Institute and Faculty of Actuaries

# Making Money Safely
## A Personal View of Risk Management in Non-Financial Corporates, Insurance and Banking

Philip G Scott FIA, FCPA, FRSA

Risk and Investment Conference 19 June 2013

## My background

- Aviva plc
- Diageo plc
- Royal Bank of Scotland
- President, Institute and Faculty of Actuaries

Institute and Faculty of Actuaries

## Risk Management

- **Good business and risk management are one and the same** and, at its heart, great risk management is about great conversations in order to drive better informed decisions.
- **Risk management is a behaviour supported by a process rather than the converse** and as such, all management have a responsibility to manage risk in accordance with values and purpose.



## Risk Management

**Good Risk Management is:**

- Led by the CEO
- Watched over by the Board
- Owned by everyone in the business
- Supported by a second line of defence
- Quality assured by Audit

# Risk Types

**Strategic**

- Economic
- Political
- Country Risk
- Competition/Products
- Anti Trust
- Earnings Volatility
- Capital Adequacy
- Business Expansion and M&A
- Market Confidence

Institute and Faculty of Actuaries

4

# Risk Types

**Operational**

- People (hiring, firing, remunerating
- Environment and sustainability
- Health & Safety
- Bribery & Corruption
- Fraud
- Anti Money Laundering
- Regulatory (including censure)
- Reputational
- Terrorism
- Raw Materials, Manufacturing
- IT , Systems and Business Continuity
- Information Security
- Taxation

Institute and Faculty of Actuaries

5

# Risk Types

**Financial**

- Capital Adequacy
- Credit Risk
- Concentration Risk
- Interest Rate Risk
- Funding and Liquidity Risk
- Currency Risk
- Asset Risk and Liquidity
- Basis Risk

Institute and Faculty of Actuaries



# Who Has What Risk?

- **All corporations have nearly all these risks in some form**
- **The most important risks differ by sector and concentration**
- **Financial institutions multiply the financial risk because that is what they trade with their customers**
- **Banks have large and fast moving risks**
- **What is the key risk for a Tug company?**

Institute and Faculty of Actuaries

## Risk Management - Corporates

- **Strategic Risk**
  - Strategic risk is important for all Corporates
  - Consumer understanding helps with emerging risks
- **Operational Risk**
  - Customer satisfaction and safety is a priority
  - Sales practices
  - The factory is often physical
  - Commodities
  - Taxation
- **Financial Risk**
  - Transactional risk is mainly with customers
  - Limited financial risk on balance sheet for consumer goods
  - Resource and project risk on balance sheet for capital goods

Institute and Faculty of Actuaries



## Risk Management - Insurance

- **Strategic Risk**
  - As per Corporates
- **Operational Risk**
  - Sales practices
  - Information technology is the factory
  - Regulators and customers distrust insurance
  - Embedded underwriting disciplines
  - Large established pricing and valuation models
- **Financial Risk**
  - Balance sheet is 10 x bigger than Corporates
  - Risk remains in the products sold
  - ALM is legally required
  - Under UK regulation, all contracts are valued and market to market (gross not net)
  - Relatively few risk decision people e.g. Product designers, valuation experts and investment managers

Institute and Faculty of Actuaries

## Risk Management - Banking

- **Strategic Risk**
  - As per Corporates
  - Speed of Crisis – Run on the Bank
- **Operational Risk**
  - Sales practices
  - Information technology is the factory
  - Banking in the ‘sin bin’ since 2008
  - Multiple risk decision points – each banker and each trader
  - Multiple complex pricing and valuation models
- **Financial Risk**
  - Balance sheet is 100 x bigger than Corporates
  - Liquidity is critical for stability
  - Annual refinancing is 20 x bigger than insurance
  - Financial risks in each product sold
  - Very different risks in Retail, Corporate and Investment Banking

Institute and Faculty of Actuaries



## Banking - The Big Risks

- **Credit risk in a downturn**
- **Concentration Risks**
- **Liquidity – running out of cash**
- **Inadequate capital**
- **Complex and volatile derivative exposures**

Institute and Faculty of Actuaries

## Risk Governance – Fit the Need


Institute and Faculty of Actuaries



## Royal Bank of Scotland Risk Governance

- **New strategic plan**
- **Significant strengthening of global risk management**
- **Changed link between risk and incentives**
- **New Board Risk Committee**
  - Walker compliant
  - Oversight of all risks
  - Taking deep dives

Institute and Faculty of Actuaries

## Risk Information

- Corporate Strategy
- Risk Appetite (but not the only document)
- Risk Attitude (just as important)
- Risk MI (always important, but never perfect)
- Risk Policies (vital, but keep them simple)

Institute and Faculty of Actuaries

14

## The Financial Crisis – Risk Control Failures

- Miss-priced credit to borrowers
- Miss-priced credit default swaps
- Uncontrolled OTC derivatives
- ABS structures disconnected origination from banks underwriting
- Over reliance on wholesale funding in banks
- Inadequate capital requirements during boom times
- Inadequate stress testing
- Unregulated financial service companies
- Excessive M&A on borrowed money
- Bonuses drove selfish behaviour

Institute and Faculty of Actuaries

15

## The Financial Crisis – Lessons for Risk Management

- **Tail risks do happen - in very unpredictable ways**
- **Emerging risks are more important than those you see today**
- **Scenario testing is vital**
- **Risk management needs both scale and the authority in financial institutions**
- **The risk management framework should be clear to everyone**
- **Quality risk information is needed**
- **Product design and pricing should be consistent with the risk appetite**

Institute and Faculty of Actuaries



## Actuaries in Risk Management

**Strengths**
- Disciplined risk assessment
- Statistical foundation
- Financial engineers

**Weaknesses**
- Left brain bias
- Narrow experiences

**Opportunities**
- Making financial sense of the future
- Being the model builders and 'scenario testers'

**Threats**
- Inability to show relevance of our skills

Institute and Faculty of Actuaries

## Making Money Safely

- Good risk management is just about 'making money safely'
- Fit risk management resources and processes to the scale, type and frequency of the risks
- Make great risk management your competitive advantage
- Great risk management will help create wealth, not destroy it

Institute and Faculty of Actuaries



Institute and Faculty of Actuaries

# Thank you.

## Making Money Safely

### A Personal View of Risk Management in Non-Financial Corporates, Insurance and Banking

Philip G Scott FIA, FCPA, FRSA

Risk and Investment Conference 19 June 2013