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Summary: The idea that risk management in banks is an exact science is no longer fashionable. The risk community has failed in the eyes of many, and needs to come with a new approach to re-establish itself. Dealing with uncertainty should be a cornerstone in that approach. This newsletter explains why. Newsletter 11 will address how uncertainty can play a role.

Dear reader,

These are good times to be a regulator. Demand is up and funds are plentiful. Also, anybody who can lead the way out of the financial distress is guaranteed attention at cocktail parties. On the downside, expectations are also up and miracles are expected. On January 16, the Financial Times quoted the chairman of the US House financial services committee: "by the spring I believe we will have passed a bill which empowers a systemic risk regulator".

There have been many calls for the regulatory community to look beyond individual firms. Indeed the stated purpose of the BIS is to ensure the financial stability of the banking system, not to safeguard individual institutions. In that respect, the US initiative is not a new policy goal but rather a new approach to that goal. What is new is that entities that are now unregulated are to be included, such as hedge funds and private equity firms. Looking at the history of risk management and regulation, there are three major factors that should play a central role in this new approach to systemic risk: Governance, Reporting and Uncertainty

Governance

In banks, the management of risk has been increasingly fragmented rather than unified. Specialist silos of credit risk, market risk and operational risk units have been created, to name only the Basel pillar 1 risk types. Some institutions have a token "Enterprise Risk" programme, which typically consists of someone with a stapler, or, in more sophisticated versions, a mysterious black box that combines VaR numbers.

To set up an appropriate risk governance structure, it should be realised that risk is generated throughout the institutions. The first principle must therefore be that the business owns the risk. They are in the best (if not the only) position to manage it, prevent it from running out of control, monitor the status, check against expectations and most importantly take immediate action. They own the risk, are accountable and responsible for the correct implementation of methods and for the evaluation of results. At the same time, and part of the first principle, an independent risk management function must own the risk methodologies. The desire to integrate risk management units into the business is as rampant as the urge for accountants to develop advisory units. Both are fundamentally flawed and should be anathema in any regulation.

The first thing systemic risk regulation could do is to lay down the law on the acceptable governance structure for risk. Banks and others will protest vehemently, but the chances of actually influencing risk behaviour without a clear set of rules for roles and responsibilities are zero.

Reporting

The way risk is reported is likely to change as a result of a systemic risk regulation. The Basel II standards are a likely departing ground. The various approaches (basic, standardised and advanced) acknowledge that different levels of sophistication exist in firms, and seeks to exploit those in the interest of 'better numbers'. "Better for who", one could ask. With the realisation that risk models have not provided sufficient advance warning of actual risk, the least that could be done to get a grip on systemic risk is to enforce staggered reporting for all firms. This means that those firms who wish to report under IRB, must continue to report under the Standardised approach indefinitely. That way, both the effects of the various approaches can be gauged and industries, sectors, regions, etc can be compared more easily.

Uncertainty

One of the topics risk management has downplayed is that of uncertainty. A buffer for uncertainty (for systemic risk and bank specific risk) is mentioned in the Basel II text (my emphasis) in exactly one place:

> ***757.*** *Pillar 1 capital requirements will include a buffer for* ***uncertainties*** *surrounding the Pillar 1 regime that affect the banking population as a whole. Bank-specific uncertainties will be treated under Pillar 2. It is anticipated that such buffers under Pillar 1 will be set to provide reasonable assurance that a bank with good internal systems and controls, a well-diversified risk profile and a business profile well covered by the Pillar 1 regime, and which operates with capital equal to Pillar 1 requirements, will meet the minimum goals for soundness embodied in Pillar 1.*[1]

The existence of uncertainty in the risk approach must receive more attention than this in the treatment of systemic risk. The topic is much more complex in terms of environmental influences, feedback loops, data incompatibility, model differences between firms and inaccuracies in reporting, to name just a few of the fundamental problems. In these days, not many people need to be convinced that the certainties implied, suggested and used in the risk methodologies have tragically misfired. Risk is first of all about uncertainty, with cast iron models, predictions and known confidence intervals coming a very distant second.

A first step that must therefore be made quickly is to include an approach to uncertainty in the risk world. This includes an appropriate taxonomy[2], associated language, and a research terminology that puts the risk statements in the right perspective. This is already common in policy analysis where the complexity defies a deterministic approach, and should also become part of the risk management tool kit, which is equally devoid of deterministic models.

Creating a systemic risk regulator is not going to stabilise the financial industry overnight. But stability will be enhanced by setting clear governance rules, stipulating minimum reporting requirements and by re-introducing uncertainty in the risk approach, stability may return sooner.

The public are likely to agree that this is worth the burden of another regulator.

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[1] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards - A Revised Framework*, June 2004

[2] An example of such a taxonomy is presented in: W.E. Walker, P. Harremoës, J. Rotmans, J.P. Van Der Sluijs, M.B.A. Van Asselt, P. Janssens and M.P. Krayer von Krauss, *Defining Uncertainty. A Conceptual Basis for Uncertainty Management in Model-Based Decision Support,* Integrated Assessment 2003, Vol. 4, No. 1, pp. 5–17