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Risk Bearing Capacity and the bearers of responsibility

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ABSTRACT

Risk is a topic which has gained attention beyond specialists in organisations and academics since at least the publication of Beck's (1986) work on the "society of risk". Beck wrote under the shadow of the nuclear meltdown of Tchernobyl which made clear that we are exposed to risks we cannot necessarily perceive, but are immediately affected once they are realised. The financial crisis of 2007/8 brought the immense risk which the financial industry represents and the regulation aiming to control these risks, to a broader attention. Central to the banking business is the requirement to deal with risk inherent in any business, to provide instruments to manage the consequences of risk, but also to trade these instruments. Additionally to risk management, as required by legislation or regulations such as the Financial Accounting Standards, the aim of banking regulation is also to manage the inherent added risks resulting from the aggregation of risk, i.e. those risks that are created by the management of financial risk by the act of trading the risk. Given the immense importance of risk and its management it is a necessary task to not just discuss the content of regulation, but also the central terms used in it. To ask what do these terms mean, which connotations must be considered when using them, how do they lead our attention? The intention of this paper is to have a closer look at the term "risk bearing capacity" and its use in the banking regulation of the Basel accords.
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One needs courage in order to think in general – *if only the courage of one's own fear.*
(Derrida 2011: 147)

1. Introduction

In her article "Risk(ing) Metaphors" Joni Young (2001) demonstrated how ambivalent metaphorical language can be. Metaphors focus and deflect our attention to risk and guide our actions and perceptions, especially regarding the thinkability of risk management. Risk is a metaphor with a variety of meanings, she claims, but using metaphors always also contains a risk of misunderstanding and exclusion of other potential meanings. Risk must be controlled and managed and is, seen from this perspective, something external, an *other.* Her argument addresses three different metaphorical groups: orientational, in which risk is seen as a down; as attribute, where risk is seen as a quality; and ontological, examples of which are risk as substance, moving object, burden, exposure, disease or adversary (Young, 2001: 612). The ontological quality of risk as exposure is exemplified in the financial industry. Exposure is a term central to risk management in both the Financial Accounting Standards and the banking regulation of the Basel accords. Thus a company is said to be exposed to risks. The formulation of the regulator constructs risk as a particular type of condition where the company is left in a state of suffering without adequate shelter (Young, 2001: 616). Risk is a burden. The metaphor of risk as burden and its use in the Financial Accounting Standards as demonstrated by Young provide a direct link to the topic of this paper. "By thinking of risk as disease, substance or burden, we begin to conceive that we may control risk" (Young, 2001: 618). Young's research on risk as metaphor is aimed at making us aware of the term's capability to construct the reality in which we act. Taking different

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metaphors, she concludes, may redirect our thoughts from a belief that we can control risk towards a view that enables both to see and realise the blind spots.

Earlier Elton McGoun (1995) had a close look at the "history of risk management". He followed the track of the attempts to measure risk and found the somehow surprising development that the probabilistic measure was seen extremely critical around the 1930s, but that this scepticism vanished completely by 1950: "Yet it is difficult not to wonder at the way the technical problems were so easily dismissed after they had led a probabilistic measurement of risk to be rejected by 1930" (McGoun, 1995: 530). His conclusion is that these assumptions are deeper beliefs based on a faulty ratiocination. Twenty years later we still see risk management very much relying on calculation.

In a paper titled "Finance theory: A house with no windows" Keasey and Hudson (2007) commented about the autistic tendencies of finance, in their case portfolio asset allocation. Finance theory, they claim, takes data from the outside world but often ignores the rich complexities of the context. Interestingly enough, their article was published during the time when the global financial crisis emerged. The intention in the following points to the complexities of the terms involved in risk management and what can be overlooked. Young (2001: 615), in quoting the accounting standard for Research and Development Arrangements notes that "Companies have to bear the risk of failure". From this formulation it is only a short step to the idea of a *risk bearing capacity*. During a discussion with a risk manager of a German bank on the difficulties and contradictions of implementing banking regulation, the term 'Risikotragfähigkeit' (risk bearing capacity), a central term of German banking regulation was highlighted. It was apparent that the term can have a different interpretation than is commonly assumed.[1] What does this term mean? We know what it should mean. It is an expression to summarise all the aspects of risk connected to the special risk in the banking business as well as the risks any company faces. It denotes the capability of the bank to bear its material risks. However, the term 'Risikotragfähigkeit' (risk bearing capacity) has in German a strangely ambivalent meaning. Who or what is bearing what? Does someone have to bear the risk, or, does the risk have the capability to bear? And, if yes, what is risk able to bear? And what about the responsibility when taking a risk? Starting with the significance of the term risk bearing capacity in banking regulation it soon turns out that a discussion of the meaning of *to bear*, *responsibility* and *justification* helps to understand a crucial change in the question who is responsible, or accountable to bear the risk.

The range of meaning of 'to bear' was among the topics of Jacques Derrida's last seminar (2002/3, published in 2011) and can be fruitfully connected with his discussion of responsibility. Based on these arguments, in sociology the figure of the *bearer of responsibility* reveals an almost oxymoronic character. (Boltanski & Chiapello, 2003; Boltanski & Thévenot, 2007; Boltanski, 2008, 2010) Taking risk involves potential collateral damage. On the financial markets, the aspect of the distribution of damage beyond the market participant taking it, gained infamous attention as systemic risk. If banks, considered as system-relevant, fail, the whole banking system is also in danger of failing. Such a situation, should this be the case, immediately calls for an intense justification. As it turns out, banking regulation, as laid down in the Basel accords, has a different demand on justification as would be expected considering a critique of justification conditions (Forst, 2011).

2. Risk bearing capacity

The Swiss town of Basel provides the name for a crucial part of international banking regulation. Basel is the seat of the Bank for International Settlements (BIS) which, among other tasks, hosts the central secretariat of the global committee on banking supervision called the Basel Committee. The committee was set up by and consists of representatives of national banks and national regulation authorities. It negotiates a framework of regulations for all banks worldwide, the Basel accords, known as Basel I, II and III. Triggered by the bankruptcy of Herstatt Bank in Germany in 1974 due to uncontrolled and almost unlimited engagement in huge deals in international foreign exchange markets, the Basel accords formulate common rules how to calculate any kind of risk and how much capital must be reserved to cover losses from these risks. This is called 'capital adequacy'. Rules for internal auditing and disclosure add to the calculations. Although these regulations are not immediately binding, their purpose is to be transformed into national legislation and regulation. In Germany this is the task of BaFin, the German Federal Financial Supervisory Authority.

The term is introduced in the German "Minimum Requirements for Risk Management", including a translation:

> "Auf der Grundlage des Gesamtrisikoprofils ist sicherzustellen, dass die wesentlichen Risiken des Instituts durch das Risikodeckungspotential, unter Berücksichtigung von Risikokonzentrationen, laufend abgedeckt ist und damit die Risikotragfähigkeit gegeben ist" (MaRisk,[2] AT 4.1).
>
> "On the basis of the overall risk profile, the institution has to ensure that the material risks are covered by the risk taking potential at all times, taking into account any correlation between risks where appropriate, and that the institution is therefore able to bear its material risks."

'Risikoträgfähigkeit' is translated here as to be "able to bear its material risks". The obvious difference between the two versions stems from a basic characteristic of the languages: German tends to prefer nouns when describing facts; English expresses these more in verbal form. "Risk Bearing Capacity" is a 1:1 translation that is, to my experience, widely used.

[1] I am grateful to Thomas Regehly who shared this initial game on words with me.
[2] Minimum Requirements for Risk Management, December 2010, BaFin, German Federal Financial Supervisory Authority.

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