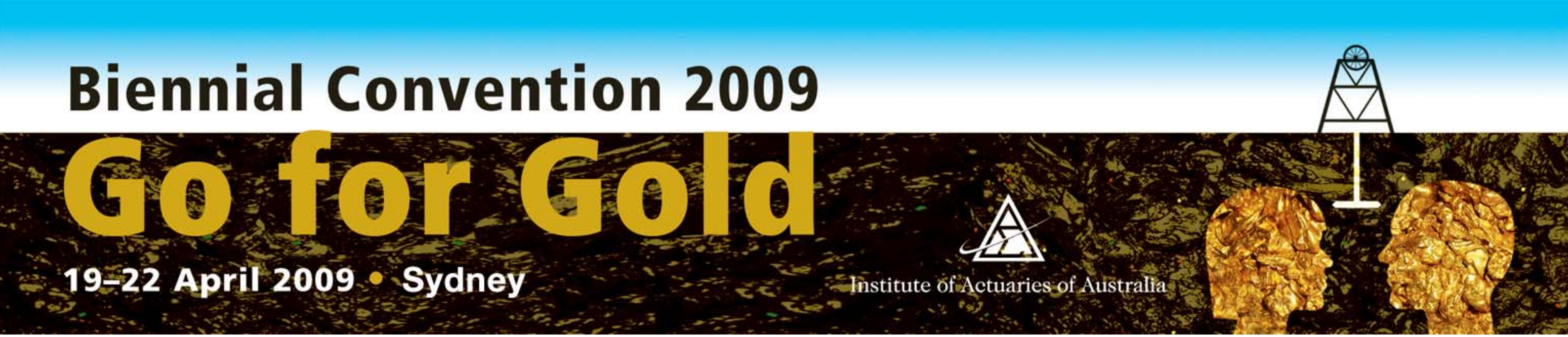


ERM – Capturing the Upside

Brett Riley

Topics

1. Introduction
2. Risk Culture
3. Management Oversight
4. Risk Appetite
5. Strategy
6. Better Planning

Topics

7. Better Information & Reporting
8. Case Studies
9. Conclusions

Introduction

- Aim of this paper
- What is Risk?

  The likelihood of failing to meet objectives

- What is ERM?

  *The generation of **superior performance** in a firm through the use of **better information** & the **improved management** of **all risks** which threaten achievement of **objectives***

Key Ingredients

Risk Culture

- CEO sponsorship is critical
- Implementation Issues
  - Communication is important
  - Treatment of “stars”
  - Induction & training material
  - Remuneration structures
  - Performance objectives
  - Other

Risk Culture

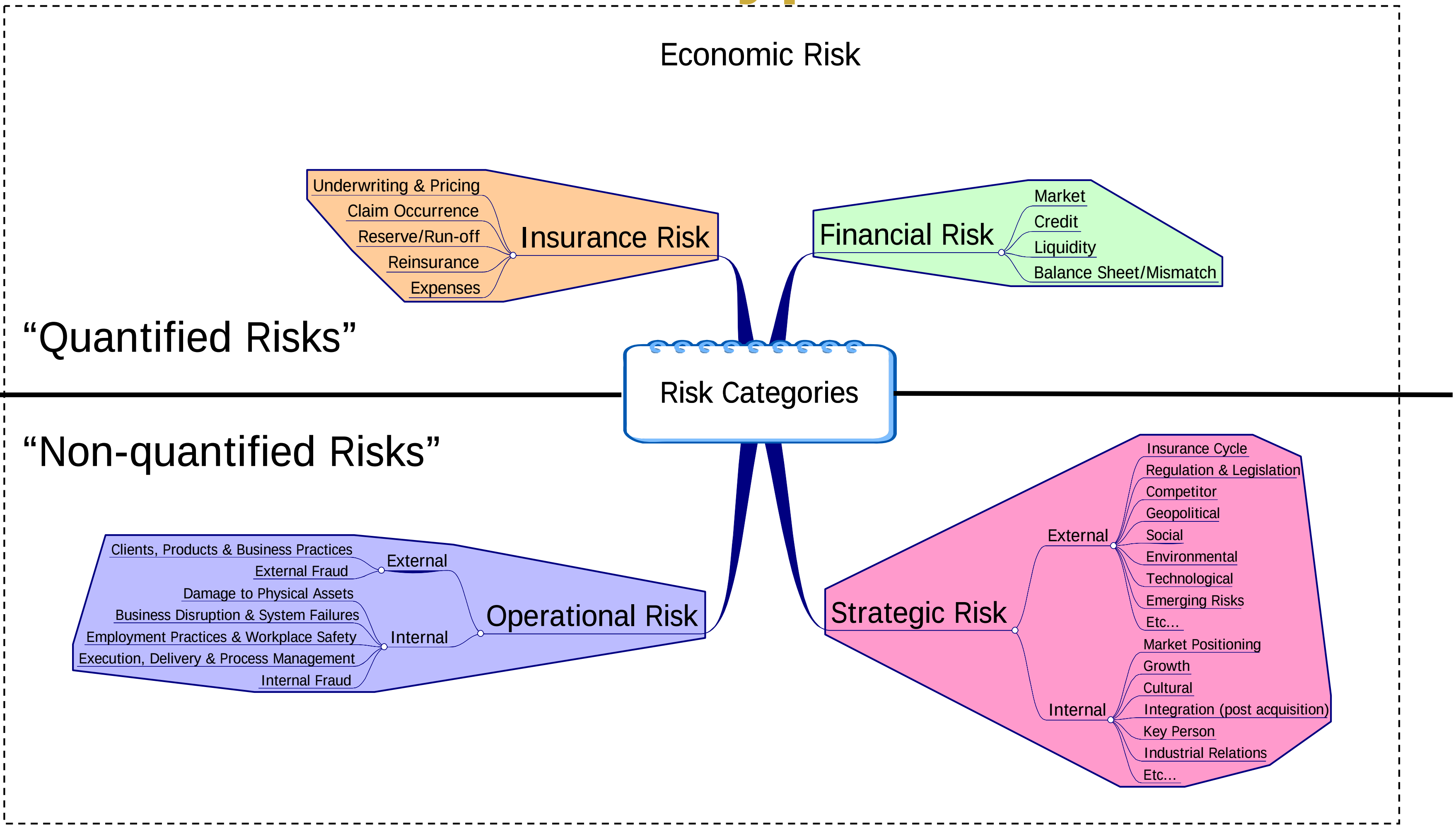
- What should the CEO say?
  - RM is everyone's responsibility
  - RM is business as usual
  - CEO should lift the prestige of RM
  - Differentiate from internal audit & compliance
  - Promote an open risk culture
  - Link RM to corporate & personal objectives
- Don't let RM (unnecessarily) slow decisions

Management Oversight

Desirable management features:

1. Excellent communication (incl. listening)
2. Thorough understanding of business
3. A suitable vision & strategy for ERM
4. Leadership by example
5. Disciplined execution of strategy
6. A view over & interest in all risks (see over)

Risk Types


Economic Risk
"Quantified Risks"
"Non-quantified Risks"
Risk Categories
Insurance Risk
Underwriting & Pricing
Claim Occurrence
Reserve/Run-off
Reinsurance
Expenses
Financial Risk
Market
Credit
Liquidity
Balance Sheet/Mismatch
Operational Risk
External
Clients, Products & Business Practices
External Fraud
Internal
Damage to Physical Assets
Business Disruption & System Failures
Employment Practices & Workplace Safety
Execution, Delivery & Process Management
Internal Fraud
Strategic Risk
External
Insurance Cycle
Regulation & Legislation
Competitor
Geopolitical
Social
Environmental
Technological
Emerging Risks
Etc…
Internal
Market Positioning
Growth
Cultural
Integration (post acquisition)
Key Person
Industrial Relations
Etc…

Management Oversight

So how should management manage?

- Clearly stated roles & expectations
- Understand limitations in RMF
- Hope for the best, plan for the worst
- Need a central RM function
- Ask lots of “what if?” questions
- Obtain multiple points of view

Risk Appetite

- What is it?

  An explicit statement of the amount & types of risk a firm is willing to take

- Why have one?
- Key components
  - –Maximum probability of impairment
  - –Maximum acceptable earnings volatility
  - –Other limits
  - –Which risk types will be taken

Risk Appetite

- Other components – Risk Capacity & Risk Limits
- Implementation Issues
  - Management to draft, Board to review
  - Use workshops
  - Use DFA / internal model if possible
  - Set first cut against current risk profile
  - Have clear consequences for various breaches
  - Don't be too aggressive or too conservative

Strategy

- First step – clear vision & objectives
- Strategy follows – explicit connection to RM
- Aim – efficient portfolio risk/return profile
- Diversification vs Core Competencies
  - Example – general insurer
  - Example – large investment risks

RM Cycle

Source: Buehler, K et al (2008b)

1 Identify & understand your major risks
Do you have clarity about the risks that will affect your firm's future performance, & deep insight into the risks that matter most?

2 Decide which risks are natural
Do you understand which risks your company is competitively advantaged to own & which you should seek to transfer or mitigate?

3 Determine your capacity & appetite for risk
Are you holding the amount of risk needed to deliver the returns you seek?

4 Embed risk in all decisions & processes
Are critical business decisions made with a clear view of how they change your company's risk profile, and are core business processes consistent with your approach to risk?

5 Align governance & organisation around risk
Are the systems and infrastructure in place for you to monitor & manage risks that are being taken in your business?

Risk Mind-Set & Culture

Strategy

- Other practical issues
  - Seek natural counterparties / internal hedges
  - Example – internal captive for R/I
  - Example – LMI & a short position in equities
  - Keep pursuing (new) risk transfer mechanisms
  - Don’t transfer too much risk

Better Planning

- Untapped potential for better RM
- Use to develop more extreme scenarios
  - The GFC can be cited (e.g. combinations)
  - Use return periods not probabilities
  - Focus on real events not financial metrics
  - Useful to calibrate DFA model

Better Planning

- Plan responses for the unexpected e.g. BCP
  - Both upside & downside
- Prepare loss scenarios to breach thresholds
  - Park consideration of probabilities until later
- Link to Actuarial Control Cycle
  - Reserving → Pricing → Planning → etc

Better Information & Reporting

- Critical for good ERM
- Take a “fundamental” approach
  - Map business processes
- Could data capture be better?
- Better risk reporting
  - Are there better KRIs not being used?
  - Include emerging risk assessments
  - Improve reporting of group impacts

Case Studies

1. Goldman Sachs
2. TXU
3. AIG
4. NAB

Many other examples (usually of failure!)

Sources cited at end

Case Study 1 – Goldman Sachs

- Traditional investment banking vs trading
- Sub-prime experience
- Entrepreneurial – embraces risk taking
- Strong protections
  - Consider capital at risk
  - Invest in risk management training
  - Open risk culture

Case Study 1 – Goldman Sachs

- Four key features according to Buehler et al:

1. Strong quantitative skills
2. Good oversight of business
3. Partnership heritage – stakes in business
4. Strong principles – protect reputation

Case Study 2 – TXU

- Background – impact of deregulation
- New principles:
  - Retain risks with competitive advantage
  - Actively manage risk capacity e.g. debt level
- Contrarian position re power price exposure
- Restructuring & outsourcing
- 2004 onwards – great performance (lucky?)
- Private equity LBO in 2007

Case Study 3 – AIG

- Background – portfolio of businesses
- Criticism of CDS market – justified?
- Key issues
  - Large position in an untested rapidly growing market
  - $67b equity & $441b notional CDS exposure ($58b to sub-prime) at 30 Jun 2008
  - Did AIG hold a competitive advantage in CDS?
  - Damaged sound insurance businesses
- Where should you place your excess capital?

Case Study 4 – NAB

- Homeside losses in 2001 - $A4bn
- Problems
  - –Poor oversight from head office
  - –Hedging problems identified but not fixed
  - –Business risk from refinancing
  - –Poor MSR asset valuation & poor modelling
  - –Understaffing of RM department
- Some fallout but not severe

Case Study 4 – NAB

- FX option losses in 2004 - $A360m
- Problems
  - –Aggressive responses to competitor queries
  - –RM problems not properly escalated – culture
  - –Poor VaR model
  - –Poorly structured incentives for traders
- Upshot – many fired, APRA & market reply
- Lessons

Conclusions

- No single approach to ERM
- Approaches will evolve
- Do ERM for commercial reasons
- Expect the unexpected
- Six key ingredients identified for attention
- Potential benefits

Key References

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