GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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Conduct Risk

Doing what is "Right"

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Dear Subscriber

What a year for both the banking industry and for risk management. Are we seeing its coming of age as the new regulatory structures, rules and recommendations begin to take effect? We see this trend as evidenced by the increasing requirements for risk management restructuring within the global major banks, new risk training academies 'enforced' by European regulators for failing banks, risk modelling validation, as well as risk-based internal audit and the review of internal audit itself. The *Global Risk Update* looks at how the risk management world is changing, focusing on specific areas and producing in depth original articles that consider these themes.

Due to the number of recent cases that continue to batter the confidence of the financial sector the lead article is by risk specialist Markus Krebsz on Conduct Risk which focuses on the importance of doing what is 'right' from a UK regulatory perspective and draws international implications. Starting with a definition might be the hardest part.

Second in a series of interviews is that of e-commerce guru, Maelle Gavet, CEO of OZON Holdings, Russia's leading on-line retailer conducted by former Bank of England's Sandra Quinn. Credit risk? Operational risk? The article features looking at risk within the on-line sector and the approach OZON have taken in a market with 11 time zones, little credit card purchasing, goods inspection and pick-up centres – all part of a tenaciously unchanging cash-on delivery culture.

One doesn't need solely to read the *Financial Times* to learn about the hammering auditors are still getting and internal audit is indeed struggling to respond effectively even as it continues to deal with the new sound practices paper promulgated by the Bank for International Settlements. Questioning whether internal audit is measuring up, Jonathan Ledwidge looks at why internal audit has not always delivered and the challenges posed right now by conduct risk and corporate governance.

In the month where the World Islamic Economic Forum took place in London, Dr Natalie Schoon CFSI IFQ reflects on what Islamic risk management really means in a market such as Afghanistan where there are clearly many challenges. As the first sukuk was established in the US property market this year will the current economic cycle trend towards using Islamic finance principles to solve banking problems?

The insurance market is getting ready (again) to respond to Solvency 2 as it continues to stumble towards implementation. Regardless of the regulatory driver, in the current environment firms need to ensure that their business - and product models are operating effectively. Risk specialist Mark Dougherty and risk modelling expert Jan Fishman have provided an in depth article on defining the internal model for risk and capital management under the Solvency 2 Directive which links the rules to enterprise risk management and risk appetite.

As partners to the G8UK Deauville Partnership Arab Women in Business Conference this summer, Risk Reward was pleased to sponsor W3BF | Worldwide Women in Banking and Finance as our Corporate Social Responsibility project. In the first of a series of articles looking at the issues faced by women in financial services, risk expert Liz Taylor looks at what is means to work with men in risk management and the challenges she faced (not for the faint-hearted).

Finally financial behaviouralist Rohan Badenhorst looks at an area which is frequently not considered within risk management, negotiation risk. Few executives are actually trained in negotiation techniques, yet many need to undertake complex negotiations without an understanding of the techniques that are available. Senior executives frequently require additional assistance and mentoring in such areas.

We hope you enjoy this edition of the *Global Risk Update* and welcome your comments or suggestions for topics that you would like us to address in the future.

Dennis Cox BSc, CFSI, FCA
Chief Executive Officer

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TO THE EDITOR

Do you have risk issues in your organisation or region you would like to share? Email your thoughts to the Editor at editor@riskrewardlimited.com

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Conduct Risk – Doing what is "Right"

Markus Krebsz is Head of Risk and Director at Risk Reward Ltd. He is a published author, senior industry leader and Member of the United Nations Economic Commission for Europe Group of Risk Management Experts (UNECE GRM), Credit Rating expert advisor to the World Bank and Advisor to the European Commission.

With regulators around the globe growing teeth and using their supervisory powers, banks globally have been confronted with a huge wave of new regulatory requirements. In addition they have also been dealing with game-changing and previously unseen fines to repent their sins of the past.

Given the ongoing public perception that the financial services industry has lost touch with society and that ethics and principles have not appeared to play a prominent role as to how firms conduct themselves, this area is rapidly becoming the main focal point for financial regulators globally.

After the fall-out of the financial crisis, regulatory attention has been heavily drawn towards firms' conduct, meaning the behaviour of banks and financial institutions. Recent changes in the UK supervisory model, culminating in the establishment of the Financial Conduct Authority (FCA) are indeed evidence of the shifting focus towards 'conduct risk'.

Conduct risk is here to stay and needs to be at the heart of banks' strategies, business models, risk appetite frameworks and **everything** these firms do. Consequently, the conduct theme and in particular sound behaviours, need to be embedded into each and every firm's cultural fabric, not simply to in order to satisfying regulators' desires but more importantly, to survive the new financial world order.

Defining Conduct Risk

Although there has been a lot of noise recently related to 'Conduct risk', accompanied by a range of academic research and practitioners' white papers, a clear definition of the term itself is quite hard to come by. The FSA previously gave some guidance in the Retail Conduct Risk Outlook 2011 but with a focus on retail conduct risk:

> **"Conduct risk – that is, the risk that firm behaviour will result in poor outcomes for customers."**

Although a good starting point, when taking the FCA's new strategic objectives into account, namely consumer protection, safeguarding the financial system and ensuring effective competition – which naturally also include wholesale markets, it is tempting to define it somewhat more holistically:

> **"Conduct risk is caused by action(s) – or inaction – of an individual financial institution or the financial services industry that result in customer detriment, negatively impacts market stability or restrict effective competition."**

Conduct Risk – Doing what is "Right"

'People' or 'Conduct' Risk within the Operational Risk Landscape

Where people design or manufacture products, including the provision of financial services, things can (and frequently do) go wrong. Naturally, this includes areas such as poorly designed processes and procedures as well as shoddy pieces of software or incomplete code of algorithmic models, to name a few. This is what is largely known and often referred to as 'people risk'.

In contrast, other operational risks that are not attributable to 'people' are thought of as and are considered to be caused by an 'external factor'; essentially this would fall into the more traditional 'external events' Operational Risk category under Basel II. This includes the likes of natural disasters, terrorism, cyber attacks, phishing and the like.

Assuming most natural disasters and other external events are uncontrollable, we may conclude that people risks are – at least in theory – controllable, albeit some with limitations. Most, if not all people risks, are somewhat due to inappropriate conduct; with the caveat that appropriateness is somewhat depending on the individual circumstance and/or context that is being observed.

Consequently, inappropriate behaviour or misconduct may be considered as one of the main root causes of people risk.

The Nuances of "Right"

Whilst the management of conduct risk in general and the FCA in particular is focused on 'doing the right thing', this does beg the question how to define what is 'right'?

There certainly appear to be several nuances of doing the 'right' thing, such as

- **You're instructed;** i.e. being obedient and compliant with rules
- **For the right reason;** i.e. something that is appropriate but may not agree with formalised rules
- **For others;** i.e. ignoring one's own needs and wants by doing something selflessly for others

Looking at these different nuances, you may argue that the regulatory model, i.e. the rules-based approach, would have been perfectly satisfied by ticking all the regulatory boxes, meaning as firms have been told what to do by the regulators.

However, in the new supervisory world and from a conduct risk perspective, this is not sufficient: Firms need to be aware that the regulators, and in particular the FCA in the UK, are keen on firms doing things right. This means selling the right product to the right customer at the right time under the right circumstances, and also constantly evaluating whether something that was previously right is now not appropriate anymore.

In theory, this sounds fairly simple and straightforward, but in practice this is likely going to pose a major challenge for most, if not all firms. And naturally, it will take some time to instil this approach into firms' corporate cultures by bringing it to life.

Regulatory pushes into areas of 'Conduct'

Since the Financial Crisis in mid-2007, regulatory approaches evolved away from rules-based and towards risk-based regulation. In fact, with the creation of the FCA, there are now one (out of two) supervisory bodies in the UK specifically focussing on conduct and with the following beneficiaries and stated outcomes in mind.

- **Consumers** get financial services and products that meet their needs from firms they can trust
- **Firms** compete effectively and have the interest of their customers and integrity of the market at the heart of how they run their business
- **Markets and Financial Systems** are sound, stable and resilient with transparent price formation

On the continent and across Europe, with a future possibility for the centralisation of prudential banking supervision, there is the expectation that the national supervisory authorities (NSAs) are more likely going to focus on conduct risk, similar to the development we have seen in the UK. As such, the UK is somewhat seen as a first mover in the regulatory space and developments here are certainly closely being monitored by both, the regulatory community as well as regulated firms themselves.

Having said that, whilst common themes in the conduct space will continue emerging and will be addressed by the regulators affected, there is likely going to be much less convergence for conduct risk when compared to prudential regulation.

Conduct Risk Performance Measurement

Given the areas under particular scrutiny by the FCA from a conduct risk perspective, namely

- Consumer protection,
- Effective competition and
- Robustness of the financial markets and systems,

it is important to understand within this context how the FCA will supervise firms in the UK. The supervisory model in order to monitor these areas will be based on the following three key pillars:

- **Firm Systematic Framework (FSF),** which mainly comprises structured assessments of firms in order to prevent mishaps

- **Event-driven supervisory work,** allowing to address problems more pro-actively as they emerge, by deploying better use of market surveillance and analytical intelligence

- **Issues and Product-driven supervisory work,** mainly driven by sector risk assessments addressing issues which may cause potentially poor outcomes for consumers and market participants.

Conduct Risk – Doing what is "Right"

The **Firm Systematic Framework's (FSF)** particular focus is an assessment of the firm's conduct risk and closely examines firms for the following:

- Business model
- Strategy
- Conduct embedment of Treating Customers Fairly and Market Integrity by assessing:
  - Governance and Culture
  - Product Design
  - Sales and Transaction processes
  - Post-sales /services and Transaction handling.

The purpose here is to measure the sustainability of the firm's business in respect of conduct and with a view of identifying future risks to the firm, its customers and the stability of the market. This somewhat represents a refreshed Business model threshold condition check that firms will have to undergo when receiving their initial regulatory authorisation.

Following the FSF, the FCA decides remedial actions firms will need to take and communicates these to them. The frequency and scope of these assessments is determined by the conduct supervision category for the firm: your firm, essentially meaning you need to actively develop and articulate how your firm is tackling conduct risk.

Of course, this needs to come **straight from the top,** i.e. the Board, requiring strong cultural leadership, and then cascade through all organisational cracks and crevices in order to embed conduct risk awareness throughout your organisation. This includes policies and governance and building the capability to measure it with suitable key performance indicators and management information and regulatory reporting systems.

As part of this approach, you need to **embed conduct risk management** into the product design process of your firm, as this is one of the key areas of regulatory scrutiny with a focus on transparency and simplification.

And yes, your board and senior management needs to be aware that supervisors globally have started looking increasingly not only at much tougher penalties but also considerably more criminal prosecutions by **holding individual persons liable for wrong-doing of their firms.**

Doing what's right by not just ticking the regulatory compliance box but also right within reason should help reducing the risk of an individual's prosecution - but it requires an almost continuous self-reflection and self-assessment by asking:

- **"Should I/we be doing this?"**
- **"Is it right now and will it be considered to be right later?"**
- **"How would this decision look to others, including the regulators from the conduct risk perspective?"**

FCA Conduct Supervision Category	Firm's characteristics	Supervisory classification	Firm systematic framework activities & frequency
C1	Banking and Insurance groups with a very large number of retail customers. Universal/investment banks with very large client assets and trading operations.	Fixed portfolio	Continuous assessment Following the analysis by working through the assessment on a two-year cycle.
C2	A substantial number of Retail customers Large Wholesale firms	Fixed portfolio	Continuous assessment Following the analysis by working through the assessment on a two-year cycle.
C3	Retail Customers and/or A significant wholesale presence	Flexible portfolio	Focus on firms that are outliers compared to their peers. Focused review of their business, how it's run and how it's controlled.
C4	Smaller firms Including almost all intermediaries	Flexible portfolio	Lighter assessment than for C3 firms. 'Touch point' with all C4 firms once every four years.

(Source: "Journey to the FCA", October 2012, see Reference & Further reading section below)

What's next: And how can your firm address these new requirements?

The broad definition of conduct risk outlined above implies that this is **prevalent throughout your firm's activities and largely driven by the principles and spirit of good conduct** and not just a simple ticking of regulatory compliance boxes.

Hence, it needs **a clear definition of this risk type and an assignment of conduct-related responsibilities** throughout

Conduct Risk – Doing what is "Right"

And by the way, just in case you wondered, **'doing nothing' is also a decision to doing something** (i.e. being consciously inactive and accepting the status quo), so if you are discovering wrong conduct in your firm, turning a blind eye because it generates profitable business and always has been, will not protect you/your firm when good conduct is concerned.

What does it mean for me and my firm?

As evidenced recently by the USD 13billion fine imposed on JP Morgan as well as other banks and financial institutions, regulators globally are sharpening their teeth and expertise to improve behaviour and market conduct throughout the industry. **Conduct risk is at the centre and key driver of many supervisory initiatives.**

If your firm is not managing these risks pro-actively by addressing conduct-related issues head-on, then you may be in for a rude awakening meaning more heavy fines, potentially imprisonment, reputational damage and probably most important, an exodus of your customers.

In addition, you may be subjected to increased regulatory scrutiny, including temporary closure and/or restrictions on your trading & other business activities limiting your competitiveness.

By selling the right product in the right circumstance and the right time to the right customer, you are doing what's right for both, your firm and for society.

You and your firm are playing a crucial part in this but you need to constantly question yourself and your employees whether or not if it what they are doing (or not) is 'right'. That is the real challenge and one that will not go away – if anything, will intensify further.

Conclusion:

Pro-active conduct risk management is not a luxury; it is a necessity ensuring regulatory and commercial sustainability by benefiting your customers as well as your firm.

The author invites your comments via email to MK@riskrewardlimited.com

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NOTES

1) See also Roger Steare, The Corporate Philosopher, http://www.thecorporatephilosopher.org/

2) See also "Journey to the FCA, October 2012", http://www.fca.org.uk/static/documents/fsa-journey-to-the-fca.pdf

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FCA Risk Outlook 2013: http://www.fca.org.uk/static/fca/documents/fca-risk-outlook-2013.pdf

ICAEW Instilling integrity in organisations website: http://www.icaew.com/en/technical/ethics/market-foundations/instilling-integrity-in-organisations

IRM Risk Culture website: http://www.theirm.org/RiskCulture.html

LSE Centre for Analysis of Risk and Regulation (CARR) website: http://www.lse.ac.uk/researchAndExpertise/units/CARR

OECD Update Report on the Work to Support the Implementation of the G20 High-level Principles on Financial Consumer Protection: http://www.oecd.org/daf/fin/financial-education/G20EffectiveApproachesFCP.pdf

Real integrity: practical solutions for organisations seeking to promote and encourage integrity website: http://www.icaew.com/en/products/accountancy-markets-and-ethics/real-integrity-briefing

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Being Real About Risk

Sandra Quinn, MD of Quinnity Limited interviews Maelle Gavet, CEO of OZON Holdings, Russia's leading online retailer. Sandra is a former UK regulator and risk director who now works with growing and start up businesses to help them establish risk, controls and compliance that work in innovative environments. Following her recent work with Groupon in the UK, GRU asked Sandra to speak with the French Chief Executive about risk in a growing e-commerce business.

The first thing you notice interviewing Maelle is her refreshing approach to being a leader of a business. Albeit she is CEO of Russia's equivalent to Amazon and far from being an Amazon copycat, she makes it clear she isn't disappearing into target numbers. She keeps it real and wants OZON to be its own company.

OZON was Russia's first online shop, established in 1998. Maelle joined OZON after six years at Boston Consulting Group, first as its head of marketing and customer relations, and then becoming CEO in 2010.

Maelle, what's the number one thing you uniquely bring as a CEO?

This is the question she is most uncomfortable with. She often sees a cult of leaders with which she is uncomfortable. *'Nobody can work without a team around him or her'* and she points to great work she and the OZON team have done on acquisitions and establishing a new warehouse, changing the company approach and setting up an in-house call centre. *'I find it hard to say it's all me'*. Contrasting this with internet start ups she highlights that in a lot of young businesses *'a lot depends on the guy who creates the business'*. Having got past the start up stage, OZON at fifteen years old doesn't need to depend on one person, albeit there is a lot of respect for its founders. *'The role of the CEO is direction but a single person doesn't make or break a company; but a single team can make or break a company.'*

If 'walking the floor' is a key thing for traditional offline business leaders to get to know their company, what's your e-commerce equivalent?

Maelle has three equivalents of this, starting with the OZON call centre. *'Especially in the first year I sat in the call centre every single week, now I do it once a quarter and that's all I can manage'*. The second is the warehouse where she goes to pick and pack orders. *'Last year it was the nightshift where I spent 24 hours to pick and pack the orders'*. The third is the delivery system where once a year she works at the pick up points and drives with the couriers.

Who have you learned most from?

Too many to name. Maybe twenty *'So many mentors, that I can feel really lucky'*. She cites *'incredible Russian people'* who showed her how to build a business.

Colleagues and clients at BCG showed her how to be a good consultant. When she moved to OZON she learned a lot by looking at Bernard Lukey, the former CEO.

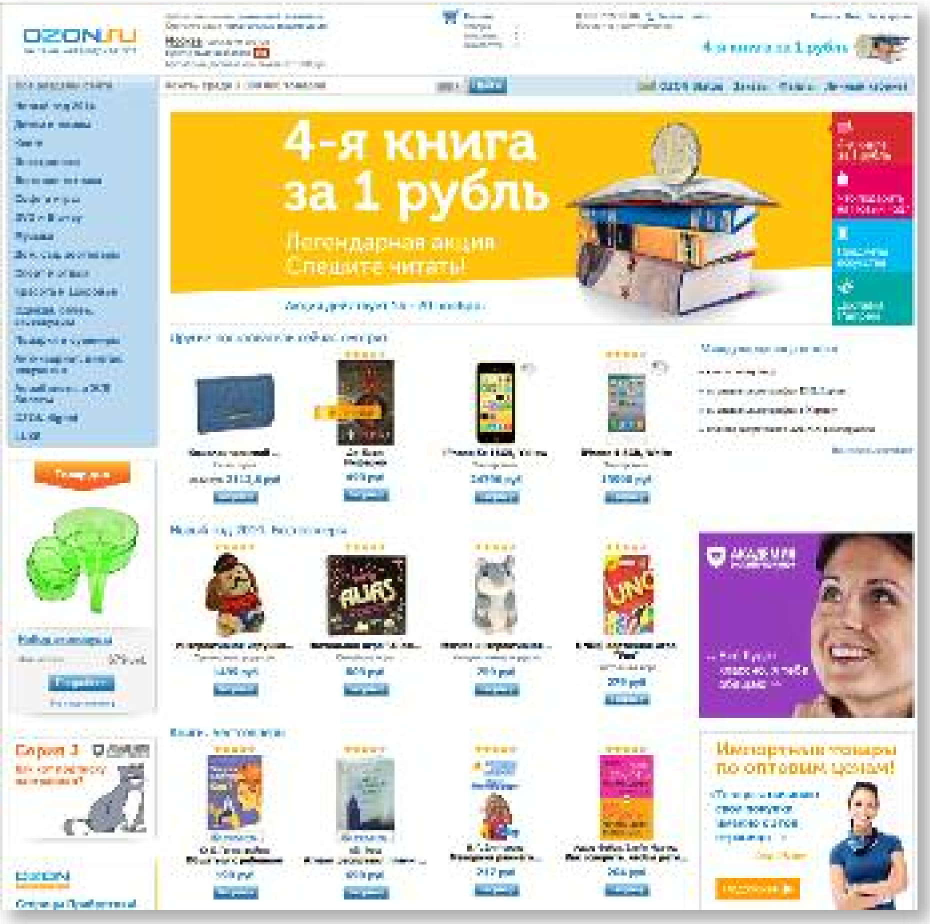
So what is her ambition for OZON?

'Ambitions are big'. They continue to expand market share and their goal is to build a general B2C e-commerce platform with one of the biggest online travel businesses in Russia, having bought Sapato selling shoes and shortly moving into clothes. They have developed B2B capability to undertake delivery, and created E-Solutions which provide an online solution for offline companies. OZON plans to provide a *'total e-commerce experience'* either through its own platform or through others.

Being Real About Risk

So what is her approach to risk?

Maelle's approach is intensely practical. She describes risk management as a discipline as in its infancy in the online business in Russia but notes that people are learning through experience, often through having problems. *'In our industry in Russia it is not always considered a top priority for many e-commerce firms; the priority risk management will be IT risk management. How do you make sure your website is not down? How do you make sure you can resist attack? How can you make sure that your database doesn't leak? Do you have enough servers to power your website?'*



OZON has extended its risk view to payments and delivery which they treat as key risks. Maelle and OZON focus on them explicitly. Russia remains a cash based economy so cash payment is part of the Russian culture. *'Delivery is at the core of our business because in Russia it is hard to rely on existing infrastructure.'* And they make it not just risk management but also a competitive advantage. *'We are the biggest delivery system for e-commerce in this country'*.

How does fraud feature in her approach to risk?

In a more cash based consumer market, OZON's business is 80% cash on delivery with pick up points of goods for customers numbering over 2000 across the country. *'Our market situation is very different so this is one problem we don't have. So we have others'*. This makes cash management a bigger risk issue than card payments which is the challenge for other e-commerce companies. Cash payment *'is part of the Russian culture and part of the customer expectation and a lot of people have debit cards so they can withdraw money twice a month'*. But clearly this is something OZON is working with, recognizing as a Russian company that this is the market standard.

The offline experience is critical to online success

To Maelle, focusing on the offline experience is crucial to the success of the online. *'If you make the offline experience right, then you make the online shopping right.'*

Partly this is driven by a customer demographic which is getting used to the online experience in Russia. But it represents practical management of the risk that most online retailers have faced – focusing on the web experience and seeing the customer experience as a function of their online quality.

Maelle continues: *'They want to talk to a human being and have someone who can answer. They want to go to a pick up point and open the goods before they purchase it to make sure it's what they bought'*.

So OZON will continue to focus on getting its website right but Maelle contrasts this approach with firms whose principal worry is about the conversion rates on their website and the colour and position of a button on the website.
'We've tested that like any online retail and it is important. But at the end of the day it doesn't mean that the customer is going to return to make their next purchase. It doesn't depend on the size or colour of the button you put on the checkout page. It's going to depend on whether their overall experience is good. And that means was the price right, was I delivered on time and if I had a problem was there someone I could talk to sort it out.'

Maelle is self- critical of her approach to risk. But my impression is that it's an intensely practical approach which others in her industry could learn from. And one that her customers should feel good about.

The author invites feedback and comment via email to Ms Joanna Kraska JK@riskrewardlimited.com

Has Internal Audit Measured Up? What Do We Do Next?

Jonathan Ledwidge is Director of Risk & Internal Audit at Risk Reward Limited, an author and thought leader on issues surrounding change and transformation within banking.

Over the past few years banks have constantly been in the news, unfortunately rarely for the right reasons. A number of different scandals have hurt both the reputation and image of the industry. Foremost amongst these scandals are:

The Financial Crisis – a well documented global disaster
A Foreclosure Crisis – the reaction of banks to mortgage defaulters
Libor Manipulation – affected the most important borrowing/lending rate in the world
Rogue Trading – several episodes where unauthorised trading exposures lead to huge losses
Energy Markets Manipulation – subject of major new investigation by the SEC/CFTC
Money Laundering – a number of major banks have paid very hefty fines
Insider Trading – has involved some major figures on Wall Street and the City
Product Mis-Selling – massive fines for major banks

This does not make good reading for anyone involved in the industry but auditors in particular have real cause for concern.

The Failure Of Internal Audit

Internal audit is supposed to be the one function within an organisation that provides independent overview and assessment of all other functions i.e. not just management in general but risk, credit, compliance and finance. It is internal audit's responsibility to provide senior management with an assurance that all functions are performing to the best of their ability such that they will safeguard the assets and reputation of the institution.

Yet it is apparent that in one form or another the function has failed, and the fact is that it continued to fail, despite the plethora of new rules and regulations that have been imposed in recent years.

Whichever way you want to look at it, the ongoing inability of internal audit to identify, report or cause management to act on major failings reflects very badly on banking institutions on a whole but particularly badly on auditors, internal as well as external. The sheer scale of some of the scandals noted above makes such failure even all the more disturbing.

My own personal experience, gained from working as a consultant with a number of major global financial institutions, is that internal auditors themselves have become sceptical of their role and the effectiveness of their work. While this should not be surprising, it does lessen the likelihood that internal auditors will be able to rise to new challenges.

What does all this mean for the internal auditor?

How can auditors continue to retain the faith of management or indeed faith in themselves?

Is the current approach to internal audit flawed and if so what do we need to change?

If there is a need for change where do we begin and what do we need to do?

Governance And Internal Controls Remain The Primary Responsibility Of Management

The first thing that internal auditors have to remember is that the maintenance of an appropriate system of governance and internal controls remains the primary responsibility of management, and not internal audit.

Such an assertion is perhaps small comfort but for the internal auditor it is important from two critical perspectives. The first is that it firmly establishes where the primary blame for failure resides and the second is that it provides a very clear and strong indication as to where internal auditors must begin their quest for improvement.

The quest for improvement must begin with management and the business.

Challenging the Board and Senior Management: Conduct Risk

It is imperative that internal auditors understand that the quest for better governance and internal controls does not begin with the audit of governance and internal controls but with a thorough examination of management and the business.

If internal auditors are to change and add greater value then they must move beyond simply examining and reporting risks and internal control failures after the fact. Instead, internal auditors should adopt an approach which includes challenging management and the board to explain to them how and why the very nature of their business and operational strategies are consistent with good governance and internal controls.

For example, internal auditors should be asking of management how the risk appetite and profile of the business is consistent with the aims and objectives of the institution. They should enquire and determine as to whether or not there are periodic review mechanisms that ensure all assumptions made about the business; credit, risk, markets, customers, profitability and overall resources remain consistent with those aims and objectives.

More importantly, internal auditors should enquire as to how the institution's business approach, including its delivery of products and services, will specifically impact customers under a variety of scenarios, and how such an approach deters or avoids negative outcomes.

The absolute need to adopt this approach was recently reinforced by messages from the FCA (Financial Conduct Authority) which has developed a laser-like focus on "conduct risk".

A loose interpretation of conduct risk is "the conduct or behaviours arising from the provision of products or services that are likely to have an impact on customers. Institutions should note that the assessment of conduct risk goes beyond compliance with regulations".

In other words, it is no longer good enough for an institution to focus on complying with regulations as in the event of a negative outcome for customers, its conduct and behaviours will also be taken into account.

Auditing Corporate Governance

As internal auditors must be prepared to challenge the board and management on their business assumptions as well as their stewardship of corporate governance and internal controls, the obvious question that arises; how should one audit corporate governance?

The first and more traditional approach is checking to ensure that there are clear lines of authority from the board and senior management and that every business line or activity is covered by those lines of authority. Consistent with this is the need to ensure that there is an authority and a mechanism for assessing and reporting each of those business activities by all of the relevant control functions: audit, risk, SOX, credit, compliance and finance.

All of the above should be captured within the institution's corporate governance framework which should be documented and signed-off at the highest levels. The framework must also include the relationship between the board, and management and its various committees, e.g. Audit Committee, with the rest of the institution.

The second approach is one which many (if not most) organisations find more difficult but which in reality is just as important as the first. It involves ensuring that management has established a mission and a system of values (cove ring such issues as ethics, integrity, whistleblowing etc.) for the institution. It is then important to establish whether or not there are appropriate mechanisms for ensuring that said mission and values are recognised, understood and consistently practised throughout the institution, including in the delivery of products and services.

The real difficulty is that this goes well beyond the realms of compliance activities and into the question of how one engenders good behaviours.

The Challenge Of Overly Complex Organisation Structures and Systems

Another area in which internal auditors must challenge management is in the very structure of the business they are required to audit.

One of the most significant challenges for many internal auditors in large organisations is that the structure of many institutions or business units, meaning the IT systems, processes and procedures, has become overly complex. Sometimes, this is due to the sheer size of the organisation but this is not always necessarily the case. In such instances, the most difficult part of the audit is determining the scope and then defining where it begins, where it ends and what needs to be covered in between.

Rather than routinely accepting such complexity as a fait accompli, internal auditors should be advising management that such structures expose the organisation to higher yet avoidable levels of risk, and then work with management to reduce it.

Undertrained, Underdeveloped and Poorly Integrated Operations Staff

We have all experienced it.

You are conducting an audit of operations and you ask someone in the processing chain what happens to a document or process after they have completed their task. You get a blank stare after which you are politely told "I don't know". It is then you realise that many of the people working in operations have no idea what the person to either the left or the right of them is doing.

This might be OK if you are in a bottled water factory where someone watches to see that all the bottles are filled with water, another checks to see that the caps are on and finally someone ensures that that bottle of water with a cap on it is placed in a box or on a palette for distribution.

However, banking and financial services are so different due to complexity and continuous change. As such, if operations staff remain static, it increases the risk that something might fall through the cracks. The problem is this; in banking and financial services things that fall through the cracks are internal control weaknesses that could cost millions and sometimes billions of dollars.

Auditors should encourage Operations to improve the efficiency and effectiveness of their operations teams by way of better staff training and team development. There is no question that a similar argument can routinely be made for managers and staff in other functions such as credit, risk and compliance.

Internal auditors should always remember that the operations internal control function is the first line of defence and the better that works the better it is for both auditors, management and shareholders.

Improving The Efficiency and Effectiveness Of Audits

There are far too many audit departments that have programmed themselves to do a certain number of annual audits irrespective of what is happening around them. In many cases the whole idea of the audit function is to impress the boss by demonstrating just how many audits were completed on-time during the year. Where there is a branch network the focus becomes how many branches can be audited in the year.

I call the above "robot auditing" in that it turns the whole internal audit department into robots and the mere act of doing an audit is an objective in of itself. Why is this a negative approach?

1. It emphasises **quantity over quality** and that can never be good under any circumstance
2. It is inevitable that some areas of the business will require greater focus and attention than others
3. Turning auditors into robots has an adverse effect on the morale of the audit team
4. Poor morale leads to poor audits and higher staff turnover which again leads to poor audits

There is a simple way to avoid all of this. Adopt a risk-based audit approach.

Adopting A Risk-Based Audit Approach

In order to adopt a risk-based audit approach the internal audit function must establish a consistent framework by which is assesses the risk inherent in each identifiable business activity. This assessment would include such factors as product or service complexity, P/L and/or balance sheet impact, the legal and reputational risks involved and the current state of the internal controls.

Once such a framework has been established, internal audit then has a approach which they can present to management describing what specific areas of the business they will focus on and why, as well as, why other areas will move from an annual, biennial or even quarterly audit.

The risk-based audit approach enables scarce audit resources to be focused on the areas of the business which have the most risk. This automatically enables internal audit to provide management with greater assurance and insights as to the status of governance and internal controls and the risks they potentially represent to the organisation and its assets.

Training And Development Of Internal Auditors

Finally, in addition to gaining knowledge about the technical aspects of products and how they must be managed, it is imperative that internal auditors keep abreast of all the legal and regulatory developments which impact financial services.

Unfortunately, the post financial crisis era has witnessed a plethora of new legislation and regulation from the US, the UK, the EU, the Basel Committee and a whole host of other bodies in various jurisdictions. It is a necessary challenge to keep up.

Yet learning the requirements of new legislation and regulation are but one part of the story. The other part is learning how these new requirements are to be implemented and what actually constitutes best and sound practices.

Internal auditors should consistently seek out learning environments which provides them with opportunities to both update their legal and regulatory knowledge as well as learn from industry specialists and their peers.

Internal audit exists to provide the board and senior management with a reasonable assurance, not a cast iron guarantee. In order to provide that reasonable assurance it needs to now take a major step forward.

For comments and feedback Email Jonathan Ledwidge at JL@riskrewardlimited.com

Islamic Risk Management – Afghan Style

Dr. Natalie Schoon is an internationally renowned risk management, Islamic banking and finance expert, based in London. Following the most recent Islamic fund development project in Afghanistan, GRU asked her to contribute an article on risk management in that country.

Similar to any other jurisdiction, Afghanistan has implemented the appropriate regulations to comply with Basel II and the Financial Action Task Force (FATF). Anyone could be forgiven for thinking that theoretical and practical implementation of these regulations is the same. Practice has a tendency to be different from theory and risk management in Afghanistan is no exception.

The Regulations

Banks established in Afghanistan are subject to the Banking Law of the Islamic Republic of Afghanistan and the regulations of Da Afghanistan Bank (DAB). The regulations that are issued and maintained by DAB are similar to those found in other jurisdictions and include procedures for licensing, cooperation with foreign regulators, and the requirement for sound and prudent management, internal control procedures, and risk management processes. The government of Afghanistan has, in addition to the banking law, also introduced a law on combating financing of terrorism, anti-money laundering and proceeds of crime law, and laws regarding secure transactions related to moveable and immoveable properties.

Capital Adequacy

DAB's capital adequacy regulations were issued in 2006 and span a whopping 13 pages which makes them shorter than many summary papers on the subject. DAB applies a risk based approach for the calculation of capital adequacy and requires all licensed banks to maintain adequate levels of capital commensurate with their activities. DAB applies the CAMELS approach taking into account factors such as asset quality, concentration of credit risk and types of assets and liabilities, and off-balance sheet exposures. Banks are required to maintain at least 12% risk weighted capital at least half of which needs to be Tier 1 capital. Either way, banks need to maintain a minimum capital of 500 million Afghani (approx. USD 10 million).

The minimum ratio of total regulatory

Islamic Risk Management – Afghan Style

capital to risk weighted assets is calculated as Total Capital minus prescribed deductions divided by Risk Weighted Assets.

DAB applies slotting criteria for risk weighting with four risk categories attracting 0%, 20%, 50%, and 100% risk weighting.

DAB Risk Weighting Categories

1. **Category 1 – 0%.** Including cash in Afghani and readily convertible currencies, balances with and claims on selected central banks, and loans fully collateralised by precious metals and precious stones, current accounts with DAB, or cash.

2. **Category 2 – 20%.** Including loans fully guaranteed or collateralised by selected central banks or central governments, cash in the process of collection, and banks operating in selected jurisdictions.

3. **Category 3 – 50%.** Including first lien residential mortgages, and loans to finance pre-sold or pre-leased real estate construction.

4. **Category 4 – 100%.** Including loans to private individuals, and any assets not captured in any of the other categories.

The recent changes in capital adequacy regulations resulting from the financial crisis appear to have largely passed by DAB, at least for the moment.

Assessing Credit Risk

Afghanistan is largely a cash based society particularly in relation to private financial transactions. Businesses, however, do turn to banks or suppliers for their financing needs. Besides the rather briefly defined capital requirements and regulatory reporting requirements including large exposure reporting, DAB does not provide the banks with any further requirements in their risk management operations. Generally speaking, banks in Afghanistan follow very similar principles to other banks in applying "know your customer" principles, and assessing the credit worthiness of clients.

There are, however, some interesting issues that apply to determining the credit risk of business counterparties. As a result of the economic and political circumstances in Afghanistan, many businesses have only relatively recently been (re)established, many of them with the use of funds made available by foreign donors. The vast majority of these funds have been provided free of charge as part of the on-going development effort. One of the unintended side effects of this situation is that businesses do not seem to have a notion of the obligations associated with taking out a loan such as the fact that it has a cost associated with it in the form of interest and the requirement of timely repayments. As a result, the efforts associated with recovering funds can be significantly higher than in some other jurisdictions.

Whether it has been due to the availability of free money, the economic climate, or both, many businesses have rapidly grown in a short period of time without necessarily evolving beyond the paternalistic stage of management. Although businesses have to be registered with the Ministry of Commerce, they are generally still run by the owner and his closest family, and are hardly seen as a separate entity. Accounting information is sketchy at most, and accounting systems are typically not in use. The absence of accounting information including profit and loss accounts, income statements and cash flow projections make forecasting difficult which is further hindered by a lack of financial analysis skills and other required resources.

In order to guarantee a loan, banks typically request collateral well in excess of the loan amount. This is not different from financial services in other countries. The ability to seize the collateral, however, is by far more difficult than it would be in western countries. Although a form of title deed exists, not every type is recognised by the current government causing further challenges for credit risk management.

In order to overcome the challenges that exist with repayment habits and the enforceability of collateral, many financial institutions have implemented the practice of requesting character witnesses to

The rules and regulations in Afghanistan are easy enough to abide by, and from what can be observed, easy enough to bend if needed.

assess the willingness and ability of an applicant to repay a loan or to request guarantees instead of, or in addition to, any collateral. The enforcement of guarantees can, however, have completely different side effects. Having followed due process, and finally calling on a guarantor may result in the bank being repaid. Even so the original borrower may not live too long thereafter as guarantors generally do not take kindly on being called on and literally take the law in their own hands.

Conclusions

The rules and regulations in Afghanistan are easy enough to abide by, and from what can be observed, easy enough to bend if needed. Practical solutions are found to overcome challenges with managing credit risk. In a country generally still considered a war zone with different cultural norms, where repayment of a loan is generally deemed to be optional, collateral cannot really be enforced, and calling on a guarantor may result in the death of the original borrower, managing credit risk may sound like a completely different kettle of fish, but the principles largely remain the same. After all, in the end it is all about maximising the chance to be repaid.

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Defining the Internal Model for Risk & Capital Management under the Solvency II Directive

Mark Dougherty is an international Senior Corporate Governance and Risk Management professional and Chartered Professional Accountant (CPA)/Certified Management Accountant (CMA). For over 25 years, he has had a successful track record in implementing regulatory initiatives to establish industry-leading standards in Basel II, preparation for Solvency II, Sarbanes-Oxley (SOX) in Banking and Insurance in Risk Management. Since 2007, Mark has worked in the UK/Europe as an independent consultant for Virgin Money, Aviva Insurance, Chartis/AIG Insurance, RSA Insurance and Legal & General Insurance.

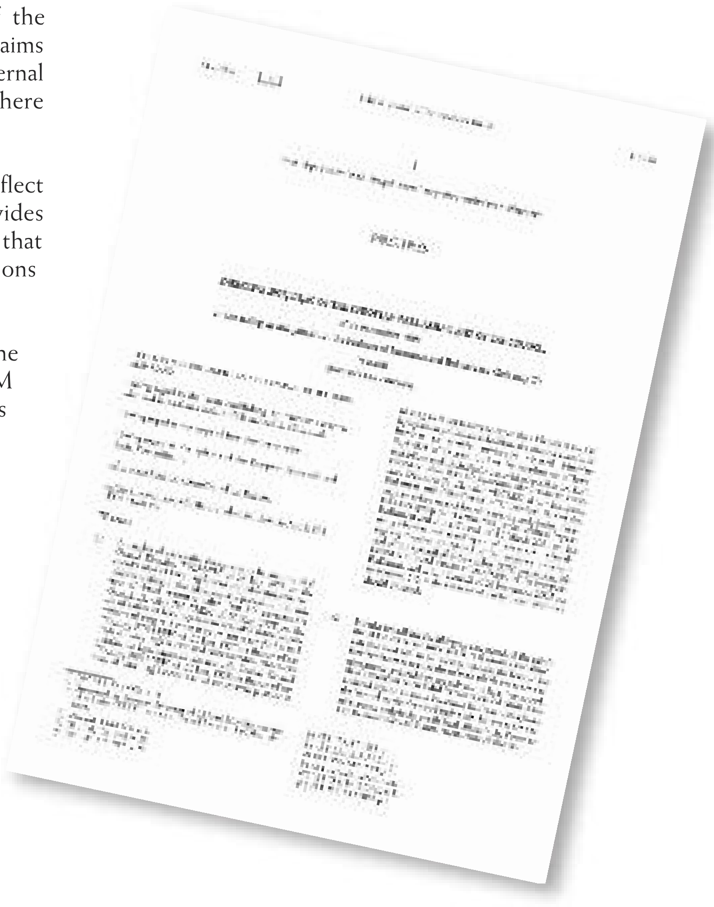
Yan Fishman is a senior Business Analysis and Software Development Professional specializing in computer assisted solutions for the financial institutions. He has had a leading position in the development of a mortgage control system for a major Savings and Loan Corporation, as well as designing, developing and implementing computer based Credit risk models for the variety of the major bank business lines. Mr. Fishman is an I.S.P (The Information Systems Professional of Canada) and ITCP/ IP3P (Information Technology Certified Professional aligned with the International Professional Practice Partnership).

In this article, the authors explain the challenges in defining the risk and capital internal model.

The Internal Model is a key component of the Solvency II regime. The Solvency II Directive aims to allow a full Risk and Capital-related Internal Model (IM) approach to be used where requirements are met and approval has been granted.

Authorised insurers are allowed to tailor their IM to reflect the broad range and scale of risks they face and provides them with an opportunity to build models that systematically assess the existing risks and interactions between risks in their own firms.

It also provides an important foundation for the Enterprise Risk Management system. Specifically, the IM is an essential vehicle to measure and monitor risks across the company, enhance risk management capability and ultimately determine capital requirements.



Solvency II vs. Basel II (and Basel III)

Defining and developing an Internal Model is a specific explicit requirement of the Solvency II Directive (applicable to specified insurance entities in the European Union).

Basel II and III, for banking/deposit-taking organisations, with its international focus, have similar objectives to Solvency II but take a different approach. In banking, Basel II Accord

Defining the Internal Model for Risk & Capital Management under the Solvency II Directive

allows the creation of the advanced IM based on the specific risk type, including credit risk (Foundation-Internal Ratings Based and Advanced- Internal Ratings Based), market risk (Internal Rating Based) and operational risk (Advanced Measurement Approach). Basel III maintains the same approach.

There are both similarities and differences in the risk universe between insurance and banking. While insurers have credit, market, liquidity (considered small by some) and operational risks like banks they also have other insurance specific risks (many say that "risk" is the "business" of Insurers).

There are three keys risks in Solvency II that are unique for Insurers. First, Underwriting Risk, which is the risk that claims are higher than expected; this can be caused by external or internal factors. The second is Actuarial Risk, which is the risk that actuarial assumptions are wrong (mainly Life related or longer term policies). Finally there is Claims Risk, which is the risk that claims are mismanaged.

From a modeling perspective, therefore, the most significant difference between Basel II and Solvency II is the treatment of full internal models. Pillar 1 of Basel II effectively only allows a full internal model approach for market risk and operational risk. In the field of operational risk for Basel II, firms can choose the Advanced Measurement Approach (AMA) backed up by a sophisticated internal model (including scenario and loss distribution approaches). For credit risk, which tends to be the largest component of a bank's capital requirement, companies are only allowed to use internal models to determine the parameters (probability of default, loss given default and exposure at default) to feed into a supervisory prescribed model.

Solvency II allows a full and comprehensive internal model approach. This reflects the broad range and scale of risks faced by different insurers and allows them the opportunity to build a models that better reflect the existing risks and risk interactions n their own business environment as well as risk mitigation resulting from the risk management techniques used (including diversification).

Under Solvency II, the Internal Model covers all quantifiable material risks including Insurance, Market, Liquidity, Credit and Operational. The risks modelled will be those relevant to the applicable legal entities and lines of business. The above approach ensures that the Solvency Capital Requirement (SCR) will be calculated using the Internal Model for all significant risks within the organisation. Under the Solvency II Directive, the SCR represents the level of capital required by an Insurer, covering all material risks, which will cover the risk of 'ruin' occurring on a 1 in 200 year period basis. It therefore represents a buffer against unexpected loss and acts as an 'early warning' indicator for the supervisor.

Solvency II permits firms to apply for approval to use full or partial internal models for the calculation of their regulatory capital requirements, as an alternative to using the standard formula. The internal modelling activity is required to be integrated into the risk management activity of the firm. To meet Solvency II requirements, firms will need to continue the refinement of their internal model and to integrate their IM into their risk and capital management frameworks.

Firms intending to seek approval for their internal model will require demonstrating the compliance with several mandated tests and requirements, including use, statistical quality, data, documentation, calibration and profit and loss attribution. In addition, activities such as sensitivity, stress and scenario testing will also need to be evidenced.

Similar to banking's Basel II accord, the Solvency II Accord's advanced models are used for the key insurance risks as well as other risks (such as Credit Risk, Market Risk, Operational risk, etc.), institutions must ensure that the models they are using are sufficiently integrated into their risk management systems that are conceptually sound and operating with integrity.

Solvency II - Pillar I - Demonstrating adequate financial resources

Solvency II provides for two different solvency-related requirements: The SCR (Solvency Capital Requirement) and the MCR (Minimum Capital

Requirement). The SCR represents the required capital for regulatory solvency, and is calibrated to give protection against a 1 in 200 years chance loss event that basic own funds will remain positive. The MCR represents the level below which capital resources must not fall in order not to lose the regulatory authorisation to write new business.

The SCR may be calculated either by using a standard formula or an approved internal model. All firms will need to be familiar with the standard formula for calculating the SCR. The MCR is calculated using simplified calculations based on technical provisions and amount of annual premiums.

A robust Internal Model may be used, subject to regulatory pre-approval, to replace the Solvency II Pillar I standard formula capital calculations.

In addition to this, insurers need to demonstrate the quality of their financial resources to meet the SCR and MCR. These resources are known as the "own funds" or "excess of assets over liabilities" on the Solvency II balance sheet.

Internal Model and its role

There is a strong and negatively correlated relationship between Risk and Capital capital assessment process reviews the firm's entire risk profile as a prerequisite to determining capital requirements. Therefore, capital assessments are important in risk management. There are three key capital-related steps in the risk management process: (i) cataloguing and assessment of the firm's risks, (ii) review of how the firm addresses those risks, (iii) calculation of how much current and future capital is necessary to cover those risks through the IM. This last point incorporates the concepts of capital planning and capital adequacy in Capital Management.

The risk and capital framework, that includes the IM, need to be incorporated into the business processes. The Risk/Capital framework should provide details for capital structure, allocation and reporting, as well as assisting with the investment strategy and supporting Management in decision-making.

The IM is important in supporting strategic initiatives, including:

- Decisions on risk-taking and sustainable profitable performance.
- Determination and measurement of the effectiveness of risk mitigation approaches.
- Determination, validation and assessment of the Risk Appetite, supporting underwriting excellence, strong controls and tight financial management.

A firm's Internal Model needs to be integrated within its overall risk management and decision-making activities. Most importantly, it should be routinely used to quantify risks and assess a firm's economic capital.

The Solvency II Directive does not define specifically the internal model required to be used. The IM for the firm is designed by the organisation itself.

Insurance firms are required to design their IM which is defined as an integral part of the company risk management system developed to analyse the overall risk position, to quantify risks and to determine the economic capital required to meet those risks based on its specific risk profile.

Solvency II permits firms to apply for approval to use their full or partial internal models (where parts of the SCR calculation make use of the standardised formula) for the calculation of their regulatory SCR capital requirements, as an alternative to applying the results of the standard formula.

The internal modelling activity is required to be integrated into the risk management activity of the firm which is in turn is integrated into the risk and capital management framework. Approval to use an internal model will require the Company to demonstrate compliance with several mandated tests and requirements, including, statistical quality, data, documentation, calibration and profit and loss attribution. Activities such as sensitivity, stress and scenario testing will also need to be evidenced.

In addition, the Company will need to demonstrate that it meets the requirements of the use test, such that the IM is widely employed in and plays an important role in the managing of the business. Demonstrating compliance with this test is a key prerequisite for model approval. The Internal Model becomes a key part of the risk and capital assessment process (ORSA) and model's outputs influence a number of key business functions.

The overall structure of the Internal Model (in particular the outputs) is constantly evolves driven by the changing demands of the business requirements in a continual feedback loop.

How to manage the Enterprise Risk Management (ERM) cycle using the IM

The ERM Risk Framework is the overarching environment that incorporates the risk & capital IM and associated processes for the identification, assessment, measurement, managing, monitoring and reporting of risks.

At the heart of an Enterprise Risk Management (ERM) system is the Internal Model.

As per Illustration 1, the IM is a representation of the risk and capital management processes which support management of the business. The IM assists management in defining the overall risk profile of the business and in calculating the capital requirements of the current operations and plans as well as making decisions that take into account the risk and capital implications of those decisions.

The IM is a key part of the risk and capital assessment process, and model outputs influence a number of key business functions. The Internal Model must have the right capabilities and granularity to meet the business needs (for users: decision-making on performance assessments, pricing, etc.).

The scope of the IM must be wide enough to properly capture the business and risk profiles of the businesses of the applicable entities. Given the importance of the Internal Models to the running of the businesses, there will be constant internal pressure for model refinement and improvement of accuracy of capital calculation

The reporting/disclosures element is the processes and procedures employed to identify, assess, monitor, manage, and report the short and long term risks a firm faces or may face, and to determine the own funds necessary to ensure that overall capital needs are met at all times.

The Internal Model is a key tool of Risk Management which quantifies the risk profile to determine the required economic and regulatory capital. The Internal Model covers all quantifiable material risks. The Internal Model is the collection of the required Inputs, Capital Calculation engine, generated Outputs and related documentation. The calculation engine is the mathematical-based system which is used for the quantification of capital requirements for the risk categories specified.

The Capital Calculation engine is the Capital Modelling software used. It is the model used to generate capital-based outputs. The technical kernel is the mathematical-based capital calculation engine which is used for the quantification of capital requirements according to risk categories.

Assumptions are of two types: (i) made throughout the Internal Model where there is little or no internal or external data available for Internal Model input and key assumptions are made using expert judgment and (ii) other required assumptions as applicable. External models are defined as the use of third party models to feed the capital calculation engine.

The Internal Model Governance processes ensure the adequacy and effectiveness of the Internal Model. Internal Model Governance ensures that the information from the model is delivered on time, complete and accurate, and also acts as a point of request for ad-hoc uses.

Risk monitoring and reporting on business performance is important. Output from the Internal Capital Model provides outputs and analytics for the use of risk-adjusted performance measures to report and evaluate performance on the firm's activities. As well, Internal Risk Monitoring (through MI) includes monitoring and reporting on sources of risk to their respective Management teams as well as Senior Management.
Regarding Corporate Governance, the Internal/Capital Model's outputs are used to assess and analyse for key decision-making in order to influence and shape business decisions, opportunities and planning (within the applicable risk appetite).

The Internal Model Governance processes ensure the adequacy and effectiveness of the Internal Model. It covers requisite policies and controls. Provides information and feedback loops with the senior executives, Board Risk Committee and Board.

Use Test

The Use Test requires the insurer to demonstrate that there is sufficient discipline in its Internal Model development and application such that it is 'widely used in and plays an important role in' the management of the firm. Through this, supervisors can be sure that an internal model is appropriate to the business, if it is widely used and plays an important role in how the firm measures and manages risk in its business.

The Use Test demonstrates that the internal model is widely used and plays an important role in the firm's system of governance and in particular, its risk management system, decision-making processes and the Reporting/Disclosures system. Other tests, for example those which are specified by Solvency II, include statistical and data quality standards and Validation standards.

The use test requires the Company to demonstrate that there is sufficient discipline in its Internal Capital Model development and application such that it is widely used and plays an important role in the management of the firm. Through this, regulators can be sure that the Internal Capital Model is appropriate to the business. Demonstrating compliance with this test is an essential condition of Internal Capital Model approval. The use test supports the assertion that the Internal Capital Model is established and retained (i.e., embedded) as part of firm's normal operation and into its everyday use.

Solvency II requires the firm to demonstrate that the Internal Model is widely used in its system of governance and in particular, its Risk Management system, business decision-making processes and the Own Risk and Solvency Assessment (ORSA).

IM Validation

In developing models in-house, a series of validation standards must be designed and utilized to ensure the firm meets the regulatory requirements.

Validation is a defined review process that ensures the overall appropriateness, accuracy and effectiveness of the design and operation of the IM and its governance, and that it continues to reflect the risk profile of the firm, demonstrating that the appropriate risk and capital processes are in place.

The IM Validation (for Risk and Capital Management) requires testing to ensure that the measures of the quantification of risks, such as rating systems, parameters or operational risk metrics, are accurately calibrated and are consistent with a bank's policies and procedures.

Other Matters

There needs to be processes in place to ensure that the IM is continuously refined and improved, where relevant and required, to reflect changes to the nature, scale, scope and complexity of the business covering all key risks and lines of business.

There is also a need to ensure that the performance of the Internal Model is efficient and effective based on the IM's design and operation. In addition, there needs to be a process in place to ensure on-going compliance with the requirements of the Internal Model's regulatory approval.

Documentation is integral to the integrity of the Internal Model and Internal Model Governance. A critical component is the standards for the required supporting documentation. The documentation standards include the following key requirements: clarity, completeness, accuracy, proportionality and an audit trail. The documentation will need to be sufficient and appropriate for a "knowledgeable independent third party" to understand same.

Where applicable there is a need to identify and document any significant drawbacks and weaknesses in the IM.

Conclusion

The "Risk Model" is the firm's representation of the risk management processes to support management of the business, including articulation of the overall risk profile of the business and to calculate the capital requirements.

The Internal Model is developed by the financial institution to determine the capital requirement on the basis of the company-specific risk profile.

The Risk Model is the overarching environment that incorporates the risk & capital model and associated processes for the identification, assessment, measurement, managing, monitoring and reporting of risks.

During the recent financial crisis many firms had insufficient risk management in place. In addition, the risk management and capital models had significant deficiencies. For examples, they often had poor input data, were incorrectly designed, had flawed assumptions and bore no resemblance to the real world.

It reminds us of a not so old saying by the late Aaron Levenstein of New York's Baruch College that models (including risk and capital models) are like bikinis – what they reveal is suggestive, but what they conceal is vital.

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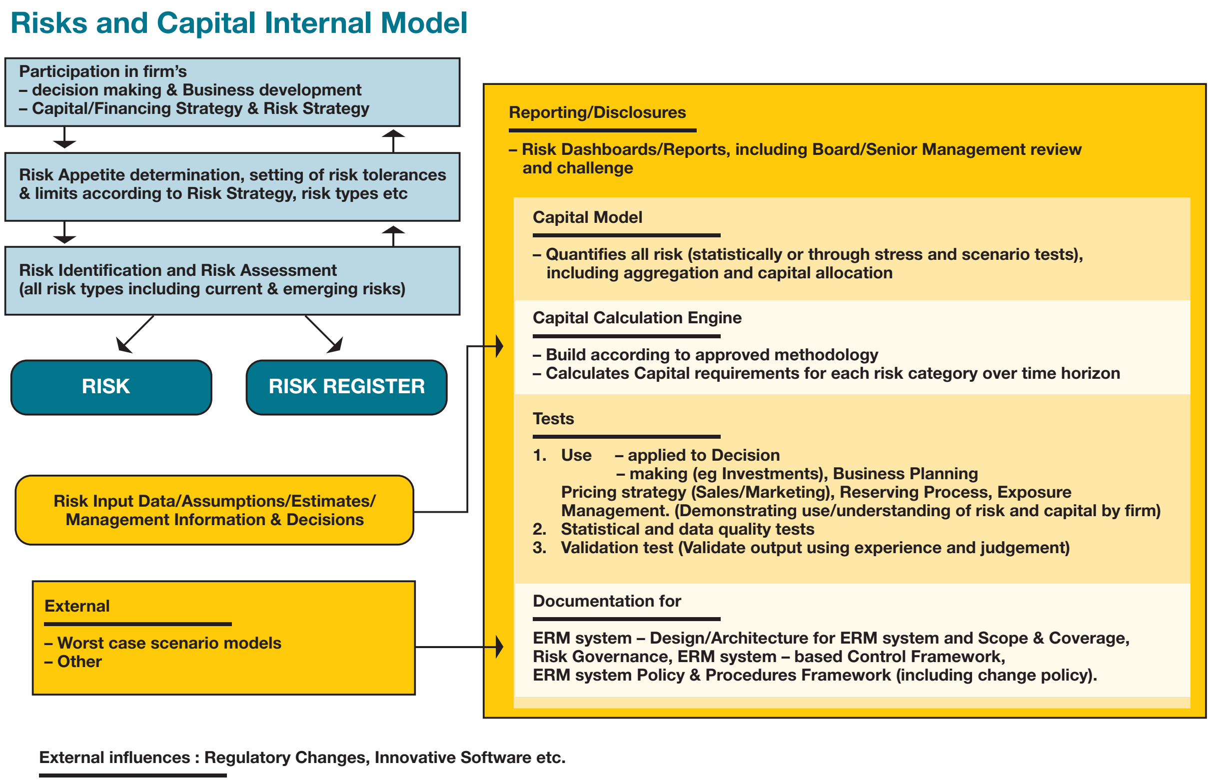
Illustration 1 – Example Design of an IM of the Risk and Capital Management processes



Working With Men in the Risk Environment

Hard hat and thick skin required

Liz Taylor is an internationally experienced Insurance Risk Practitioner known in both developed and emerging markets and to a wide variety of industry and public sector audiences.

Being a woman has advantages and disadvantages in the world of risk management, but how you play them depends on you and only you. Any woman in business, particularly one who is operating at senior level, has to maximise the advantages and minimise the disadvantages.

Emotion, pain and anger were always a hard thing to manage. So many times I had to blink back the tears or to hold my tongue. Doing risk management in a man's world never fazed me much, particularly in an industrial environment where you had to climb up the outside of ten story silos in a force-eight gale to inspect some piece of equipment. But when I got down, put the hair back in place, and tidied up the moisture marks under the eyes, I was told that it was a test, and that I was expected to back out of it. I just smiled and asked a technical question about the equipment. Underneath, I was seething.

On another occasion, as the new Risk Director, the board meeting was over, and everyone shuffled out. I popped to the ladies to tidy myself up before the evening's dinner, and when I came out they had all gone. Not only had they failed to offer me a lift, but they had also neglected to tell me where they were going for a pre-dinner drink. So when I arrived at the dinner venue, I waited for over an hour and a half for the others to roll in, noting that they were rather the worse for drink. Did I scream and shout like I felt like doing? Of course I didn't. I just notched it up to another of those experiences when you feel hurt and betrayed beyond telling.

I was lucky, blessed with a physical size and strength that put me on a par with the smaller men and a cheery countenance that made me look on the bright side of things all the time. But I still felt moved to tears when I felt betrayed, or belittled by my

male counterparts. However, never did I give them that satisfaction, rather reverting to quick quips or turning the conversation to something else.

Women's clothes, perfume and makeup were always a trial for me. There were no senior women from whom I could learn. Once, an HR director looked me up and down and gave me a heap of verbal abuse for wearing trousers. Yes, he did that, and I'll never forget looking him straight in the eye and asking if he would prefer that I minced around in a skirt and high heels on open meshed flooring in the factories. His jaw dropped.

I had learned my lesson a few months earlier, having been summoned at short notice to attend the site of an accident. I'd not stopped to get into my boiler suit and protective shoes, rather preferring to dash up to the factory floor some six stories high. It was a lovely flowing blue skirt that I wore. I remember it clearly. There were pretty white polka dots and the skirt went everywhere with me, never showing a crease and always elegant and dressy.

There are times when you could say something that a man could never say to another male colleague...

When I descended the factory, the skirt was torn to shreds. I had been lucky that I'd not also been pulled into the compressor along with the skirt. But all I could think of was maintaining my composure and keeping a modicum of pride by winning the tug of war with the machine enough not to have to walk through the factory showing my unmentionables below the smart white blouse. But on examining the skirt when I had the privacy to do so, it was ruined beyond hope. But I won that day. No-one saw and no one sensed my discomfort.

Whilst my female colleagues tended to have a wide range of clothes and wore something different to the office each day, I tended to stick to just two or three trusty outfits and cycle them through the week, slightly changing the accessories or mix. Having clothes that didn't crease, or show small stains were particularly useful if one had to attend site, put on a grimy hard hat, or jump into a dirty vehicle.

When working at a senior level, I learned pretty early that it was not a good thing to stress the difference between women and men. Amongst other experiences that one would rather forget was the one where a finance director leaned over to me and asked me what perfume I was wearing. The ensuing conversation resulted in his, for some strange reason, making abusive remarks about my husband. So I stopped wearing perfume. I also found that make-up soon blotched, ran or leaked onto a white shirt if the wind and rain had their evil way with your face. The maximum allowable was some waterproof mascara if anything.

Others' reactions often left me in wonder, particularly that of other senior women. I had made it to senior management quite early at the age of 31. My male colleagues by then had taught me to make jokes ruder then they could, to lack surprise when faced with extreme nudity even pornography when showed into the male domains and to put up with extreme sexist behaviour with equanimity and guile without ever damaging one single man's ego.

It was at the National Conference of the Association of Insurance and Risk Managers when my top guest, the female President of the equivalent organisation in the USA tugged on my arm and said: **"Where are all the gals?"**

As the current Chairman of the association I'd been specifically told that I was not to make it a platform for feminist issues and so I'd not made any inroads into the balance of male to female membership. I turned to her and shrugged.

"We have 5 women for every 95 men" I responded. She looked at me in horror and said; **"Well how the **** did you get to be the President?"** I smiled sweetly and explained that we did not do 'Presidents' in the UK, preferring instead to stick with Chairmen. By the time I had bored her silly she had forgotten her question.

Persuading people to do things that they didn't want to was where I felt as a woman I had the greatest advantage. To smile sweetly, put on the charm and then to hammer home the question was normally all it needed to be effective.

There are times when you could say something that a man could never say to another male colleague. Such as the time when I had to face the head of a business and tell him that he valued a tonne of stock more than he valued an individual's life. He denied it of course, but then I was able to demonstrate the times when he had fired more than one operator when stock was ruined, but when a lad of seventeen had been killed through utter negligence, no-one had even been taken to task. Standing calmly, telling him this quietly face to face, in a way in which he could not deny it, helped make changes that day, and hopefully saved more lives.

On another occasion I was remonstrating with the CEO of a large business unit about the lack of supply chain management in the business and using a number of illustrations to demonstrate that this was causing loss of business and value, as well as causing incidents where the reputation of the business was being brought down. He actually said to me then, "I can see what you say and it makes me uncomfortable because I already knew it. But no one else had the nerve to bring me the proof. Thank you." I had worked hard on that occasion to maintain calm and to mirror his body language.

In minimising the disadvantages, it is good to avoid stressing the difference between you, avoid overtly feminine clothes, makeup and perfume whilst remaining sassy, smart and comfortable. Maximising the advantages means using all the tools that you can muster. It helps to use charm, keep calm, learn about body language and about assertiveness and to behave at all times with utter professionalism. It also helps to develop a really thick skin.

The author welcomes your feedback and comments via JK@riskrewardlimited.com

Negotiation Risk

Rohan Badenhorst (CIMA) is a financial services professional and thought leader specialising in 'the big picture', systemic and structural relationships within and among financial organisations. Risk takes many shapes and forms. Being able to navigate the route map and understand the landscape of negotiating transactions, deals or commercial contracts will help us envision the expected outcomes more clearly. In the first of a two part series of articles, Rohan Badenhorst, CGMA, takes us through the various levels of appreciating the nuances and reality of Negotiation Risk

Have you ever experienced the sinking feeling that you have been outfoxed in a negotiation scenario?

Of course you have. We all have at some point or another come across someone, somewhere, somehow who was just plain better than ourselves at negotiations.

Negotiation certainly is a skill we can learn and nurture our entire lives.

At the core of our everyday existence, we have to be negotiators at heart.

Negotiations have many facets and layers to them and bearing in mind Pareto's efficiency and golden rule of the 80 / 20 principle, certainly 80% of us are continually stuck on Level 1.

We see five distinct and different levels of negotiation.

Negotiation Risk

Level One – The TRANSACTION-based negotiation

This is the level where at least the majority, if not 80% of individuals find themselves. Effectively people with a transaction based approach don't really enjoy or relish the cut and thrust of any good negotiation (or negotiation process). Mostly flung into situations where you have to let go of your safety net and comfort blanket in order to get the best 'deal' available to the organisation or party you are negotiating for. We call these situations the 'size of the slice' negotiations. Effectively the zero sum game negotiations where each party is negotiating in order to extract the largest chunk of an already carved up pie.

Level Two – The RELATIONSHIP-based negotiation

This is the level where we really start differentiating ourselves from the 'crowd'. We believe that only 16% of negotiators find themselves 'comfortable' at this level. Basically these are skills individuals who understand that there actually is a 'pie' out there and that the main focus is on getting a large a slice as possible of this pie. We call them the win-win negotiators.

Level Three – The VALUE-based negotiators

This is where we believe only 2.5% of the really skilled negotiators find themselves on the continuum. Value-based negotiators actually understand and appreciate the fact that the size of the eventual pie has not yet been determined. They seek the 'hidden value' in the negotiation and possession and design the deal in such a fashion that both or all interested parties secure positions that are both advantageous, yet can become even more so via cooperation and collaboration. Quite a powerful place to be.

However, we pause at this point to reflect on the basic premise of the three levels we have explored so far. Astute observers might have noticed that all three levels are based on what we refer to as 'extractive' tactics and strategies. The main tasks of the negotiator is to extract the maximum value from the deal for themselves or their related parties, the organisation or group of individuals they represent.

Moving on to levels four and five requires a complete step change and mental adjustment only around 0.5% [or the rest] can make.

These negotiators are so rare and valuable that to come across the few out there really is a privilege and a special situation to savour. There rewards and returns are exponential, compared to the 99.5% transaction negotiators.

Level Four – OPPORTUNITY-based negotiators

Opportunity-based negotiators have at their core being a desire to grow and develop markets. Sometimes called 'rain-makers' there is a mistaken perceptions that these highly skilled negotiators have the ability to move markets or are market makers. That is true to some extent, however they understand that value in any deal is not about an extraction of the value, but more about the creation of value. This is a fundamental mental step change. Eccentrics these characters may even be, but once you come across an opportunity based negotiator, you know you have began to meet your match and are dealing with a very special type of negotiator.

Level Five - CRE8(OR)S

Cre8(or)s or rather creative negotiators are so rare that we shall not spend too much time analysing their style and influence on negotiations. Bear in mind that these types really appreciate and rarely actually engage in a negotiation, because they spend so much time designing a deal that most of 'hard' negotiation tactics are delegated to skilled professionals. It is important to understand that these individuals dwell in a completely different 'universe' of negotiations to the rest of the population. This is why only around 0.1% of individuals fall within this category.

Actions

The great opportunity for the vast majority of us mere mortal negotiators dwelling in level 1 is that the only way is up the ladder and that through skills training and practice we can develop the talent necessary to become better negotiators. One of the key ingredients to appreciate is the fact that once you get beyond a transaction based negotiation, and by transaction based negotiation we refer to the 'supermarket' negotiation, because you have to accept the price of the product presented to you, every negotiation has at its core a design element to it. Take some time to think and appreciate the design elements of the negotiation to become a more successful negotiator.

In the next article of this series on Negotiation Risk, we will focus more closely on design elements and risk factors of the relationship and value based negotiation.

Rohan Badenhorst invites readers comments and feedback via JK@riskrewardlimited.com

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