European Risk Management Council

Risk Landscape Review

March 2017

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DEAR READER,

I am delighted to introduce this first edition of the Risk Landscape Review. We intend to make it a regular. The goal of this and the future Risk Landscape Review publications is to provide a top risk assessment for the financial service industry and to share the best industry practice. As the ERMC runs think tank meetings on regular basis, we are going to report discussions that take place in various Council's meetings. We also plan to include most relevant articles and essays written by the Council's members – top executives, senior decision makers and internationally renowned experts.

The launch of the Risk Landscape Review is an important milestone for the Council. We are running think tank meetings on a regular basis since 2011 and senior representatives of more than 130 organisations participated in our events in the last 6 years. Yet, we have never published papers before. In the last several months, I heard from the Council's members and meeting participants the same question: Is the Council going to produce any kind of knowledge products such as white papers, risk analysis or recommendations? The Risk Landscape Review is an answer to this question. ERMC's moto is be a place for idea exchange without boundaries. With this publication, we create a new space where ideas in risk management, regulation and compliance can be exchanged and the best industry practice can be shared.

This month, the ERMC ran its first annual flagship event – the UK Risk Management Leadership Meeting. This one-day event brought together 166 senior executives from 89 organisations. The speaker line up was exceptional with more than 30 representatives from government agencies, regulators, CEOs, CROs, chief economists and leading risk experts. Therefore, we decided that our first Risk Landscape Review should reflect the discussions that took place at the Leadership Meeting. While the majority of the materials in our publication is inevitably linked to the Leadership Meeting, we are keen to listen and respond to the interests of our readers and look forward to get your feedback and comments on this first edition.

Finally, I would like to thank all of you who contribute to the ERMC activities in various ways. And my big thanks to all contributors of the first Risk Landscape Review publication.

Yours sincerely,

Dr Evgueni Ivantsov

Chairman

European Risk Management Council

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Risk Management in the Brexit Era

By Dr Evgueni Ivantsov

When the wind of change blows, some people build walls, others build windmills. Old Chinese proverb

2016 was a year that reinforced a message to risk professionals: our world becomes less and less predictable. Two major events that happened last year – Brexit and Trump's presidential victory - were largely unpredicted. Pundits, guru forecasters, opinion polls were largely wrong. These two major geo-political events had a significant impact of political, economic and business climate. We are living now in a different and a fast-changing world where new risk drivers are emerging.

How could Brexit affect the future risk landscape? It depends on how the negotiation process will go and what will be the final configuration of the deal between the UK and the EU. The ability to strike the best possible deal for each side depends on how each side can use its strengths and exploit the opponent's weaknesses. The art of negotiation will be the most important winning factor.

A military strategist and philosopher of ancient China, Sun Tzu, formulated a military rule: *appear weak when you are strong, and strong when you are weak*. This rule is fully applicable to the modern negotiation strategy and is widely used in politics and business. When I think about Brexit, both negotiation teams use Sun Tzu's rule to entrench their positions before the active phase of negotiation begins.

For the UK team, the most serious weakness is the threat of "hard" Brexit. No deal means that the UK will access the EU market under WTO terms.

UK's economy is about 16% of EU-27 economy and heavily depends on trading ties with the EU: about 44% of UK exports in goods and services go to the EU countries and 53% of imports came from the EU-27. As a trade party of a smaller size with a high trade dependency, the UK would suffer much more than the EU in case of disorderly Brexit.

The UK negotiation team made some efforts to convince their opponents that the hard Brexit would not be a problem for the UK. Using Sun Tzu's rule, Terisa May sent a message to the EU that the UK was prepared to crash out of the EU saying: "No deal for Britain is better than a bad deal for Britain".

Another weakness that the UK negotiation team faces is a short time frame for the Brexit negotiation. A two-year negotiation window is extremely tight considering a complexity of agreements that the sides need to achieve. The UK team did well to mitigate this weakness by a tactical postponement of an Article 50 activation by nine months and used this time to prepare for the negotiation. This understandably irritated the EU counterparties whose leaders tried to push the UK to trigger the Article 50 as soon as possible.

However, this successful tactic of the time frame extension came to an end when Britain finally officially notified the European Commission about its departure from the EU.

After that, it will be interesting to see how positions of both negotiation teams will reverse: the UK team will try to accelerate the negotiation process, while the EU team will likely use various excuses to delay it and, therefore, to gain negotiation power. Time will run against Britain - as a clock starts ticking, each day increases the advantage of the EU team who will try to push a crucial part of the negotiations close to the deadline and then squeeze the UK team when the hard Brexit becomes quite real.

What does it mean from risk management perspective? It means that the visibility of future risks will be very low and the next two years we be a political roller-coaster. It is likely that we have to wait two years until we can get any clarity about possibility of the UK-EU deal and its final configuration. Both parties will keep their negotiation strategy highly confidential.

In addition, there will be numerous political, economic and social forces that can affect the Brexit process and interplay with Brexit risks. For example, results of general elections in several European countries could change the balance of power in Europe and affect a political climate in Europe. A final UK-EU deal, if negotiation teams can reach one, will require approval of a qualified majority of EU countries. This increases risk of derailing the deal at the very last moment due to a veto power.

Geo-political winds will continue to blow and geo-political forces will dominate and re-shape the European risk landscape. It creates new challenges for risk professionals in the financial service industry.

Historically, we focused more on financial risks and developed models and tools that allowed measuring, monitoring and mitigating these risks. Geo-political risk has never been an area where financial institutions build their knowledge. Due to the uniqueness of geo-political events and absence of statistically significant historical data, it is much harder to predict future shocks that stem from geo-political risks than financial risks and even more harder to mitigate such shocks.

How can we manage risks in such unpredictable environment? I can expect three main shifts in contemporary risk management because of a rise of political volatility.

The first one will relate to ways we use quantitative tools. While statistical methods and quantitative models will still be intensively used especially in certain areas of credit and market risk management, a focus will inevitably shift to qualitative analysis to inform a decision-making process. In particular, stress testing should grow from a predominantly regulatory and capital adequacy exercise to a decision-making and strategy tool.

Assessing potential shocks driven by geo-political forces and events with no historical precedents like Brexit, we need to change a priority in our stress testing. This can finally bring to an end the maniacal and often useless number crunching as a key element of contemporary stress testing. We need rather to prioritise qualitative scenario analysis and spend our time developing and testing practical mitigating action plans.

Secondly, high uncertainty of the risk landscape that we observe now pushes risk management to develop and put in place a comprehensive crisis management framework. In the environment of uncontrollable and largely unpredictable risk events, crisis management is vital and the crisis management ability becomes an important competitive advantage. It largely predetermines a company’s failure or survival in case of an extreme shock.

Finally, growing geo-political risks accentuate more that our world is getting very interconnected with majority of serious risks having a global nature. To effectively manage and mitigate these risks, financial institutions need close cooperation with each other, with local and central governments, with regulators and policy-makers and with other stakeholders.

This idea was brilliantly formulated by Rolf Alter, OECD Director of Public Governance and Territorial Development, who said at the UK Leadership Meeting: “A future risk management is a networking thing”. I treat it as the key conclusion of the whole Meeting.

When we deal with global challenges, it does not make much sense to try to solve these problems alone. An individual firm can try to hire best risk specialists and build “walls” to protect the firm from a wind of change, but hoping to outsmart the entire world is quite naïve.

A winning strategy today is to establish an effective collaboration of private business, government, regulators and other stakeholders to set a framework in place that allows to mitigate global risks and ensure a sustainable growth of the industry. It’s finally time to come together to build “windmills”.

Dr Evgueni Ivantsov is Chairman of the European Risk Management Council and author of *Heads or Tails: Financial Disaster, Risk Management and Survival Strategy in the World of Extreme Risk*.

The Mechanics of Brexit

By John Bruton

I have been asked to talk about Brexit. Everything I say will be a personal opinion, not representing anyone else.
Everyone would like to know what form Brexit will take, and how it will affect them.
Unfortunately, it is next to impossible even to begin to answer that question until we first see what the UK will actually look for. Only then can we begin to speculate in an informed way about how the negotiation might go.

In what I say today, I will try to describe the mechanics of the three negotiations that will probably take place:
- the negotiation of a Withdrawal Treaty.
- the negotiation of Treaty covering the Future Framework of relations between the EU and the UK and, possibly
- the negotiation of an Interim Agreement, to apply after the UK has left the EU, but before a full Future Framework Treaty has been finalised and ratified

TWO NEGOTIATIONS....ONE ABOUT WITHDRAWING, THE OTHER ABOUT THE FUTURE

Article 50 of the EU Treaty says
“Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union.”

AGREEING GUIDELINES ON THE EU SIDE

It is important to note here that it will be the Commission that will do the actual negotiation with the UK, but it will do so under guidelines agreed by the Heads of Government of the 27 Member states meeting in the European Council. It will also have to bear in mind that the final deal will have to approved by the European Parliament too.

Given that the European Council operates by consensus, and that its members are heads of government and each of them have countries to run at home, agreeing these guidelines will take time and be difficult. Any one country can object to any part of the guidelines.

There are wide differences between EU member states in their sensitivity to developments in the UK. It is to be expected that:
- some will emphasise a continuing right for their citizens to live and work in the UK,
- others will emphasise trade with the UK, and yet
- others will emphasise how the make gains for their businesses from the exclusion of UK competition (for example in financial services).

THE FUTURE FRAMEWORK FOR EU/UK RELATIONS

It is also important to note that Article 50 says that the proposed Withdrawal Treaty shall take account of the" framework" of the withdrawing states" future relationship" with the Union. There is no guidance in the Treaty as to what this "framework" document might say.
In their Referendum, UK voters were asked if they wanted to leave the EU, but their views were not sought on the sort of framework for future relations they would approve.

Nothing appeared on the ballot paper about:
- access to the EU market for UK produced goods or services, about leaving the European Economic Area (which includes several non-EU countries) or about what UK voters would want the agreement with EU to say about
- the status of UK citizens already living in EU countries after the UK has left
- the status of EU citizens already living in the UK or about
- the future rights of EU or UK citizens to live and work in one another's jurisdictions or to avail of social services while there

DIFFERENT PROCEDURES FOR CONCLUDING THESE NEGOTIATIONS

Article 50 continues: "That agreement (for the withdrawal of a state) shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament."

So while the Council guidelines for the negotiation require consensus, the actual approval of the final withdrawal Treaty can be done by qualified majority. But there is a time limit because Article 50 goes on to say "The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period. "

This two-year time limit applies to the Withdrawal Treaty, but there is no time limit for the negotiation the Framework for future relations. If, within two years of the sending by the UK of its article 50 letter seeking to withdraw from the EU, a Withdrawal Treaty has not been agreed by the UK on one side, and a qualified majority on the EU side, the UK is simply out of the EU, with no rights at all on the EU market beyond those enjoyed by any state anywhere in the world.

This is a real doomsday scenario, but it is a realistic possibility, because the gaps in the negotiating positions between the UK and a potential blocking minority of EU states (26.3% of weighted votes representing at least 35% of the EU population) are very wide. But, at least, the withdrawal Treaty can be approved on the EU side by a qualified majority (73.9% of the weighted votes representing 65% of the EU population).

Agreeing the terms of the Framework agreement with the UK, of which the Withdrawal Treaty must “take account”, will be even more difficult, because this Future Framework Agreement will probably have to be unanimously agreed by ALL 27 EU states and their parliaments, unless it is a very narrow agreement covering only trade in goods.

If it is wider than this, it is likely to be deemed a so called “mixed agreement”, which is an agreement that includes matters where the competence is shared between the EU and the member states.

A ROCKY PATH TO RATIFICATION FOR A FUTURE UK/EU FRAMEWORK DEAL

In this case, every member state parliament, as well as every member state government, will have to approve the Framework agreement with the UK.

This is what happened with the recently concluded EU Agreement with Canada, which, as you will remember, was threatened with a veto by Belgium, because under internal Belgian constitutional arrangements, all five subsidiary parliaments in Belgium must agree to any international treaty signed by Belgium, and two of them did not agree.

A similar threat to an Agreement with the UK could come from a decision to call referendum in a member state. For example, the future of an EU Agreement with Ukraine has been put in doubt by its defeat in a referendum in the Netherlands, requisitioned by a petition of only 300,000 signatories out of a total population of 17 million, and on a turnout of slightly above the minimum required of 30%.

It is easier nowadays to organise petitions online, so this could be another threat to a Framework Agreement with the UK, not just in the Netherlands, but in any other countries with similar petition/referendum provisions.

The UK could not really object to this happening because the UK itself, on 23 June, used a national referendum to make a decision affecting the whole of Europe in a profound way.

COULD THE UK CHANGE ITS MIND?

Could the UK change its mind, when it discovers that things are not turning out as its voters, and those politicians who favoured leaving the EU, hoped they would?

Article 50 says: “ If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.” Article 49 requires the unanimous agreement of all existing member states, and of the European Parliament, to the readmission to the European Union of a member state, just as it would to a state applying to join for the first time.

In other words, the UK, seeking to rejoin the EU after having left, would be in exactly the same position as Serbia, Montenegro or Turkey is today.

A more interesting question is whether the UK, having written its Article 50 letter in March 2017, could decide, say in late 2018, just before the two year time limit would expire in March 2019, that it wanted to withdraw the letter, and stay in the EU after all , on the existing terms?

This is not an easy question to answer. Article 50 doesn't say that notification, once given, can be withdrawn, but nor does it say that notification can't be withdrawn.

The prevalent view is, perhaps, that notice can be withdrawn prior to actual withdrawal from the EU but the position is not clear. If revocation of an article 50 notice was not accepted by all other EU members, the Court of Justice of the European Union would have to decide the point. This may all sound a little fanciful at this point, but it is possible that, by late 2018, the UK might have a different view on EU membership, to the one it had on 23 June 2016.

It would certainly have to organise another referendum, which could be difficult given the rigid two-year deadline for complete exclusion, in the absence of an agreed Withdrawal Treaty. But if the discussions on the Framework Agreement were going really badly, or if the economic costs of separation were just proving greater than expected, and if prospects did not look like improving, a majority of MPs might decide to consult the voters on the possibility of taking back the Article 50 letter.

Already there is some sign that UK opinion has shifted slightly since the 23 June Referendum. Asked in a Eurobarometer poll last September, three months after the Referendum, whether they thought the UK benefitted from being in the EU:

- 56% in the UK said they thought the UK had benefitted, an increase of 5 percentage points on the previous poll and
- only 34% said they thought it had not, a drop of 2 points on the previous poll

If that trend were to continue, things could look different in the late 2018 or early 2019. But it would be very difficult politically to change course. National pride would be hurt. Telling voters they made a mistake is rarely a winning political strategy......even though voters do sometimes make mistakes.

CONTENT OF WITHDRAWAL TREATY

Let me now turn to what I think will be the content of the two negotiations

First, the Withdrawal Treaty negotiation and Second, the Framework of Future Relations negotiation. My understanding is that the Withdrawal negotiation itself is likely to cover quite a narrow, but very contentious, range of issues. These will probably include five broad topics:

- What the UK will have to pay to leave, what will be the UK share of any remaining financial commitments dating from its time as a member, covering matters such as pensions of EU officials, other obligations outstanding, less the UK 's share in EU assets
- The mechanics and costs of moving EU institutions, like the Banking Authority and the Medicines Agency, out of the UK and into an EU country (perhaps Ireland)
- The Rights of EU citizens already living in the UK, and UK citizens already living in an EU country. The rights of future migrants from the UK to the EU, and vice versa, will be for the Future Framework negotiation
- The relationship of the UK with the WTO after it has left the EU
- Special situations concerning the land boundary between the UK and the EU, as in Ireland and at Gibraltar. It is good that this being dealt with upfront, and not just buried in the wider Framework negotiations. But, obviously, the content of the final Framework deal, if there is one, is bound to affect what happens on the Irish border.

While these five issues are, on their face, straight forward, the UK contribution to the EU budget was elevated into a big issue in UK politics over the past few years. False statements were made before the referendum about the amount the UK would get back by leaving, and a gain of £350 million a week was promised by some who now hold high office in the UK government. So this could become a very difficult discussion.

CONTENT OF FUTURE FRAMEWORK TREATY

The Future Framework negotiation will be a much wider one and will take in matters such as:

- whether the EU Common External Tariff will have to be levied on agricultural products coming into Ireland from the UK, or Northern Ireland

- how the origin of imports from the UK will be verified to ensure that they are not dumping third country products on our market,
- how veterinary and food safety standards will be verified, and how and by whom smuggling will be suppressed.
- whether geographic indicators will be recognised
- if there will be a tariff free quota to allow existing trade levels to continue, or if all trade will bear the appropriate tariff.

The tariff issue will be particularly difficult in the food sector, because this is the sector in which the EU has the highest tariffs, and restrictions, on third country imports in order to protect the incomes of EU farmers. Everything depends on what sort of food and agriculture policy the UK decides to follow outside the EU. Will they go for a "cheap food" policy like they had, before they joined the EU 40 years ago, or will they retain current supports for farmers and rural life?

There is no indication, so far, as the what choice they will make, at least after 2020.

Negotiations about product safety, rules of origin, and related issues will arise with all products and services, even those to which no tariff applies, because once it has left the EU, the UK will be free to depart from recognised EU standards.

If the UK rejects the jurisdiction of the European Court of Justice, as Prime Minister May says she will, there will no longer be a referee to interpret the rules of the shared market, and all markets need a referee. If one wants to assess the likely complexity of a Future Framework Agreement the UK and the EU will have to negotiate with one another, one has only to look at the content of the Agreement the EU has concluded with Canada.

As well as tariffs and trade, that agreement had to cover:

- product testing and standards....would each side recognise the other side's tests for every product or would there still be duplication?
- mutual recognition of professional qualifications....a huge field
- the right of EU and UK firms to sell goods and services to government entities in one another's jurisdictions
- protection from discrimination against EU investors in the UK and vice versa
- access to fishing grounds

The EU and the UK negotiators will not only have to reach agreement on the substance of how these matters are to be handled, but they will also have to agree a procedure for settling disputes about interpretation, because the UK, outside the EU, will not accept the rulings of the European Court of Justice (ECJ).

But probably the most contentious issue in the Future Framework negotiation will be right of people to emigrate to the UK from the EU, and vice versa. Control of Immigration was not, initially, one of the UK's complaints about the EU. Amazingly in light of subsequent events, the Blair government actually opened the UK to central and east European EU immigrants, in 2004, before it was obliged to under the EU Accession Treaties for those countries. But, during the Referendum campaign, immigration became the central debating point, and leaving the EU was presented as the way of "taking back control" of immigration.

The case was over stated. Of all immigrants moving to the UK in 2014,

- 13% were UK citizens returning home.
- 42% were EU nationals emigrating to the UK.

But the biggest number,

- 45%, were non-EU nationals moving to the UK.

The UK already had full "control" over 45% of all immigration, which came from non-EU countries, and the Minister who exercised that control then, the Home secretary, is now the Prime Minister.

But in politics, perception is sometimes more important than reality, and immigration from the EU is perceived to be a problem by UK voters.

The EU side has taken a firm line on this. There will be no participation of the UK in the EU Single market without free movement of people to work. If capital is free to move, people should be free to move too. No Single market without free movement. Discrimination on the basis of nationality is excluded within the EU, and a state should not be able to leave the EU, introduce such discrimination, but still have all the other benefits of access to the EU market. If that option were the open, others EU members would be inclined to follow the UK out of the EU.

The fact that there must be unanimous agreement, by all 27 EU countries, to the Future Framework is relevant here. Countries like Poland will not be keen on a breach of the free movement principle.

WILL AN INTERIM DEAL BE NEEDED IN 2019?

I think it should be clear, from all I have said, that finalising a Framework Agreement with the UK within the two-year time frame will be so difficult as to be almost impossible. The Agreement with Canada took six years to negotiate and it was much less complex than any agreement with the UK would be. So what happens, in late March 2019, when the 2 year deadline is reached, if the Withdrawal Treaty has been agreed, but the Future Framework negotiations are still going on, with no certainty whether they are going to succeed or not?

In this case, some form of interim agreement with the UK might have to be reached. This might involve the UK leaving the EU, losing its voting rights, but still retaining full access to the EU market until a final Framework Agreement was reached.

There will be almost as many knotty questions to answer about that sort of an Interim Agreement as there would be about a Final Agreement. For example, what contribution would the UK then continue to make to the EU budget? Would there be a time limit on the Interim Agreement, and could it be extended?
Would the UK accept the jurisdiction of the ECJ during the Interim? Would an Interim Agreement have to be approved by the parliaments of all 27 member states?
Does the EU Treaty allow for such an Interim Agreement?

CONCLUSION

My conclusion from all of this is that the decision of the UK Conservative Party to have a referendum on EU membership, without a clear alternative being known, was unwise because it will lead to a huge diversion of time and talent away from more constructive purposes.

Since the Referendum, the UK government has, retrospectively, interpreted the vote to mean a decision to leave the EEA, and leaving the European Customs Union, things that were not on the ballot paper, and are not required by its wording at all. That is undemocratic.

Brexit poses disproportionately great challenges to Ireland. It will require us to build new and stronger alliances in every EU country, and to do that we will need to understand the interests of other countries almost as well as we understand our own. We must not make the mistake David Cameron made of thinking that an understanding with Germany will deliver what we want from the EU. In the EU, every country counts.

John Bruton is s a former Irish Prime Minister. He also served as a leading member of the Convention that drafted the proposed European Constitution. From 2004 to 2009, John Bruton served as EU Ambassador to the United States.

The Economic and Geo-Political Risks

By Gerard Lyons

What are the economic and geopolitical risks that lie ahead? Perhaps the good news is that since last summer, markets have been caught out by the strength of the world economy. There is global reflation, reflecting a number of factors, including a more relaxed fiscal stance and solid jobs growth across many countries. As a result, 2017 looks set to be the first year for some time where economic forecasts for the world economy are revised up as the year progresses.

Can it last? For some time now there has been a genuine concern that a correction in financial markets is long-overdue. It is remarkable how resilient investor sentiment has been in the face of many shocks over the last eighteen months: misplaced fears over a China hard landing at the start of last year, June's Brexit Referendum result, Trump's victory in November and, of course, the Fed's policy tightening.

Volatility in financial markets is low. The VIX index, while a measure of volatility in the US, is seen as a generic guide to global market volatility. Over the last month it has averaged 11.82. To put this in perspective, it reached 80.86 in November 2008 during the financial crisis and 22.5 at the time of November's US election. This would suggest that markets now, led by the US, expect no nasty surprises.

Since the 2008 financial crisis, monetary policy has been the shock absorber across western economies. Interest rates were cut and many other measures adopted, with central bank balance sheets expanded.

This prompts a number of questions for now. One, is whether markets are pricing properly for risk? In a low interest rate environment there has been a search for yield, pushing some market to high levels. Second, and an important question that needs to be asked by banks is what constitutes a risk free asset? Normally one would say, government bonds and housing. But with the price of both high is this still the case? Third, how vulnerable might western economies and markets be to monetary policy tightening? The US and UK economies after all, are at the stage of the economic cycle where they might usually be expected to slow.

This points to the need for predictable and gradual actions by the Fed. The danger though, is that the Fed tightens too much. To its credit, it seems to realise this and hence its communication with the market has been clear.

In addition to such risks, there is a need also for a much broader debate as to the drivers of monetary policy, including whether factors such as "liquidity gaps" should be more important than "output gaps" in driving policy thinking. The interaction between MIP, MAP and MOP, or micro prudential, macro prudential and monetary policy is also central, as is the relationship with fiscal policy. High levels of public sector debt raise the risk of further financial repression and point to a focus on boosting nominal GDP growth, not austerity. There is a need for policies that boost demand, lending and confidence, driving up wages, while reducing future debt levels.

One of the biggest challenges in economics is that of “group think” and it is evident in the attitude towards Brexit. I continue to believe that Brexit will be positive for the UK, but with Article 50 now being triggered the next few months are likely to see significant noise and uncertainty surrounding the forthcoming negotiation. The French Presidential election too, could also yet produce a shock to the market.

There are wider political and geopolitical risks, and now include high on the agenda, cyber security. This is important both at a firm specific and national level. An example of the latter risk might include the resilience of the payments system.

Under President Trump, the key future relationship is between the US and China, and the key region is the Indo-Pacific. While there are many reasons to be positive about future economic prospects in the US, China and across that region, there are also significant issues. Tail risks are much higher, where small probability, high impact events could have huge impact. Examples include a crisis in North Korea or even the danger of a deterioration in trade relations between the US and China, and possible tensions in the south and east China seas. The latter two are not immediate risks.

How well positioned is the financial sector for future growth and how resilient will it be in the face of any setbacks? The stress tests by the Bank of England and by the European Central Bank in recent years point to a far more resilient sector, although on the Continent there are still specific issues for some banks. Overall, London will continue to position itself as an attractive place to do business from, thus retaining its global appeal. This includes future growth markets such as the trading of the Chinese currency, the growth of "green bonds" and as a centre for Islamic finance. Given its combination of skills, knowledge and experience there is little doubt London will remain the major financial centre of Europe. For financial firms and banks in London, the important issue is to adopt the right business model for future success, as well as to be prepared for possible shocks and future opportunities.

Dr Gerard Lyons is Chief Economic Adviser to Parker Fitzgerald. Parker Fitzgerald is a strategic adviser and consulting partner to the world’s leading financial institutions.

The Macro Risks Facing the UK, Europe and World Economy: Politics to the Fore

By Keith Wade

The biggest macroeconomic threat facing the world economy at present is fragmentation where we see a break up of today’s open markets into smaller trading blocs as countries increase tariff barriers and restrict the flow of labour. The fear has been brought into focus by the election of Donald Trump as president of the United States, the Brexit vote and by the rise of populist political parties across Europe who are all looking to close borders to goods and people.

President Trump heralded his decision to cancel the Trans Pacific Partnership (TPP), the deal to open up trade between the US and much of Asia, as a good one for the American worker. The move, however, runs contrary to the thinking of most economists and the protectionism behind it threatens many of the institutions set up after the second world war to foster economic co-operation and global prosperity. Higher tariffs may protect domestic industry, but they also mean higher inflation which, by reducing real incomes, slows spending and weakens growth.

Our analysis of financial markets and economic cycles finds that such a stagflationary mix often heralds a difficult period for investors as central banks seek to protect their inflation goals by tightening policy. Bond yields rise and equity markets de-rate, inflicting losses on investors.

So far though markets have been robust under the new US administration as investors have focussed on the potential benefits of deregulation and fiscal stimulus, although the lack of any further follow through on protectionism will have come as a relief. Deregulation will create opportunities particularly in banking and the energy sector, however we would be concerned that a significant fiscal boost will push inflation higher.

President Trump has promised to create 25 million jobs, but this seems at odds with the latest employment report which puts unemployment at 7.5 million or 4.7% of the workforce. It is possible that this understates the available labour supply, but even if we make adjustments for part time and discouraged workers there are just under 15 million people looking for work (on the broad U-6 measure). Even this figure is an over estimate of available capacity as the unemployment rate rarely falls below 3% and has never fallen to zero in the US.

In short, the US is late cycle with the economy close to full employment such that supply would struggle to meet the increase in demand triggered by tax cuts or an increase in infrastructure spending. The likely outcome would be an increase in wages and inflation with little benefit to growth. Again, as with protectionism, risk executives need to be mindful of the prospect for higher inflation and interest rates.

Europe is the focus now for political risk. The Dutch general election did not deliver another populist shock as Prime minister Mark Rutte held onto power. The populist challenger Geert Wilders made little headway. However, this does not mean an end to political risk in Europe as we have a full agenda with the French presidential election, the German general election and probably an Italian general election.

Of these we would highlight the French and Italian votes as carrying the most risk. The stakes are high with leading contenders promising referendums on membership of the EU. Marine Le Pen of the Front National is leading in the opinion polls and is expected to win the first round of voting. She is not expected to win the second round, but this assumes that voters will unite behind whoever stands against her and that the opinion polls are accurate.

The first assumption is probably correct (although maybe challenged in the event of the controversial Republican Fillon making the final round), whilst on the second, the experience of the US presidential election told us simply not to trust opinion polls.

An Italian vote would probably hold more risk. Beppe Grillo's Five Star movement has closed the gap with the mainstream incumbent Democratic party. So there is a real risk of an Italian vote to exit the Euro in a referendum in 2018. According to the EU's own survey (Eurobarometer) Italy has become increasingly pessimistic about the future of the EU and on balance is negative on the outlook. An Italian exit, leading to the break-up of the Euro is possible and although the risk may still be low, the consequences would be immense. Alongside capital flight we might expect a significant default on Italian government debt denominated in Euro as a new and devalued currency is introduced.

Finally, on the UK. There is a consensus that the economy has shrugged off the effect of Brexit. Economists were too pessimistic about the impact of the decision on growth, but that does not mean the economy is out of the woods. The most difficult period is just beginning as the UK attempts to strike a deal with the EU and uncertainty increases.

Consumer spending which has kept the economy growing is beginning to falter as inflation rises. Business investment has already stalled in the wake of the Brexit vote and is unlikely to recover until a deal is done. My concern is that the UK goes over the "cliff": a member of the EU today with tariff free trade with the single market to being just another WTO member the day after. It is not widely recognised that the UK will be unable to do deals with non-EU countries until it has struck a deal and left the EU customs union, so there will be little to compensate for the loss of access to the single market. Experience says major trade deals take much longer than the two years allocated and, in the absence of a transitional arrangement, the UK risks a very hard landing in 2019.

Keith Wade is Chief economist Schroders plc. He is responsible for the Schroder Economics group and member of the Group Asset Allocation Committee.

Geo-Political Risks & Hard Security: Remarks at the UK Leadership Meeting

By Sir Stewart Eldon *KCMG OBE*

My colleagues on the panel have covered some of the 'softer' geo-political risks. It is my turn to look at the 'harder' end of the security risk spectrum.

Before turning to a few geographical areas of potential conflict it's worth examining a couple of systemic risks.

The first is resource famine – that at a time of uncertainty & austerity Western political leaders will not allocate the resources necessary to assure security and defence. A comparison of the respective growth rates of the NATO and Russian defence budgets makes somber reading.

In addition to the substantial mass of the Russian armed forces, their capabilities are improving at a significant rate, not just in traditional areas of military spending but in cyber and hybrid warfare. Under Putin they are also beginning to practice what they preach. So the Trump Administration is right to be urging NATO Allies to meet NATO defence spending targets – though I'm not sure those targets are necessarily enough to meet the requirements of effective and credible defence.

The second systemic risk lies around deficits in leadership. Such deficits can take many forms, and with Brexit and Trump we are in something of a new era. But I would highlight above all the dangers of a lack of strategic patience and, linked to it, deficits in military/security credibility. Russian sensitivities over, for instance, the Caucasus and Ukraine have been telegraphed clearly for many years. Have we been sufficiently fleet of foot in responding to them in a NATO, EU or national context?

The West's 'hard' security relationship with Russia - in all its manifestations – must come top of my geographical risk list. Confrontation will not necessarily be in the form of traditional military conflict; experience in Ukraine, Syria and over the US elections suggest that hybrid warfare and various forms of cyber-attack/destabilization may be more likely. Their destabilizing effects can be very significant.

China and East Asia is a second focus of potential conflict risk. Its manifestations are complex, ranging from North Korea through Chinese maritime & territorial ambitions to the Trump Administration's new perceptions of what the US/China relationship should be like. If Russia is a red light, China & East Asia may be an amber one. We need to watch them closely.

Others will cover the Middle East more extensively, but shifting power dynamics in the region are to my mind a third area of 'hard' geographical security risk. Examples are more assertive Russian/Turkish/Iranian activity over Syria and the ongoing competition for influence between Saudi Arabia and Iran.

Nearer to home there are the security implications of Brexit. I think that these aspects cannot and should not be ignored in the negotiations. Here's why.
In terms of broad security provision the UK is one of the strongest members of the EU. At the soft end of the spectrum, its aid programme, political influence and reach are all significant. Its police and intelligence services are more effective than most, and the British have been one of the key drivers of co-operation in EUROPOL.

In terms of hard security, Britain and France are the only two EU members whose military sophistication and capabilities approach those of the US. Together with Greece, Poland and Estonia the UK is one of only four EU countries that meet the NATO 2% target for defence spending. Its contribution to EU maritime operations has been significant; there are bilateral UK/French Defence structures; and the UK is a partner in Eurofighter, Airbus and other significant European Defence industrial cooperation.

In EU terms the UK is therefore a significant nett security provider. A clean break would significantly affect the EU's ability to deliver its broader security objectives, in terms both of resources and effectiveness. Europe has good objective reasons to want the UK to remain part of the game. This interest is mirrored on the UK side; shared security co-operation is self-evidently more effective than going it alone. But in areas where there is a clear British advantage (defence, intelligence, cyber-security) the case for concessions to the EU is less compelling. Certainly there seems little reason post-BREXIT to allow the impact of the British Aid programme to be blunted by burying it in an EU Aid framework.

So in this area of the impending BREXIT negotiations more cards than most lie on the UK side. However, in these uncertain times it would be dangerous for either party to lose sight of the overriding need for better security, irrespective of the framework in which it is provided. It would be in no-one's interest to allow a resurgent Russia free reign. As the NATO Secretary General said at last month's Munich Security Conference, 'Deterrence starts with resolve. It's not enough to feel it. You also have to show it.'

One important factor contributing to the current uncertainty has been the foreign and security policy of the Trump Administration, not least in terms of its approach to Russia and attitude to NATO. Like it or not, that will play into the BREXIT negotiations. If the UK is able to fulfil its traditional role as a transatlantic bridge it makes little sense not to use it, even if it might give the May government additional BREXIT negotiating leverage.

President Trump's concern about levels of European defence spending should have come as no surprise. It is an issue that has been festering for years and of concern to successive

US (and UK) Administrations. Without a substantial course corrective NATO will simply not have the resources to credibly deter an adventurist Russia or the tackle the other complex problems on its agenda. The Wales NATO Summit made a start on tacking the problem but more clearly remains to be done. Now the Americans are asking, with justification, for firm commitments and threatening to penalise those who do not pay.

This faces Europe with some important, and linked, choices. On one level it is perfectly correct for Chancellor Merkel and Mr. Juncker to say that security policy should not be reduced to the size of defence budgets. But that misses the key – and urgent - point that credible hard security is both a vital necessity and costs money; the US has been contributing more than its share for decades.

Another key European choice concerns the future articulation of defence. It's highly likely that post-BREXIT some will argue for developing enhanced European Defence structures. That is respectable enough, provided it does not detract from NATO efforts. But in the absence of solid links with both the UK and US military establishments new structures will have difficulty in proving themselves effective without enormous effort and expense. That too is an issue that will need to be factored into the overall BREXIT deal.

Security and resources are inextricably linked. It's worth remembering that Article 2 of the NATO Treaty binds Allies to seek to eliminate conflict in their international economic policies and encourage economic collaboration between any or all of them. A recent IISS report on defence spending, while hotly contested by the British government, illustrated the difficulty of maintaining the NATO target in times of austerity. An uncomfortable corollary of BREXIT will be the need for the UK to spend much more on foreign policy, trade promotion, security policy and defence. The sooner this choice can be confirmed the stronger the UK's hand will be in this area of the negotiations.

My final advice to the risk leaders at this Meeting is (i) to strive for a coherent view of current security risks and challenges and what should be done about them and (ii) ensure that channels are in place to convey that view to all in government who need to hear it. Without both coherent objectives and access to the right decision-makers it is next to impossible to shift the debate in the way you want it to go.

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Geo-Political Uncertainty in the Middle East: Towards Quantifying Political Risk

***By James Watt** CVO*

Of the three main geographical areas of current geo-political risk - Russia/Europe, East Asia and the Middle East - the last is the most often in the Western public eye. The region's turbulent recent history illustrates the extensive failure on the part of several of its States to provide the conditions of safety and prosperity for their citizens. The majority of Middle Eastern States are fragile, imposing authority through often brutal and constrictive security measures, rather than governing through the willing consent of the governed. The result is less economic performance, more poverty and inequality, and more despair.

Of course, it is important not to over-generalize: the Middle East is home to a wide variety of States. Some, such as the Gulf monarchies, have the resources and the ability to adapt that should ensure their successful continuation. And, for all the tension and rivalry between Saudi Arabia and Iran, it would be madness for either side to let this turn into open conflict: both sides are open to mediation. All the global powers want to avoid conflict between them. Their rivalry can be managed.

For the major threats to peace and stability in the region, it is the more populous, historically complex other States that should concern us. This is the point at which political risk managers have to venture beyond the easy indicators - the interruption of oil supplies, for example, or the closure of transport routes, or the outbreak of actual fighting - and look at wider political, economic and social factors.

It is important to bear in mind the major demographic trends, and the visible pressure on increasingly scarce natural resources. Chief among the latter is water: the acute rural poverty, and migration to the cities, that preceded the eruption of conflict in Syria in 2011 was due largely to drought and the exhaustion of traditional water supplies. Even in Egypt, one of the oldest hydraulic civilisations in the world, the Nile waters need to be better managed as growing demand and competition for them upstream with Ethiopia place additional burdens on supply.

The demographics though are the main lead indicator of future challenges. Birth rates remain among the highest in the world, at over 3% on average, even as the supply of housing and schools fails to keep pace. Jobs need to be created at a far faster pace than has ever been achieved historically. Growth rates of GDP tend to be in the 2 to 3% range, when what is required is around 6% simply to keep up with new entrants to the labour market. We have seen State collapse in Yemen and Libya since the critical year of 2011, unwisely dubbed the Arab Spring. We have also seen partial State collapse and terrible devastation in Syria since the same year. Tunisia and Egypt have survived the turmoil, but with their economies damaged and underperforming, notably in the important tourism sector: it takes a relatively small terrorist presence, in an otherwise safe country, to ruin tourism.

It is not only those States which were wracked by the events of 2011 that remain under stress. Iraq suffered a broad disruption of its communities, its politics and its economy, in the years that followed the disastrous invasion by the US and UK in 2003. It then suffered the murderous onslaught by the so-called Islamic State from 2014, which is now being crushed in Mosul, but which will remain a destructive insurgent and terrorist presence for years to come.

Turkey is in a different category. It is part of the region, and far more highly developed. But since the failed coup of July 2016 has sunk further into the populist authoritarianism that is President Erdogan's preferred mode of operation. His earlier peace overtures to the Kurdish part of Turkey's population has been replaced by military confrontation and political persecution, setting the scene for years of strife ahead. And Turkey remains vulnerable to the spill-over of the jihadist terrorism that is likely to afflict both Iraq and Syria.

Israel, meanwhile, remains relatively insulated from the chaos in its regional neighbourhood. Iran, the other non-Arab power in the Middle East, functions fairly well as a society and has a form of democracy which does give expression to citizens' choices. After years of poor economic performance imposed by sanctions, it needs investment and trade: despite the stated policies of President Trump, it will probably make some progress towards achieving them in coming years.

How can risk managers begin to quantify the major risks present in this confused and complex regional reality? Needless to say, there can be none of the mathematical exactitude that goes with calculating Basel III leverage ratios, for example, or even the slightly more subjective art of devising credit ratings. The rating agencies do a good job in general of assessing country risk. But I think we can add some valuable dimensions ourselves. Here are some rules of thumb:

- Be clear about what really is a risk and what is not. If you read some of the headlines, there is “risk” in Russia replacing the US as the hegemon in the Middle East, or of China stepping in to safeguard its oil imports from the Gulf. In broad historical terms this is a change, but in itself it is not tragic: the involvement of other large powers in upholding stability is in principle a good thing. The risk comes from a culture of zero-sum rivalry being allowed to prevail, when what is needed is mature and visionary leadership on all sides. The same dialectic can be applied to a host of issues that worry political leader-writers, but need not necessarily worry economists or companies.

- Be clear about the risks relevant to your specific business. The long-term socio-economic decline of a country is important as a framework for your decision-making, and can be a precursor of the kind of sharp political challenges to the status quo that emerged in 2011. But the finer detail reveals opportunities, or neutral risks, in many situations that have been treated with exaggeration or excessive pessimism. We should never underestimate the resourcefulness of populations living in adversity, not their interconnectedness with the rest of the world even in wartime.

- Use the local knowledge you probably have in-house to do reality-checks on the big analytical picture you are getting. One of the many good things about migration today is the wealth of bright young talent from all over the working in a major city such as London. Talk to them and get a feel. Ground truth can give you the confidence to break away from the market herd.

- To make extra sure, give us a call at the Ambassador Partnership!

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CROs "Risk Heat Map" Evolution

By Denis Hall

The typical way that something makes it onto the risk heat map of a bank is usually evolutionary. The topic is first socialised, and then it makes the top ten, entering at the bottom. Like a twinkling star, it will either fade into obscurity or continue to expand and be ever brighter and a few turn into a super nova. Rarely will your top risks change dramatically without warning, but there are a few situations that I have observed that can cause a "top spot first time entry" without being on the previous month's list.

My guess is that most risk managers will be able to cite one or two instances where they have observed an unknown risk with a high severity that suddenly becomes more likely. There are two categories of risk that stand out to me as areas that would cause this sudden shift and top slot entry onto the map. Perhaps there is also a third category that is becoming more prominent of late; political volatility. It is not difficult to imagine in today's world how politics will impact your business model. Certainly more risk associated with a political agenda will make the heat map, but this is not something that I have observed, Brexit and Trump victories were a possibility way before becoming crystallised.

Category 1 is the Regulatory agenda. It is fair to say that the regulator will be following known risks. Occasionally their topic is brand new, but to be clear it is not usually the regulation itself that is the risk, it is the organisations failure to comply with that directive, risking fines and/or sanctions. Outsourcing is high on risk managers list this year because regulatory scrutiny has increased, it was on the page last year as well just not so hot.

The impact of regulation can of course make a huge difference to the business proposition. GE Capital was unregulated at the parent level until the Federal Reserve took consolidated regulation in 2011 and designated GE a SIFI. At that point the regulatory requirements became paramount and so regulatory compliance was a huge risk because the manpower, infrastructure and culture was not in place to easily make the required upgrades. Regulatory matters then occupied the top risks for the business until there was a strategy change

Category 2 is an abrupt change in business strategy. Again, I am using my experience with GE Capital as the example. After putting in four years of effort to reach the SIFI standards with the prospect of more effort and cost in the future, the parent company GE decided in April 2015 to sell off the bulk of its financial assets, retaining only its captive businesses enabling a de-designating of the SIFI status.

The risk heat map at the holding level changed dramatically overnight. The previous risk of not being able to recruit sufficient staff to do work associated with meeting Fed requirements was replaced by the staff retention risk to see us through the disposition plan. Prior to this strategy watershed, the health and volatility of the Capital Markets was not on the heat map. This became the number one risk. If the markets didn't hold up, then achieving the business goals of disposition would prove impossible or at least expensive. As it was the timing was perfect, and the bulk of the transactions were signed ahead of time during 2015 and early 2016.

When considering changes in the "risk heat map", it is important to understand an impact of Fintech, Financial Technology to give it it's less sexy name covers a wide range of activities. This can mean digital banking initiatives from existing Banks and Finance Companies. It can be individual companies that are founded on technology that may, or may not, leverage existing infrastructure. These also range from pure transaction driven applications, as in a simple current account, to the crowd funding companies.

In my opinion, the positive impact coming out of the emergence of Fintech companies is that it has given the traditional banks a kick up the backside. Banks have had to move faster down the digitalization path, and to rethink their product set and onboarding routines, by making everything simpler and more customer friendly. If you can achieve speed and customer focused intuitive processes without compromising on compliance and security, then that is positive. I am sure regulators will closely examine how Fintech companies, and by default also the existing players, are ensuring integrity and sustainability in the system.

The risk is that some new players will arbitrage the system rather than bringing true innovation. This will see revenue pools shrink. At this point, there are any number of Fintech companies not in a profit situation and eventually these will be weeded out, but not before doing harm to the system. What I think we should do is be careful using Fintech in our vocabulary and be more specific. Technology is such a dominant force in today's financial sector. Referring to heat maps, I bet there is not one institution without Cyber (that too by the way is an over generalisation) as one of its top risks. Financial Technology has so many facets we need to define what we talk about. Fintech and Cyber have become so much the "in" buzz words that inclusion in any expense request rationale is likely to get approval.

Denis Hall is Chairman of the supervisory Board of Hyundai Capital Bank Europe and the Board Member of Cembra Money Bank in Switzerland and Moneta bank in Czech Republic. Until December 2016, Denis was Chief Risk Officer International of GE Capital.

CROs Risk Heat Map: Remarks at the UK Leadership Meeting

By Kevin O'Rourke

In my opinion the top risk that affects the entire financial markets and all financial institutions that can be characterised as high probability with high severity is the threat from cyber crime and the risk of cyber terrorism. Specific for the banks, the top risks relate getting strategy and business models correct given the current persistently low interest rate environment together with the surmounting cost of regulatory compliance.

If we just look at the US, Europe and China we are probably in an unrivalled era of uncertainty.

United States

- Appears to be on a path of Retreat from the World Stage
- Given the potential void this could create by stepping back from being the International Arbitrator and funder
- Could bring heightened tensions across the Globe - particularly in areas such as the Middle East (US not involved with the Syrian peace deal), Russia – Ukraine and the Balkan states
- What might happen with North Korea given the potential destabilisation of US – China relations or the US – Japan Alliance

Europe

The risk landscape is dominated by Brexit. We know Britain is leaving and it's unlikely that the UK will reach a deal with Europe. Beyond that is relatively unknown territory and our journey to this territory poses many political questions. The most important are:

- The Scotland independence question.
- Will there be a breakup of the EU?

Several general elections in Europe will take place in coming months that could lead to or increase a probability of a breakup.

- Will the anti-establishment and apparent rise in nationalism derail the European Project?
- What will a post Merkel Europe look like?
- What will happen in Turkey?

China

There also many important geo-political questions that we need to be answered. In particular, Trump's administration foreign and international trade policy brings additional uncertainty in future China-US relationships:

- Will the retreat by the US see a rise by China?
- Will the void created by US retrenchment be filled by China?

There is additional uncertainty related to Chinese internal political situation. 2017 is a year of 19th National Congress of the Communist Party of China which will be a highly important political event.

Outside geo-political risks, we need to focus on operational risk. I believe operational risk is extremely relevant today. Its importance has changed quite considerably over the past few years not only because of the technological advances but also because of the focus on trust within the banking sector.

It's not that long ago that operational risk was consider the poor relation in Risk terms. Credit risk has always been there with some theory behind like Credit metrics, Portfolio management theory. Market Risk has always been the cool thing to be in with all the quants stuff going on. Liquidity Risk again has always been seen as a dealing room thing and certainly came into vogue during and after the Northern Rock episode. I have, however, often referred to operational risk as being perceived as a Goal Keeper in Brazil: everyone knows it's important but nobody wants to it. I believe that perception of operational risk has changed completely over the past few years.

The last Financial crisis brought the banking industry to its knees and there has been a concerted effort to re-establish any trust that was lost. A loss that was caused by credit, market or liquidity events is bad but an incident that could impact customers or be perceived as incompetent or negligent has assumed huge relevance and significance. No one wants to be the Headlines for such an event. The emergence of the cyber threat and issues such as conduct risk have all led to a dramatic escalation in relevance and importance of operational risk.

What can we do to mitigate against the threat from cybercrime and attacks? Although there is a great deal of money being spent on securing the IT perimeters within organisations it is also really important to invest in creating and continually updating staff awareness of the importance of information and building security. People risk within the whole cyber scene is very significant and we need to continuously re-enforce and build awareness of the threat and explain how simple, low cost measures can be vital in protecting against cyber crime.

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Is Good Data Governance the Answer to Managing the New Unknown Risk in Banking?

By Lee Thorpe

On 8th March, the European Risk Management Council launched its first flagship event, the UK Risk Management Leadership meeting, which brought together leading executives to discuss some of the most important risk management topics dominating the agenda at the moment. One of the things that the European Risk Management Council highlighted was that nothing is really changing within the risk community.

Risk is calculated from historical data and those same risks that executives have been worrying about for several years - low interest rates, challenger banks, regulatory pressures and cyber threats - continue to remain top of mind.

A cultural change is needed that encourages the risk industry to have a more forward-thinking approach. Part of the challenge is that banks are trying to cut corners to keep up. Low interest rates are suppressing margins and new entrants are emerging that are chipping away at the profitability of banks. Take the payment industry as an example.

We've seen countless examples of where technology firms like PayPal, Apple and Google have emerged within a niche space that is less regulated to offer services traditionally delivered by the big banks. This is taking money away from the large infrastructures and complex processes that banks rely on to demonstrate compliance. At the same time, the manual and complex processes surrounding regulatory requirements are proving expensive to maintain and creating more areas for processes to break and fail.

We're seeing that financial institutions have spent too long creating complex models but have failed to think about how the processes will be executed on a monthly basis. The next trigger point for the risk community will be around stress testing, which is used to identify those unknown risks that financial institutions are facing by testing how different scenarios would impact balance sheets.

From next year, stress testing will become more complicated and will include IFRS9 forecasting. As the scenarios that banks face as part of stress testing become more extreme, the complexity of modelling will also become more difficult. The danger is that complicated statistical models are conceptual and difficult to repeat time-and-time again for compliance purposes. For example, one company has 150 data scientists that have built 50 models in the last year but haven't managed to move anything into production.

To build powerful and predictive risk models that can be moved into production, there needs to be an underlying data model and structure that is built on the availability of clean data. Both legacy and challenger institutions are collecting increasing volumes of data but need to consider how to ensure the quality of data. For instance, if you are using social media to collect customer data then you can't guarantee that it will always be accurate. Only once you have good data, can information be automatically analysed, modelled and executed for better risk management.

Yet as the risk industry has moved online and become more automated then it has introduced new, unknown threats, for example, the potential for an IT failure or a breakdown in the process between people and technology. To reduce the chance of that risk materialising then the process needs to be monitored effectively.

Good data governance will create a better risk process – from modelling through to reporting – that requires less manual interaction and ensures financial institutions can apply complex systems in a structured way to reap the benefits.

We've now reached a point where regulation risks putting a cap on the progression of the industry. Banks are becoming a utility that is expected to operate with lower risk, lower profitability but a far higher amount of capital. Unless there is an automated process that is well governed to create efficiency then banks can't be agile anymore. Automation offers an opportunity to help traditional banks compete in a digital realm and become more efficient. However, only if they have the right data.

Lee Thorpe is Head of Risk Business Solutions at SAS UK and Ireland.

Cyber Crime Today and How to Combat It

By John Unsworth

It is a rare day when some form of cyber crime hasn't been highlighted in the media. The most recent British Crime Survey (2016) highlights that cyber crime, and its use as an enabler for additional offences such as fraud, currently accounts for more than 50% of all crimes reported in the United Kingdom. Cyber crime is a subject spoken about by many, but fully understood by few.

So, what is Cyber Crime? Why should you care about it? Why is it increasing? What can you do about it? Why should you do anything about it?

What is Cyber Crime? Cyber crime has many definitions, but it is essentially where a crime is committed using some form of online attack. This could be attacking your website and shutting it down (a DDOS attack), sending you or your colleagues emails with malicious links in them (a phishing attack) that places malicious software (malware) on your devices and allows criminals to access your files and steal your data, or shut your systems down. Businesses and individuals don't always see or feel the cyber crime, but they see and feel the subsequent theft or fraud when their intellectual property, customer data or money is stolen by criminals.

Why should I care about it? From a business perspective, the easy response to this question is "because it causes you untold harm when an attack is successful and results in financial loss, reputational damage or disruption to your daily business". Another reason is that in the cases where data is taken, it places, you, your clients / customers and your staff at further risk of being victims of crime due to their information being made available to the highest bidders.

Why is it increasing? Cyber crime is increasing because we have entered a technological age whereby the methods of committing crime on a mass scale, without having any physical or personal contact with a victim has risen at an exponential rate. Criminals are operating, and developing their skills online, where they have access to hundreds of thousands of potential victims. Unauthorised access to boundless personal and financial information to enable further offences is being facilitated through the deployment of computer viruses and malware, and exploitation of cyber security vulnerabilities.

Traditional crime requires an offender and victim to come into contact with each other, or for an offender to physically enter a victim's property or vehicle. Cyber crime removes this need, and makes cyber dependent crime as a low risk, high reward venture for the criminal. Frankly, cyber crime is increasing because what rational, or self respecting, 21st century criminal would not seek to prosper from the opportunities that the growth of the internet has provided?

What can be done to combat it? Globally, there is a lot being done to combat cyber crime. Numerous organisations for both commercial and philanthropic purposes offer cyber security services and products, and widely share the latest knowledge regarding what types of crimes are being committed and what can be done to prevent them. Software providers regularly send out updates to their systems to better protect their users against the latest threats. New technology is increasingly coming with inbuilt security. Media reporting increases awareness of cyber crime with the general public, and there are numerous videos, infographics and commercials highlighting the threats and what can be done about it.

It would be hard to argue that 'those who can', aren't actually doing anything to help ensure wider communities are better protected. The biggest challenge to the prevention of cyber crime, and the difference between a successful and unsuccessful attack, typically stems from a general apathy of businesses and individuals to accept their role in the process and to make efforts to take control of their own security. The syndrome known as 'it won't happen to me' is alive and kicking when it comes to the discussion of cyber crime, and how to prevent it. Successful cyber attacks, particularly against businesses, whether this be a Phishing email, a DDOS attack, an invoice fraud or a website defacement usually have one thing in common. An inadvertent, or a fully conscious, decision made by a human to either click on a link within an email, to not update to the latest software or to provide remote or physical access to a system containing data.

When it comes to the prevention of cyber crime, simple actions can make all the difference, and they are generally within the control of the individual organisations. A combination of technical solutions, such as implementing protocols like DMARC to help prevent phishing attacks, or compliance with the Cyber Essentials or ISO27001 schemes, alongside the upskilling (professional development) of employees regarding what constitutes secure online behaviors is paramount to a business being able to confidently say they are doing everything they can to be safe, and to provide assurance to clients, customers, regulators and their own employees that everything possible is being done and that security of personal data is an important value for the organisation and its staff.

Why should I do anything about it? Aside from the moral arguments of it being the right and sensible thing to do i.e. to protect all the personal and sensitive data you hold, the carrot for acting now is to help your business to survive and grow in an ever competitive business place. The stick is that with the introduction of GDPR in 2018, ignorance of the problem won't be a valid excuse. There is no room for apathy or gambling with your online security. You need to act and you need to take control of your individuals, and your businesses, online demeanor.

Technology provides untold opportunities for businesses of all sizes, it helps us to be more efficient, it helps to increase our reach to clients and customers, it helps us to share information and communicate, it provides opportunities for agile and remote working and can reduce our overheads through our offices being wherever we have internet access. All opportunities bring risk, the question is whether your organization has assessed those risks and put plans in place to manage them? If you have, then please share and help us to help others be protected. If not, take this as your call to action and don't find yourself saying "if only I had acted earlier".

John Unsworth is the Chief Executive of the London Digital security Centre (LDSC). The LDSC is a not for profit organisation founded by the Mayor of London as a joint venture with the Metropolitan Police Service and the City of London Police. The LDSC works with Private Sector, Academia and Public Sector to help Small and Medium sized businesses be protected against Cyber Crime and better prepared to take control of their digital security.

Effective risk mitigation, operational resilience and crisis management

By Tomas Hazleton

One of the most imperative tasks of risk executives is to build the operational resilience necessary to withstand systemic or idiosyncratic shocks, where effective crisis management oftentimes serves as the last line of defence that determines the survival or failure of a financial institution.

An important starting point in building operational resilience is to critically analyze experiences from recent crises, including the lessons learned from managing those crises and the "ingredients" necessary to achieve robust operational resilience, such as developing essential skills, early warning signal tools, risk systems and infrastructure for effective crisis management.

One of the lessons learned from previous crises sadly is that both the industry and the regulators were ill prepared in terms of their respective abilities to assess the true probabilities of the tail risks we face. This in turn has led to an underinvestment in the mitigants against those tail risks—whether in the form of capital and liquidity, system and processes, skills and training, scenario and stress testing, or contingency planning and testing.

The most important “ingredient” necessary to achieve robust operational resilience is an organisation’s culture—having the right culture. This starts with mitigating against hubris—that “we know more”, that “we are better”, that “we are different”, and therefore “it can’t happen to us”. In order to achieve robust operational resilience, the organisation needs to be willing to accept that bad things can and will happen. The next step is to identify all of the significant risk threat vectors and single points of operational failures. Then the firm should develop contingency plans and monitoring tripwires which would prompt them to invoke those plans. This culture should be reinforced by ongoing training and testing.

Scenario analysis and stress testing are rightly considered as an effective practical tool that should help an organization to build a robust defensive mechanism against systemic or idiosyncratic shocks. But is stress testing as we run it today a crisis management tool or mainly a regulatory exercise? The answer is that it is rather a regulatory exercise which tends to be “one size fits all” and, therefore, discounted by financial institutions from an economic risk management perspective.

Moreover, some specialists highlight that in reality stress tests very rarely inform risk management decisions. However, stress testing should and could help inform crisis management preparations, if the stress tests are properly linked back to real scenarios or events which could give rise to the stresses. It can help to put in place risk monitoring and contingency plans before a crisis. In other words, in order to make stress testing less academic and more practical, it needs to be linked back to something less abstract and more realistic—a scenario that could actually happen mitigated by contingency plans that could actually be implemented.

What are most important practical steps that CROs can make to ensure that their organisation is well prepared to sustain the next perfect storm? Perhaps, again CROs need to make sure that their organizations have the right governance model with clearly defined roles, responsibilities and decision-making authorities combined with robust risk management and crisis management arrangements. This is critical for ensuring organizations can detect and respond to crises effectively.

There is an ongoing tension in many organisations over who “owns” the risk—the business or risk management—and how the organisation should respond when its risk management framework is flashing bright red in the lead up to a crisis. This can be illustrated by anecdotes of a major financial institution’s risk management framework flashing red in advance of the Asian and Russian currency crises in the 1990s, but management failed to act decisively to reduce its exposures while other financial institutions were maintaining the status quo. The lesson learned is that it is not enough to have a risk management framework without the willingness and ability—the empowerment—to listen and act on what it is telling you. Until this occurs, we are more likely to be crisis managers than risk managers!

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