Where the **buck stops**

Risk management units alone cannot avoid the damage from periodic bouts of irrational exuberance. Rather, that responsibility lies with the chief executive, argues ***David Rowe***

The efficient markets hypothesis (EMH) argues that, in free and competitive markets, prevailing prices always reflect a process that collectively incorporates all relevant information. Like so many hypotheses in the social sciences, this one is only approximately valid. Free markets have proven time and again that they are far more efficient at guiding investment decisions than central government control or the pseudo-market model of 'crony capitalism'. Most particularly, they are far more ruthless than any politically based process at undermining incumbent technologies and organisations. In the long run, free markets have always outperformed planned economies and always will. This enduring truth should not blind us, however, to an equally enduring weakness of free markets – namely, periodic bouts of irrational exuberance.

If human beings were cold blooded logic choppers like the Vulcans of Star Trek, we might expect the EMH to be more universally applicable. In fact, we humans are driven by a complex and shifting mix of logic and emotion. In this constant flux, optimism and greed are always competing for predominance with pessimism and fear. Beyond that, collections of humans have a dynamic that is quite distinct from that of single individuals.[1]

The recent market crisis triggered by the impact of a slowdown in the US housing market, combined with reckless lending in the form of subprime collateralised debt obligations, is a case in point. It has raised anew the question of how financial institutions can avoid, or at least minimise, the damage from these periodic upheavals. "Why," many will ask, "after the growing focus on risk management over the past 20 years were major, highly sophisticated institutions apparently blindsided to the tune of losses in excess of $80 billion and counting?" Much of the answer lies, it seems to me, in the continued fragmentation of financial risk management and the struggle to keep up with the relentless pace of product innovation.

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Most regulated institutions have been producing daily value-at-risk estimates for more than 10 years. In many cases, however, they have been fighting a losing battle to incorporate new products fully into their VAR systems on a timely basis. Furthermore, enterprise VAR estimates are often assembled in a way that effectively precludes rigorous enterprise-wide risk stress testing.[2] In my experience, few organisations can respond quickly and confidently to senior management requests for what-if analysis around a worrisome contingency. The ultimate goal of risk management information systems must be to inform the seasoned judgment of those responsible for balancing risk and return. Failure to consolidate exposure data and supplement these with effective risk analytics at the enterprise level undermines the information required for strategic risk decisions.

In a broader sense, however, the problem lies in a failure of top management to take enterprise-wide risk management seriously. Business units are organised around specific markets and products. All too often top management, starting from the chief executive, views its role as demanding '20% more than last year', come what may. No business unit head is going to retreat from a dangerously exuberant market when doing so inevitably means losing his bonus and that of his team. A truly brave risk manager might insist in closing down a business that looks dangerously over-extended and might even succeed. If competitors continue to post big profits for another two years or more, however, he or she is unlikely to be around when the inevitable crisis occurs.

At the end of the day, only the chief executive can make the crucial call to withdraw from an activity where the ephemeral concept of risk outweighs the all-too-tangible attraction of short-term profits. When he was US President, Harry Truman famously kept a sign on his desk saying 'The buck stops here'. If a financial institution is to have any hope of avoiding, or at least minimising, losses from the aftermath of periodic bouts of irrational exuberance, its chief executive must follow Truman's commendable example. Keeping your head when all around you are losing theirs is not easy, but as Truman also said: "If you can't stand the heat, get out of the kitchen." ■

[1] I sometimes hear people say their legislature is not acting rationally. My usual reaction is, 'Of course not! A legislature is not a person, it is a social entity and such entities have a dynamic of their own that does not mimic the behaviour of an individual'
[2] See Rowe, D, From VAR to Stress Testing, Risk December 2006, page 87