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A Risk Management Agenda for 2011

Summary
An active agenda for risk management should encourage risk managers to look beyond their current scope. Risk management could take the lead in many of the discussions the financial world is struggling with, from remuneration to capital calculation and a broader approach to risk management. It would be an ambitious but useful agenda for 2011.

Dear reader
Those of us working in Risk Management (RM) are frequently told that we must be having a ball. The reason is often the unrelenting market turmoil, mounting sovereign risk as well as the fear mongering that accompanies the housing bubbles, currency wars and the call for stricter regulation. That is true to some extent, but the risk community is generally not coming up with spectacular responses. And maybe there are no spectacular responses. Like climate change, these problems have been in the making for a long time and any turnaround will be gradual rather than sudden. Meanwhile, the risk community must explain how it will contribute to these issues. I see four areas we could put on our agenda for 2011 and where risk managers can take the initiative:

- ✓ Widening the risk analysis spectrum
- ✓ Taking a stand on risk versus reward in the remuneration debate
- ✓ Reforming economic capital calculation
- ✓ Learning to communicate risk results

Widening the risk analysis spectrum
Risk management has (re)gained its independence after a disastrous spell in which risk and business were expected to mingle beyond recognition. That is now happily in the past. At the same time, there have been valiant attempts to examine risk in a broader context, sometimes as ‘enterprise wide risk’ sometimes as ‘integrated risk’. Neither of these fields have been very successful so far. We need to try again. To make it more successful, the risk function could start by thinking about how to tackle three known obstacles:

- how to look beyond its own silo approach of credit risk, market risk etc to develop a common framework, language and methodology to incorporate all risks;
- how to look beyond the bank’s organisational structure to capture the whole life cycle of products and the whole environment involved in the banking process; and
- how to look beyond the traditional clients (like the trading floor) and include analyses from the perspective of other stakeholders (depositors, investors, public bodies, etc).

Taking a stand on risk versus reward in the remuneration debate
The debate on remuneration, and particularly the public outrage regarding bankers’ bonuses has all parties firmly entrenched. To the general public, bankers are money grabbing amoral scoundrels, regulators are powerless dunces and the customer is badly served by both. At the other end of the spectrum, banks appear to shrug off the entire remuneration debate as no more than a temporary nuisance and a purely internal affair at that. They are missing the point.

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The problem is not about rewards per se but about *risk*-versus-rewards. It is indeed unacceptable that agents benefit from upswings without taking any risk during downturns. That is a design flaw banks need to root out. By paying more attention to the entire value chain in banking, and the risk that each party takes within that value chain - from investors and depositors down to traders, mid office, back office and management - a better rewards system distributing gains and losses should be developed. That is a complex issue without easy answers, but the risk profession should take a stand in these discussions and develop an approach for it.

Reforming economic capital calculation

In the wake of the financial crisis, a number of proposals have been made regarding appropriate levels of minimum regulatory capital at bank level. The discussion regarding the appropriate levels of *economic* capital has been much less lively. This is a missed opportunity. Capital drives business behaviour just as remuneration drives personal behaviour, and new regulatory capital requirements should be accompanied by a rethink of economic capital models, lead by risk management. To ensure that decisions can be scrutinised, the economic capital model itself should be made public and its results should be reviewed independently.

Learning to communicate risk results

Partly as a result of years of silo mentality, the risk management community has developed its own methods, written in its own language and communicated in its own style. If the risk community is to play a larger role with a broader audience, we need to learn to communicate better. That starts with making clear what risk can and can not do. Often, the implicit assumptions in our models and in our data gathering are left unexplained. That can lead to misguided trust as well as to misguided scepticism regarding the outcomes of our analyses.

We should require all our risk managers to learn to explain the models, the inputs, the assumptions, the conditions, the trustworthiness and the relevance of the findings not only in technical terms, but also in terms of consequences for any stakeholder. A good place to start will be the stress tests and the scenarios which are now being developed. The decisions based upon these findings are not governed by risk alone, but risk management is in the best position to point out where modelling stops and wishful thinking begins. Unless we educate the broader management, chances are that the whole exercise will be sterile exercise.

Conclusion

There is a Dutch saying[1] that can roughly be translated as ‘whose bread I eat, his song I sing’. We are now in charge of our own bread. With this (regained) independence, risk managemers should consider drawing up their own agenda for 2011, focusing on serving a broader community with sound and impartial advice.

[1] In Dutch this reads as: ‘Wiens brood men eet, diens woord men spreekt’, the Latin version is ‘Cuius enim panem manduco carmina canto’.