
What are we missing in risk management?

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Abstract This paper addresses five possible 'blind spots' in the current practice of risk management. These are: (1) the 'divinity of the gods' — the inability to criticise senior management; (2) the 'rush of herds' — the inability to project and predict mass delusions and hysteria; (3) 'black swans' — the failure of models to anticipate outlier events; (4) 'the error of success' — the human inclination to think that current success will repeat itself; and (5) 'academic pomposity' — the regression towards intellectual obscurity among academic writers.

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Cruising down the interstate highway at 70 mph, a driver comes up behind an 18-wheeler truck and decides to pass. He glances at his rear-view and then his side-mirrors. Seeing nothing, he starts to swing into the passing lane, but is startled to hear a loud horn as another sedan speeds by. This is the classic 'blind spot' of driving. Most drivers are aware of the blind spot, yet they never really change their behaviour, and are still surprised when they narrowly avoid an accident.

Compare this with the discipline of financial risk management, which has been practised for more than two decades and people are comfortable with its processes. Multiple organisations, from The Committee of Sponsoring Organizations of the Treadway

Commission (COSO), Basel and standards organisations in Australia, New Zealand, Japan, Canada and the UK, to the International Standards Organization and Sarbanes-Oxley, have defined it and how it is supposed to work within organisations. Others seem to be comfortable with the process. Practitioners feel secure in their work. But are people deluding themselves? Is the tidal wave of acceptance, academic literature and public information creating complacency? Are blind spots being missed?

Potential blind spots can be grouped into five main categories: the divinity of the gods, the rush of herds, 'black swans', the error of success and academic pomposity. This paper describes these

potential blind spots, citing several authors whose writings are normally outside the realm of risk management. Reading too narrowly, listening only to the inner cognoscenti, is in itself a blind spot.

First, consider the degree to which it is assumed that certain individuals within organisations have achieved something close to divinity, where their words and actions cannot be challenged. There is no better example of this blind spot than the recent and continuing obscenity of excessive pay for senior executives. Well over a century ago, Hans Christian Andersen wrote about such deliberate blindness in his story, 'The Emperor's New Clothes' — but how many risk officers have actually read, remembered and inwardly digested the moral of this tale? Does a risk manager have the right and obligation to raise and discuss all manner of risks, *except* for those arising from the remuneration of an organisation's top officers and directors? The mirror does not work in this area.

Basic pay, the granting (and backdating) of options, and exit packages are all assumed to be beyond the purview of those assessing risk, despite the recent history of savaged reputations. People like to believe that when a CRO reports to the CEO and the governing board, he or she will be able to ask any question, challenge any presumption. Yet when the board and senior officers are in tacit collusion on matters of pay, these reporting relationships are useless. Many board members, frequently senior officers of other corporations and protective of their own bloated packages, prefer to avoid the issue. Is it not natural for a somewhat junior officer to be reluctant to question the pay granted to senior

executives, given that these seniors can terminate employment at any time? It may also be enlightened self-interest, as some risk officers may yearn for higher positions where they can also extort extravagant pay. Unless and until risk officers are prepared to raise serious questions about this pay, their organisations face the risk of adverse publicity that can be extraordinarily punishing in today's markets.

The result: the presumed divinity of these gods, clothed in nothing, remains unchallenged.

The irrational rush of herds is a second potential blind spot for risk officers. Too many practitioners (and their models) assume rational and relatively predictable behaviour over time, from both individuals and groups. Is this true?

Seven years ago, in February 2001, Avinash Persaud, then managing director of State Street Bank in London,¹ suggested that the proposed Basel II accords could lead to an increase in systemic risk for banks if they adopted a herd-like response to the new rules and played follow-the-leader. His subsequent paper, 'The macroeconomics of Basel', which he delivered in his first Mercer Memorial Lecture at London's Gresham College in October 2002, elaborated on that thesis.

Persaud suggested that 'the starting point of good regulation is aligning the points of government intervention with the points of market failure'.¹ He then cited three characteristics of banks: they pose systemic risks, they are part of the information industry, and they exhibit herd behaviour. He went on:

'But the irony is that the accoutrements of sophisticated risk management, daily

marking-to-market and market sensitive risk limits, only provide a defence if a handful of banks use them. If regulators encourage all banks to use them they will provide no defence and will make the financial system as a whole riskier.¹

His conclusion:

‘Basel II will lead to more amplified cycles and more instability. It is complex where it should be simple. It focuses on processes when it should focus on outcomes. And it is implicitly pro-cyclical when it should be explicitly contra-cyclical.’¹

He also described the possibility of such herd behaviour as has recently been seen in the dot-com, housing and subprime lending bubbles:

‘Banks or investors like to buy what others are buying, sell what others are selling, and own what others own. They are measured and rewarded by relative performance. They are more likely to be sacked for being wrong and alone than (for) being wrong and in company.’¹

His conclusion:

‘Today, risk managers mistakenly prefer to worry about quantifiable risks than unquantifiable ones.’¹

All this in 2001 and 2002.

*Extraordinary Popular Delusions and the Madness of Crowds*² remains the classic text for those interested in delusions and bubbles. But when each one of us is a part of a lemming-like rush towards the cliffs we seldom acknowledge our situation in our euphoria and the enveloping dust. Systemic contagion is not normally a part of the sophisticated financial models on

which too many financial risk managers rely.

Back in 2001, Robert Shiller, of Yale University, wrote a critical analysis of this kind of behaviour in *Irrational Exuberance*,³ another important reference book for the risk manager’s library. He concludes that:

‘we are left now, as always, with the daunting problem of assessing not only their various probabilities — each of them by itself small and hard to quantify — but also the probabilities of several of them happening together, which would make the combined effect all the more serious ... Irrational exuberance continues to pose hazards for business decision makers.’³

Are practitioners deluding themselves that the well-defined and generally accepted framework and processes for risk management can actually improve organisational decisions? Are over-reliance on systems, the increasingly complicated quantitative models and the increasing volumes of information creating in and of themselves the same type of bubble that has been experienced recently?

Julia Homer, the editor of *CFO* expressed it perfectly in her March 2008 editorial: ‘Eventually, the sun will glint brilliantly off the expanding curve of yet another inflating bubble. Let’s hope that when that happens we are not blinded by the glare.’⁴

The herds will always move back and forth.

A third potential blind spot is the black swan, the extreme tail of the quantitative analyses that so dominates current risk management thinking. Nassim Nicholas Taleb, of course, is the

articulate author raising awareness about these events, in *Fooled by Randomness* (2001) and in 2007's *The Black Swan: The Impact of the Highly Improbable*. He argues that 'our world is dominated by the extreme, the unknown, and the very improbable (improbable according to our direct knowledge) — and all the while we spend our time engaged in small talk, focusing on the known and the repeated'.⁵

Mumbling about the inconsequential is a reminder of the phrase 'in the room the women come and go, talking of Michelangelo', from T. S. Eliot's *The Love Song of J. Alfred Prufrock*. Taleb cites many of the human characteristics discovered by Daniel Kahneman, Amos Tversky, Paul Slovic and others, the patent irrationalities that scuttle the traditional models of the 'economic and logical man'. After one begins to understand the narrative fallacy, the fallacy of silent evidence, the Ludic fallacy, anchoring, overestimating the effects of both pleasant and unpleasant future events, and excessively focusing on consequences rather than probabilities, how can quantitative models ever be trusted again? People are deluged with information, which is why these quant models have been necessary in the first place. Taleb dismisses them out of hand: 'having plenty of data will not provide confirmation, but a single instance can disconfirm!' He describes the 'triplet of opacity':

- the illusion of understanding (the failure to acknowledge randomness);
- the retrospective distortion (looking through the rear-view mirror);
- the overvaluation of factual information.⁵

As *The Economist* noted in its 1st March,

2008 analysis of the insurance business, 'modeling risks is not necessarily the same thing as managing them'.⁶ Without data on outliers, how on earth can anyone begin to 'manage' them intelligently?

Taleb and others emphasise the importance of acknowledging how little we know and how important it is to accept the dominance of uncertainty. Another writer, well outside the traditional boundaries of risk management writing, has also expressed this. In *The Canon*, Natalie Angier writes:

'Scientists are accustomed to uncertainty, and to admitting how little they know. In fact, not only are they accustomed to uncertainty, they thrive on it. This is another of the core messages they'd like people to absorb, right down to their stem cells, if possible: that science is an inherently uncertain enterprise, and that uncertainty is, paradoxically, another source of its power.'⁷

Is this not the idea we must instil in risk management?

A fourth possible blind spot comes from a medical doctor who observed that when a physician makes a series of diagnoses that turn out to be correct, they become 'anchored' (another Kahneman and Tversky term) in this success, reducing their ability to recognise possible alternatives and more remote causes for illnesses. A frequent contributor to *The New Yorker*, Jerome Groopman wrote *How Doctors Think* in 2007, and his dissection of the thought processes of physicians also represents a call for change in risk management processes.

First, he suggests using heuristics: 'heuristics serve as the foundation of all

mature medical thinking, how they save lives, and how they also can lead to grave errors in clinical decision-making'.⁸ Billy Vaughn Koen of the University of Texas also wrote about the use of heuristics in managing risks in engineering in 2003 — another example of risk management insight from a totally different profession. Groopman's recommendation leads naturally to what he calls 'the uncertainty of the expert': 'you have to regularly question everything and everyone'.⁸ How many risk managers practise this approach? Groopman continues, arguing that the ready and continuing acknowledgment of 'I don't really know' can lead to *greater* patient confidence:

'Does acknowledging uncertainty undermine a patient's sense of hope and confidence in his physician and the proposed therapy? Paradoxically, taking uncertainty into account can enhance a physician's therapeutic effectiveness, because it demonstrates his honesty, his willingness to be more engaged with his patients, his commitment to the reality of the situation rather than resorting to evasion, half-truth, and even lies.'⁸

Has the success of financial risk management over the past ten years turned to hubris?

Some observers see signs of withdrawal into a secure and cosy nest of like-minded individuals, disregarding the insights and questions from outsiders. After all, organisations like the Professional Risk Managers International Association (PRMIA), the Global Association of Risk Professionals (GARP) and the Risk Management Association (RMA), each with tens of thousands of members, have bloomed into major global forces,

spreading the idea of risk management and encouraging organisations around the world to hire these specialists.

Financial risk management is as prone to become insular as insurance and safety risk management, where ingrown views are prevalent. In global risk management today, there is too little interdisciplinary interaction, too little searching for risk insights from other professions such as engineering and medicine. Here again, excessive and rapid success may be leading to a lack of questioning and introspection.

A fifth and final potential blind spot can be found in what purports to be communication about risk management within the academic community. In order to spread the use and effectiveness of risk management, its processes should be made clearer and simpler. The opposite seems to be happening with the academic community. The language is convoluted, opaque and abstruse, increasingly aimed at a narrow group of the cognoscenti. It is the exact opposite of the prescriptions for clear and effective writing found in that bible for communicators, *The Elements of Style*, by William Strunk, Jr. and E. B. White:⁹ use the active voice, keep to one tense, omit needless words and be concise.

The problem is much like the introverted theological scholastics of the Middle Ages, engrossed in their own prose and religious predicaments, trying to measure the number of angels on a pinhead.

Consider two examples taken from recent journals (the authors and publications are deliberately not given to protect the guilty!):

'In accordance with a recent survey of the Basel Committee on Banking Supervision

about AMA practices at financial services firms, we assume that the loss frequency processes $N1$ in 1.1 follows a homogeneous Poisson process with rate $\lambda > 0$. Then the aggregate loss (1.1) constitutes a compound Poisson process and is therefore a Lévy process (actually, the compound Poisson process is the only Lévy process with piecewise constant sample paths.)

Or decipher this:

'Independent samples t -tests showed significant differences between the two groups in their trust beliefs, $t(373) = 5.46$, $p < 0.001$, $d = 0.56$ and trust intentions, $t(370) = 3.78$, $p < 0.001$, $d = 0.39$. To test if the magnitude of change in trust following integrity information was significantly different for Low and High Integrity conditions, we carried out a 2×2 mixed factor MANOVA.'

When writing about risk management becomes so convoluted that the vast majority of practitioners are left in the dark, it is time to return to clarity and common sense.

Not only does the rear-view mirror miss some onrushing risks, but it is also aimed directly towards the past. This mirror is a sound analogy for the problems that face risk management today. Practitioners should continue to ask questions about the possible frailties of the gods, about how easily herds develop and rush precipitously towards the cliffs, about how the unexpected must include events that have never happened before, about how easily

people are gulled by apparent success, and how communications must be improved.

Yes, the discipline has its blind spots and it always will. This means practitioners must continually dissect, doubt and question. Toronto's Diana Del Bel Belluz stated this eloquently: 'Risk management is about adapting to change, elegantly. It's about preparing for the future.'¹⁰

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