Prof. Dr. Lukas Menkhoff, Head of Department for International Economics at DIW Berlin

NINE QUESTIONS TO LUKAS MENKHOFF

»Asking more than one question is key«

1. Mr. Menkhoff, in many countries the law requires financial institutions to give financial advice to people who are going to invest money. How do financial institutions normally assess the risk attitude of their customers? The most common way involves asking clients to self-assess their attitudes toward risk or their hypothetical response to a risky situation. Typically, clients will choose from a number on a scale: say from one (very risk-averse) to five (very risk-tolerant). This is an established method, widely used and accepted.

2. What are the disadvantages of this method? The biggest problem is that the outcome is not very reliable. The answers given may depend on the circumstances, on the specific risk item that is asked for and on the way of eliciting risk attitude. Another problem is that one's answer to the same question is not always the same over time.

3. What kind of strategy would you recommend, in order to find out how much risk a customer is willing to take? We recommend using multiple-item risk measures. The fact that more than one question are being asked is key. We use the average of these single-item measures to create a more reliable multiple-item risk measure.

4. How many items are possible? In academia we have a rich set of possible items that can be used: at least ten or twenty. Combining two or three could help elicit more reliable responses.

5. Which way is the best? Unfortunately it is very difficult to say anything general about what works best, because the specific circumstances also play a role. Different measures have their own advantages and drawbacks, and may work better or worse among certain target groups or national populations. Though we do not know what way is generally the "best" way, we know that it is usually more reliable to combine two or three different ways.

6. Can you give an example? All our methods are forms of self-assessment carried out in different ways. For example, an advisor can simply ask the client to evaluate his or her risk attitude using a scale that runs from very risk-averse to very risk-tolerant. Another method involves asking for specific examples. You could ask clients how much they would invest in a safe asset and how much they would invest in a risky asset if given a specific amount of money. The allocation between safe or risky assets provides a lot of insight into the client's risk profile.

7. Is it more difficult for financial advisors to implement multiple-item risk measures? I don't think that the multi-item-measure takes much more effort on the part of the financial advisor. The initial meeting between a financial advisor and a client may take twenty to thirty minutes, during which the financial advisor tries to find out the client's financial situation, goals, income and so on. Asking two or three simple questions as part of this process does not really take much time.

8. What are the policy consequences of the multiple-item risk measure? As things currently stand, I do not foresee any direct consequences in terms of policy—but it seems advisable that financial institutions make use of more than one measure in order to reliably assess risk preference.

9. Are multiple-item risk measures suitable for fields beyond finance? Yes, I think so. I think this issue is relevant in any field that involves risky decisions. In principle, it can be transferred to health decisions, such as whether one opts for a riskier or less risky treatment. It can also be applied to decisions regarding education.

Interview by Erich Wittenberg

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