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Rethinking the moral economy of risk
management

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UK Walker Review 2009

- ‘the obligation of the board in respect of risk should be to ensure that risks are promptly identified and assessed; that risks are effectively controlled; that strategy is informed by and aligned with the board’s **risk appetite**; and that a supportive risk culture is appropriately embedded...’ (**para 6.5**)
- The role of the board risk committee should be to advise the board on **risk appetite and tolerance** in setting the future strategy, taking account of the board’s overall degree of risk aversion’ (**para 6.18**)
- ‘Alongside an internal reporting line to the CEO or CFO, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need.’ **Recommendation 24**

The moral economy of risk management

- Banking crisis: new/intensified focus on risk management...
 - ‘Risk governance’ as term of art; the governance of risk management = ?
 - Affirmation of ‘actorhood’ (Meyer) of the ‘Board’ as unitary actor; CRO as servant of the Board; Board as ‘meta-actor’?
 - New/intensified ‘accountability objects’: ‘risk appetite’, ‘risk culture’
- This is a kind of ‘moral economy’?

'Moral economy'

- Meaning 1: embeddedness of economy in society; role of social/cultural norms in structuring economic activity, explaining cross-national variation; analyst role to reveal hidden social foundations and values? Normatively to recover moral in the technical (Jasanoff)
- Meaning 2: managerial practices as sources and vehicles of normativity which are recursively reproduced; e.g. embeddedness of world level ideas of rational, responsible, accountable actors in management practices... 'governed by governance' (Drori)
- Analytical task to explain the normativity of managerial practice....history of 'common' sense present
- ..specifically how and why risk management has become so central to ideas of good governance?...Governance as 'discipline' in Foucault sense....but failing rather than 'iron cage'.
- Risk management as an 'accountability object'

'Moral economy'

- Mary Douglas suggestive: 'a culture needs a common forensic vocabulary with which to hold persons accountable and further that risk is a word that admirably serves the forensic needs of the new global culture'
 - '...a debate about accountability..is carried out incessantly in any community'
 - 'A risk is not only the probability of an event but also the probably magnitude of its outcome, and everything depends on the **value** that is set on the outcome.'
 - 'This argument is not about the reality of the dangers, but how they are politicized.'
- Perhaps this 'cultural' approach never more understandable than now e.g. **remuneration** explicitly connected to risk management agenda for first time = crisis as condition of possibility for new 'accountability objects' within risk management agenda
-but the close alignment of risk management with corporate governance underway well before crisis....need to explain nature and timing of this.

'Organized' Uncertainty

- observed expansion of risk 'discourses' since 1995
- Explanation: versus functional explanation; versus riskier society thesis – symptom of intensified mode of organizational accountability?
- 'Method optic': soft constructivism: uncertainty/risk/dangers related dynamically and nominalistically (Hacking) = 'uncertainties' become 'risks' when they are made into risk 'management objects' = Knightian uncertainties can, and are, organized as 'risks'
- = expansion more than technical; risk management being articulated as part of the good governance which **expresses** neoliberal alignment of risk-taking and safety.....

'Organized' Uncertainty

- Wave of 'standardization' projects for risk management 1990s; responses to crises/events but also 'world of standards' (Brunsson et al.)
- 'risk management' as 'boundary object' for different interests – finance, accounting + control, insurance, regulation; reinvention of roles
- Increased focus on, and belief in, ideas of integration, enterprise-wide, holistic risk management (ERM); normativity – cannot be against 'integration' as a value.
- Abstraction and genericization of risk knowledge
- Risk management being framed aspirationally as strategic; about enterprise and opportunity; neoliberal 'risking' selves outside of society
- = convergent pressures for an = "ERM consensus" consisting of 4 'moments' of expanded significance of abstract principles of risk management. Example of institutionalisation of task (Abbott) across professional struggles
- Calculation; process; people; regulation

'ERM consensus': calculation

- Calculative foundations long actuarial history, life and general insurance: 1990s challenges to insurance
- Financial institutions: pressures to govern quality of lending/trading; charge business for risk capital;
- Search for RAROC, Economic capital 'at risk'; organizational politics of charge
- VaR as capital at risk methodology; JP Morgan RiskMetrics 1993.
- Abstract elements of VaR widely diffused and accepted versus contested specific realizations of it; VaR as hybrid
- Capacity for new organization-wide descriptions emerging from portfolio theory: 'x% probability that losses will exceed y in a given period z'
- = new accountability language, regardless of what we now know

'ERM consensus': calculation

- Reconstruction of risk management field by VaR and related techniques: new expert modellers and agencies; new centres of risk control; pockets of unaccountability?
- Techniques which began as trading control; influence structuring of regulation (epistemic capture - language of finance vs law)
 - Basel 1 amendment and acceptance of internal risk models in 1996; readable as 'enforced self regulation' (Ayres and Braithwaite, 1992) but also as shift in regulatory register
 - Basel 2 as moral order; 'seeing like a state' (Scott)
- = VaR more than technique: plenty of critique within Finance; part of 'financialization of governance' as comprehensible basis for board oversight....when underlying realities of CDOs not comprehensible.
- expansionary potential of VaR ideas, adapted beyond the context of market risk (operational risk)
- *Enterprise* level VaR logic of diversification dominates understanding of *system* network effects

'ERM consensus': process

- Increased concern about organizational internal controls and quality control in 1980 and 1990s; context of new governance thinking
 - COSO 1991; G30 1993 (post Orange County); KonTrAG, 1999; Turnbull 1999; COSO 2004
- Risk management conceptualized as process; relate control design to objectives; governance and culture as foundation of risk management. Institutional demand for calculation to be 'governed'
- Cybernetic model of control; lack of organizational realism vs legitimacy as organizing idea, blueprint for Basel 2 and Sarbanes-Oxley
- Project of making organizations 'readable' (Scott) and 'auditable' (Power); well-known deficiencies, but.....
- institutionalization of 'risk maps/registers; rational representations of order' vs actionability

'ERM consensus': the CRO

- Chief Risk Officer (CRO) as emergent role corresponding to significance of risk management; 'voice of risk'
- Risk calculators vs oversight of 'risk culture'; cf Abbott (1988) offloading 'dangerously routine' tasks
- Officerships as generic; semi-regulatory insiders; work hard to represent their effectiveness; internal representation of organizational norms (Teubner)
- Draw on abstract knowledge but operate as mediators; possible internal conflicts for cross-cutting roles
- Institutionalized role vs response to risk; head of risk now a part of 'good' organizational design and governance; regulators expect this.
- CRO emerges as centre for organizational account giving; now a focus for reform (UK Walker review: **CRO as new moral agent**, fulcrum of good governance)

'ERM consensus': regulation

- UK late 1990s: risk management as organizing idea for public sector reform; attraction of neoliberal ideas of risk-takers, enterprise; e.g. UK civil service reform
- Regulation increasingly relying on organizational risk management systems; NB values of diversity (Hood et al 2001) vs abstract similarities?
- Regulatory state as risk management state BUT
- ERM ideas emerging as organizing blueprints and standards for regulatory process itself; risk-based regulation as model for regulation, and 'accountability object'.
- =...macro-prudential and systemic regulation dominated by micro-prudential ERM model and conduct of business focus..?

'ERM consensus' as moral economy'

- 4 elements of 'ERM consensus' = world level 'assemblage' (Meyer, Boli, Drori)?; standards as progressive externalization and codification of norms of practice
- This sense of moral economy order not about varieties of implementation; new kind of talk which is easy to diffuse and implement (Brunsson); abstraction and unreality part of strength of discursive effects of ERM consensus
- = ERM not just technique but 'web of norms' = ways of talking about organizing filter into practice but not as 'implementation'
- ERM as moral economy, posits unity, integration, holism but this flies in face versus organization theory of networks, hybrids. Social demand for view and control from the top? ERM = 'Seeing like an organization'
- ERM a risk-based vision of administrative objectivity and rationality? Postivism of the control system, control 'facts' becoming significant management data. Increased mediation of social risk by organizational internal controls and systems

'ERM consensus' as moral economy'

- To what extent has crisis challenged this 'ERM consensus..?'
- Multiple causes, diagnoses of financial crisis: economics; credit rating; regulators, greed, auditors, macro-prudential supervision, risk models, bank governance, bad management, sub-prime, ABSs, CDOs
- embeddedness of financial system in society via role of state (taxpayer) as bank of last resort – what is the politics of this recognition of embeddedness.....?'
- Partly intensification of demands for good governance, 'fit and proper' Directors; Board capacity to 'govern' risk, to know 'risk appetite' and to demonstrate this? UK Walker Review; Revised Combined Code 2010
- But.....

'ERM consensus' as moral economy'

-should 'ERM consensus' be regarded as part of 'wide ranging intellectual failure' (Lord Turner, Chairman of FSA)...as micro-foundations of macro-crisis?
-Easier to blame individuals than systems of thought. 'ERM consensus' as an idea too big to fail?
- Would not be only cause (failure of agency and perverse incentives) but contributed to 'knowledge climate' – both in terms of ethics and epistemology (power, 2009)
 - Promotion of immaculate images = **illusion of control** (Langer)
 - Reinforced **entity** focus.....system risk as sum of the parts?
 - 'Thin' conception of **risk appetite**

ERM and illusion of control

- ‘Audit society’ roots of crisis? ERM consensus promoted investment in risk bureaucracies with centralised compliance orientation (cf HSBC and Std Chartered as exceptions?); inward looking audit trail emphasis
- dominance of compliance-mentality in risk management/regulation as compared to imagination of different states of the world = organizational barriers to stress testing.
- Cognitive distraction: risk managers/regulators ‘busy’ on easy things (conduct of business) vs leisurely but hard areas (prudential management of system)?
- Issue mirrored at regulator level: Haldane (2009) admits insufficient focus of stress testing on complex system level
- Holt (2004): risk management better understood as developing mechanisms for *encountering* uncertainty, and generating actionability; preparedness for surprise vs preparing for blame = Look to practice for normative resources? What kind of politics, media necessary to support such an understanding?

ERM and the entity

- ‘Enterprise’ as ontological/normative assumption...
- ERM consensus and neoliberal individualization = financial system safety as sum of risk and solvency of parts.....despite ‘systemic risk’ recognition
- ...ERM consensus led to convergence and loss of diversity which increased risk and contributed to system failure; all balance sheets of financial institutions look the same (Haldane)
- Fragile seeds of change visible in ‘complex system dynamics’ turn in financial regulation (Haldane) could be complimented by discourses about financial system as ‘critical national infrastructure’
- Is this a new starting point for positioning firm level risk management as part of system; moral discourse about place of financial entities in society fragile....is ‘ERM consensus’ being reconstructed?
- New aggression of UK FSA does not necessarily mean change in this consensus; but ‘risk appetite’ as interesting dimension.....

Risk Appetite

- Risk ‘appetite’: ‘the amount of total risk exposure than an organization is willing to accept or retain.....’
- = neoliberal version of ‘risk tolerance’, which has a long history of debate in safety sciences; point at which values/choice ‘input’ into risk management
- ‘appetite’ implicit celebration of actor risk taking? But consensus that crisis a product of lack of clarity and strength at board level.....
- ..present intensification of risk appetite as an ‘accountability object’, part of renewed focus on ‘risk governance’ (Walker) plus New Code, May 2010
 - **C.2 Risk Management and Internal Control: Main Principle**
 - The board is responsible for determining the nature and extent of the significant risks **it is willing to take** in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.
- ..yet paucity of public discussion about ‘risk appetite’ as site of organizational and social values? Whose appetite?
- Site of potential democratic leverage? But.....

Risk Appetite

-Technical, capital metrics emphasis, focused on target credit ratings = *depoliticization* of technology = ERM consensus embodies 'thin' theory of 'risk appetite'
- Present focus on risk appetite as 'accountability object' assumes it can be known and articulated clearly by boards – pressure to do this.
- But if appetite is about internal values and trade-offs, we would expect operational frictions...
- Organization scholarship suggest more plausible to conceptualise a plurality 'risk appetites' in organization to be managed e..g. New product development: developer, entrepreneurial logic vs controller logics
- Vs myth of unitary risk appetite of the organization, starting point for risk management in facts of conflict....
- = Risk appetite not a static 'accountability object' but a variety of processes of 'appetising' which is always ongoing, may be semi-conscious and partially revealed.

Risk Appetite

- Grasping this embedded life of risk appetising as a prerequisite for partial codification in a formal risk appetite policy documents means that....
-Never likely to be perfect and risks of making tacit knowledge explicit and codified; 'risk appetite' a fuzzy object - is clarity of risk appetite sought by FSA even possible?
- Risk appetite as living part of risk management process; policies best understood as basis for conversation within organization and with its environment = point of 'structural coupling' (Luhmann)
-but being potentially transformed into an 'accountability object' within a compliance logic. Pressure on boards to demonstrate knowledge of fuzzy object will lead to illusory clarity.
- Ethical and political dimensions of risk appetite may continue to be understated....to save ERM
- These reflections open up possibility of a research agenda for risk appetite.....in vacant space between purely technocratic and purely political....
- Toolkit for normative project of rethinking moral economy.....

Risk Appetite: a research agenda

- Organization theory and recent KPMG survey both suggest non-unified ‘appetite’ view is normal; fragmentation vs perfect coding of organizational behaviour.
- So key question could be HOW IS A UNITARY RISK APPETITE POLICY CONSTRUCTED, REPRESENTED AND DISSEMINATED?
 - History of the category – most likely financial services
 - How are broad policies linked to performance metrics/KRI design and operation; bottom-up and top down
 - How is conflict (= disagreement on goals) represented or effaced?
 - How are ethical/moral dimensions represented or not i.e. ‘what we don’t do?’ = what risk appetite statements leave out. How are ‘disapproved behaviours’ (Douglas) represented in risk appetite policies?
 - Do claimed risk tolerances really operate as triggers or not? Organizational politics of override of formal appetite
 - How does the risk appetite policy evolve; what are its processual features?
 - What effects of its status as an ‘accountability object’? How can we explain cross-organizational variation?
 - In what sense a ‘moral compass’ for organizations?

Conclusions

- ‘better’ risk management/risk governance demanded in all jurisdictions; more challenge plus policing of ‘risk appetite’
- Pre-2007 formation of ‘ERM consensus’ risk management; emerged as elaborated form of organizational normativity (accountability) only loosely coupled to ‘real’ dangers?
- = risk management as indicative of a kind of (neoliberal?) organizational virtue of self-control, actorhood and intentionality (Boli); Auditable risk management systems – part of account giving; organizations show *how* they do things. Likely to intensify...
-but recent history shows this moral order is constantly surprised by its failure.
- Internal tensions in the ‘ERM consensus’ between logics of discipline (control) and opportunity (value creation via risk taking)...now we are experiencing swing back to discipline? But consensus itself robust....
- Risk appetite now emerging as critical category of practice, but historically ‘thin, technocratic’ conception of risk appetite;Missing/understated element potential for different kind of organizational register and moral discourse.....