savings could buy any European or American Bank.

Because causal analysis of risks coupled with scenario analysis of possible developments can prevent major losses or risk events from happening in the first place, it is a harder sell. But one that should be attempted more. Banks have been envious of the Spanish regulator’s restriction on certain products. As a result, some of the Spanish banks have fared much better than their peers. No model would have come up with these kinds of directives, but causal and scenario analysis can do so, and could have done so for many ailing and failing institutions.

Finally, if we want to understand, e.g. our credit risk exposure, we need to look into the causes of the credit losses we experienced and we must examine plausible scenario’s and their impact on our exposure. Just going by numbers will not be enough. The business environment is too complex to be captured in a number or a fixed formula The same is true for market risk, operational risk, and all the other risk types that have been invented to get a grip on the complexity of business. The explosion in risk types is itself testament to the hydra-like state of risk management.

With that in mind, it looks as if 2009 could be an interesting year.