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CRO Q&A

The Changing Face of Risk at Today's Global Financial Institutions

To foster understanding of the evolving nature of the risk function, Robert Iommazzo from SEBA International engaged in a series of interviews with top risk executives ranging from a broad set of global financial services institutions inclusive of commercial and retail banking, investment banking, interdealer brokerage, wealth management and reinsurance. While diverse both in product and geographic scope, all share one thing in common: a strong performance in managing risk during the recent financial crisis.

Question: How has the financial crisis changed the way you focus on risk?

Raj Singh, Chief Risk Officer, Swiss Re: It's changed in many different ways. One thing we are definitely looking at is models – the quantitative plus qualitative aspects – and really questioning their assumptions a bit more. Another that really is being challenged is extreme risk or tail risk, which is what we do in insurance and reinsurance. In reinsurance we primarily use tail VAR to measure risk, but also having an understanding of the extreme scenarios.

James Stewart, Chief Risk Officer, The Bank of Butterfield: Operationally, there has been a significant amount of emphasis on extreme events, and along with it a tremendously increased emphasis on stress testing and all the related infrastructure that comes with it. There is increased emphasis on safety, soundness, and liquidity and the flight to quality at a jurisdictional level. It has completely changed the way that banks manage their balance sheets, particularly with respect to funding structures. There is an increased emphasis on liquidity trending toward a more conservative bend among regulators. This has an impact on earnings, but at the end of day your earnings … along with safety and liquidity… are part of the picture that your stakeholders are looking at.

Lionel Lopez, Chief Credit Officer, National Australia Bank: In my observation, risk has remained much the same before and throughout the crisis. Risk is all about common sense; it is about understanding the impact of your activities. I think one of the main issues behind the crisis was that a lot of people just didn't understand the impact of what they were doing.

Question: What are the most pressing challenges for risk executives today?

Stephen Anderson, Chief Risk Officer, Europe, HSBC: The challenge for risk executives now is to evaluate risk across the whole suite of risks an organization faces and to be less of a transactional approval function, and more of an enterprise risk management function, looking at not just their traditional market risk and operational risk, but also pensions risk, insurance risk, and strategic risk.

Hervé Geny, Chief Risk Officer, ICAP: Liquidity risk has taken on a life of its own. We're redesigning all our policies, procedures, and methodologies for measuring liquidity risk and setting up limits against liquidity. Business continuity planning is also clearly a challenge.

Raj Singh: Risk measurement and methodology need a lot of attention because of the whole change in the data, especially on the financial risk side. The second element in our focus is to make sure that large transactions where we take significant exposure get the right attention of the right expertise, including the independent sign-off from risk. The third area would be risk infrastructure. Last, but not least, would be the focus on talent, because probably in this crisis talent and experience have helped us more than the systems.

Question: Is there a further need to strike the right balance between qualitative and quantitative measures within risk? How do you see the future application of risk models?

Stephen Anderson: Models and quantitative methodologies for assessing risk are and will remain incredibly important, and as the technology evolves to where they can be used in other areas of risk management, their role will actually increase rather than decrease. However, what has to evolve alongside that is an understanding of the limitations of any one model, or of the generic limitations of models, and of the role of judgmental overview or judgmental analysis.

Hervé Geny: At ICAP, we do not use purely quantitative methodologies, but tend to put our efforts on scenario modeling and trying to understand what can happen in any particular business and how the events are linked to each other, so the type of scenarios we are looking at are things that take in to account more than one risk. As we go through the scenarios with the businesses we understand better where the risk falls so we can put the right controls around this risk. I think risk models are going to evolve into more of a mix of quantitative and qualitative methods.

James Stewart: Models can be very effective in terms of managing capital and dealing with more sophisticated stakeholders, but they tend to pose a number of challenges in conveying a view of risk that is easily understood by people. When we report to the Board, we use both qualitative and quantitative expressions where appropriate, but I have found that the qualitative expressions lend themselves to good, effective communications. It's an ongoing challenge, and finding the right balance is essential.

Question: How are you currently working with your Executive Committee / Board to help establish and implement a corporate risk culture? Are you seeing a blurring of the line between the boundaries of General Management and Risk? Who owns risk?

Lionel Lopez: My role is to manage and control the independent risk function of the Personal Bank and ensure that the risk appetite framework is embedded and not breached. I see myself as a partner to the business, providing input to the business strategy and also contributing to the business growth while ensuring risks are understood and under control. I think everybody in the business owns risk; we are in a business which is all about risk. Business should be aware about their inherent risks and ensure they have the operating controls in place to mitigate those risks. The risk function is here to set up the risk appetite, providing risk management skills and tools to appropriately manage risk, and also ensure the control frameworks are working.

Raj Singh: One element we are seeing which is gaining importance is the overall control framework beyond just risk, from risk to operational risk, to the overall audit functions, to the overall underwriting review functions, and making sure that it is all linked. Risk is ultimately owned by the risk taker and the business, there is no question there. We have to provide the transparency, give the warning signs, look at the risk tolerance and other elements, but the ownership has to be with the business.

Stephen Anderson: One of the things I am working on at the moment is looking at the history of HSBC where risk decisions were made which had an influence on the future success and the future shape of the organization, and using those as examples to teach the new generation the importance of our risk culture. The business of banking is risk and without risk, there is no banking and there is no banking without risk. I think there are certain places within risk which are clearly owned by the risk function, but risk as a commodity is owned by everybody.

Question: As more regulation continues on the horizon, what suggestions do you have for central bankers and policy makers?

Hervé Geny: I think one of the things that led to the crisis is that when new products came on the market, regulators looked at them in isolation rather than trying to put them into the context of everything that exists already. It's important that they go from an incremental view to redesigning the system as a whole, and I think they are doing this right now.

Raj Singh: We need to make sure we respect the different business models between banking and insurance. Insurance definitely has been affected by the crisis but the funding models and liquidity scenarios are different. Also, we need to be careful of unintended consequences: whether it's insurance, reinsurance, or banking, ultimately additional capital charges will have to come out of the total financial system and the real economy.

Stephen Anderson: I don't necessarily believe that numerous layers of additional regulation is the answer. I think that some of the things that led to a complete collapse in the emphasis on portfolio, quality, and mortgage lending underwriting standards and concentration issues all go back to common sense, basic risk management principles that we somehow lost sight of.

Question: What makes a good CRO?

Stephen Anderson: Number one is a commercial understanding. I don't think it's possible to be a good Chief Risk Officer, unless you understand what makes your business tick and how your business makes money...and I think also the Chief Risk Officer has to be somebody who has a pretty consistent view of what the risk appetite of the company is and what portfolio of risks the company should have and what the risk tolerance of the company is.

Hervé Geny: First, openness and transparency. Second, to be adaptable and act almost as a translator, listening to the business and translating what you are looking for into measures and controls, and also the reverse, to explain new controls and methodologies to the business very clearly. And third, to have a strong vision of risk culture to maintain a strategic direction.

Lionel Lopez: There are three key strengths a risk leader should have. First is creativity and innovation; second is an orientation towards data, facts, and process, with the ability to make decisions based on those; and third is strength in people management.

Raj Singh: The most important factor is integrity – being an influential partner to the business, but also being influential enough to say no. Another key element is that we have to be pre-emptive in the risk function. To examine the ashes and explain how the fire happened is not terribly helpful, it's looking at the sparks and trying to think about how do we prevent that from becoming ember.

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James Stewart: You really need to understand the business. You can't stay in a world where things are too theoretical – at the end of the day, you have to be a banker, and understand what goes through the minds of people out there on the front line trying to win business and have it executed in a speedy, prompt, service-oriented way.

Conclusion

While the fundamentals of risk remain constant, recent financial events have placed a new premium on qualitative insight. As risk professionals become more involved in strategy, they must combine a strong vision for risk with a real understanding of their institutions' business models and processes. Ultimately, this blend of quantitative acuity and human insight is essential for creating and maintaining an effective culture of risk management.

As an executive search firm with a dedicated and established practice within the Risk and Finance functions across the global banking and financial services sector, SEBA International is continually engaged with the issues shaping the risk management field today. Robert Iommazzo is a Managing Partner of SEBA International and leads the Risk & Finance practice. Robert can be reached at riommazzo@sebasearch.com.