thinking aloud

The Walker review and the Dynamics of Risk

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The Walker Review of Corporate Governance in UK banks and other financial industry entities is a recipe book, not the meal itself. It is a lot bolder and more innovative than first meets the eye. But, the real work still has to follow.

It asks the pivotal question: how can we address risk more strategically and sustainably? What must our minds and senses be alert to, especially when we need to overcome our own resistance to confront the uncertain and unexpected?

Risk concerns the future. It is an assessment of expected gain or loss. Whilst, technically, the value of those results may be positive or negative in general when we refer to risk management, we tend to focus more on the potential harm that may arise either from incurring a cost (human, financial or other) or by failing to attain some benefit, how ever that may be measured.

Framing is a fundamental problem with all forms of risk assessment. In particular, because our brains get overloaded, we take mental shortcuts and the risk of extreme events is discounted because the probability is too low to evaluate intuitively. As an example, one of the leading causes of death is road accidents caused by drunk driving, partly because any given driver frames the problem by largely or totally ignoring the risk of a serious or fatal accident. An event that everyone agrees is inevitable may be ruled out of risk analysis due to greed or an unwillingness to admit that it is believed to be inevitable. These human tendencies for error and wishful thinking often affect even the most rigorous applications of risk management and should be a major concern.

All decision-making under uncertainty must consider cognitive bias and cultural bias. No group of people assessing risk is immune to "groupthink" – the unquestioning acceptance of obviously wrong answers simply because it is socially painful to disagree. One effective way to solve framing problems in risk assessment or measurement (although some argue that risk cannot be measured, only assessed) is to raise fears and other negative emotions by way of open and frank discussions. Wishful thinking is the formation of beliefs and making decisions according to what might be pleasing to imagine instead of by appealing to evidence or rationality. It has consistently been shown that people will predict positive outcomes to be more likely than negative outcomes. A prominent example of wishful thinking is economist Irving Fisher saying that "stock prices have reached what looks like a permanently high plateau" a few weeks before the Stock Market Crash of 1929, which was followed by the Great Depression. Wishful thinking is emotionally appealing and leads commonly to red herrings.

There is a lot of focus now on the high bonus culture, but that is a red herring and raises the irony of wanting people to take risks on your behalf, but beat them when they want rewards for doing so or the risk turns bad. It is a sort of Faustian Pact that leads government and the public to into arrangements with risk-takers so that we do not have to deal with the fears and uncertainties of risk ourselves. This should lead us all to taking a more thoughtful approach to risk. The question is how we manage risk between us; how we address the consequences of risk collectively. In this, the Walker Review has addressed behaviour that leads to consistent breaches of regulations. We have outlined how risk managers attempt to describe behavior in strategic situations, in which success in making choices depends on the choices of others. They believe they can predict how actual human populations will behave when confronted with situations analogous to the game being studied. But this particular view can be criticised because the assumptions made by risk managers are often violated. They may assume that populations always act in a way to directly maximize their wins, but in practice, human behavior often deviates from this model and what we have instead are explanations for why populations behaved they way they did, rather than serve as predictions of future behaviour.

Walker has surfaced many issues about risk that won't go away simply with a report or a change of government. The dynamics of risk have to take account of powerful constituencies. Being a risk manager or board member of a bank or other financial institution has always been difficult, but it especially so in the past 4-5 years because of their organisations' considerable size, global reach and their inherent complex nature. The size problem is compounded by the industry's fragmented and inherent contradictory nature. Like any other economic system, banking has to align and reconcile the conflicting interests and expectations of a number of constituents such as customers, finance professionals, government, voters and taxpayers, who all hold different and often discrepant priorities. At the same time, the anxiety-raising nature of economic threats and crises encourages the creation of institutional defences, rigid boundaries and projective mechanisms that significantly hamper any attempt to collaborate to accomplish a common task or to steer the banking industry at all. These conditions are further exacerbated because the nature, functioning and cost to the economy has become one of the most important issues in the UK political arena. The economy is one issue that substantially moves voter sympathy, and it will be the one that probably decides the nature of the next Government in 2010. The Walker Review is the response to the highly controversial collapse and possible demise of the Western market economy regime that has led to a rush by this Government towards a system based on a combination of regulatory organisations, regional co-ordination and centrally monitored performance standards and cost control. Operating under the double scrutiny of the Government and the press, everyone expected Walker to come up with a major restructuring that would affect virtually every component in the economic sector. A complete redesign was expected to create a network of medium-sized banks that are meant to be responsible for delivering sound economic judgement and overseen by the Financial Services Authority. It was hoped that the Government's intention would be to create a system of banking that is more UK-centred, that increases integration between banks and the rest of the economy, reduces 'risk', maximises the return of the bailout funding and produces tangible improvements for the public, manufacturing and commercial sectors.

In this mood of public hysteria, it is no wonder that the Walker Review has been received with so much disappointment. Now everyone wants to go back to the status quo ante and they were expecting that Walker would do just that. It is now inconceivable for the banking industry to continue ignoring the regulators and political powers. The structure that banking organisations say they create and the ones they actually do create are two different entities. There is a gap between probity and organisational objectives. Real management happens in the corridors. Real transactions take place when the Board meeting is over. Boards' coping modes include running meaningless routines. The resistance side of banks is holding back on regulation. Walker does not address fraudulent marketing, nor the question of what happens when the principal people in banks have no authority. What are they expected to do when faced with an untenable proposition? They resort to what is called parallel cognition to deal with situations where they are expected to know what the future holds and they do not. They resort to the use of risk models that are presented as acclaimed reality. Risk models are no use since they make assumptions using numbers. Making judgment calls is risky. It is a human weakness to consider a number as a reality. Risk managers are parachuted into Boards to communicate a philosophy of risk. But they are stripped of their authority because they are used as a veneer to support unlicensed risk appetite.

When confronted by the risk experts, Board members might say 'I don't get it, can you explain?' The risk experts explain but use the same words and complex concepts. To ask a second time for them to explain reduces the Board member's authority. The experts know that people won't dare to ask a third time because that will strip them of all authority. Therefore the experts are always ahead of the game. The group dynamic makes this happen.

Inevitably we are on the psychological and behavioural end of understanding structural power games in which the essential fact is that the finance industry is more powerful than either the government or the regulator. Banking is fickle – it can take its business wherever it wishes. The threat of leaving is powerful. Banks are cold-hearted and have no loyalty. There is always conflict between government and finance, because the government needs the bank's money and its ethics therefore become compromised. To rein in banking, there has to be international regulation. Walker can only address local governance issues. The picture is much bigger and everyone is implicated and has responsibility for its solution.

At the heart of the Walker Review is a multi-disciplinary approach which commingles Board responsibility with the expertise of law, finance, psychology and social science. The coming together of such disciplines to consider Corporate Governance and the evolution of BOFI Boards creates a mindset of learning from each other, it is the benefit of this mindset rather and a focus on collective responsibility to keep looking for new solutions that will improve governance nothing else, nothing more.