

INDEPENDENTLY PROMOTING DEBATE AND FRESH THINKING IN THE FINANCIAL SERVICES INDUSTRY

## Back to basics: Rethinking Risk Management and Regulation in a post-crisis world

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### Summary

- The global financial crisis has highlighted a range of weaknesses in the operation and management of certain financial institutions, markets and regulations. The overwhelming number of contributing factors makes it very difficult for lessons to be learned and for institutions and their regulators to focus their limited resources on the most beneficial areas for risk management reform.
- One solution to this problem is to ask the risk managers that work in financial institutions for their views on the causes of the crisis and the lessons to be learned.
- Interviews with 20 risk management professionals from across the financial services sector, revealed a rather different perspective on the crisis to many more mainstream (government/regulatory) reports. Risk managers appear to place much less emphasis on economic and market-wide factors - such as low interest rates or the growth in securitisation - and much more on the **micro-level human/social aspects** of the crisis.
- Specifically they attributed the crisis to weaknesses in the management of certain financial institutions and regulatory agencies, weaknesses that were driven by factors such as **inappropriate risk cultures, poor risk communication** and an **over-reliance on mechanistic (model driven) approaches** to risk assessment and control.
- A key priority then for many financial firms is to improve their risk cultures, ensure that risk awareness is enhanced throughout their organisations and that they take a long term view of profitability and growth.
- In addition they need to adopt the qualities of so called 'high reliability organisations' placing less emphasis on the quantification of risk and more on the early detection and prevention of crises. This is a move that will require enhancements in internal communication and expert human judgement rather than investment in models and machines.
- Regulators should focus on raising the quality of risk management and the appropriateness of financial institutions' risk cultures. This will require a change of policy emphasis, but not necessarily more prescriptive regulation. They also need to promote risk awareness and preparedness over mechanistic approaches to modelling risk. Risk based capital reforms have led to a focus on objective measurement over effective management: there needs to be more of a balance between modelling and judgment.

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*CII Introduction: the global financial crisis has sparked considerable debate and analysis of its causes and of the lessons to be learned. A confusing array of reports, papers, books and articles have been published; making it hard to come to a consensus on what should be done. This paper seeks to make sense of the crisis in terms of its implications for the management of risk. It reflects on the future for the practice of risk management, and provides some recommendations for financial institutions, and their regulators.*

*With widespread changes to the UK's regulatory framework underway, now is an opportune moment to reconsider how supervisors should assess firm's cultures and behaviours. This thinkpiece paves the way to understanding what a 'good' risk culture might look like and how firms, incentivised by regulators, can go about achieving it<sup>1</sup>.*

*The implications and recommendations provided follow on from previous research published by the Financial Services Research Forum (FSRF) which used data from interviews with 20 industry professionals to investigate the causes of the crisis and the lessons that need to be learned from it<sup>2</sup>.*

## The Causes of the Crisis

To learn the lessons from the global financial crisis it is important to understand its causes. Broadly speaking the varied causes that have been identified can be categorised as follows:

- Micro (institution specific) versus
- Macro (market level factors and or factors at the level of national/cross-national economies)

The diagram on page three below illustrates this using the main causes that have been attributed to the financial crisis<sup>3</sup>.

For the risk managers that were interviewed, it was generally agreed that the causes highlighted in the lower left hand box (micro level human/social factors) were the most significant. In particular they indicated that the root cause of the crisis was weak risk management, both on the part of certain financial institutions and their regulators. This weakness

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<sup>1</sup> The CII recently published a 'Paper in Professionalism' on the theme of culture and regulation: *A New Approach to Financial Regulation - Embedding Professionalism* (May 2011)  
[http://www.knowledge.cii.co.uk/system/files/CII\\_PP8\\_Embedding\\_Professionalism\\_10Jun2011.pdf](http://www.knowledge.cii.co.uk/system/files/CII_PP8_Embedding_Professionalism_10Jun2011.pdf)

<sup>2</sup> Ashby, S. (2010) *The 2007-2009 Financial Crisis: Learning the Risk Management Lessons*, Financial Services Research Forum, Nottingham.

<sup>3</sup> For a fuller discussion of the crisis and its causes see Appendix 1 of Ashby (2010).

stemmed from human and or organisational deficiencies in: risk perception, risk communication and comprehension, and risk culture. As two of the risk management professionals interviewed for the original report stated:

*"I'm a great believer that when you do look at underlying causes you use root cause analysis and try to go back to basics.... when I look at risk there are two underlying causes – one is god and one is people." (Finance Director, UK Insurer)*

*"For me it's human behaviour. Everything else comes off the back of that whether its governance, culture, capacity, capability or implementation of framework – it all comes back to the person." (Independent Risk Consultant)*

## Questions and Implications for Risk Management and Its Regulation

### The Financial Crisis was Largely Self Inflicted

In the opinion of the above risk managers the crisis was not the result of bad luck in terms of unexpected shocks to financial markets or the macro-economy. Rather it was the result of weak risk management, both on the part of financial institutions and their regulators. These weaknesses stemmed from the following:

- Inappropriate attitudes towards risk taking and risk management. Some boards and senior managers under-estimated the risks their institutions were taking and failed to give risk management sufficient priority. Equally there were risk managers who adopted a compliance orientation and in so doing alienated themselves from front line business operations.
- A lack of knowledge and experience in managing risk. Senior managers and in some cases risk managers lacked the necessary skills and experience to make sense of their institutions' risk exposures.
- Poorly designed risk management systems, including reporting systems and risk appetite frameworks. Such design failures meant that boards and senior management either did not have the information they needed to make effective risk management decisions or became overloaded with facts and figures of unnecessary complexity (e.g. the outputs of risk models).

## Some Commonly Cited Causes of the Financial Crisis

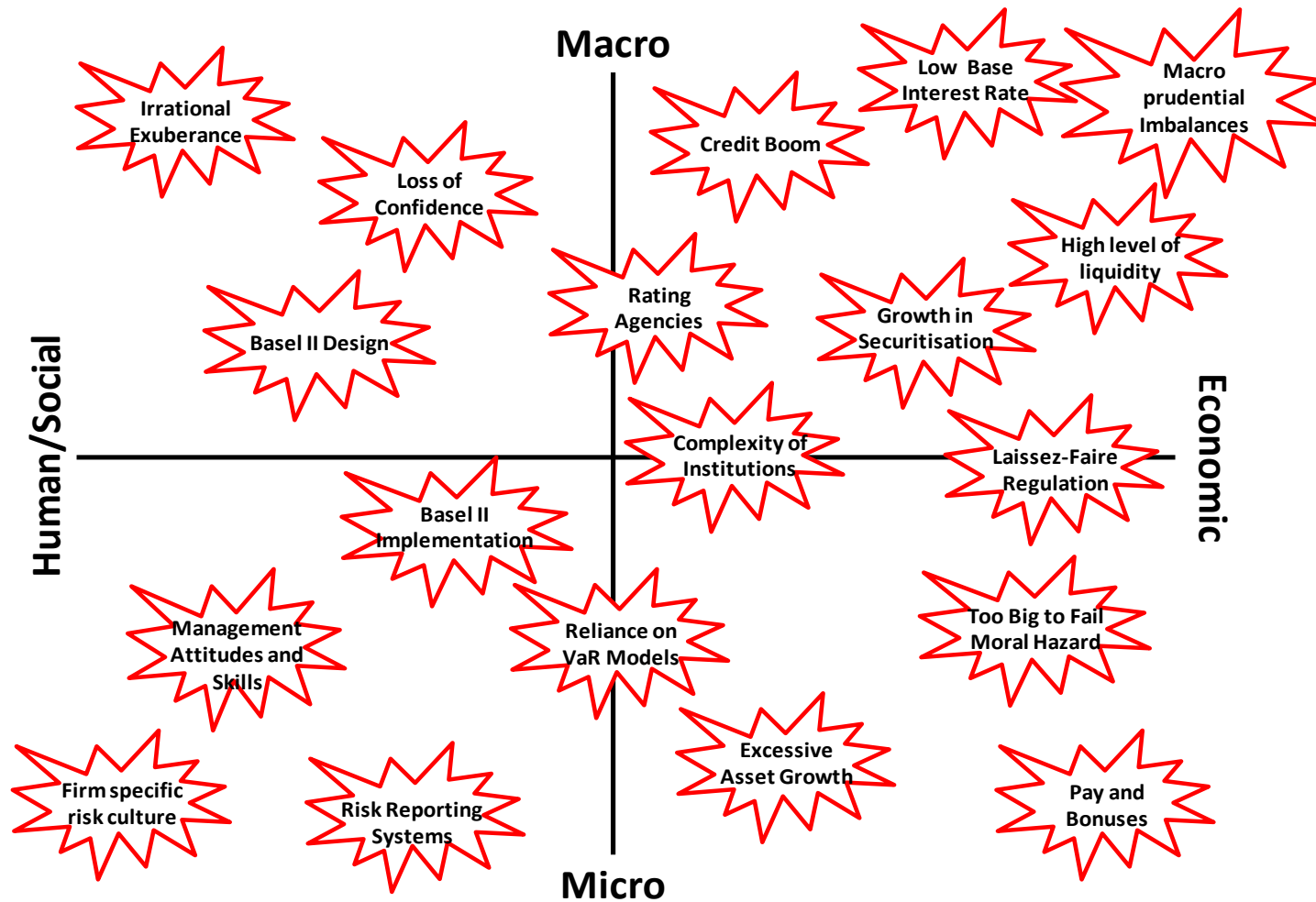


Figure 1

## Structure versus Agent: the Power of High Reliability Organisations

Structural reforms such as the enforced separation of retail and investment banking activities, or the breaking up of large institutions, have been a key area of debate in the light of the global financial crisis. However, one of the interesting features of the crisis is that institutions of all shapes and sizes got into difficulty. In the UK, most of those that required state intervention were predominantly retail banks and got into trouble as much for their retail activities as for their investment banking.

Equally, certain large, conglomerate banks all but avoided any difficulties, HSBC being a case in point. In fact it was arguably the early warning provided by its retail banking activities (where arrears levels within its US sub-prime subsidiary were identified and quickly escalated) that prompted HSBC to reduce its CDO exposures just before the crisis broke.

The implications of this are that discussions about the structure of financial institutions cannot be divorced from those about the behaviours and competencies of their decision making agents (i.e. management). Even in high risk environments risk can be controlled by effective management (who are competent and professional, and are prepared to communicate with each other and work together) operating within an appropriate risk culture that promotes risk awareness, values management judgement as much as models, and links risk and strategic management.

This observation has interesting parallels with research into so called 'High Reliability Organisations' (HROs) – such organisations possessing very similar characteristics to those highlighted by the interviewees and roundtable discussants. Many leading writers on organisational risk<sup>4</sup>, suggest that complex high-risk businesses need to operate as HROs if their chances of failure are to be reduced significantly. HROs are organisations in which errors can have catastrophic outcomes, but which conduct relatively error free operations over a long period of time, making consistently good decisions, resulting in high quality and high reliability operations. Though not all organisation

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<sup>4</sup> See Weick, K. and Sutcliffe, K. (2007) *Managing the Unexpected*, 2<sup>nd</sup> Ed., John Wiley & Sons, San Francisco, Roberts, K. (1990) "Some Characteristics of One Type of High Reliability Organization", *Organization Science*, 1(2): 160-177, Bourrier, M. (2005) "An interview with Karlene Roberts", *European Management Journal*, 23 (1): 93-97

theorists share this belief in the power of HROs<sup>5</sup>, the evidence from the financial crisis is sufficiently compelling to prompt further research and debate into this overlooked aspect of the crisis and the management of financial institutions.

## The Effective Management and Regulation of Risk is both an Art and a Science

One of the consequences of the Basel II Accord has been an increase in the use of quantitative risk modelling for all areas of risk – this trend beginning even before the Accord was finalised in 2006. The implication being that the more sophisticated an institution's risk models the better its risk management practices will be. Solvency II in the insurance sector is based on a similar premise.

However, none of the risk managers that were interviewed supported the view that the risk based capital regulations that underpin initiatives such as Basel II or Solvency II will lead to improvements in risk management. Indeed for some the financial services sector's increasing reliance on risk models was seen as a key cause of the crisis.

That is not to say that risk models do not have their uses, just that they must not be over-relied upon. The deficiencies of risk models are well-known<sup>6</sup>: they are rather better at explaining the past than predicting the future, and can induce an artificial confidence and complacency in our understanding of the variability of possible outcomes. Most importantly, there are many aspects of risk and risk management that do not lend themselves to formal mathematical modelling (such as many operational risks).

## Putting Risk into Perspective: The Role of Risk Appetite

The term risk appetite relates to the amount of risk an organisation is prepared to take to achieve its objectives (or alternatively the level of performance needed to compensate for the risk incurred)<sup>7</sup>.

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<sup>5</sup> Leveson, N., Dulac, N., Marais, K. and Carroll, J. (2009) "Moving Beyond Normal Accident and High Reliability Organizations: A Systems Approach to Safety in Complex Systems", *Organization Studies*, 30(2-3): 227-248.

<sup>6</sup> Jorion, P (2009) "Risk Management Lessons from the Credit Crisis", *European Financial Management*, 15(5): 923-933. Power, M. (2009) "The Risk Management of Nothing", *Accounting, Organizations and Society*, 34 (6-7): 849-855. and Slovic, P. (1999) "Trust, Emotion, Sex, Politics, and Science: Surveying the Risk-Assessment Battlefield", *Risk Analysis*, 19(4): 689-701.

<sup>7</sup> AIRMIC (2009) *Research into the Definition and Application of the Concept of Risk Appetite*, Association of Insurers and Risk Managers in Industry and Commerce, London, UK.

Effective decision making in a world of risk requires context. In particular decision makers need to understand where risk exposures could be profitably increased and where they should be decreased (because they exceed the associated appetite for risk). Many factors will influence this decision from the returns that could be generated from particular levels of risk exposure to the risk preferences of key stakeholder groups such as consumers, shareholders and regulators.

According to the risk managers that were interviewed insufficient context (in terms of effective risk appetite frameworks) was provided to the decision makers of certain financial institutions, meaning that they took excessive amounts of risk – whether accidentally because of a lack of information or deliberately because of weak controls. Hence finding ways to support improvements in the use of the concept of risk appetite by financial institutions should be a key element in developing lasting solutions to the prevention/mitigation of future crises.

### Poorly Designed Regulation Does More Harm than Good

As indicated above many of the risk managers attributed, in part, the crisis to weaknesses in regulation and supervision. This observation illustrates that regulation and supervision can have serious and unexpected consequences. Moreover, such consequences can create the preconditions for major system wide events, because of the large number of institutions that they can effect.

This means that regulators (whether banking or insurance) must take much more care when implementing new regulations. While they might assume that imperfect regulation is better than nothing, the evidence suggests that it can actually do more harm than good.

### The Future? A Five Point Plan

Though they may be hugely expensive financial crises represent an opportunity to learn. It is important that financial institutions and their regulators do not squander this opportunity. Below is a five point plan.

<b>1. Culture</b>	<b>Firms</b> Review your risk culture and make changes as necessary. Are your staff and directors risk aware? Are they prepared to report potential risks and concerns and act on them in a timely fashion? Do they take a long term view of profit and growth? Do your risk managers focus on business needs or enforcing compliance?
	<b>Regulators</b> Pay more attention to the risk cultures of financial institutions. Ensure that you have the right supervisory tools and appropriately skilled supervisors to allow you to monitor risk culture and require improvements if necessary.
<b>2. Appetite</b>	<b>Firms</b> Have a clear understanding of your appetite for risk, ensuring that this is communicated to all key decision makers and that risk exposures are compared against the stated appetite on a regular basis.
	<b>Regulators</b> Provide clear and consistent guidance on risk appetite. Ensure that firms disclose appropriate information to shareholders and other stakeholders on their appetite for risk.
<b>3. Management</b>	<b>Firms</b> Effective management is about balancing ‘hard’ (objective) and ‘soft’ (subjective) factors such as risk/financial models and human behaviour. Ensure that your managers have the skills and experiences to understand both – training them or recruiting new managers as necessary. Learn the lessons from High Reliability Organisations whose managers combine attention to frontline performance with a flexible mindset (thinking ‘outside the box’ when appropriate), open communication and a preparedness to take prompt action to reduce risk where necessary (e.g. where exposure exceeds the stated appetite for risk) <sup>8</sup> .
	<b>Regulators</b> Remember that management is at least as important as measurement and that not all risks can be measured effectively. Ensure that the regulatory and supervisory emphasis given to Pillar II risk management considerations is at least as much as that given to Pillar I (capital requirements).
<b>4. Performance</b>	<b>Firms</b> Incorporate risk management considerations into your performance management framework. Ensure that staff are rewarded for performance over the long term and for maintaining a balance between risk and return (in accordance with the stated appetite for risk).
	<b>Regulators</b> Provide appropriate guidance. Work in partnership with firms by highlighting and promoting good practice.
<b>5. Stakeholder</b>	<b>Firms</b> Engage with stakeholders on risk management considerations – providing greater transparency on factors such as employee remuneration, risk appetite, key risk exposures and emerging risks.
	<b>Regulators</b> Do not underestimate the importance of Pillar III disclosure regulation.

<sup>8</sup> For an overview of the qualities of the management of HROs see Coutu, D. (2003) “Sense and reliability: a conversation with celebrated psychologist Karl E Weick”, *Harvard Business Review*, 81(4): 84-90 and Bourrier, M. (2005) “An interview with Karlene Roberts”, *European Management Journal*, 23 (1): 93-97

## Conclusion

*“In four years when hopefully everything is sorted, lethargy will set in and then something else will happen... Inevitably it comes back to human fallibility. I just wish people realised that.” (Finance Director, Mutual Insurer)*

History has shown that financial crises are all but inevitable. However that does not mean that with good risk management their frequency can't be reduced or the severity of their impact lessened.

The global financial crisis was ultimately caused by management weaknesses within both financial institutions and their regulators. As such it could have been prevented and if the right changes are not made now to management practices to make financial institutions more reliable then a similar crisis could well happen again.

This paper also challenges the notion that greater regulatory prescription and capital requirements are required or that simple solutions such as caps on bonus

payments will prove effective. Rather a more permanent solution to the prevention of future financial crises is likely to combine enhancements in the risk management and governance practices that are implemented by financial institutions and their regulators with mechanisms that support cultural change. Moreover this cultural change needs to be both organisation wide (in terms of the overall safety culture) and function specific, particularly in relation to moving the attitudes of risk functions away from compliance and towards a more business-like orientation (for example, by using risk management staff and risk reports to support strategic decision making).

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