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Risk management and calculative cultures

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ABSTRACT

Enterprise risk management (ERM) has recently emerged as a widespread practice in financial institutions. It has been increasingly codified and encrypted into regulatory, corporate governance and organizational management blueprints. A burgeoning literature of regulatory and practitioner texts is indicative of the apparent diversity of ambitions, objectives and techniques that constitute the ERM agenda. Making sense of these developments is a challenge. This paper presents field-based evidence from two large banking organizations suggesting that systematic variations in ERM practices exist in the financial services industry. The cases illustrate four risk management ideal types and show how they form the 'risk management mix' in a given organization. Further, drawing on the literature of the roles and uses of management control systems (MCS), the paper explores how ERM achieved organizational significance in the studied settings. The findings are indicative of the current co-existence of alternative models of ERM. In particular, two types of ERM models are postulated: one driven by a strong shareholder value imperative (*ERM by the numbers*), the other corresponding to the demands of the risk-based internal control imperative (*holistic ERM*). This paper explains the differences in the two risk management mixes pointing towards alternative logics of calculation [Power, M.K., 2007. Organized Uncertainty—Designing a World of Risk Management. Oxford University Press, Oxford], which I conceptualise and describe as different *calculative cultures*. The study suggests that calculative cultures, which in these cases shaped managerial predilections towards ERM practices, are relevant, albeit so far neglected, constituents of the fit between MCS and organizational contexts.

1. Introduction

> 'One of the things we have been struggling with over the last couple of years is how best to integrate meaningful high-level risk information into the strategic planning process. . . . The reason why the risk management function is called 'Strategic' is that the purpose should really be top-level coverage.'

(Chief Risk Officer, Strategic Risk Management, Gotebank).

> 'Most of the people doing strategy [and planning] don't understand risk. Most of the risk people don't understand strategy. . . .People who do strategy [and planning] know they have to work out economic profit and they know they have to work out how much risk is involved, but they are not very interested in it. They are more interested in income and what is going to happen to the market place. They don't want to get involved with risk all the time. The risk people spend all this time on calculating how much risk they have got and they don't look at the bigger picture. Getting both sides to talk to each other is the hard part.'

(Assistant Director, Group Strategy and Planning, Fraser Bank).

Making risk management strategic is a common pledge vowed by a string of chief executives who are currently taking the helm at troubled banking enterprises, weighed under the highest losses reported in recent credit history.

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The importance of making risk management 'count' in high-level strategic decisions is perhaps the most agreed upon lesson that industry actors are taking from the current credit crisis. As the Wall Street Journal commented on 15 November 2007: 'After an era of go–go growth that led firms into profitable but chancy areas like mortgage securities, the industry is moving toward the kind of leader who gets down into the nitty-gritty of risk management.'

Indeed, the rise of risk management in recent years has drawn attention from several commentators who have been marvelling at the increasing spread and codification of risk practices under the term enterprise risk management (ERM). Michael Power noted the 'explosion' of risk management practices as a social phenomenon: 'the risk management of everything' (Power, 2004). He proposed that ERM might have emerged as a 'world model': 'If we were to imagine the creation of a new banking organization, we know that it could not be founded without rapidly adopting the mission and principles of ERM.' (Power, 2003a: 10). International bank capital regulation and corporate governance are two areas where the prominence of ERM was particularly ubiquitous. The Basel Committee, leading the reform of banking supervision, endorsed enterprise risk management as an umbrella notion that can accommodate the techniques required for bank capital adequacy calculation: '. . .integrated firm-wide approaches to risk management should continue to be strongly encouraged by the regulatory and supervisory community.' (BIS, 2003b: 2).

Many banks have adopted the mission and principles of ERM (PricewaterhouseCoopers, 2005, 2007; Deloitte, 2007). Yet we know little of how enterprise risk management works in action. Several questions are unanswered. What do risk managers do and what functional and structural arrangements organize their activities? What degree of organizational significance do risk managers have? How are risk control systems used by decision makers? Similar questions are being asked in the wake of the current crisis of confidence in the risk management capabilities of banks implicated in the credit debacle (Treasury Committee, 2007a, 2007b). As regulators and policymakers search for the answer in the spotlight of media and public scrutiny, this paper looks behind the scenes of risk management to its actual organizational settings, to examine the organizational processes through which the 'risk voice' is made influential, or not, as the case may be.

Risk techniques were developed by financial institutions to address the issue of capital adequacy (how much capital cushion should a bank hold?) and the internal allocation of capital to business units (how much capital should individual business units carry?). The amount of capital reserved by banks is a key regulatory and managerial concern in the financial services industry. Risk techniques determine adequate capital requirements in proportion to the amount of risk taken, suggesting that banks should reserve more capital for higher risk-businesses and carry less capital for less risky ventures. Not derived from accounting principles, but from 'economic calculations' of risk, the risk-based capital amounts rarely coincide with the traditional accounting capital figures that banks carry in their books.

The risk-based capital calculations are advocated by a new controller group, risk managers, as internal representations of risk profiles, complementary to accounting capital. Risk capital calculations may or may not get acted upon and put into action to determine *actual* capital allocations in the course of the planning process. In case they do, they add a new facet to accountability. Risk-based capital allocations open the possibility for capturing the so-called *risk-adjusted* returns that individual business units (or a group of business units) earn. Their technical novelty is that the accounting capital amounts used in the performance metrics are replaced by the *risk capital allocations*: thus, risk-adjusted return represents a departure from, and a complementary performance measure to, traditional accounting metrics.

Given that the suggested applications of ERM in financial institutions belong to the realm of financial decision making and management control, it is somewhat puzzling that accounting researchers have so far given little attention to the subject. All the same, the literature of management control systems can help us make sense of enterprise risk management. In return, the existing body of work on management controls should be enriched by exploring ERM as another facet of organizational control and accountability. The common area of interest is the roles and organizational significance of calculative practices.

Twenty years ago accounting was viewed mostly as a technical subject and little was known of 'the organizational processes . . . through which the technical achieves its potential' (Hopwood, 1983: 291). Recognising this, a number of important manifestos called for an organizational, rather than a singularly technical approach to accounting research (Burchell et al., 1980; Hopwood, 1983). Subsequent studies illuminated the roles that calculative practices play and the intended and unintended consequences they have. These studies can be called upon in the course of exploring and scrutinising the roles and organizational significance of risk management.

The objective of this paper is twofold: First, it conceptualises and synthesizes the diverse practices described by the normative literature on ERM. Second, based on notions developed in the management control literature of how calculative practices achieve organizational significance, and extensive field evidence, the paper explores the forms and uses of ERM and the roles that risk managers have come to play in actual organizational settings.

This paper presents evidence from a field study undertaken in two large banking organizations. The focus on banks has a caveat emptor: risk management here (supposedly) addresses the question of bank capital adequacy, which is a regulatory requirement not faced by non-financial institutions. As the observed risk managers, however, will be shown to have wider objectives, and try to become involved in strategic planning, performance management and control, the study has implications for all risk managers who cast their nets wide and cultivate strategic control ambitions. These cases may have implications for not only banking specialists, but also for the theory and practice of enterprise risk management in general, as a corporate governance and management control discipline.