

# RISK AND ICE

## RISK MANAGEMENT NEEDS TO RECOGNIZE DIFFERENT SEASONS OF RISK



Last winter, the kids were able to skate on the lake for more than five full weeks. About two weeks into that period a new sign appeared beside the lake: HIGH RISK AREA. They all laughed. Any power that the word RISK might have had was totally diminished in their minds, because over cautious adults were applying it to ice so strong that one of the teenagers had been able to drive his car onto it last night.

But by early spring, that ice was melting around the edges and became dangerous. But the sign still said the same thing. HIGH RISK AREA.

In reaction to the continuing financial crisis, many firms are starting new risk management programs. They often begin by defining the word RISK. What follows is usually generic and usually almost totally useless. In some technical sense, there is risk out there in all directions. But is any of that risk really RISKY? Is any of it actually DANGEROUS? And now, the Treasury proposal for financial regulatory reform suggests that a systemic risk regulator take more of a risk management approach to the entire financial system.

Like the lake, there are times when situations are low risk and times when they are high risk and times when they are absolutely dangerous. Risk Management programs both for companies and for the entire financial system need to be designed to recognize the different situations and to act accordingly.

The environment for any “risk” can be seen to have four main stages:

**Stage 0**– Low Risk Environment. It does not seem to matter how much risk is taken on during this stage. Every decision to take an additional risk pays off handsomely. Over and over again the naked,

unhedged position beats out the carefully hedged position; the uninsured risk beats the insured risk. During this environment, people slowly drift away from being concerned about risk and risk management because they are looking at others who are not concerned making lots and lots of money. Capacity for risk taking does not seem to be an issue and some will take much more risk than could possibly be prudent in any other environment.

**Stage 1** – Normal Risk Environment. This is when the long term averages seem to hold up well. Investors and insurers experience mostly gains, but with enough losses to maintain focus on appropriate risk management.

Volatility is in the normal range, so hedging and reinsurance programs have the expected impact. Risk management seems to be designed for this environment – because it was. Capacity for risk taking is carefully matched up to risks, but taking risks up to capacity is usually seen to be the best course in this environment. Capacity is usually defined in terms of something like a one in 200 year loss, but no one really expects to experience a loss of that size. That just wouldn't be normal.

**Stage 2** – High Risk Environment. Suddenly, things get really RISKY. Almost any course of action presents potentially fatal threats. Some unexpected event usually triggers a shift from a Stage 1 to a Stage 2 environment. Natural or man-made catastrophes or sudden major shifts in markets might be

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triggers. Capacity that during Stage 1 was seen as a perpetual resource now suddenly seems like it may or may be sufficient. Suddenly people are extremely concerned with how risks are (and were) managed.

**Stage 3 - High Loss Environment.** Many of those risks have turned into LOSSES. Survival of the institution (and potentially the entire financial system) is uncertain. The market senses that many previously respected firms will not make it through this period and that suspicion drastically slows business activity. Risk management focus needs to be on helping to opportunistically finding that course of action that will save the firm. For the firms that fail, risk management efforts shift to workout.

One way of looking at the financial crisis is to recognize that markets acted as if we were in a Stage 0 Environment and piled up more and more risk. So much so that they skipped right past Stage 1 to Stage 2 in 2007 and Stage 3 in 2008.

And where was Risk Management? Those who were doing their risk management “by the book” were busy looking for lakes where they could put up HIGH RISK AREA signs. That is because the book version of risk management is written for the Stage 1 Environment and uses Stage 1 thinking. Risks are expected to fit into neat formulas that represent the historical experience for each risk. Regulatory systems such as Basel 2 and Solvency 2 are firmly rooted in Stage 1 thinking and experience. Prior episodes of Stage 2 and Stage 3 environments may be incorporated into these views, but not as something unexpected and uncontrollable but as things that in retrospect are completely explainable.

In 2005 and 2006, the markets and business managers feeling that they were in a Stage 0 Environment; they acted like the kids at the lake and almost completely ignored their risk management folks. They just kept skating. Why not? The ice was strong enough for that car. In fact, they all drove their cars out on the lake and started to build houses out on the lake.

So for future risk management to be effective there are two choices. The first choice is to hope that the regulators and central banks and the new systemic risk regulator do their jobs better and that henceforth we always stay in a Stage 1 Environment. And that is the choice that many seem to be working towards. The second choice is for risk management to recognize that we will have all four stages in the future and make plans for how to manage risk in all four environments.

The first choice, which seems to be the direction that the governments are taking, is just another version of the “it’s different this time” thinking that is common during Stage 0 Environments. Or maybe it represents a Stage 1 type of thinking that because, in retrospect, we can explain the past difficulties, that we have tamed risk.

The other choice is going to be more costly and will require much more far-sighted thinking. It requires recognizing that the possibility of future shifts from one stage to another for new reasons exists at all times. It means thinking through possible approaches to risk and risk management during all stages instead of working with a Stage 1 ERM system that is abandoned or ignored during Stage 0 and inadequate during Stages 2 and 3.

It will probably mean ignoring the calls for a fixed set of rules about risk (that can be immediately arbitrated) and creating something that flexes with the environment. During Stage 0, the system needs to flex to allow more but not unlimited risk taking. During Stage 2, risk taking needs to shrink but not disappear. But Stage 2 risk management needs to focus on the possibility that Stage 3 may happen at any time. So the risk taking needs to be carefully reviewed during Stage 3 for liquidity and illiquid risks need to be avoided and unwound as quickly as possible. Stage 3 risk management then focuses completely on triage. Which losing situations can benefit from workout attention? And which liquid positions can be sold with the least damage?

With this new emphasis for risk management, the most important skill becomes outward and forward looking to understand where the environment is and where it is moving. Previously, much of risk management attention has been directed inwardly towards evaluation of existing risks and looking backwards to historical experience to do that.

If the role of identifying potential shifts in stages is accepted as a major role for risk managers, then in addition to preparing reports looking inwards about the risks of the firm, the risk managers will be regularly reporting on the strength of the ice and can be ready to put the sign out only when it is actually thinning.

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