Thinking

How can the financial services industry improve its approach to risk management?

What safety net? the US Federal Deposit Insurance Corporation had to close 24 banks in 2013 – six years after the financial crisis struck

Ever since the 2007-08 financial crisis, firms have been asking their accountants to discuss key risks, including those unrelated to financial reporting. Even so, more recent crises affecting financial services companies strongly suggest that these firms and their auditors, investors and regulators still weren't aware of the scale of the accumulating risks until it was too late.

It's clear that we need a better measurement framework for risk exposure. One proposal, which has been tested in financial services firms, is to measure risk using a common unit of exposure. Basically, this new method, which we call risk accounting, adapts the management accounting system so that the information typically attached to a transaction when it's registered in a bank's system (product, customer, market segment etc) is complemented by information on risk that's triggered when the transaction is accepted. In this way, a calculation of risk-weighted transaction values may be enabled and accounted for.

To create a risk accounting system, an organisation's risk managers work with operational staff to come up with scores denoting each department's exposure to risk and the effectiveness of its risk mitigation procedures in every process for which it's responsible. In doing so, they use three sets of standardised tables relating to the three "risk drivers" that are present in all business processes:

- The risk characteristics of the relevant products.
- The amounts accepted for processing in accordance with accounting records.
- The effectiveness of the operating environment at mitigating risk.

A risk mitigation index for each process is then derived using best-practice templates. The risk weights assigned to each transaction are used in the calculation of its exposure to risk using a new metric, the risk unit. The resulting scores and weightings are applied in a scorecard under which operational metrics are computed, consolidated and aggregated.

Once the residual risks of individual transactions are quantified, they are aggregated by risk type (market, credit, operational, liquidity etc) and then by department, region, product and customer. Feedback loops can then be designed to give managers nearly real-time information on risk.

Risk accounting is tied to the people, processes and systems involved in an organisation's interactions, both external and internal. The result is the proactive mitigation of risk, where risk weights are determined through a structured process that embeds the expertise of operational managers into the very fabric of the risk measurement system. A potential benefit of risk accounting is that it integrates the enterprise's risk management and financial reporting systems. And, because risk accounting is an extension of management accounting, setting and monitoring the organisation's appetite for risk can become an integral part of its budgeting and planning cycles.

Indeed, it can be argued that the disclosure of an enterprise's financial situation and the associated determination of its capital adequacy should be a function of accounting instead of the financial modelling that's widely relied on at present. If accounting is to meet the challenge posed by the financial crisis and take the opportunity presented by the clear inadequacy of current methods, its core function must adapt in order to accommodate the risk exposures inherent in financial transactions. FM

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