Preparing for Financial Surprise

Michael Power

Department of Accounting and Centre for Analysis of Risk and Regulation, London School of Economics and Political Science, London, Houghton Street, London WC2A 2AE, UK. E-mail: m.k.power@lse.ac.uk

This essay shows how Todd LaPorte’s work on reliability-seeking organizations contains insights for how we might understand the financial crisis of 2008–2009. In particular, the financial system was not perceived and described as critical infrastructure, there was a regulatory overemphasis on routine operational practices at the entity level, and there was insufficient countercyclical leadership. These and other of LaPorte’s ideas bridge the divide between the two ‘cultures’ of financial and non-financial risk management.

We can be badly surprised even in the most examined of situations (LaPorte, 2007, p. 61).

1. Introduction

Crises tend to be both epistemologically democratic and distributively inegalitarian. The former because the credibility of expertise is often damaged to the extent of creating a ‘level playing field’ of ignorance; the latter because the victims of crises are rarely those in positions of responsibility. We know very well that the greatest harm usually descends on those least able to defend themselves.

The financial crisis of 2007–2009 is no exception, although the victims may be less immediately apparent than in the case of a natural disaster. Described in the United Kingdom as a ‘wide-ranging intellectual failure’ (Turner, 2009), the crisis questions what regulatory officials and others should have known and should have done, both to prevent it from happening and also to mitigate its impact. A great deal has been written on the multiple causes of the crisis, tracing them variously to institutional, organizational and psychological ‘failure’ of one kind or another. Considerable criticism has been reserved for economics itself, or rather its neoclassical manifestation in macroeconomic modelling and financial economics. Leading economists have been prominent in the debate and ideas of market-efficiency and financial system self-regulatory capacity have been popularly pronounced as dead.

For all these and other instances of introspection, blaming and demands for regulatory reform, there is a sense that regulatory knowledge itself has not moved on. For reasons that social scientists understand very well, we are always likely to seek solutions that upset existing practices and norms least, thereby getting more of the same (Briault, 2009). To avoid such policy conservatism, the institutional ability to transfer insights across fields is acutely important. Crises create windows for problem-focused disciplinary exchange that are nearly impossible in normal times; methodological and substantive boundaries temporarily relax. As the need to rethink fundamentals emerges, so too do the traditional barriers between forms of expertise, academic as well as managerial, become more fluid – for a while. Yet a crisis is hardly a sufficient condition for the development of new knowledge, as we see again and again. Brokers and mediators are also needed.

In this respect Todd LaPorte’s work on how organizations might prepare for ‘untoward surprise’ has much to say about how we should think of the banking crisis and its solutions, even though his ideas are conceived in a very different context. Indeed, shortly before the onset of the crisis, in a special issue of Journal of Contingencies and Crisis Management, LaPorte (2007) provided a set of rather prescient reflections. This essay pays tribute to his insights, there and elsewhere, by suggesting how they might travel across the institutional and intellectual divide, and even illuminate a new moral economy for the world of finance.

2. The regulatory discourse of critical infrastructure and high reliability

LaPorte’s work underlines the importance of organizational vocabularies and discourses; they have a ‘performative’ character by making specific actions and interventions thinkable and legitimate. The cool bureaucratic language of prudential financial management was undoubtedly falsely comforting, and therefore unable to inform the preparedness for fundamental surprise of the kind that occurred after the collapse of Lehman Brothers in 2008. This was an event which certainly produced: ‘... novel, unprecedented institutional operating conditions and analytical challenges [...] well beyond imagining’ (LaPorte, 2007, p. 61).

If we accept this broad sense of performativity as the view that discourses provide the conditions of possibility for thought and action, then a normative programme for institutional change would necessarily involve some
fundamental reconceptualization. For example, banks and the networks within which they operate should re-position existing discourses of ‘risk appetite’ in terms of values of high reliability and catastrophe avoidance. This is a space where efficiency norms can be trumped by those of system resilience (LaPorte & Consolini, 1991). Adapting the ‘performatve’ theory of speech acts to this prescriptive policy end might permit the concept of ‘high reliability’ to be repeatedly enacted and to constitute a new regulatory style. It could be part of a policy discourse that reminds banks and their regulators to ‘devote considerable effort to simulating emergency situations and practicing responses to them’ (LaPorte & Consolini, 1991, p. 35).

Financial capital is a form of system redundancy and therefore resilience. Expert knowledge of risk capital as a buffer against shocks had changed dramatically over two decades or more, shifting from a juridified, non-economic and highly prudential concept to become more elaborately calculated and ‘risk sensitive’ in the Basel 2 regulatory climate. This ‘calculative turn’ in the understanding of financial regulatory capital has had, and continues to have, its own politics: regulator system resilience requirements for higher capital can conflict with the aims of banks as commercial enterprises. Yet, the pre-2007 authority of practices of fine-tuning financial capital via elaborate models has been damaged by this crisis. There is heightened attention to asset quality and liquidity, which has the potential to re-position the idea of capital as preparation for fundamental surprise, and as an aggregate resource for the resilience of critical financial infrastructure. Proposals for countercyclical reserving of capital i.e. extra reserving when times are good, go some way towards this idea. But perhaps ‘extraordinary leadership’ in LaPorte’s sense is also needed in order to maintain the social and institutional imagination of crippled infrastructure and its consequences for society and communities.

3. Critical infrastructure: representation and intervention

LaPorte’s work reminds us that system resilience is not simply a technological fix. It can only begin with both the will and capacity to describe the financial system and its vulnerabilities, rather than relying on myths of its self-regulating and auto-risk-diversifying character. What seems clear is that the commonplace description of the financial system as global was only partly true; the experience, both economic and legal, of the failure of that system has been shown to be irredeemably national in character and consequence. Bankers and financial regulators either forgot, or were unable to articulate clearly, their role as guardians of a critical national infrastructure on a par with energy and water.

One possible reason for this failure has to do with the mix of regulatory knowledge and the relatively intense focus on micro-organizational forms of risk management (e.g., capital, internal controls). In this way, regulators sought to extend their influence deep inside the working of financial organizations but failed to invest as intensely in understanding the system in which financial organizations were components. Again, LaPorte (2007, p. 61) reminds us that ‘In the face of current sustained efforts in realizing ‘micro-efficiencies’, organizational capacities are increasingly brittle with declining redundancy and very limited resilience’. Extending his point, efficient ‘enterprise risk management’ at the individual financial institution level created an illusion of system resilience because the sum of the rational parts resulted in a deeply vulnerable whole (Haldane, 2009; Power, 2009).

LaPorte & Consolini (1991) suggest, intriguingly, that high reliability organizations (HROs) work in practice, and not in theory, because they manage to institutionalize three modes of operation, namely: routines, high tempo activity and emergency responses – each with their respective legitimate authority structures. Arguably, financial regulators have not operated as HROs in this sense because resources and cognition gravitated to the routine mode of operation in the form of easily digestible blueprints for management action. The financial system as a whole only seemed safe because each individual firm or unit could demonstrate extensive audit trails of compliance and risk management to the regulator – symbolic but not real risk management. As LaPorte reminds us, ‘institutional norms and processes that in calmer times act to facilitate public functions (e.g., accountability practices) . . . become inhibitors to fashioning novel responses in times of crisis when flexibility and improvisation is in order’ (LaPorte, 2007). Or, to put it another way, a society which seems to manage risk via the intensification of auditing and monitoring (Power, 1997), in fact makes itself more vulnerable by damaging the institutional conditions for encountering fundamental surprise.

This is not to say that systemic financial risk was never imagined or feared. There was always a broad understanding of interconnectedness risk, in which fragility in one financial institution might trigger a ‘contagion’ of actions, which, while rational in themselves, could be destabilizing as a whole. The fear of system-wide cascades is why the electricity grid is managed as reliably as it has been. Yet it seems that the balance in financial services was wrong and the focus was predominantly upon individual institutions and calculations of their individual financial strength. The macro-prudential knowledge system proved to be inadequate and there are currently attempts to rethink its foundations. For example, Haldane (2009) conceptualizes financial markets as complex adaptive systems, drawing lessons from other network disciplines – epidemiology, biology and engineering.

Haldane’s analysis provides a new image, and mathematization, of the vulnerability of a financial network that was both ‘robust and fragile’; ‘more complex and less diverse’. He points to feedback effects under stress, and how the complexity and dimensionality of the network further increased uncertainty, a tendency exacerbated by financial innovation. The result was that financial diversification strategies achieved the opposite of risk reduction because
of a loss of diversity of business models and related risk management practices. The similarity of banking balance sheets, devices intended to make vulnerability 'readable', would have been a red flag in any other resilience-seeking context. That is, network connectedness acts as a source of resilience only up to a point – after which it can ‘flip’: 'long periods of apparent robustness, where peripheral nodes are subject to random shocks, should offer little comfort or assurance of network health. It is only when the hub – a large or connected financial institution – is subject to stress that network dynamics will be properly unearthed' (Haldane, 2009, p. 11).

The scale of interconnectivity that increased prior to the crisis had ‘normal accident’ properties, in the sense that the complexity of chains of claims and claims on claims made the ‘counterparty risk’ of collateralized debt obligations practically unknowable and beyond control. Yet an illusion of control was created by atomistic risk management within the financial system: ‘Imagine assessing the robustness of the electricity grid with data on power stations but not on the power lines connecting them’ (Haldane, 2009, p. 22). Under these extreme conditions, the traditional portfolio concept, which is central to resilience strategies of all kinds, needs to be supplemented with a more network-sensitive analysis capable of understanding the vulnerabilities created when all actors seek to diversify in the same way. Yet the required re-description of the properties of the financial system as critical infrastructure rather than as ‘efficient market’ also needs institutional leadership.

4. The leadership challenge

LaPorte (2007) suggests a need for institutional leaders to make ‘extraordinary efforts’ to embrace the possibility of surprise in which they would face situations well beyond their experience. The operational and behavioural challenges in seeking discomfort are considerable, but the leadership question is rather clear: leaders must ‘inspire citizen dread’ and preserve memories of past crises with ‘periodic reminders of likely suffering’ to ensure a continuing stewardship focus towards critical infrastructure. This can be taken as meaning that leaders should not allow values of macro-prudential precaution to drift, despite the pressures from industry.

LaPorte reminds us that the necessary rebalancing of knowledge, from ritualistic routines at the organizational level to network dynamics at the system level, poses significant leadership and expertise challenges in maintaining a sense of what could be lost. Nothing less is required than a new moral economy of the financial system, and there are some signs of leadership to this effect. In the United Kingdom, the value of the financial system to the real economy is being challenged at the highest levels (Turner, 2010). Financial regulators are also currently pressing financial organizations to engage more than ever in ‘stress scenarios’ – to imagine extreme life-threatening events now and their response plans. The growing prescriptive emphasis on liquidity is also in effect forcing firms to be less connected and more knowledgeable about chains of credit than hitherto. And all this leads to increased capital, as a shock buffer, at the organization level.

Yet these efforts are likely to lose momentum without an organizing narrative from institutional leaders, a narrative that firmly locates the financial system as part of critical infrastructure, and therefore as part of national social and economic security. The danger is that ‘stressing’ exercises become proceduralized and make crisis events appear to be more routinely manageable than they are (McConnell & Drennan, 2006; Boin & McConnell, 2007). The kinds of capacities needed in a crisis may have very little to do with any safety blueprints (Weick, 1993). But these capacities in the financial system appear to have little value. For example, business continuity specialists continue to occupy a humble and semi-detached role in most financial institutions.

Without extraordinary leadership, existing practices of financial stress-testing will not necessarily lead to the kind of ‘preparedness for surprise’ envisaged by LaPorte. This is particularly important given that ‘stress-testing to date has focused on institutional, idiosyncratic risk. It needs instead to focus on system-wide, systemic risk’ (Haldane, 2009, p. 23). It is not just a matter of the testing itself, but of the moral climate within which stresses are applied. Even armed with the superior network diagnostics of the kind envisaged by Haldane, regulators are prone to be cautious about their institutional reputation and may engage in blame management. New leaders in banks and regulatory organizations will need the courage to be as morally countercyclical as their plans for capital reserving. In short, they will need to accept criticism in good times because they are guardians of system safety.

5. Concluding comments

Overall, this reading of LaPorte suggests that risk-management in the financial sector has been a case of institutional misdescription of critical infrastructure, a regulatory over-emphasis on routine operational practices, and an insufficiency of fear generated by leaders. At the time of writing, it seems that we are living through a period in which much can and should be learned across the divide between financial and non-financial analyses of crises and accident.

There are some promising examples of efforts to think across this divide. For example, Perrow’s (1999) ideas about ‘normal’ accidents have been applied to the world of finance (Mezias, 2004; Palmer & Maher, 2010). Yet this work is but a trickle. Very few papers in the Journal of Contingencies and Crisis Management deal directly with financial crisis management or critical financial infrastructure (an exception is Sheaffer, Richardson, & Rosenblatt, 1998), and the same is most likely true of other leading journals in risk management. So when it comes to scholarly thinking about crises, there still seem to be ‘two cultures’. For this reason, I pay tribute to the
originality of Todd Laporte’s thinking over many distinguished years and suggest that it will continue to be relevant for bridging these cultures and for creating a better understanding of the financial system as critical infrastructure.

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References


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