GLOBAL riskupdate

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WHO MANAGES RISK BETTER – BANKS OR INSURERS?

At a recent industry event in London, Dennis Cox, CEO, Risk Reward Ltd, participated in the debate to consider this rather interesting question. This brief article further explores the issues raise, how the each industry evolved their own risk management and asks it is really about enterprise risk after all?

Who manages risk better? In answering we need to consider both where the two streams of risk management are, together with the impact of changing regulation within both markets. Banking and insurance risk management both have been around for many years yet each was good at some things and not-so-good at others. Perhaps what is most unusual is that elements that one stream was good at the other might almost ignore, or vice versa. Prior to 1990 neither banks nor insurance companies really had implemented effective enterprise risk management. Within banking "risk management" was almost seen as being synonymous with corporate or personal credit risk management. The common approach normally adopted within insurance was to focus on actuarial risk.

This led to significant differences between both risk management streams. Banking tended to focus on the now, looking towards expected credit losses to develop effective product pricing. For insurance given that actuarial liability by its nature tends to focus on unlikely events it is perhaps unsurprising that these risk managers tended to focus on the relevant tail liabilities for those risks that were being covered. Both streams therefore effectively focused on the risk attached to their primary income source. Looking at the relevant income and risks within these two industries, the most important might be seen as:

	Income	Key Risk
Banking	Interest income	Credit default
Insurance	Insurance Premiums	Increased event risk

The Problem

The challenge here is that by focusing on these specific risks, others are left outside of the discussion. Typically focusing on a single risk could easily lead to suboptimal risk management and loss of income or at worst the firm. Within both insurance and banking various other risks would be managed within different areas, for example:

RISKS	MANAGEMENT AREA
Operational Risk	Operations
Liquidity Risk	Treasury
Counterparty Credit Risk	Often omitted
People Risk	HR
Strategic risk	The CEO
Reputational risk	Often Omitted

This then leads to the obvious conclusion that neither banking nor insurance actually were as good at enterprise risk management as engineering or manufacturing. The question then is why?

Insurance Industry

The domination of the actuarial profession led to the idea that actuarial risk equated to risk management. Of course that is not really the case since the actuarial risk calculation is essentially looking at profitability for the firm. It considers

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the risk attached to tail liabilities offsetting additional exposure through reinsurance as appropriate.

What Solvency II is seeking to achieve is the consistency of risk modelling in the insurance industry that Basel II seeks to achieve in the banking industry. Through bringing an enterprise risk culture into the business Boards of insurers are able to understand the combined risks of the business. This will improve decision making and ultimately profitability while reducing earnings volatility.

There are still limited true ERM people available and the greatest challenge to both banking and insurance is to develop such resources.

With the impact of the actuarial profession there was always advanced modelling within insurance for the income generative areas. Other areas were poorly considered. Operational risk was seen as operations risk and became the responsibility of the Chief Operating Officer perhaps by default. No modelling was done and in that are perhaps bizarrely no consideration of unexpected loss was taken into account. The non-operations part of operational risk including legal and human resources risk, were not addressed.
Another area that appeared to get missed was counterparty credit risk. This is the risk related to working with financial institutions. Some insurance companies almost ignored this risk setting what might at best be termed facilitation limits to deal with them. Other firms relied exclusively on external ratings to develop limits failing to recognise the inherent limitations that such an approach would have. Finally some did not have any limits at all and just carried out business.
In summary, good modelling in some areas, but a paucity of work in other areas.

Banking Industry

Banking risk was always seen as being synonymous with credit risk. Credit risk was then also seen as an art rather than a science so limited modelling was conducted. Again prior to Basel 2 many firms did not undertake enterprise risk management and you can still see some of the legacies of this in the reporting lines adopted by banks now. Too frequently the risk committee does not have all risks reporting into it and accordingly it cannot consider the full risk environment when developing its solutions.

The development of market risk as a science in the 1980s and 1990s led to highly qualified modelling professionals joining the banking profession. A disconnect from the risk management team and the Board frequently then developed with limited understanding of the impact of risk mitigation strategies making it onto the Board agenda. The use of models within market and liquidity risk became a replacement for risk management as opposed to tool of risk management, that is, the end rather than the means.

This actually resulted in risk management becoming separate from the business rather than part of the way we do business. This separation caused risk management functions in banks to look towards providing data to the regulators as opposed to actually supporting the business. The failure of many banks to successfully embed a risk management culture into the business resulted in many risk management projects not adding any value to their firms. It is with Basel II and the 2003 sound practices paper that many banks started to recognise the issues and deal with the consequences.

So, we asked, which was better? Insurance perhaps and if not then banking. Both had much to learn from engineering or manufacturing which embedded risk management as part of their quality driven cultures. Neither insurance nor banking chose to do so, which is perhaps at the heart of the recent crisis.

The Future

Clearly there is a convergence between insurance and banking risk management. In many ways enterprise risk management is not industry specific; rather it seeks to identify, model, measure, mitigate and report the risk profile of the firm. In those terms the identification of the total risk profile on a consistent basis using modelling that is understandable to the senior management team is not in any way an industry issue.

The development of a qualified risk management industry staffed by enterprise risk management ('ERM') professionals is currently underway. There are still limited true ERM people available and the greatest challenge to both banking and insurance is to develop such resources. The importance of the qualifications issues by the CISI (Chartered Institute of Securities and Investment UK) and PRMIA (Professional Risk Management International Association), for example, is clearly paramount in achieving this. But many people will start with a skill in a single area – perhaps actuarial science or credit risk – then become a Head of ERM. Training to enable true comfort in all areas of risk management should be required prior to the role being undertaken but frequently this is not the case.

Until we are able to develop sufficient global ERM talent to support the global financial market then we have to expect more problems to appear. Further as the techniques become more complex, driven by increasingly confusing regulation, the demands on senior management and non-executive directors also increases. This increasing demand on risk management will remain a challenge for the next decade or more.

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