The Actuarial Profession
making financial sense of the future

Strategy Risk Forum – 27 October 2011
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Strategy risk – the case for and against!

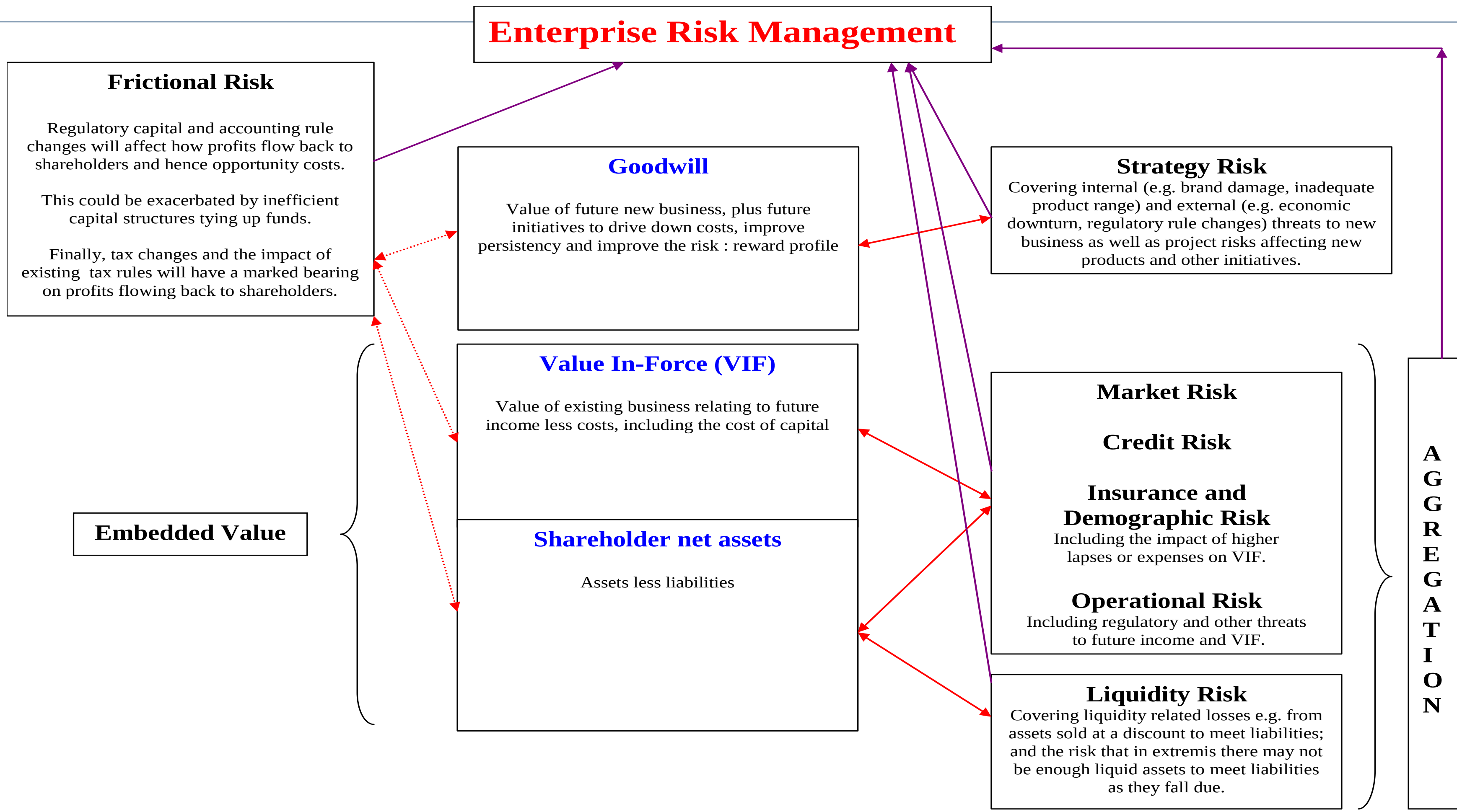
27 October 2011

Strategy Risk – a possible definition

Strategy Risk Definition

- The Actuarial Profession's Risk Classification Working Party has looked into how different financial institutions classify risks including risks relating to strategy.
- One of the Working Party's findings is that there is a very broad range of definitions for what constitutes Strategy Risk. Indeed some institutions do not have a Strategy Risk category per se (e.g. using the term Business Risk instead).
- For this presentation, we have used the Working Party definition of Strategy Risk: the risk posed to the goodwill of a firm, where goodwill relates to excess of a firm's worth over its embedded value. It thus covers risks relating to new business and initiatives to reduce costs and persistency (not already including in EV).
- Note this is narrower than the concept of Strateg<u>ic</u> Risk outlined in the profession's recent ERM Guide, which covers risks such as Market Risk which pose a threat to the attainment of strategic goals.

Working Party's view of risks



Strategy Risk – Concepts

- The risk classification proposed by the Working Party breaks Strategy Risk down into exogenous and endogenous factors.
- Exogenous factors would include:
  - Impact of markets and economic conditions on sales
  - Tax and Regulatory impacts such as CGT changes and RDR
  - Actions of competitors
- Endogenous factors would include:
  - Quality of products and services offered
  - Project failures e.g. failure to launch new product
- Endogenous factors includes Brand and Reputation Risk relating not only to reputation impacts (e.g. perception of poor financial strength; reputation damage of misselling and other operational events) but also whether our brand supports our strategy.

Strategy Risk – Concepts

- Strategy Risks relate not just to new business but also to initiatives / projects to:
  - Drive down expenses – relative to embedded value assumptions (propose that Insurance Risk covers where assumptions rely on a project to deliver cost savings and this does not deliver)
  - Improve persistency – again relative to embedded value assumptions
  - Improve the risk : return profile through hedging initiatives – with the reduction in economic capital requirements / costs offsetting any premium that a hedge counterparty may require
- A firm may calculate its appraisal value including “goodwill” relating to future sales and project benefits, and quantify the Strategic Risk impacts of reduced sales / failed projects against this value
- Alternatively it may view “goodwill” as the excess of a firms market capitalisation over embedded value, and consider the impact of poor new business results etc. on this differential.

Strategy Risk – Exogenous Risk Categories

- Market Risk related:
  - Equity market falls reducing investment sales and pension transfer values, but increasing demand for other types of funds
  - Base rate changes affect how attractive deposits are to other savings products
  - Medium term bond yield changes affecting structured product terms and fixed rate mortgage deals
  - Equity volatility changes also affect structured product terms
  - Residential property prices and rents affecting the attractiveness of buy-to-let with the former also affecting average mortgage protection case sizes
- Other Macroeconomic Risks including:
  - Change in mortgage lending volumes affecting the volume of mortgage protection business
  - Unemployment affects general demand and scheme membership for corporate pensions
  - Pay rises levels which affect corporate pension increment business

Strategy Risk – Exogenous Risk Categories

- Credit Risk related – changes in credit experience affecting future new business profitability (though re-pricing can mitigate this)
- Insurance Risk related – changes in persistency levels and other experience affecting future new business profitability (ditto)
- Fiscal :
  - Changes in the tax on different products affecting demand for each
  - Overall tax burden affecting demand for products
- Political Risk – political uncertainty affecting demand
- Regulatory Risks to sales and goodwill including:
  - Impact on distribution of products e.g. RDR
  - Regulation of products themselves e.g. Stakeholder price cap
  - Knock-on impact of regulatory capital changes (e.g. S2) on sales

Strategy Risk – Exogenous Risk Categories

- Risk from general demographic and social changes e.g. increasing internet usage; ageing population who are “asset rich, cash poor”
- Product market trends e.g. growth of Wrap differs from expected
- Competitor Risks including:
  - the impact on sales of competitor pricing…
  - …and competitors tying up of distribution channels
  - also covers “poaching” of staff
- Distribution Risks e.g. reductions in adviser numbers at key distributors, or worse, distributor insolvency
- Product Provider Risks – where a firm relies on another providers products, the risk these are withdrawn or terms made less attractive.
  - Includes insurers’ reliance on reinsurers.

Strategy Risk – Endogenous Risk Categories

- Product Risk – that these aren't good enough to meet target market
- Service Risk – covering not only inadequate service to meet target market expectations but also inappropriate service models (e.g. offering a "Rolls Royce" service not justified by margins available)
- Brand and Reputation – risk from:
  - Reputational damage from operational failings such as misselling; or self-inflicted damage (e.g. Ratners)
  - Concerns over financial strength (from market and other events)
  - Brand that does not support strategy
- Project Risks – failure of projects to:
  - Enhance (/make good gaps) in product and service proposition
  - Cut expenses and improve persistency
  - De-risk portfolios and improve risk : return profile

Strategy Risk – Endogenous Risk Categories

- Pricing capability – not having:
  - Sufficient expertise in pricing products;
  - Data to effectively price products in the market
- IT systems – cant support where we want to go in the first place
- Strategic partners – e.g. failure of joint ventures; outsourcing partners cannot handle proposed new products
- Poor planning including defective assumptions
- Initial expenses risk of higher commission rates than expected; lower case size and margins; and higher quote costs
- Cost base – risk our cost base makes us uncompetitive
- Leadership – poor strategic direction leading to sub-optimal strategy
- Aggregation – combined impact of all the above

Does Strategy Risk exist ?

The case against….

Is Strategy Risk not just a component of other risk types ?

- There is an argument that there is no distinct category of Strategy Risk per se, and that strategy impacts should be looked at as part of other risk categories:
  - Impact of equity and other market movements in sales should be considered under Market Risk;
  - Reductions in projected new business profitability due to adverse claim, expense or persistency should come under Insurance Risk;
  - Reputation impacts from operational loss events should come under Operational Risk…
  - …while Market, Credit and other risks would include the damage to (perceived) financial strength and its impact on new business;
- Similarly there is an argument that Project Risk should be a high level category in its own right.

Does Strategy Risk exist ?

The case for….

The case for a distinct Strategy Risk category

- Strategy Risks differ in impact and mitigation from other risks, even where they share the same cause:
  - Market falls may lead to falls in sales as well as embedded value impacts, but the impact is not clear cut: falling Corporate Bond values and rising spreads during the credit crunch actually lead to an increase in Corporate Bond ISA sales.
  - Similarly, how such events are mitigated is different: the impact of Market Risk on embedded value may be mitigated by derivatives, but for new business, the focus might be more about diversified offerings e.g. being able to offer structured products when markets are weak.
- Operational Risk events may lead to reputation damage, but this is not clear cut: successful PR can neutralise the impact on brand.
- By the same token, some brand damage can be self-inflicted, without any particular operational failing…

Self-inflicted brand damage – example #1

Self-inflicted brand damage – example #2

Excepts from Gerald Ratner’s speech to the Institute of Directors, April 23rd,1991:

‘…We also do cut-glass sherry decanters complete with six glasses on a silver-plated tray that your butler can serve you drinks on, all for £4.95. People say, "How can you sell this for such a low price?", I say, "because it's total crap”’

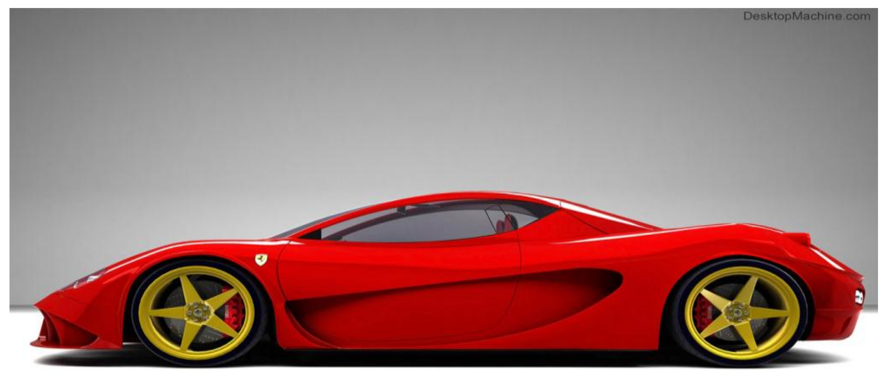
‘…[Ratner’s earrings are] cheaper than an M&S prawn sandwich but probably wouldn't last as long’

After the speech, the value of the Ratners' group plummeted by around £500 million, which very nearly resulted in the firm's collapse

The case for a distinct Strategy Risk category

- Ignoring operational failures and self-inflicted damage, damage to brand can arise due to unfounded rumours being circulated by 3rd parties i.e. with the firm giving no cause for the brand damage.
- Finally, even where there has been no damage to the brand, and the brand is well-regarded, there is a risk that it still does not convey the values a firm associated with.
- Integrated Financial Reporting Initiative – impact of strategy on society
- Sustainability reporting – what is long-term overall impact of corproate strategy on main stakeholders?
- Evidence on product, customer and distribution strategy by European insurers (Klumpes and Schuermann, 2010, GPRI)
- Corporate governance (consolidated entity) versus ‘regulated entity’ (FSA) perspectives
- Solvency II versus IFRS: what is the entity subject to strategy risk?
- M+A strategy of insurance firms operating in major EU markets – benchmark?

Strategy Risk – Concepts



Conclusion

- We have set out a possible definition of Strategy Risk, and explored the merits of whether Strategy Risk should be considered a distinct category in its own right or as part of other risks.
- There are merits in either approach, and ultimately the answer will depend on how each firm manages risk.
- However, we would note that ERM is about taking a holistic approach to all risks: the key is that we acknowledge the links between Strategy and other risks, and incorporate strategic impacts in assessing the impact of Market and other risks.
- At the same time, we need to consider the unique characteristics of risks to strategy and why these need distinct treatment.
- The increasing importance of ‘sustainability reporting’ calls for a new perspective on ‘strategy risk’ that incorporates elements of learning, ‘consolidation’ and risk capital management
- IFRS versus Solvency II may imply different conceptions of ‘relevant entity’

Views from the floor ???….