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Epistemic Dimensions of Risk Management

In his 2009 letter to shareholders of JPMorgan Chase, Jamie Dimon cites regulatory lapses and mistakes as contributing causes of the 2008 financial crisis. But, he goes on to say, “We should not and do not blame regulators for the failures of individual companies, ever – management is solely to blame. … The heart of the problem – across all sectors – was bad risk management.” Dimon identifies excessive reliance on rating agencies, stretching too much for current earnings, and failing to act quickly enough when markets got bad as among the bad risk management practices of market participants (JPMorgan Chase 2009 annual report, 25-26). Risk management thus understood encompasses the responsibilities of managers who are engaged in revenue generation as well as those who oversee aggregate risk management functions.

Banking is essentially a business of assuming and managing risk, and the same can be said for much of the financial services industry. It is an ongoing challenge to do risk management well. The risk management failures of the 2008 financial crisis were preceded by the collapse of the Long Term Capital Management hedge fund in 1998, due to an underestimation of risks posed by economic crises. And they were followed by JPMorgan’s own ‘London Whale’ trading in losses in 2012, in which the Bank lost in excess of $6.2 billion due to an ill-conceived trading strategy that was neither appropriately vetted nor monitored.

Risk management is *inter alia* epistemic: Risk management relies on individual and collective cognitive successes such as knowledge, understanding, well-founded judgment, and accurate prediction; and risk managers implicitly take these cognitive successes as among their

central aims. Cognitive successes and the means by which they are achieved constitute the epistemic dimensions of risk management.

Failures of risk management are often epistemic failures. The aforementioned excessive reliance on credit rating agencies, underestimation of risks posed by economic crises, and failure to vet a trading strategy are all examples of epistemic failings. Given the epistemic character of risk management, we might do well to consider its challenges from a distinctively epistemic perspective. From such a perspective, effective risk management requires identifying, cultivating, and implementing organizational *good epistemic practices*. Organizational good epistemic practices are practices that realize valued epistemic ends and that are suitable for adoption.

The notion of 'good' or 'best' practices is familiar enough from professions such as law, medicine, and accounting. In the accounting profession, for example, a standard-setting body issues statements of accounting best practices. These are general guidelines that articulate concepts and objectives for financial reporting, together with specific guidelines that have been developed in accordance with the general ones. The guidelines in their totality are subject to ongoing review and revision.

Similarly, a statement of good epistemic practices will articulate guidelines for epistemic conduct for individual and groups. A candidate good epistemic practice will be one that can reasonably be expected to further an epistemic objective, for example, timely updating of a set of beliefs on incoming evidence or accurate prediction. Good epistemic practices encompass adopted policies, procedures, methods, norms, and general ways of doing things. They may include guidelines for inquiry and the transmission of information between members of a group. Like other 'good' or 'best' practices, good epistemic practices are, in principle, subject to further refinement or revision. (I discuss organizational good epistemic practices in some detail in 'Organizational Good Epistemic Practices', *JBE*, forthcoming.)

Good epistemic practices may be general or specific. General epistemic policies and norms serve to guide the development of more specific epistemic practices for specialized areas.

In the financial services industry, specific epistemic practices may be adopted for lines of business such as lending, asset management, trading, investment banking, and insurance. These practices may be developed by thinking about how best to achieve line-of-business-specific epistemic goals and by learning from past mistakes.

The good epistemic practices approach to risk management dovetails with recent work on organizational epistemic virtues and vices by, for example, Boudewijn de Bruin (2015: *Ethics and the global financial crisis*, Cambridge University Press), Christopher Baird and Thomas Calvard (2019: Epistemic vices in organizations: Knowledge, truth, and unethical conduct, *JBE* 160, 263–276), Marco Meyer and Chun Wei Choo (2023: Harming by deceit: epistemic malevolence and organizational wrongdoing *JBE*, https://doi.org/10.1007/s10551-023-05370-8).

How might managing for good epistemic practices have helped in the 2008 global financial crisis? An investigation of risk management practices during the subprime mortgage loan crisis that preceded the global financial crisis suggests some answers. In early 2008, a group of senior bank supervisors evaluated the risk management practices of eleven major financial service firms. The bank examiners identified several practices that differentiated performance, at least three of which are of interest from an epistemic perspective. First, institutions that shared quantitative and qualitative information across the organization and engaged in robust dialog about risks in the subprime market fared better than those who left their business units to make these decisions on their own. Second, firms who conducted their own assessments of the credit quality of the underlying mortgages in mortgage-backed securities and CDOs fared better than those who relied solely on the ratings of the credit rating agencies. Finally, the more successful firms utilized adaptive rather than static processes of risk analysis that could make rapid adjustments to underlying assumptions in risk measures in order to reflect current and projected market conditions (2008: *Observations on risk management practices during the recent market turbulence*, SSG).

The general good epistemic practices implicated in the practices that led to more favorable outcomes include (1) sharing information across the organization, (2) subjecting

judgments about risk to critical review, (3) refraining from relying on potentially unreliable testimony, and (4) revising assumptions in light of new evidence. (The first practice identified by the Supervisors is an instance of (1) and (2).) These good epistemic practices might have been developed by identifying epistemic goals and thinking about how best to achieve them; they might also have been informed by past epistemic failures.

Adopting a good epistemic practices approach to risk management provides a conceptual framework for identifying and endeavoring to achieve various epistemic aims that are implicit in effective risk management. Endeavoring to identify the epistemic aims of risk management brings these aims more clearly into focus, which in turn, helps us to be guided by them.