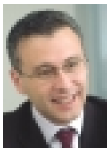
CAUSES FOR CONCERN



LOOKING BACK AT THE PAST HELPS CREATE A DYNAMIC PICTURE OF HOW RISK MANAGEMENT HAS, THROUGHOUT NECESSITY, EVOLVED, SAYS **LUCA GIULIANI** OF PRICEWATERHOUSECOOPERS.

It seems like a long time has passed since Nick Leeson brought down one of the most established English financial institutions, waking up the entire financial community to the risk of rogue traders. The event triggered in both financial and non-financial institutions a series of very high-profile actions aimed at enhancing the quality of internal controls and the monitoring of market risk.

More recently, and perhaps already forgotten, we can recall the frantic and expensive rush of governments and private enterprise to mitigate the risks of non-Y2K compliant technology. The predicted catastrophic scenarios eventually proved to be unrealistic and the entire matter is now more a subject for academic discussions.

WHAT ARE THE CURRENT CONCERNS WHICH APPEAR HIGH IN THE AGENDA OF CEOS AND CFOS AND HOW DID THEY EVOLVE OVER TIME? To help answer these questions we reviewed the results of a CSFI survey (see *Table 1*) conducted in 2002 within the financial community in Europe and the US, including bankers, customers, regulators, rating agencies and other observers.

The overall survey result clearly indicates how, for most organisations, the current operating environment uncertainty is the key concern.

- *Credit risk* tops the list because of the likelihood of severe loan losses resulting not just from recessionary forces but from what are seen as poor lending decisions in the heady days of the 1990s, such as dotcoms, energy, third-generation telecoms, overstretched consumers lending and mortgages, that might further deteriorate the already weak balance sheets of corporations and introduce systemic risk.
- The rising position of *complex financial instruments* is indicative of the fears opened by Enron, the opaqueness and complexity of

TABLE 1
TOP TEN CONCERNS.*

1996	1997	1998	2000	2002
1. Poor management	1. Poor management	1. Poor risk management	1. Equity market crash	1. Credit risk
2. Bad lending	2. EMU turbulence	2. Y2K	2. E-commerce	2. Macro-economy
3. Derivatives	3. Rogue trader	3. Poor strategy	3. Asset quality	3. Equity markets
4. Rogue trader	4. Excessive competition	4. EMU turbulence	4. Grasp of new technology	4. Complex financial instruments
5. Excessive competition	5. Bad lending	5. Regulation	5. High dependence on technology	5. Business continuity
6. Emerging markets	6. Emerging markets	6. Emerging markets	6. Banking market over-capacity	6. Domestic regulation
7. Macro-economy	7. Fraud	7. New entrants	7. Merger mania	7. Insurance
8. Back-office failure	8. Derivatives	8. Cross-border competition	8. Economy overheating	8. Emerging markets
9. Technology foul-up	9. New products	9. Product mis-pricing	9. New entrants	9. Banking market over-capacity
10. Fraud	10. Technology foul-up	10. Grasp of technology	10. Complex financial instruments	10. International regulation

*'Banana Skins' survey by Centre for the Study of Financial Innovation (CSFI), sponsored by PricewaterhouseCoopers, www.csfi.org.uk

derivatives, and their capability to connect seemingly unrelated institutions.

- The high position occupied by *business-continuity* and *insurance* is mostly the result of the effects of September 11 and the risk of further acts of terrorism. Although the financial community believes the markets proved remarkably resilient, given the size of the shock, the attacks showed weaknesses in addressing operational risk at a system-wide level.
- Also striking is the emergence of *domestic and international regulation* as a top-level concern, much of which is centred on the cost of compliance and the sheer weight of regulation. But serious considerations are also given to the effects of implied risks, such as the increased systemic risk driven by one-size-fits-all regulation and the push toward the replacement of judgement by rules.

If we compare these results with those from the same surveys of previous years, we can draw a more dynamic picture of how the landscape of risk has evolved over time.

The mid- to late-1990s focused on the quality of management and strategy as new challenges loomed – technology, fresh forms of competition, new products and rogue traders. By 2000, concerns about market excesses were rising rapidly, fears of an equity market crash were mounting and the asset quality of many companies were put under increasingly discussion. Those fears are culminating in the current concern of the direct survival of organisations in a more than ever uncertain environment.

If we analyse from an event/time perspective, it is striking to notice how most of the concerns became important as a consequence of actual events, indicating more a re-active than pro-active attitude toward risk management.

For example, let's look at technology risk. During 1996 and 1997, the fears of potential systems foul-up as a consequence of the increased automation in banking and treasury operations (in eighth and ninth place in 1996 and tenth in 1997) were gradually receding, and it is not until 2000 that the technology concern came back very high under the form of grasp and dependence on technology (fourth and fifth place). This was mainly driven by the e-commerce revolution which started around 1997 and the dependability of organisations on the Y2K issue. What is revealing is that technology concerns disappeared from the top 10 in 2002 as soon as waves of dotcoms started going bust and the panic over Y2K had passed.

Similarly, for the fifth place in 2002 of business continuity. The September 11 terrorist attacks triggered a flurry of activity from companies that understood their existing contingency plans did not consider the far-reaching consequences of such events and even more reactions were triggered in the hard-hit insurance industry. Insurers realised that they were doing safe enough business in terms of individual risks they were underwriting, but had completely lost sight of inter-linked risks that could result in a hefty bill for business interruption after a big one-off event.

The awareness of terrorism risk is now definitely higher, but the aftermath of September 11 and the medium to long term impacts of terrorism fears are still underestimated. The lessons learned have not been acted on quickly and fully. There is still a certain amount of complacency toward the threat of terrorism, as it is considered a low-probability although high-impact event. Nearly two years on from the events, the financial community is not ready yet or capable to fully take on such risks, leaving enterprises largely exposed.

The perception of readiness to manage the identified risks is improving on an overall basis compared with two years ago, although companies and other customers of the financial industry acknowledge a much less marked improvement.

YET HOW MANY ORGANISATIONS CAN SAY WITH REAL CONFIDENCE THAT THEY ARE MANAGING THE FULL SPECTRUM OF RISKS EFFECTIVELY? For all the sophistication of banks' credit, market and operational risk management techniques, recent events suggest that there are plenty of other risks, from the series of accounting scandals to the debate over the Basel regulations, that need to be monitored and managed. It is hardly surprising that risk is back high on the boardroom agenda.

What worries is that the financial community, while very aware of the immediate risks involving credit quality and financial markets uncertainty, tend to ignore other equally important risks.

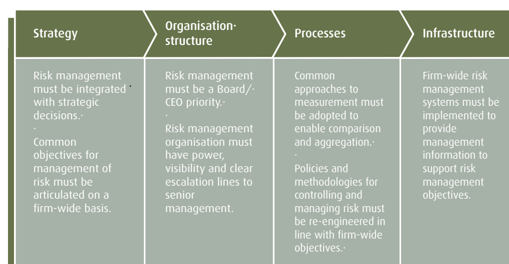
In an environment where risks permeate every aspect of the organisation and where low-probability, high-impact events are making the headlines with increasing regularity, failing to take a holistic view of risk management can have extremely serious consequences. Not all the risks are financial. Not all of them are quantifiable and organisations should not focus only on the risks they can quantify at the expense of those they cannot. For example, investment banks in the US are still being bombarded with allegations that supposedly impartial investment advice is skewed to recommend companies with whom the parent bank is doing business.

In another example, ensurers in the UK are still recovering from the damage done by a pension misselling scandal in the 1980s and 1990s, with Equitable Life adding to the problem after guaranteeing investors a 12% annual return when interest rates were high.

Managing unquantifiable risks comes down to management and culture. It is not just about setting rules. Many of the organisations involved in the above-mentioned scandals say that most of the required controls, such as oversight committees designed to ensure impartiality, were already in place. The trouble is that managers, who understandably regard their job as maximising revenues, consider that task as more important than their duty to customers and either ignored the risks of publishing skewed advice, or were allowed to remain unaware of them.

Assessing or quantifying risks is a way to increase the level of awareness and information. It does not decide the business strategy. Managers will do within their mandate from investors and shareholders. Losing money because of a conscious business decision is perhaps undesirable but definitely acceptable; losing money because of a failure in understanding the risks is only regrettable.

FIGURE 1
FULL INTEGRATION OF RISK MANAGEMENT.*



Taming Uncertainty publication by PricewaterhouseCoopers and Economist Intelligence Unit

Some leading institutions are now starting to develop ways of dealing with risk more comprehensively and factoring risk scenarios into the decision-making process throughout the organisation. They are also learning lessons from the industrial world, where companies must take into account a spectrum of risks going far beyond the financial ones. An example is the oil industry, which includes exploration, technical, regulatory, reputational and environmental risk and tends to tackle such risks on a project or asset basis, rather then compartmentalising them into risk silos.

Similarly, large corporations have learned to develop and execute strategies in a way that allows them to respond dynamically to new information. For example, pharmaceutical companies research and development activities are increasingly being managed as portfolios of 'real options', where investment money is committed in stages, subject to the successful resolution of key uncertainties such as scientific research, market research, regulatory approval, geographical pilots and so forth.

A number of factors need to be combined to create the right framework for holistic risk management. First, board-level management must take control of the risk management agenda and make risk management a strategic priority. Second, management processes need to be set up to ensure that an awareness of risk informs decision-making, compensation, corporate governance procedures and external reporting. And, third, the right enablers – the people and systems that facilitate risk management decisions – must be in place to deliver the information upon which managers can base their decisions.

In reviewing the variety of embarrassments in the past few years it is apparent that a number of these incidents can be traced back to a lack of risk management leadership from the top. A company's chief executives should lead by articulating the risks being run, the risk appetite of the organisation and the methods used to balance risk and return. Senior executive make the strategic decisions and shape the corporate culture, they cannot delegate their responsibility for risk.

HOW CAN WE THEN IDENTIFY IF THE RISK MANAGEMENT CULTURE IN A COMPANY IS EFFECTIVE? To help answer this question PricewaterhouseCoopers indicates ten key attributes characterising a 'world-class' risk management culture (see *insert*).

Looking at risk in terms of the likelihood of loss makes perfect sense. Credit risk is something every lending institution will come across in their normal activities and, after all, rogue traders are not an everyday fact of life. However, if the past 18 months have taught us anything, it is that high-impact, low-probability events do happen. And when they have the power to sink entire organisations, ignoring them is not an option.

The prize that awaits organisations leading holistic risk management is not simply an avoidance of losses but, more importantly, increased shareholder value through more actively exploiting the upside of risk. Chief executives who understand risk when making strategic decisions and who clearly communicate their risk appetite inside and outside the company have the best chance of striking the optimum balance between risk and reward, which is fundamental to value creation.

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Ten attributes of a 'world-class' risk management culture*

1. **Equal attention is paid to both quantifiable and unquantifiable risks.** The temptation to ignore risks that cannot be quantified, such as reputation risk, is avoided. Reputation protection is one of the five risk factors on UBS's risk charter, for instance.

2. **Risks are identified, reported and quantified to the greatest possible extent.** This means setting up extensive historical risk and loss database, and identifying risks precisely, rather than burying them into general categories such as credit and operational losses.

3. **An awareness of risk pervades the enterprise.** Performance measurement and pricing are risk-adjusted. Pay structures also reflect risk management priorities – compensation schemes encourage risk-taking behaviour that is aligned with risk appetite. Risk-adjusted forecasts and returns give shareholders and analysts a full understanding of the risks being run.

4. **Risk management is everyone's responsibility.** Risk is not fragmented into compartments and silos – risk management should not be either. People from IT, legal and compliance and even communications departments are involved in decision-making to inform senior managers of non-financial risks associated with the launch of new businesses and products.

5. **Risk managers have teeth.** Everyone involved in monitoring risk, even non-financial risk, has a power of veto over new projects they consider too risky. Equally, the chief risk officer has the power to drive the risk awareness and management agenda.

6. **The enterprise avoids products and businesses it does not understand.** Proper risk management depends on knowing enough to comprehend the dangers that are faced. A product or a business that is delivering outstanding growth but is too complex for management to understand is a risk too far. Put another way, if you don't understand it, don't do it.

7. **Uncertainty is accepted.** Companies such as Shell use scenarios – planning to make sure their strategy embraces uncertainty, not hides or eliminates it. Rather than basing the strategy around fixed assumptions, leading risk managers try to factor all possible developments into decision-making.

8. **Risk managers are monitored.** Risk management is too important to be left to risk managers alone. Internal audit procedures ensure that systems are running properly and the right results are achieved.

9. **Risk management delivers value.** It is not designed to stop people from taking risks but rather to create value by enhancing the chances of a project or product succeeding, and by enabling managers and shareholders to understand the level of risk they run and to manage accordingly.

10. **The risk culture is defined and enshrined.** The enterprise's risk appetite is clearly and widely understood. Whether a company's culture is entrepreneurial or conservative, risk management is aligned with that culture to give managers and employees the requisite freedom of manoeuvre.

**Taming Uncertainty* publication by PricewaterhouseCoopers and Economist Intelligence Unit