Correlating RQ and risk management

- Recent academic research suggests that measuring "RQ" - as opposed to "IQ" - may give a better guide to subconscious decision-making in risk management.
- We compare the number of self-proclaimed "Heads" among banks' total staff and banks' share price movement during the original 'Credit Crunch'.
- The result is not conclusive, but it does suggest a tangible positive correlation.

In its 30-Mar-13 issue, the popular science journal "The New Scientist", published an article titled "Time to get smarter about stupidity". The article considered why it is that highly intelligent people can also be at the same time "stupid". It is a phenomenon we have all come across from time. Indeed it is written in the folklore of financial losses; one need only think of the failure of Long Term Capital Management.

The article points out that our brains can access two different processing systems: conscious deliberative processing and sub-conscious intuition. The first of these is the intelligence measured in traditional IQ tests. It is the considered, conscious, rationalisation that we make when devoid of day-to-day influences and time pressures. However, it is the second system, our sub-conscious decision making - referred to as "RQ" - that accounts for the majority of day-to-day decisions. Sub-conscious decision making is a far more efficient form of mental processing, but it has inherent flaws - most significantly, our tendency to underestimate risks and overestimate the chances of success.

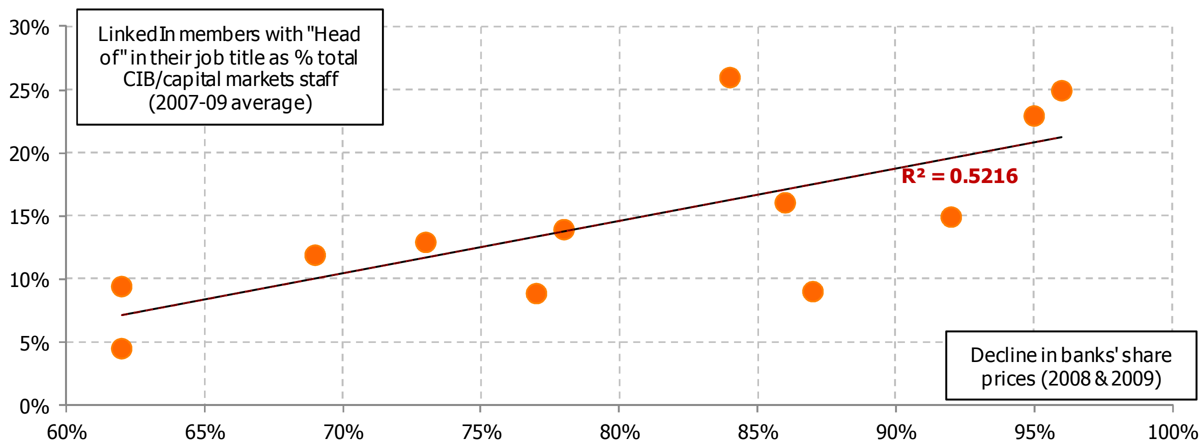
Keith Stanovich at the University of Toronto looked at the factors that determine whether an individual has a high or low RQ. He found that there was little correlation with genes or with nurture factors; the key, instead, seemed to be the individual's ability to assess the validity of their own knowledge. Andre Spicer at the Cass Business School in London and Mats Alvesson at the Lund University Sweden go further, suggesting that "functional stupidity" was a key factor in the 2008 financial crisis. They found that organisational practices at large institutions regularly shut down the employees' "risk intelligence"; in effect reducing their RQ.

We wondered if an organization, and specifically a bank, might display outward signs of higher or lower RQ without the need to test employees. Having considered a number of possible parameters, we settled on…

- … comparing the number of LinkedIn members (from 2008/09) that called themselves "Head of" against the overall headcount (reported where available, and estimated if not) in 'our' core banks' CIB/capital markets units …
- … with a decline in banks' share prices, from the start of 2007 to the end of 2008 (all in local currency).

Our thinking was that in any organisation there can only be a certain number of true "Heads" and that an excessive number of people referring to themselves as "Head of" a unit suggests hubris and/or a possible lack of self awareness (which indicates a lower RQ). By extension, a high number of "Heads" in the total headcount could also suggest excessive fragmentation within an organisation – which, in turn, complicates performance monitoring and risk management, and may lead to (large) losses.

Decline in the share price (2007 & 2008) **vs the number of "Heads"** (2008/09)



Source: LinkedIn, Tricumen estimates. The peer group comprises Tier 1 US and European institutions.

We do not expect our approach here will establish new frontiers in analytical rigour, but the result nevertheless seems intuitively correct to us: considering the importance of 'soft'/unverifiable factors in our inputs, the r-squared value of 0.52 (and rising to 0.62 if one outlier is excluded!) indicates a tangible positive correlation between the high proportion of "Heads" and a decline in the share price.

Our analysis was partly done in the spirit of fun. However, if an effective RQ test is established in the future (some researchers suggest it is at least three years away) it may become a useful addition to the risk management 'toolbox', not least as it has been found that the act of taking the test itself improves one's self awareness and decision making.

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