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Rigid, Fluid and Context-Dependent ERM

By Charalampos Fytros

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Title: Rigid, Fluid and Context-Dependent ERM

By Charalampos Fytros, CFA, FHAS

Abstract:

One of the hottest themes today is about Enterprise Risk Management (ERM). Current literature on ERM practices is immense. The last few years, the collaboration of an actuary, David Ingram and an anthropologist, Dr. Michael Thompson, has provided us with a fresh and innovative perspective towards ERM that takes its cue from what is known as Cultural Theory of Risk. Cultural theory recognizes that the world is populated by people with four fundamentally different but equally valid attitudes towards risk—this is why it is also called the theory of plural rationalities. Such basic insight is inconsistent with both the mainstream financial view that there is only one, universally valid rationality (permeating all local/partial perspectives), and the ascending behavioral finance sad recognition that such a single rationality is almost always contaminated with inherent biases. Yet, if risk managers come predisposed by different but equally valid sets of risk-concerns (as Cultural Theory of Risk asserts), then ERM should not be seen as a vigorous discipline to enhance our rationality (as mainstream finance declares) nor as an exhaustive process to debug, manage or minimize inherent biases (as behavioral finance contends). ERM should instead convert to an effort to bring out our plural identities at their best and synchronize them with the different phases of the risk-cycle in a frictionless way. We call the ERM notion of both the mainstream and behavioral finance “rigid-ERM,” and the ERM notion of plural rationalities “fluid-ERM.” The paper’s claim is that both these types of ERM practices fail to account how risk managers, in everyday normal tasks, develop their ERM practices in a context-dependent way.

Cultural theorists claim that it was not the lack of discipline on the traditional ERM regime to be blamed for the financial crisis, but the fact that such rigid-ERM practices remained unadjusted for plural rationalities. Such unadjusted practices led to huge mismatches between already in place ERM functions and the changing risk environment. The paper claims that although we should adjust for the plurality of rationalities, the solution proposed by cultural theory should not be uncritically accepted—even if each of the rationalities could perfectly match with each of the phases of the risk cycle (as fluid-ERM strongly suggests), that would not lead to best ERM practices. Although rigid-ERM leads to “stickiness” by the preservation of the old practices and thus to the inability of keeping in pace with the changing risk environment, fluid-ERM by contrast leads to frictionless adaptation that discontinues, disrupts and disperses proprietary developed practices and the accumulated expertise of the firm. Context-dependent ERM—i.e., ERM practices that risk managers normally follow—takes into account the whole context, that is both the recognition that risk environment changes and the need for the firm to develop a stable (yet open to meaningful changes) sociotechnical identity with a consistent risk attitude and appetite.