

What is Risk Management?

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..... A Personal View

Two questions to get us going

Is Risk Management an Art or a Science

Is Music an Art or a Science

My view

Risk Management is a matter of judgement

Music is a matter of taste

Art	Science

Art, Science and Judgement

Risk Analysis (etc.) is a science

(cos, it creates a short list of best actions)

(cos, the future is uncertain but not chaos)

Risk Management is a judgement

(cos, the end result is strictly measurable)

(cos, actions are taken in a human world)

Is this silly?



- ▶ The words we use create perceptions and expectations in our audience
- ▶ As a “specialist” area we can only “succeed” if colleagues generally understand – they have to relate it to their experience in other areas

Agenda

- ▶ **What on earth am I talking about?**
- ▶ The Answer
- ▶ To be announced later

Risk Management: (Advanced) Bank View

- Management
 - = action word
 - = actions taken to alter risk profile
 - = actions taken to achieve key objectives
 - = actions taken differentially to competitors

- Risk (profile)
 - = potential for outcome adverse to objectives
 - = a range of things / possibilities
 - = identification and sizing
 - = information loop into the management process

Risk Management: (Advanced) Bank View

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Risk Management: A Consultant View

Risk Management

Is

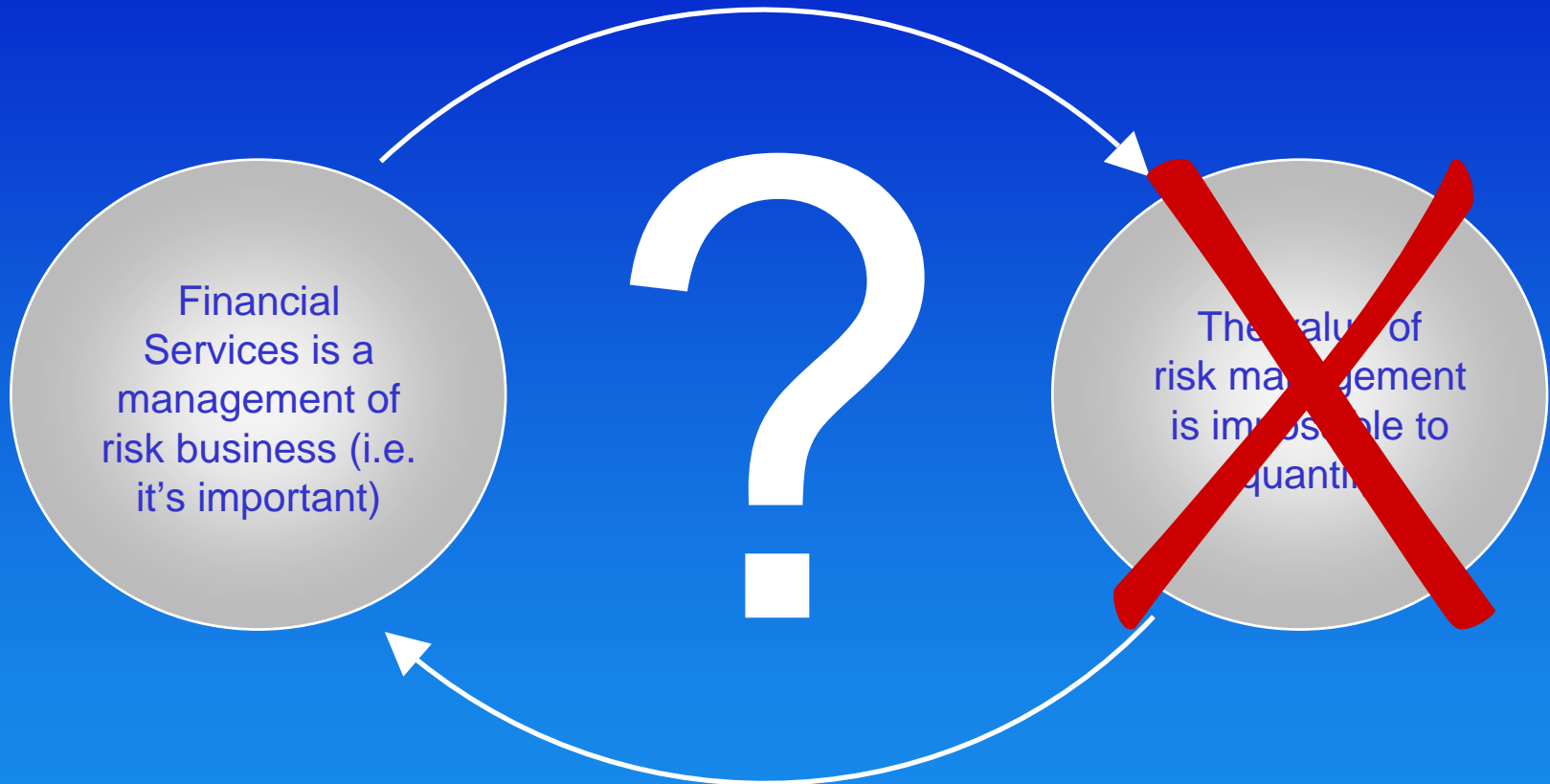
Informed Decision Making

But

Actions are irrelevant unless objectives
are clear

This presentation is all about the difference
between “management of risk” and “Risk
Management”

A Common Perception

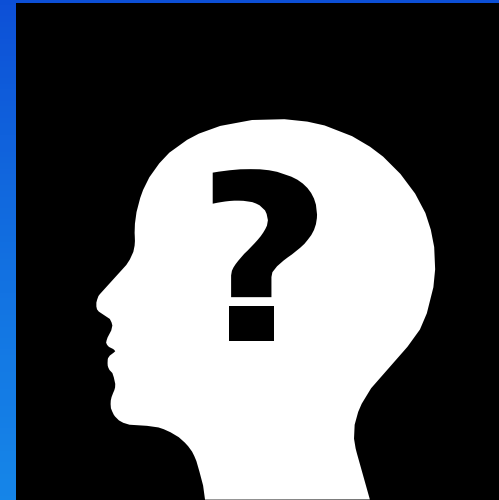


Of course there is a simple solution. . . One of these perceptions is wrong

Another Question

Which UK bank has the best credit risk management framework?

Barclays	
RBoS/Natwest	
HSBC	
Lloyds/TSB	
HBOS	
Abbey National	



Some overly simplistic financial analysis

2001	PBT/Assets (%)	Total Provisions/Assets (%)
 Abbey National <small>because life's complicated enough.</small>	1.05	0.27
 BARCLAYS	1.03	0.78
 HBOS plc	0.96	0.64
 HSBC	1.17	1.15
 Lloyds TSB	1.87	0.77
 The Royal Bank of Scotland	1.19	1.02

Can you see where quality of credit risk management has had an impact?

Typical Misconceptions about Risk Management

~~▶ Risk Management = Loss avoidance~~

~~▶ Risk Assessment can only be done through qualitative judgement based on years of experience~~

~~▶ There is no proof that automated models work better~~

~~▶ Increased use of models leaves no room for judgement~~

More Misconceptions

~~▶ Risk Management = Art / Subjective~~

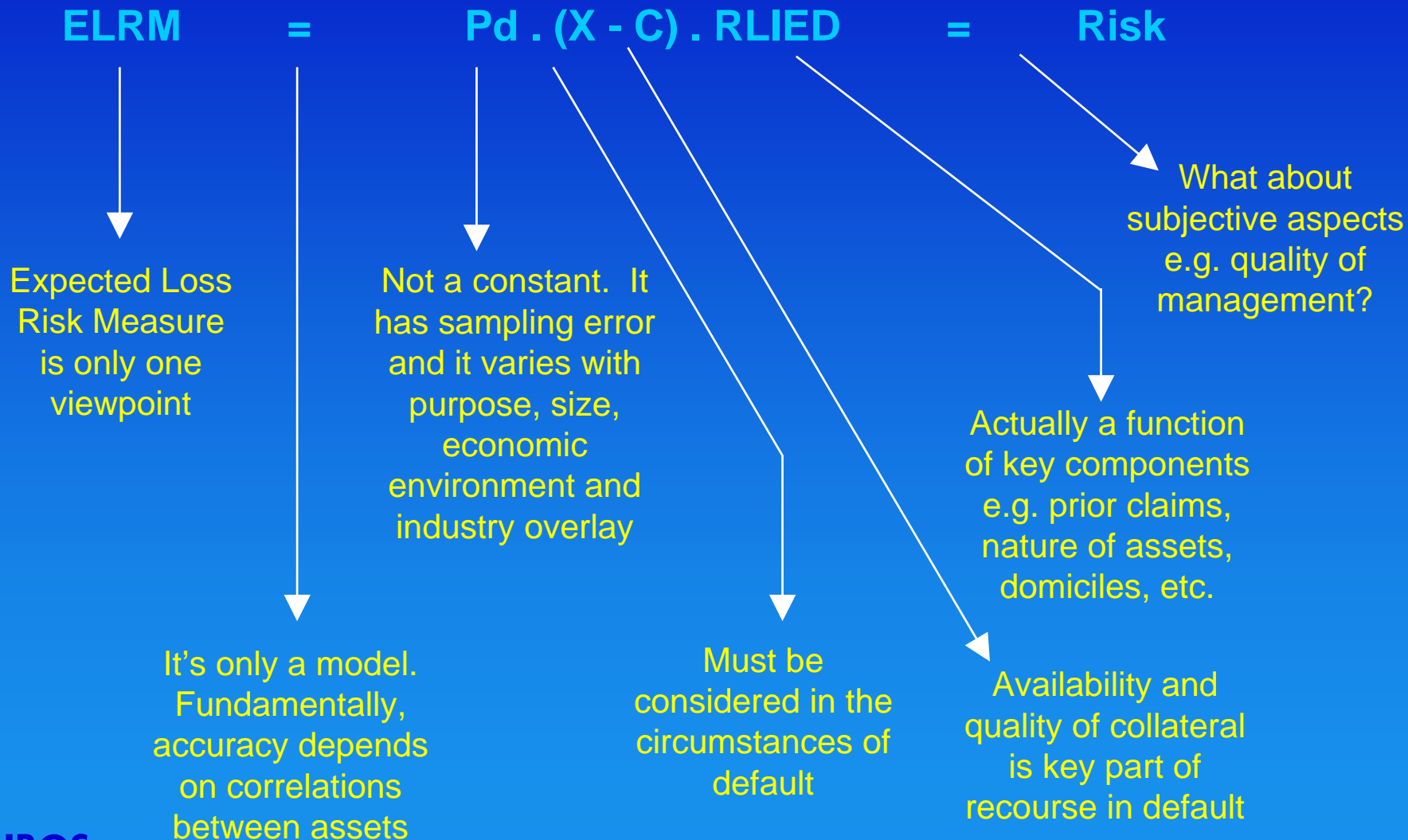
~~▶ The value / effectiveness of Risk Management cannot be measured~~

~~▶ It can be shown that “fundamental” analysis and pure judgement work best~~

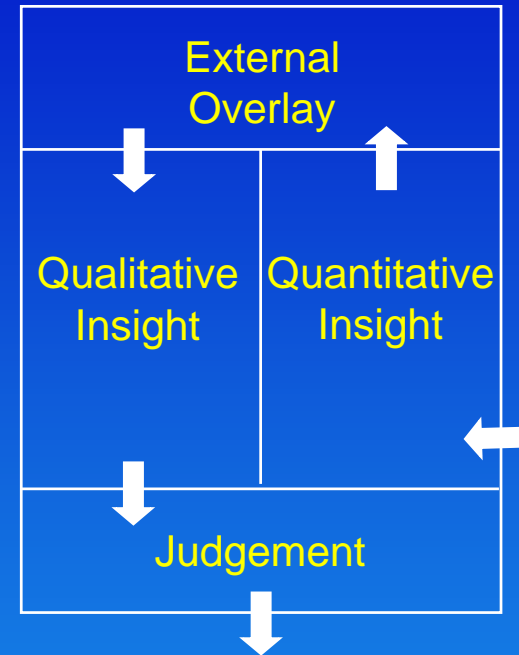
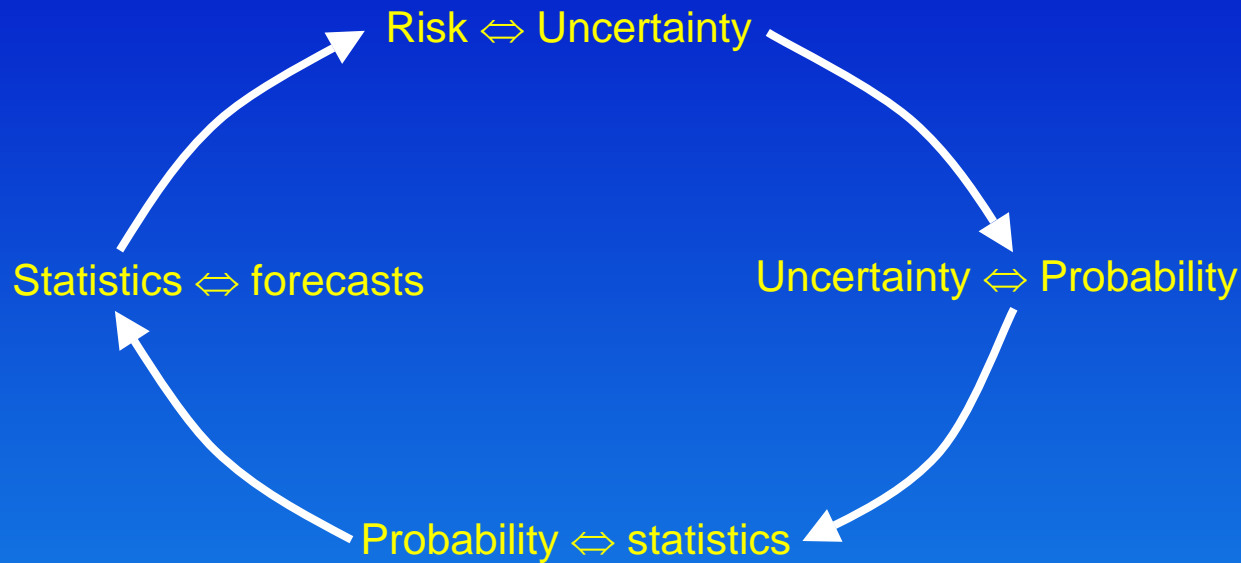
▶ No model is perfect

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Example Model Debate (Credit Risk)



Most Risk Modelling debate misses the point

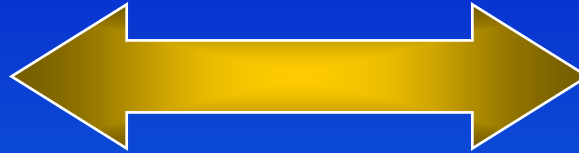


Risk assessment **IS** a matter of judgement but

? Do you want the model insight . . . or not ?

The BIS II Debate is perplexing

BISII emerged
as a result of
substantial
lobbying by
bankers



But . . .

- ▶ argue against cost
- ▶ argue against detail
- ▶ argue against generality

Bankers want capital
requirements to reflect
risk



But . . .

Bankers are
concerned that
BISII is
countercyclical

BISII permits an
'advanced
modelling' label
under which
virtually anything
is allowed



But . . .

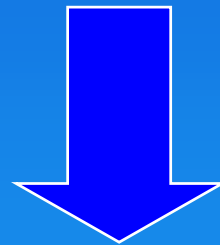
Bankers are
arguing about
which model to
aim for

Agenda

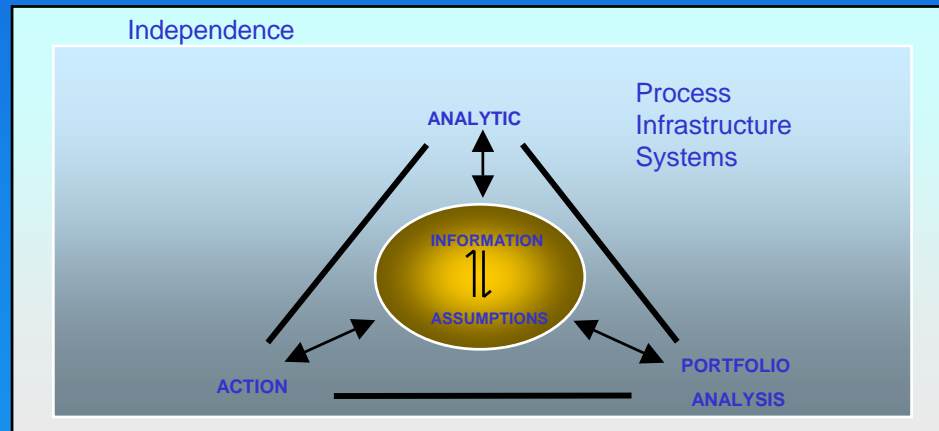
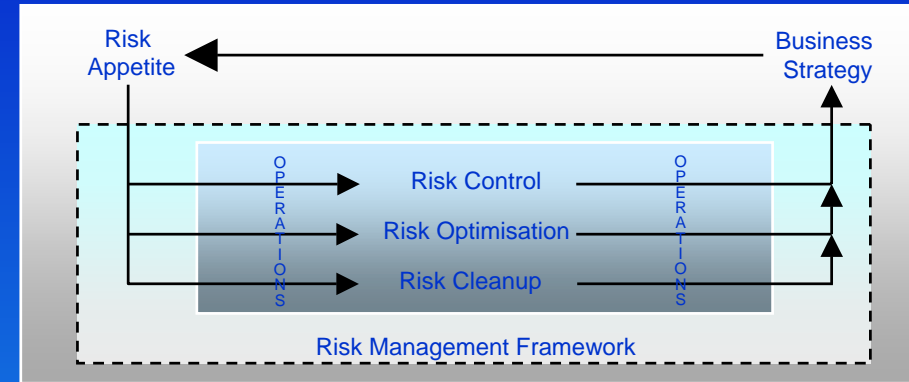
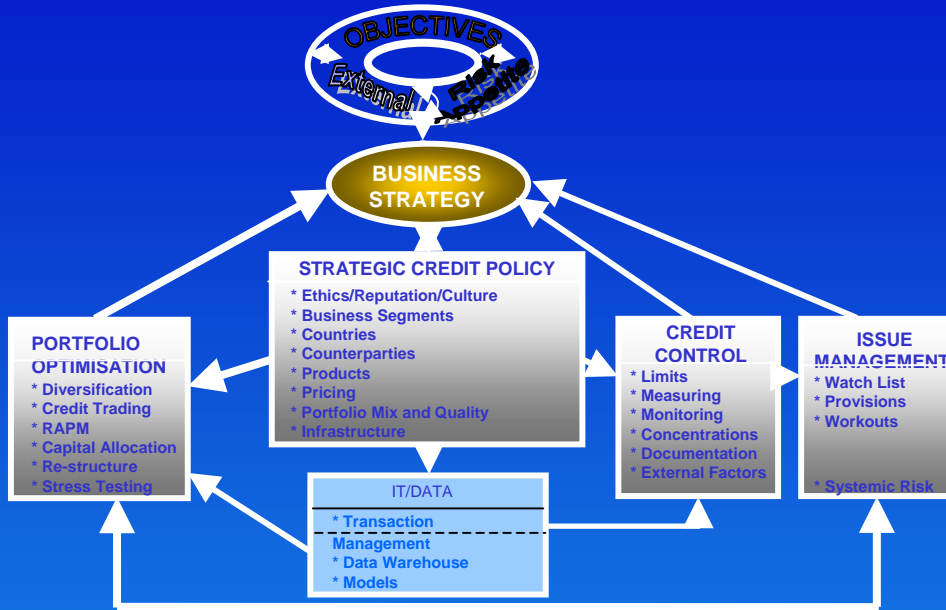
- ▶ What on earth am I talking about?
- ▶ **The Answer**

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OR



The Risk 2001 Framework*



*developed by an author is 1997

Truth and Reality are Subjective*

R2001 can't be the answer (although it may be an ideal way to achieve it) because we haven't established what the problem is that it's trying to solve!

Agenda

- ▶ What on earth am I talking about?
- ▶ The Answer
- ▶ **The Question? The Ultimate Question**
..... to life the universe and everything

..... is

..... is

..... is

..... is

What is Risk Management trying to achieve?

Financial Services Business Model



- ▶ Revenue arises from introducing and keeping income bearing flows (or in a trading business, initiating a sustainable competitive position)
- ▶ Cost arising from the processes/resources required to enable/maintain revenue generation
- ▶ A good business achieves stable⁺ achievement of forecasts over time
- ▶ Risk Management can/should be a key strategic weapon
 - increase revenue quantum
 - increase revenue quality
 - reduce cost quantum
 - enhance service delivery

The key learning point from Business Model

Risk Management is not driven by loss elimination but by risk acceptance for appropriate reward consistently over time

to

deliver the performance required by the business ownership

Which is difficult to achieve consistently/robustly without . . .

Risk Appetite

The proactive basis / guidance which sets a limit on the authority of executive management to

Plan and arrange the activities of the organisation

Accept/reject business in relation to the returns apparently on offer

Report and discuss performance in the context of risks accepted

Risk Management has two objectives

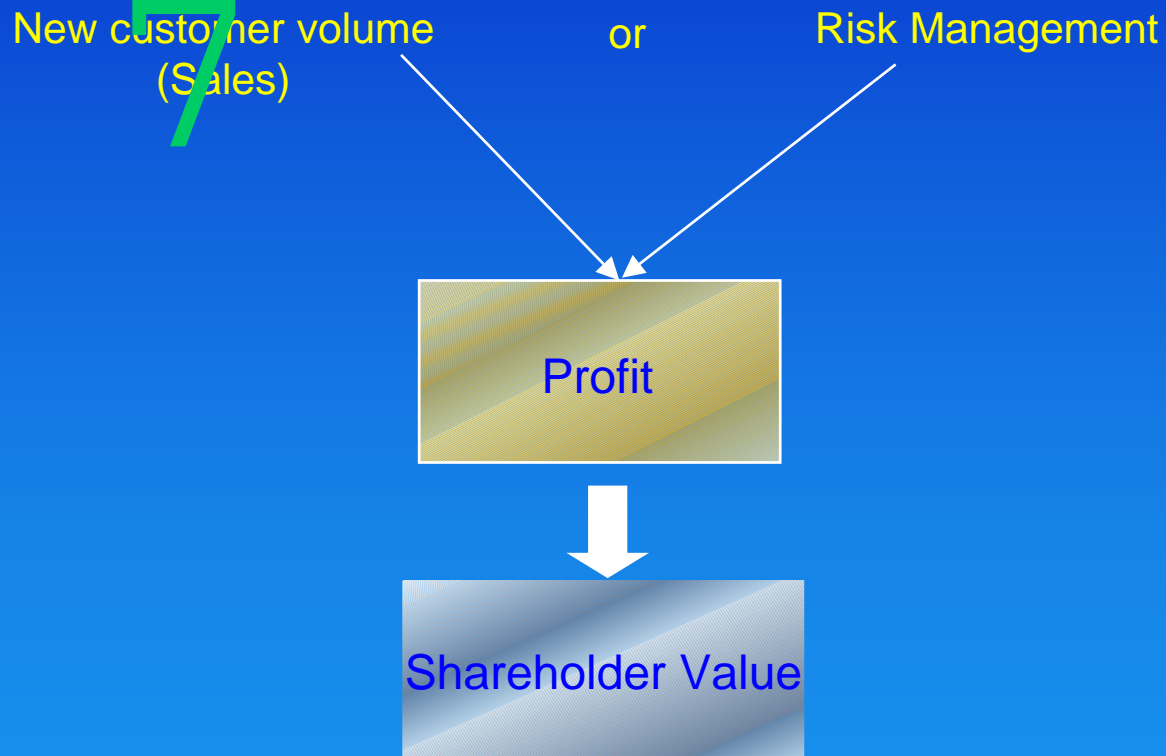
More
Profit
per
unit of
scarce resource

- ▶ Easy . . .
- ▶ But no one calls this risk management

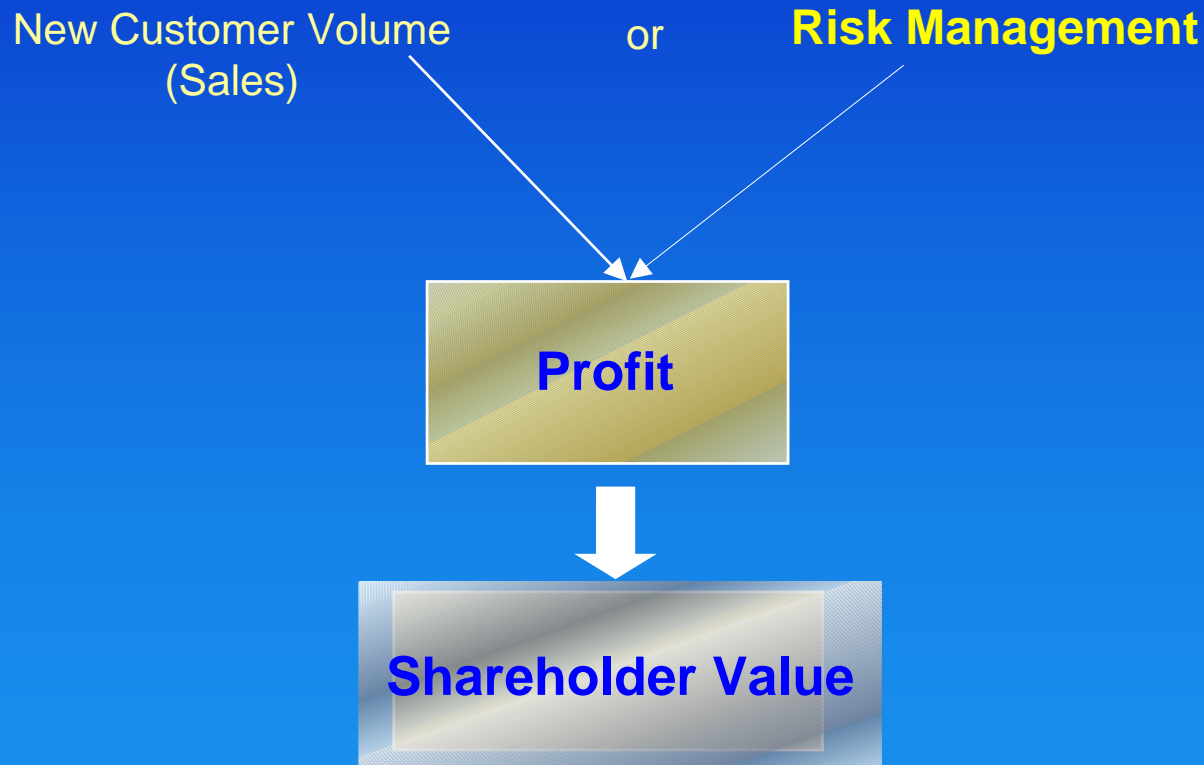
Better Profit stability
at
the cost of lower
immediate profit

- ▶ “Insurance” costs money
- ▶ “Everyone” seeks an excuse not to do it.

What is more important?



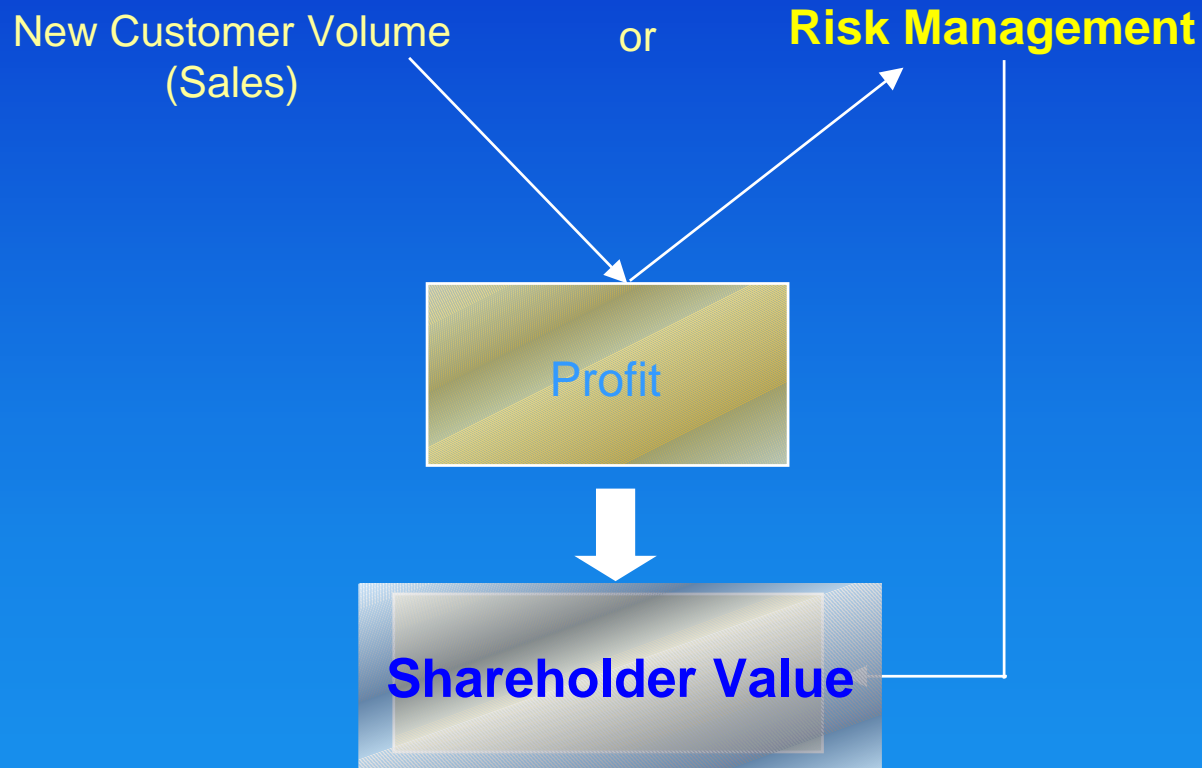
But . . .



- ▶ Identify most profitable customers
- ▶ Discriminate fraudulent, low credit, costly customer
- ▶ Identify Risk Pricing and Profit optimisation bases
- ▶ Identify and price cost of acquisition vs channel
- ▶ Identify and price attrition/persistence
- ▶ Identify and enable portfolio management and diversification
- ▶ Enable retention/securitisation arbitrage etc.

etc.

And . . .



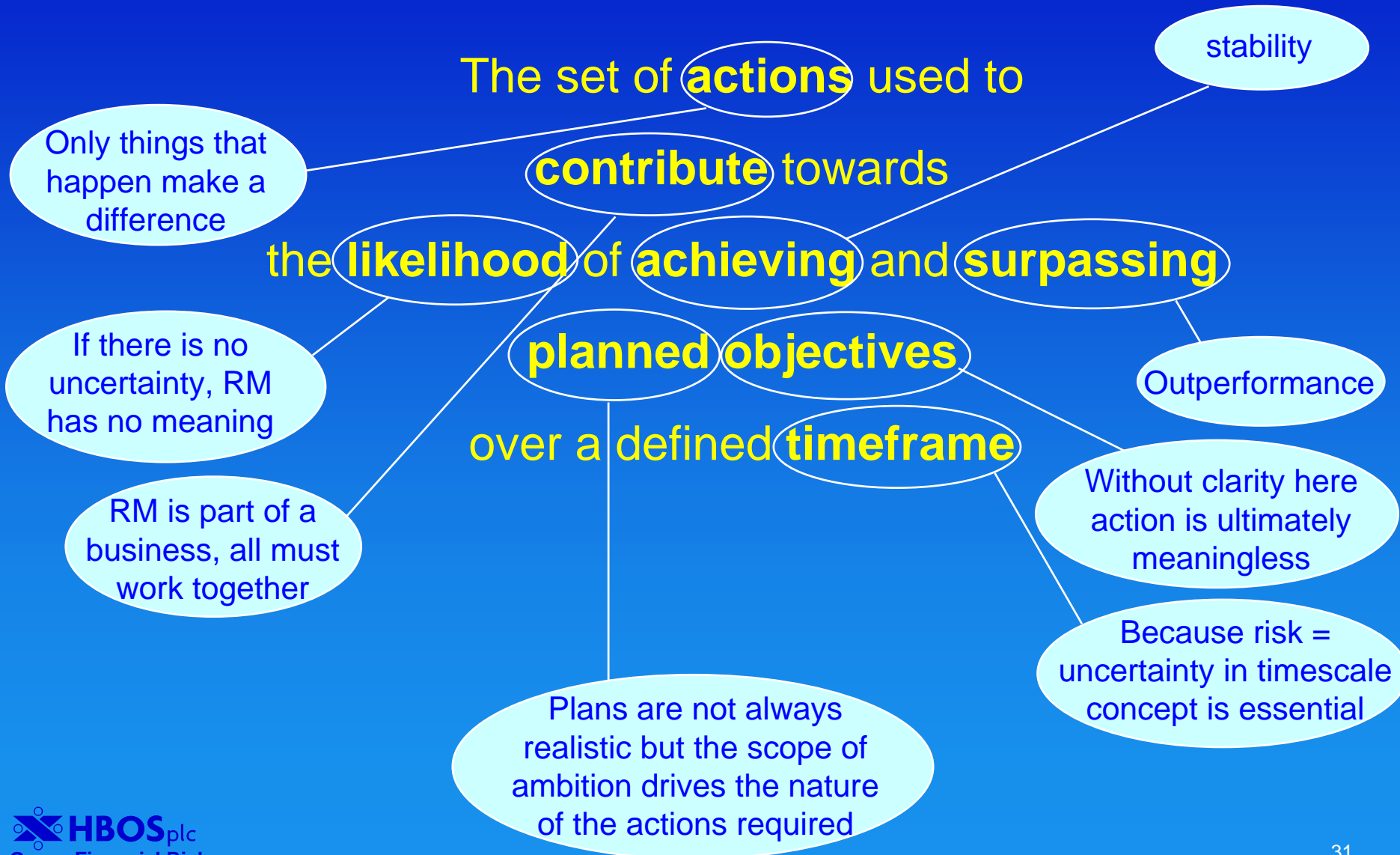
- ▶ Insurance to achieve profit stability
- ▶ Manage economic cycle
- ▶ Avoidance of catastrophe

Etc.

So, Risk Management is.....

A set of actions used to
contribute towards
the likelihood of achieving and surpassing
planned objectives
over a defined timeframe

So, Risk Management is.....



What are the consequences for Risk Professionals?

- ▶ Clear understanding of bank objectives over timescales is essential
- ▶ **Value** existing or potential actions in relation to profit quantum or profit stability drivers
- ▶ Articulate tools, techniques, systems, resources and other infrastructure in relation to enabling the two sources of RM **value**
- ▶ Imbed RM capability as **key contributors** to objectives
- ▶ It's one business, work together!
- ▶ Live, act and believe in RM as a **value** driver
- ▶ Live, act and believe in **measuring the value of RM**

Value of Risk Management?

[Sources - Expenditures] / Scarce Resources

Sources	Expenditures	Scarce Resources
<ul style="list-style-type: none"> ▶ Revenue ↑ (better risk discrimination, risk confidence, risk pricing, reduced attrition, etc.) ▶ Costs ↓ (eliminate control processes which don't contribute, better use of scarce resources) ▶ Profit stability ↑ (management of whole cycle) ▶ Volume ↑ (more effective and foster risk management processes) 	<ul style="list-style-type: none"> ▶ Risk Measurement tools ▶ Reporting tools ▶ Training to develop judgement ▶ Resource acquisition ▶ Transform business processes ▶ Risk data warehouse ▶ Other infrastructure 	<ul style="list-style-type: none"> ▶ Colleagues ▶ Capital ▶ IT ▶ Investment money

What does success look like?

Strategy, Infrastructure and processes which encourage colleagues to



When **accepting** or **maintaining** risk on behalf of the organisation

