



Look what happens when gut feel goes missing

Sir

A striking aspect of the global financial meltdown is the inescapable fact that it occurred in a market sector which has heavily engaged and embraced the discipline of risk management. Certainly some of the most highly paid risk professionals in the world were working in the financial sector: individuals of great analytical skills, hired for not only compliance but to prevent their parent organisations suffering extensive financial loss.

While most experts agree that the crisis is far from over, one has to wonder how such highly skilled members of our profession could have misjudged the risks to such an extent that sector-wide corporate collapse is haunting all but a few financial institutions.

As risk professionals, we learn lessons from losses. Our experience has been that we learn very well when losses are caused by natural sources such as cyclones, tsunamis, avian flu, etc. We also seem to be good learners when causes of losses

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are the actions of individuals such as theft, fraud or terrorism.

We appear, however, to still have a pervasive blind spot when the causes of loss are the actions of thousands or millions of people who decide things like, “I will not pay my mortgage”, “I will declare bankruptcy”, “I will no longer value the currency of my country or other recognised standards”, and “I will disengage from financial activities because I no longer trust my advisors, my financial partners, my banks or my economy to provide for my economic future”.

Ahead we all see a long hard climb up the mountain of hard insurance markets, limited credit and increased risks. The lesson I am seeing now is to know and understand the maths, but remember it's only a guide, not a master.

Many finance risk professionals believed in the sanctity of quantitative methods. They managed by what the numbers told them, and took actions only if the equations, algorithms and quotients provided them with numerical approval. They measured their strengths, weaknesses, and levels of risk by how the numbers played out, and trusted the answers.

In addition, the compliance monitors and regulators also trusted the numbers, but in the end, the numbers mean very little when millions of people think and act differently. If numeracy is the only attribute we have, we could all be replaced by calculators.

That is not to say quantitative analysis is not useful. It is the background to our work, and as risk professionals we should better understand how these models are developed and how they work.

That said, as well-rounded risk professionals there should also always be a large dose of GFA (gut feel analysis) mixed with quantitative analysis to establish risk management programs and implement mitigation strategies. After all, that is the art of what we do.

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