A personal view of risk management in non-financial corporates, insurance and banking

Making money safely
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My Background

- Aviva plc
- Diageo plc
- Royal Bank of Scotland
- Faculty and Institute 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

- **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
Risk Types

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

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?
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

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 10x bigger than Corporates
  - Risk remains in the products sold
  - ALM is legally required
  - Under UK regulation, all contracts are valued and marketed to market (gross not net)
  - Relatively few risk decision people e.g. Product designers, valuation experts and investment managers
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

Banking - The Big Risks

- Credit risk in a downturn
- Concentration Risks
- Liquidity – running out of cash
- Inadequate capital
- Complex and volatile derivative exposures
Risk Governance – Fit the Need

- Board
- Board Risk Committee
- Board Audit Committee
- Chief Executive Officer
- Chief Risk Officer
- Executive Risk Committee
- Business Risk Structures

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
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)

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
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

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
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