Risk Accounting: A Next Generation Risk Management System for Financial Institutions

Allan D. Grody
Peter J. Hughes
Steven Toms

2011 Enterprise Risk Management Symposium
Society of Actuaries
March 14-16, 2011

Copyright 2011 by the Society of Actuaries.
All rights reserved by the Society of Actuaries. Permission is granted to make brief excerpts for a published review. Permission is also granted to make limited numbers of copies of items in this monograph for personal, internal, classroom or other instructional use, on condition that the foregoing copyright notice is used so as to give reasonable notice of the Society's copyright. This consent for free limited copying without prior consent of the Society does not extend to making copies for general distribution, for advertising or promotional purposes, for inclusion in new collective works or for resale.

Abstract

The financial crisis has awoken financial service organizations to the reality that when financial transactions enter their operating environments, they trigger real-time risk exposures that can go well beyond nominal transaction values, capital charges and other measures deemed appropriate for preventing unexpected losses. Traditional risk accounting approaches have caused lagging measures of risk to be recorded in much of managements' traditional performance and risk-reporting systems. Conventional financial and risk management systems are failing management and their boards due to their inability to measure, aggregate and report risk exposures as they accumulate. In reaction to the current financial crisis, the boards of many firms are assigning the additional task of oversight of management's risk policies and guidelines to audit committees. Accountants are also being asked to discuss the enterprise's key risk exposures with management, including those beyond financial reporting-related risks.

The aim of this paper is to consider whether a more comprehensive and timely measurement framework for risk exposure is now needed and to examine one possible approach. The paper introduces a common unit of exposure measurement for a diverse set of business risks and demonstrates how nominal transaction values and relevant quantitative and qualitative risk metrics can be mapped to each transaction and used to calculate a risk adjusted transaction value. The combination of conventional risk measures derived from the capital conventions mandated by the Basel Committee on Banking Supervision and this proposed risk exposure measurement framework provides the basis for the system of risk accounting described in this paper.

Keywords: Risk accounting, Basel, risk management, operational risk, enterprise risk.