

## **Reaching the limits of risk management**

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Radical thinking has become the new norm in the current crisis, as policymakers try to stop the financial hemorrhaging. Massive bailouts, bans on short-selling, internationally coordinated interest rate cuts, nationalization – all of these new realities were unthinkable just a few months ago.

Yet while crisis management thinking has become increasingly creative of late, longer-term proposals for avoiding future crises are still pretty unimaginative.

Whether you look at what the major international financial organizations, like the Financial Stability Forum (FSF) and the International Monetary Fund (IMF) are saying, or consider the statements of national leaders like Gordon Brown, Henry Paulson or our own Stephen Harper, the proposals for future reform are pretty limited: time after time in the current crisis, we're told that more transparency, better disclosure, and better risk management models are the answers to our current woes.

In other words, they're telling us, information is the answer. If we can just get better information to the markets about the actual risks involved in these complex securitized products, then investors and institutions won't be tempted into taking on too much risk.

This emphasis on more transparency about risk is politically and economically appealing: it suggests that all that we have to do to avoid future crises is to get the numbers right, do our homework, and make sure that everyone knows just what's going on in even the murkiest parts of the economy. No need to "rush to regulate" as the IMF has put it. Just give the markets better information and they'll do their job.

There is no doubt that poor risk models were at the heart of the current crisis. The securitization boom was driven partly by some very naïve assumptions about financial risk.

Complex securitizations are particularly vulnerable to "tail risk," or the possibility of an unlikely but extremely damaging financial event. Yet, the models that were used to predict the risks in the products tended to assume away fat tails and long tails, forcing the probability of default and other problems into a standard distribution, significantly understating the risks of a serious crisis.

Many companies ignored the interconnected logic of risks, fragmenting their risk management strategy through an organizational structure in which different individuals and departments took responsibility for one kind of risk or focused on one aspect of the business. This approach ignores the ways in which different kinds of risk (market, credit, liquidity) can reinforce one another.

In these ways, financial actors seriously underestimated the complexities of the financial system, treating potentially profound uncertainties as easily defined and dealt with.

So there is no question that we need to seriously rethink the way that we understand risk. But does that mean that we can just retool the models a bit, impose some new disclosure standards and wind up with a stable financial system?

Unfortunately, the holy grail of perfect risk measurement and management is very likely just that – a rather dangerous myth.

“Risk” is a concept that assumes that the messy ambiguities of this world can be transformed in a set of probabilistic calculations, like betting odds. Recent events should have raised some red flags about our ability to adequately translate all of the uncertainties of the market into predictable calculations.

And even if it were possible to provide the markets with perfect information about the complex risks involved in some of these assets, it’s not at all clear that investors would pay attention. There were, after all, plenty of warning signs about the current crisis that most investors chose to ignore. The Bank for International Settlements (BIS) has pointed out that the same thing happened before the Asian financial crisis: the BIS provided plenty of warning signals, but the markets just didn’t want to believe them.

This is not to argue that transparency and better risk management aren’t important – they are. It’s to suggest that they are sorely inadequate, and potentially misleading in their promise of a quick and relatively painless fix.

Once we recognize the real complexity of the financial system, we need to start thinking more creatively—not just about what might go wrong, but also about how we might organize our economy to avoid this kind of catastrophic crisis.

The limits of risk management mean that we have to start making some tough economic and political decisions. It means that we can’t rely as much on industry self-regulation, on credit rating agencies’ evaluations, or on the major banks’ internal risk models. We can’t rely as much on market discipline.

It therefore also means that we need more regulation, at national and international levels. But the limits of risk management also pose real challenges for regulators, who can’t rely on better technocratic models. So we need more creative, flexible, and responsive regulation. In other words, we need to start thinking more radically about the long-term future of financial regulation and governance.

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