Risk Management: The Current Financial Crisis, Lessons Learned and Future Implications

by Neil Bodoff

Various ingredients contributed to the current financial crisis, and we can learn many lessons from the crisis. Yet rather than myopically focus on the particular minutiae of the current circumstances, we ought to pay special attention to those central issues that underpin the current crisis, past crises and future crises.

I believe that the central issue that underlies the current crisis and many others is how one measures profit. Specifically, the current crisis derives from the lack of "risk adjustment" when reporting profit; a key reform crucial to mitigating future crises is to ensure that we always measure profit on a "risk-adjusted basis."

Measuring profit on a risk-adjusted basis is critical in both of the following contexts:

1. When measuring profit for external communication to shareholders and others.
2. When measuring profit for internal compensation calculations.

There are two critical reasons for measuring profit on a risk-adjusted basis:

1. It provides more meaningful information about profit ability.
2. It reduces the incentive to take excessive risk in order to increase profits.

Currently, a firm reports its profits to external audiences without any risk adjustment; thus the firm's financial statements do not reflect the level of risk the firm undertakes in order to achieve these profits. As a result, many groups that rely on financial statements, such as investors, lenders, credit rating analysts and regulators, can be blindsided when a firm's steady, long-term profits suddenly invert to sudden, catastrophic losses; reporting risk-adjusted profit, however, highlights the extent to which a firm's profits derive from taking risk.

In addition, how a firm measures profit usually affects how the firm compensates its key employees; in turn, a firm's compensation system directly affects employee incentives for risk taking. Therefore, a firm that does not adjust for risk when measuring profit for internal compensation purposes creates powerful incentives for excessive risk taking. On the other hand, when a firm measures profit for compensation purposes on a risk-adjusted basis, there is less of an incentive for employees of the firm to take excessive risk, because increased risk does not automatically lead to the potential for increased compensation. Shareholders, creditors, rating agencies, regulators and taxpayers all have an interest in ensuring that a firm's compensation system does not generate structural incentives for future excessive risk taking.

The proposal to measure profit on a risk-adjusted basis would likely require major changes to accounting standards and financial statements, certainly no simple task. Moreover, it would also likely require substantial changes in the compensation systems of many firms, another difficult challenge. Most broadly, it would require changes in the underlying intellectual framework, psychology and embedded practice of current methods of measuring profit. Ultimately, the task of measuring profit on a risk-adjusted basis would be quite a challenge, but this reform has the potential to preemptively undermine the perverse incentives for excessive risk taking and, as a result, reduce the likelihood and severity of future financial crises.

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