European Risk Management Council

Risk Landscape Review

September 2017

- Macroeconomic Climate: Will China Remain the World's Economic Engine?
- Geo-Political Turbulence: Brexit, Trump, Putin, North Korea …
- Political Risk: Can We Measure Political Risk?
- Reputational Risk: Managing Reputation in Era of Disruptive Innovations
- Risk Culture: How to Define and Measure Culture

DEAR READER,

I am delighted to present the Q3 edition of the Risk Landscape Review. This time the Review includes five articles which address topics that have been recently discussed at Risk Council's meetings.

Macroeconomic risk: While European and US economies were struggling to deliver healthy growth, developing Asia and, in particular, China remained the engine of the global economy in the last 10 years. In his article, David Mann studies the main trends of the Chinese economy to assess the ability of China to remain a leading economic driving force in the future.

Political risk remains a prime global concern affecting business climate in Europe, US and globally. In our Q3 edition, we included two articles dedicated to political risk. Gaurav Khanna and Parag Khanna take a "helicopter view" on main destabilisation factors of current geo-politics and analyse potential risks from a historic perspective. James Watt CVO raises the question of political risk quantification. He provides his view on how a quantitative assessment of political risk should be combined with expert judgement.

In the last several years, reputation of the financial services firms suffered a substantial setback due to numerous banking failures, misconduct and money laundering scandals. In addition, fast penetration of internet technologies, digitalisation and social media is amplifying potential **reputation risks** for financial firms. How can CROs and top management ensure that reputational risk is properly controlled? In his article, Michael Fertik shares his view on how to mitigate reputational risk in the era of disruptive innovations.

In our Q3 Issue, we continue the conversation about **Risk Culture** that we started in our previous Issue. Peter Neville Lewis presents another way of defining and measuring business culture and ethical behaviour within organisations and argues that the Culture at board and senior levels in an organisation determines its group behaviours and risk appetite.

I would like to thank all authors of the Q3 Risk Landscape Review for their superb contribution.

Enjoy the reading.

Yours sincerely,

Dr Evgueni Ivantsov

Chairman of European Risk Management Council

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Asia - Positive domestic spillover from robust export growth

By David Mann, Chief Economist, Asia of Standard Chartered Bank

The world economy is showing decent signs of growth for 2017-18. Europe's growth is above trend, and the lack of significant tightening by the European Central Bank (ECB) should sustain it. The US economy has strengthened again after a soft performance in Q1-2017. Asia, however, is still the main driver of global growth. 2017 will mark the ten-year anniversary of China becoming the biggest contributor to global GDP growth. More interesting is who has taken the number 2 spot. Asia excluding China and Japan is now a bigger contributor to global growth than the US economy. Absent a major productivity boom in the west, it is hard to see this reversing any time soon. This means that while the external environment remains critical for a region so highly open to trade, the domestic and regional drivers of Asia's growth have taken on an added significance.

H2-2017 outlook is less rosy for exports and domestic activity
Asia's export growth has likely peaked

Asia will in our view see mildly softer growth in H2-2017 than in H1. The rationale for our view is that the export strength since the start of the year (which has correlated with stronger domestic activity) was driven by two temporary factors: higher export prices and China's inventory restocking cycle. Our Asia economic trackers for Q2-2017 and China's recently announced stronger-than-expected Q2 growth suggest that the strong momentum will at least last through 2017.

So far, protectionist rhetoric from the West (particularly the US) has not resulted in significant trade-negative actions. We will continue to focus on actions, which have been limited to the US exit from the (Trans Pacific Partnership) TPP, rather than words. We believe that Asia's export growth has already peaked or is close to peaking.

In addition to the price effect and stronger demand from China, Asia's export strength has mainly been driven by a limited group of products this year, namely electronics exports. Electronics now account for the biggest share of exports for most Asian economies. Since end-2016 they have benefited from strong demand for electronics components, as well as rising prices. The electronics manufacturing sector has gained importance across Asia, particularly in countries like Vietnam. Electronics exports have risen to over 26% of Vietnam's nominal GDP from 13% in 2012, exceeding even Taiwan's share. Some of the recent strength in electronics exports may well be driven by new mobile device product launches coming later in 2017. This may help the temporary boost to exports to last through the year (see Figure 1).

Let's take each of two main drivers of stronger exports H1-2017 in turn. The first was the rise in goods export prices, led by the rebound in commodity prices from their lows of Q1-2016. Looking ahead, we see limited upside for prices, while export volume growth is likely to steady. Electronics exports has also likely peaked, though remains far stronger than was the case in 2016: Taiwan's export orders and South Korea's exports show still double digit gains in nominal terms (+13.0% and 17.4% y/y respectively). Korea's export growth for the first

20 days of August eased to a still robust 6-month average of 17.5%, from +18.4% in April. New product launches will likely continue to support electronics export growth, albeit at levels lower than those seen recently. Solid electronics exports should prevent a sharp drop in overall exports, but the peak of export growth is behind us, in our view.

The second was China's inventory rebuilding, which is already showing signs of slowing. The lack of breadth in Asia's export drivers – electronics products destined for China - is a concern. In China, we see growth remaining stable, despite the many challenges and imbalances that exist. The very strong H1-2017 performance gives the authorities room to keep monetary policy tight and also focus on deleveraging the financial and broader corporate sectors. As a result, we expect H2 growth to be slightly lower than H1, but to stay above 6.5% which should be positive for the world economy. We forecast 6.8% growth for the full year 2017, followed by 6.5% in 2018. By the 2020s we expect China to be heading towards a trend growth rate in the 5-6% range. Risks from China need to be seen on a sector by sector basis. China's leverage and excess capacity excesses will remain a burden on the economy overall, but there are many other parts of the economy outside of these old economy sectors which are thriving. Also, many China bears ignore the significant asset position of the household, corporate and government sectors.

China – tackling excessive leverage

China's corporate sector leverage is our biggest area of concern in Asia. The country's credit-GDP growth gap has been flashing warning signs for years. A reading of more than 500bps faster credit growth than GDP growth (in nominal terms) is a signal of too much inefficient credit being extended (Figure 1). The five-year average of this metric hit a high of 940bps for China in 2013, subsequently narrowed to 530bps as of end-2014, but re-accelerated to a too-high 734bps as of end-2016.

We expect China's credit-GDP growth gap to start narrowing in 2017. Nominal GDP growth could, in our view, rise to c.10% in 2017, from 8.0% in 2016 and 7.0% in 2015. This is because the GDP deflator is likely to rise along with the CPI and PPI in 2017, which is welcome news for debtors. Meanwhile, we expect credit growth to stabilise at 12-13% in 2017. This should mean a narrowing in the credit-GDP growth gap in 2017 to an annual average of 200-300bps, from over 700bps at the end of 2016. However, bad debt created over the past years will likely remain a drag on growth.

We are frequently asked whether we believe China has the financial capacity to deal with its bad-debt challenge. IMF's analysis of China's augmented fiscal deficit puts the government's annual deficit at 9.5% of GDP in 2015 and 10.1% of GDP in 2016, versus the official 2.3% and 2.9% figures. The main difference in the data comes from including land sales and local-government infrastructure spending financed by debt. While we think revenue from land sales is still revenue, the lack of fiscal room implied by IMF's estimates should be taken into account.
We believe China's financial capacity to deal with the debt situation comes from its relatively strong net asset position. Even a dead-weight loss in the corporate sector of 10% of GDP, recognised all at once, could be shifted to the government sector (worst case); this would still leave government debt-to-GDP at c.70% of GDP. The government debt ratio remains at c.80% of GDP in a more extreme scenario of, say, a dead-weight loss of 20% of GDP.

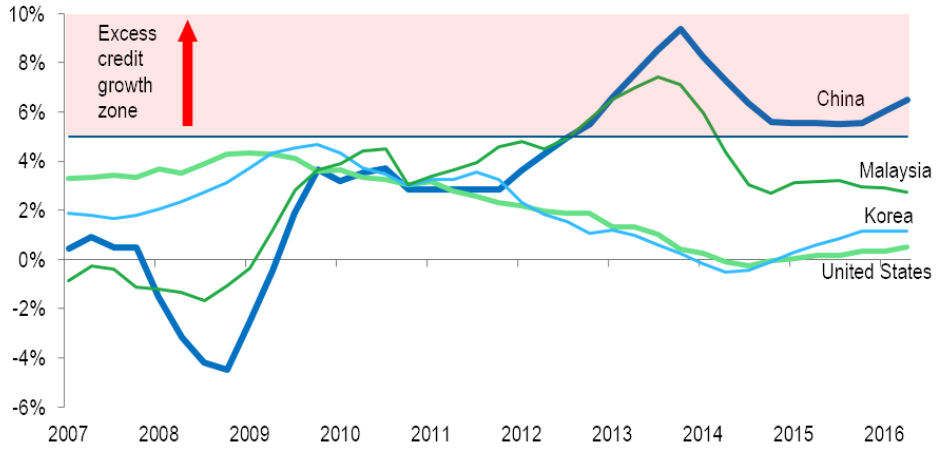
Our estimate of China's total gross government debt of c.60% of GDP in 2016 is already the highest among market participants. We include both the direct and contingent debt of the local and central governments, and the debt of China Railway Corporation. The government and the SOE sector also have a significant asset base, which can be used to pay for the losses. Central-government assets (including owners' equity in SOEs) reached CNY 51tn, or 80% of GDP, in 2014 and local-government assets (including owners'

equity in local SOEs) exceeded CNY 100tn, or 157% of GDP, according to the National Institute for Finance and Development, a think tank under the Chinese Academy of Social Sciences (CASS). Even excluding land assets, local-government assets are worth over CNY 43tn, or 67% of GDP.

For China, we think a more likely outcome than an outright financial crisis is what is already taking place – slower productivity growth. Long-term, as long as the current bad-debt pile grows and crowds out other forms of productive borrowing, slowing productivity could lead to missed opportunities as bad loans continue to be evergreened. This issue will likely be exacerbated this year given US rates and China's local interest rates will potentially increase. The sensitivity of the weak parts of China's financial system to higher funding costs will place constraints on China's ability to use the interest rate tool to reduce outflow pressure.

Figure 1: Our favourite warning metric is rising again in China

Credit-GDP growth gap, 5-year average, deteriorated for China in 2016



Source: BIS, IMF, Standard Chartered Bank

Yes, we've got Trump, Putin, and North Korea, but is the world really more volatile than ever?

By Gaurav Khanna, CIO, Fifth Quarter Fund;
Parag Khanna, Senior fellow, Lee Kuan Yew School of Public Policy

Rarely does history give us such a compelling juxtaposition—both in time and in character—as what happened one hundred years ago this Spring.

On Apr. 2, 1917, president Woodrow Wilson delivered his "War Message" to Congress outlining the rationale for the US to enter World War I. Just four days later, Congress overwhelmingly declared war upon the Imperial German government. The entry of US forces in the late stages of World War I would prove decisive in the Allied victory more than a year later. Three days after Congress' declaration, an equally powerful force was boarding a sealed train in Zurich, Switzerland. Vladimir Lenin, who had been in exile in that country for a decade, had struck a deal with the German authorities to gain secret passage for himself and 32 of his comrades to Russia. The Germans had calculated that allowing Lenin to return to Russia would destabilize the current Provisional Government and knock Russia out of the war. They were right. A mere seven months after that train arrived at Finland Station in Petrograd on Apr. 16, Lenin sat at the helm of a new Russia.

Simultaneously, Wilson and Lenin set into motion a series of events that would ultimately define the 20th century geopolitical order. The historical narrative often focuses on their differing personalities and methods. Wilson, the bespectacled former academic and idealist, sought to promote a more transparent and democratic mode of conducting international affairs. Lenin, the firebrand outsider with a hurricane-force personality, sought to foment revolution across Europe to return power to the proletariat class.

But they both shared a common belief that the world order at the time—colonial and hierarchical—was decaying and had to be replaced. It had failed the very people it was meant to serve, plunging Europe into a senseless, destructive war in which millions of lives were lost for a cause that neither the Allies nor Central Powers could articulate.

Once again, a century later, drumbeats of war are sounding and revolution is in the air. America has a very different sort of president—someone who is actively rather than reluctantly threatening the use of military force. Meanwhile, the socioeconomic inequities Lenin railed against have become a global epidemic. The combination of geopolitical risks and domestic upheavals appears set to plunge the world into a reprisal of the military and trade wars that substantially derailed globalization for the entire inter-war period of the 1920s and 30s.

Will it happen? Is the world really as prone to systemic destabilization as it was then? Is the next disaster around the corner?

Given the far higher degree of interdependence among economies than existed a century ago—spanning not only trade but also currency and debt markets, cross-border fixed investment and

portfolio capital flows, and deep supply-chain integration—the logic can cut both ways. On the one hand, instability in one corner of the geopolitical or economic system can quickly ricochet around the world. On the other hand, collective resources can be marshalled to isolate risks and strengthen systemic foundations. Examining the global landscape of the quarter century since the collapse of the Soviet Union and end of the Cold War world yields interesting conclusions about our collective ability to manage unpredicted events and risks.

Recall that the post-Cold War period was a short-lived honeymoon. In Aug. 1990, Saddam Hussein's Iraq invaded Kuwait and sent oil prices skyrocketing. The early 1990s civil war in the Congo witnessed five million deaths, the highest toll since World War II. At the same time, Yugoslavia's disintegration rapidly accelerated, unleashing a genocidal civil war that claimed nearly 150,000 lives. NATO found a new purpose and mission in the Balkans, soon to expand to Central Asia as 9/11 became the current generation's most salient flashpoint.

The rest isn't even history yet, as the long shadow of 9/11 continues to loom large. The US invasion and occupation of Iraq and Afghanistan persist in form if not with the same troop levels, while the broader Middle East is engulfed in the meltdown triggered by the 2011 Arab Spring. An estimated half million Syrians have perished in the country's civil war since 2011; the jihad terrorist diaspora made 2014-2015 the bloodiest years Western Europe has experienced in decades.

Sociopolitical upheavals have hardly been confined to the Arab world, with the 2008 financial crisis unleashing crippling economic austerity and financial repression across the West, while Occupy Wall Street and populist political movements gained steam culminating in the past year of Brexit and Trump. Furthermore, from the Taiwan Straits and North Korea to Iran's nuclear program and Russia's invasion of Ukraine, great powers perpetually find themselves on the brink of significant escalation. In 2014, Japanese prime minister Shinzo Abe toured the world, directly analogizing China to imperial Germany and warning of history repeating itself.

And yet, here we are: No nuclear war with Russia or North Korea, but a surprisingly synchronized global economic recovery. Brexit has slowed UK growth but didn't bring down global markets. Trump has backed down from his trade war threats. Energy prices are at structural lows. Greece, Italy, and Spain are still in the Eurozone.
If every downside event that occurs is viewed with the "recency bias" that inflates its significance due to its proximity in time, then we would live in constant fear and paralysis. Planning for the future would be pointless. The robustness of globalization that we take for granted would instead be a chimera.

In fact, much of what we refer to as volatility is actually just turbulence. To use a volcanic metaphor, tremors (turbulence) happen all the time, but they do not all result in genuine earthquakes (volatility). In fact, very few tremors become even noticeable earthquakes at all. The complex geological structure of the Earth absorbs and dissipates their energy across the planet's mantle, muting their impact.

Globalization itself performs a similar function—it is the planetary network that absorbs and dissipates shocks. Unfortunately, globalization today is far too often spoken of as a phenomenon controlled by a light switch, turned either on or off by conflict or protectionism. But much as analogies to the pre-World War I era are of limited utility, so too have been recent proclamations of the "end of globalization" due to 9/11, the failure of the Doha trade round, the financial crisis, nearshoring, industrial policy, and border adjustment taxes. Take your pick; all such claims look shallow as global growth recovers, trade growth expands (especially in services), and capital seeks yield in high-growth markets.

The chasm between the media amplification of noise over the meaningful signals has perhaps never been greater. Whereas every geopolitical event is presumed to cause a market crash, oil price hike, or name-your-calamity, the reality is that stabilizing forces abound such as monetary stimulus, trade reciprocity, and regional integration.

There is a dangerous tendency to view downside events as structural and upside as merely cyclical. But the reality is more one of action and reaction as energies reverberate to correct excesses. European publics swing populist, yet France has decisively elected a pro-EU president who will work with Germany to restore the Union's strength. Saber-rattling over the Korean peninsula reached fever pitch, but South Koreans just elected a dovish president whose top priority is de-escalation and peaceful reunification.

The financial markets have taken note of this dynamic, even if it remains unspoken. The bull market run that began in 2009 celebrated its eighth year in early March. While the enormous equity price gains have been the story du jour, another salient trend has not gone unnoticed: low volatility. The most cited measure of market volatility is the CBOE Volatility Index, or VIX. Technically it measures the implied volatility of S&P 500 index options; practically speaking it rises when markets fall and tends to spike sharply during large market downturns. Hence its nickname: the "fear gauge."

Figure 1 (below) shows this fear gauge since the 2008 financial crisis, when it hit its peak of 80. As that traumatic event recedes into memory, spikes in the VIX have generally been less frequent, lower magnitude, and shorter duration. Since mid-2012, the VIX has spent most of its time below 20, a level generally associated with market complacency. Many have attributed the stock gains and low volatility to the Federal Reserve's historically accommodative monetary policies, which has pushed fixed-income yields to such low levels that investors had no choice but to chase returns in stocks.

But this explanation does not fully account for why spikes in volatility are short-lived. Investors have come to realize that the collateral damage due to geopolitical tensions or local elections on companies' earnings will be minimal. Global banks are much better capitalized than before the crisis and have to provide far greater transparency into their viability and risky assets. Albeit imperfectly, the Federal Reserve and other central banks continue to coordinate and "do whatever it takes" (in ECB chief Mario Draghi's words) to keep economies moving. This combination has proved to be a very effective stability mechanism. Bouts of market panic and VIX spikes have dissipated quickly; the much feared post-Brexit market decline lasted a few days in the US. No wonder shorting volatility has been an enormously profitable trade for the past five years.

So why does it seem like the world is so volatile? That the next calamity is just around the corner?

Perhaps one answer lies in the very forces that were unleashed a century ago. Woodrow Wilson and Vladimir Lenin stepped into the moral vacuum of the "Great War" and infused a sense of purpose that no other global leader could or dared to. Wilson's "War Message" was not just a tactical call-to-arms, but an eloquent plea for a new world order founded on democratic principles: "A steadfast concert for peace can never be maintained except by a partnership of democratic nations…." Similarly, Lenin, shortly after arriving in Petrograd, exhorted the assembled crowd to join him to overturn the oppression and deception: "We must fight for the social revolution, fight to the end, till the complete victory of the Proletariat." A modern-day Wilson would have rallied the world behind the Paris climate agreement; Lenin would have held court at Occupy Wall Street. Wilson would have taken the bully pulpit to CNBC arguing for central bank coordination while Lenin would be

a sought-after counsellor to rebellious upstart political parties such as Italy's Five-Star Movement.

Both Wilson and Lenin exuded the confidence of leaders who inspire followers, which is what makes them so unlike any public officials in power today. Indeed, the lack of any figures with the persuasiveness and stature of these two giants of the 20th century gives the impression that there is no captain to steer the ship—or, more cynically, most of the elected captains are uninspiring, incompetent, or both. This certainly contributes to the sense that grand agendas will fail, or worse, be condemned to mediocre execution and dysfunction.

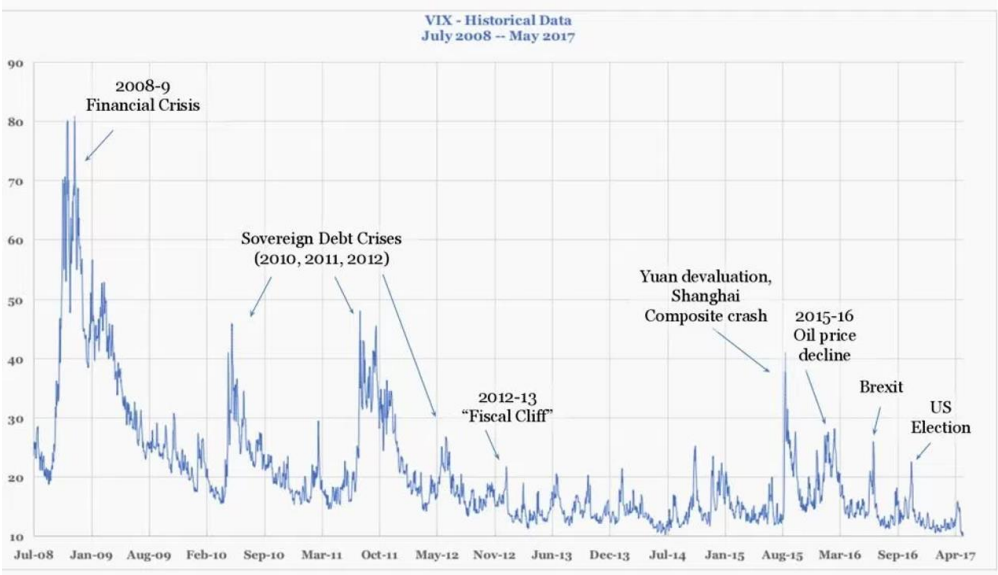
Unfortunately, there is no end in sight to the vacuum in global leadership. America's role in upholding the world's financial, military, and technological order is fundamental but being handled haphazardly. The justifications are given in tweets. The EU is without question the most successful multilateral body in history, yet no single European head of state can articulate a compelling and forward-looking defence of it. Financial institutions provide essential liquidity for sovereigns and corporations, but are viewed with rank suspicion. No wonder trust in formal and global institutions at an all-time low.

And we should not be so sanguine as to believe that earthquakes of volatility are a thing of the past. Suppressing volatility through coordinated action does not mean there aren't underlying stress factors such as economic friction, high debt, low productivity, aging populations, rising inequality, and geopolitical games of chicken among nuclear powers. Risks abound—from trade policy stoking inflation to an equity bubble to unwinding financial regulation or a China hard landing. But thus far, these scenarios have not panned out, and need not leap from tremors to earthquakes.

Rather than wait for heroes to emerge, then, perhaps we should be investing more in the stability mechanisms we already have. Indeed, the most salient consequence of globalization is that the need for singular political or economic saviours is greatly diminished. The path to long-term stability is not through centralized solutions to global challenges at all, but to self-organizing approaches led by "coalitions of the willing."

In practically every country and every region, examples abound of these coalitions emerging confronting significant challenges. Central bank coordination evolved over time and was led by a handful of unelected technocrats, not heads of state. China and its neighbours are committing over $1 trillion to infrastructure projects to smooth their commercial connectivity. Cities are banding together to share emissions-reducing technologies that green their industries, even if their respective federal governments have taken a back-seat on climate change. Lending clubs and credit unions have sprouted worldwide to bridge financing gaps for start-ups and home-owners. Coordination without centralization abounds in a connected world.

Ultimately, the legacy of what Wilson and Lenin set into motion may just be this "new normal" of globalization: Decentralized power in the hands of citizens, cities and countries operating in self-organizing coalitions. When the earth rattles and the seismograph shakes, these networks spring into action to pre-empt and isolate, surround and contain the shock. Each year we ask if this is another 1914, 1915, 1916, or now 1917. And each year proves not to be. Let us hope that by managing all the tremors, we are better prepared for larger earthquakes—or that we are able to prevent them altogether.



The Quantification of Political Risk

By James Watt CVO, a former diplomat, a partner of the Ambassador Partnership LLP and Chairman of Council for British Research in the Levant.

Political risk is a term increasingly widely used, and yet is rarely defined. For several practitioners, such as specialist underwriters, the meaning is self-evident: it is the risk to business assumptions that arises from weaknesses or changes of a critical kind in political conditions. Underwriters can and do translate their judgement of political risk into measurable form when writing the relevant policy. Taking this as a real-life starting point, I would like to examine in this article more exactly what comprises political risk; how businesses more generally might approach its measurement; and how such measurements might be used in the actual management of risk.

Political risk in very general form, of course, underlies all business decisions. Business models and plans depend on a degree of certainty, and the larger the business grows the more likely it is to have a resilience strategy based on diversification. Most business leaders would see this as a natural part of market strategy, and would only start distinguishing "political risk" where in a given country there was a likelihood of conflict, revolution, or regime change leading to expropriation, nationalisation or default on international debt. Some companies get stuck on the idea of physical risk to their expatriate employees, which is only a subset of that kind of political risk, even if it is the most urgent to handle in a crisis. Increasingly, however, in a world of globalised trading, "political" effects of a different kind impact on business. The disaster at Fukushima had a natural cause in an earthquake and tsunami, but one of its political effects was the drastic fall in demand for new nuclear power generators, as a result

of government decisions (notably in Germany) responding to popular concern. Barely two years ago few would have foreseen the political tsunami of the United Kingdom's decision to leave the European Union. Before June this year not many would have predicted a serious diplomatic rift between Saudi Arabia and the UAE, on on hand, and Qatar on the other.

Some would respond that it is simply too vague, and too unprofitable, to try to discern these large unpredictable risks, and too impractical to build in safeguards in order to protect investments that are already a mass of commercial risk calculations. I would agree. Running for cover when the risk is still theoretical is not useful, and can translate into excessive caution which in the long run leaves the field to your competitors. Knowing how to ride risk is indeed the key to entrepreneurial success.

Some businesses, despite a largely unknowable future, increasingly systematise what they already know about the specific risks to them. It seems that a surprising majority, however, do not even start to do this. Much information is probably already on internal databases, but may not make it from the accounts, the legal department or the operations team to senior management. To invent an example: you have an engineering project depending on the delivery of components by sea at regular intervals; you have insured the value of the components against loss in transit, so if a shooting war breaks out in that region and the ship goes down, you're fine. Or are you? Does the project contract allow you to claim force majeure, when with a little foresight you could have made contingency arrangements? And would you win in court by claiming the conflict was unknowable in advance? If not, that would lead to a loss significantly greater than merely that of the cargo.

Senior management need to commission the internal trawl of such information, and design a way of assessing it, updating it, and acting on it. Most risk matrices are more useful to decision-takers if they are kept simple: the detail should not be allowed to obscure the relative weight and significance of the main elements. They also need to be credible: senior management will discard them from the start of the first crisis, unless the matrices embody common-sense realism. This approach has to include recognition that not all eventualities can be predicted, but show that the decision-making process is robust enough to handle the unexpected when it happens. That process will be all the more confident if quantified internal information about risk exposure has already been compiled and kept up to date.

What then about external sources for assessing political risk, and for informing decision-making when a crisis arises? There is more information and analysis out there than ever before about the conflicts and dangers that beset countries and their regions. High quality reporting is available from a variety of sources. Universities are turning out record numbers of graduates in international relations, ready to join the myriad consultancies that offer their services to commercial clients. Not just underwriters but major law firms too have considerable knowledge of the politics and pressures in those countries, usually in the developing world, which present symptoms of risk. Some specialist consultancies offer economic and political risk ratings for different countries, which can be a useful starting point but may not provide the full requirement. A risk for one type of business might be a golden opportunity for another. As always in a crowded offering of information, the client needs to be clear about what order of risk the business is likely to be facing, and thus what kind of analysis is going to be most relevant.

Anything more clogs the process of sifting and deciding. Deciding on relevance is straight away a qualitative judgement, and this brings

out the key point about the quantification of political risk: it makes little sense without qualitative assessment being applied at every stage.

Qualitative assessment depends to some degree on long experience and a deep knowledge of a region and its history: that can be bought in relatively easily. It also calls for unremittingly logical and sceptical challenge to all assumptions underlying the call senior management are about to be asked to make on a given situation. The risk experts need to make this challenge. But so do senior managers themselves: the best risk management comes from asking difficult questions, not from commissioning reports. The widespread failure of risk management in the financial sector leading up to the credit crisis of 2007-8 was in large part due to a lazy assumption that, by buying expensive compliance capacity, the risks were being managed. Of course, the risk of being accused of not taking risk seriously could be mitigated by being able to point to these elaborate Maginot Line structures. But – as events catastrophically proved – that was not the same as guarding against the black swan that duly appeared.

The lessons from the failures of the financial sector are relevant to our consideration here of political risk for businesses more generally. The first is that in-house risk management mechanisms are inherently prone to decay and to fail, because they imperceptibly become self-justifying: the senior managers who set up the mechanisms, perhaps at great expense, acquire an unconscious bias in favour of accepting their reports, and their colleagues feel a corresponding reluctance to challenge them in order to avoid conflict. This is not to say that in-house capacity is not essential: it has to compile internal risk data, acquire external risk data, and apply the maximum of qualitative judgement to them. It has to act on the mandates and instructions that come from time to time from senior management. These are responsible and fulfilling roles to play. The final safeguard, though, is in the conscious development of a culture which encourages challenge, with the purpose of refining the risk decisions senior management are about to make. If, as often happens, this proves hard to achieve entirely, bringing in an external practitioner dedicated to asking the questions is the easiest and most practical way to achieve the same effect.

In discussing the quantification of political risk from the practitioner's perspective, rather than the statistician's, I hope I have illustrated the key points which I have found to be of most value in my own work. Quantification has to apply to the specific needs of your business if you are not to be inundated with an excess of information. It can be derived usefully in part from information your business already holds internally. There is a rich choice of external sources too. Quantified political risk however is impossible without qualitative judgement throughout. It is up to your business to design and put in place the process for combining these elements, and for being ready to offer a swift and accurate set of choices when – as will happen – history takes a turn.

The New Reputational Risk, and What To Do About It

By Michael Fertik, Executive Chairman and Founder of Reputation.com and the author of the New York Times Bestseller The Reputation Economy.

Reputational risk is real. And it's not what you think.

Many sources have shown that enterprise value – both present share price value and future underlying commercial value – is heavily correlated to corporate reputation. The Economist Intelligence Unit has said, for example, that as much as 75% of a company's value is based on its reputation.

Unless a business is fully B2B, and sometimes even then, its reputation is of course tied, in the end, to what consumers think of it. Today, that means what the Internet thinks about the business. Stated differently, that means what consumers will learn about the business when they research it online.

Again, the numbers are clear. Nearly 100% of consumers in developed countries use online media when researching products and services. Almost that many use search engines. More acutely: they rely on what they find. Vast majorities of consumers – to the tune of roughly 75% to 90% -- report that they a) would decline to do business with a company about which they've found something negative online, b) have indeed already changed their minds about an already-recommended purchase (e.g. suggested by "word of mouth") based solely on negative information they've found online, and c) by contrast, have been affirmed in their purchasing decision by a favourable online comment.

Which is all to say that Word of Mouth has given way to Word of Internet. And specifically, in important cases, to Word of Review. More on that a little later.

Every corporate thinks about reputation in one way or another. A typical breakdown in a large multinational splits the concept of reputation into two parts, "Brand" or its cousins, which are managed by Marketing, and "Risk" and its various components, which is typically managed by, well, Risk. In regulated industries such as banking, this is especially true.

Elsewhere, I have put forward the idea Reputation is such an important topic that it should now be vested with the CEO and Board of Directors. Increasingly, we are seeing the Global 5000 do just that.

But for today, we can focus on the ongoing key role that Risk Managers play in understanding and in advocating for the primacy of reputation as an essential concept of value creation and stability for a corporation.

We can oversimplify by saying that, historically, risk leadership at banks have acted as a Wise and Informed Council, identifying and observing signals arising from financial data feeds that are alternately established by regulation and maintained by the government, mandated by law, or privately enabled so as to provide better business intelligence. The concept of risk has, in this way, been traditionally similar in extent and contour to concepts surrounding "audit." A good audit, it might be said, might reveal and diminish risk.

The underlying notion connecting the traditional role of the banking risk leader and reputation is just this: that the reputational

risk to a bank arises chiefly from failure of internal financial and compliance controls. Perhaps consumers will be afraid to do business with the bank on normal terms, due to well publicized irregularity or mistake (cf. Wells Fargo's recent scandal). Or, probably more likely and maybe more problematically, the bank's reputation among regulators will suffer and yield costly punitive response.

This type of reputational risk and harm no doubt remain important considerations for leading risk managers.

But lately they have been joined by a new kind of prospective harm: the reputational risk accruing to the company from the Internet.

Consider a realistic story. Consumers in one corner of Europe start complaining online about the "bureaucratic" or "Victorian" treatment at the hands of "pencil pushing mandarins" who staff the region's bank branches. "So hard even to open an account," someone says. "Don't even bother trying to get a loan." "It's nearly impossible to talk to a human with a heart beat." Sound familiar? Yes, well, for good reason: consumers talk openly and passionately about their grievances online nowadays, and they assign to their specific experiences the value of the entire corporate. Every individual frontline person in the company IS the company for the consumer. And the consumer is far more read to shout "bl$@dy murder!" from the rooftop than he or she is to sing the company's praises, especially when it comes to a business like banking (versus, say, a business such as a hotel or restaurant, where consumers are wont to share their good tastes as well as their unhappy experiences).

Soon after the consumers complaints start to pile up, the regional manager notices that new accounts and cross-sold products aren't growing as well as they were the prior quarters, and she is left wondering if her competitors' local branches are likewise suffering.

Next, the local press picks up the story, and all of a sudden, the Big Iron is all over the story.

Now the regulators come knocking, even if very politely, because they believe they have been getting lots of complaints lately.

It is a realistic pattern, and one that, in one form or another, has been unfolding over recent years across the OECD.

But traditional data streams – and traditional audit, risk, and reputational controls – can not anticipate or handle this type of problem. In this hypothetical, a problem that is probably easily preventable – addressing the customer service complaints of what is likely a tiny number of people, at least at first, by making some substantive operating changes in the appropriate region – can be nipped in the bud if the Risk leadership of the bank is listening to an additional set of appropriate and new channels.

In my many years as Founder, CEO and Executive Chairman of Reputation.com, the leading company in digital reputation management globally, I have seen many stories that are startlingly similar to this hypothetical. They can unfold with bewildering speed and have shocking impact on stock price, commerce, trade, profits, recruiting, and morale. I have also seen boards of directors, heads of risk, and other key executives grapple with the problems in real-time. Increasingly, I'm seeing them plan ahead for these challenges, so they can be avoided.

The overall trend of External, Surprise Threats to Reputation is about to get worse. Today, consumers rely on a certain amount of "elbow grease" when researching products, services, and companies. They look at online comments and reviews. In many case, they actually read them.

But the apparatus of the Internet is enabling a sea change, one that will prompt consumers to move even faster. Soon, they will feel very comfortable relying on scores, numerical ratings for everything from "where to open a bank account" to "which teller at the bank is the best person to talk to."

Yes, that granular. And it's coming.

Online reviews already inform many parts of our lives. We all know the famous five- and ten-point systems that provide scores for restaurants, hotels, and other places we like to visit. We know the similar online scoring systems for products such as cameras and computers. But consumers still want to dig deeper into the underlying comments, as they often don't find the scores sufficiently calibrated for their individual needs and particular tastes.

But that will change. Scores are going to get more accurate, more personalized, and more pervasive.

Here's how. Over the past two decades, three technologies have appeared that, taken together, are changing the Internet and our lives.

The first was infinitely powerful search. We can nickname this "Google." Search still text-based, but it is getting more useful in visual and audio media, for example.

The second was virtually free data storage. We can call this the "Amazon Cloud" or just "Cloud." Storage has become so cheap that, for the first time in human history, it is cheaper to store something forever than it is to delete it. This is a new default setting for humanity. As a species, we don't really know how to handle it yet!

The third is more recent, the rise of what we might call Hadoop and MapReduce. These technologies make big data analytics possible by non-experts. This is similar to what Microsoft Excel did for numbers. Excel made it possible for educated people who weren't especially skilled in the art of numbers to "do numbers." Excel became so ubiquitous that eventually everyone at a company had to learn it to some degree or another. Similarly, Hadoop and MapReduce are democratizing analytics.

So what is the result of this brew? If everything about everything is stored forever, and anything about everything can be searched by anyone at any time, and if everyone can do analysis on all these things, then…. everything will have a score.

In this near-term time, which I have called The Reputation Economy (Crown, 2015), all the potential products, services, and even transactions in our lives will be assigned scores by computers. And – this one is important – humans will rely on the scores without even looking at the underlying data. They won't bother reading the text of the reviews, for example. They'll just look at the scores. Or they won't even have to look at the scores, because the computer will all the analysis required of all the various 100 options and the serve up to the consumer the top 3 that fit is her needs, in the computer's algorithmic opinion! In this moment, decisions will be all but made by computers, not humans. Consumers will depend on ratings more and more, aggregate numbers of sometimes bogus or unfair feedback.

I've spoken with many people in banking who both worried about this future time and are preparing for it now. Sometimes I meet people who seem less concerned. They point to the long stickiness of consumer bank accounts, for example, and the apparent "loyalty" of customers.

First, make no mistake: that isn't the result of loyalty. That's the result of the friction of departure!

Second, the friction is eroding. Online micro-banking options are proliferating. And we can envision a world in which consumers have a dozen or two dozen "micro-bank accounts" that they use for various purposes. In such a world, scores related to "where to get the next account," "where to do micro-banking for online bill pay," "where to do peer-to-peer lending," etc., become very important to consumers.

And therefore they become very important to the banks, their futures, and their Risk Management leaders.

This future might not affect most of the senior people now carrying the title Head of Risk for large banks – it may not happen soon enough to matter to their careers – but it might. The key is to lay the pipes for digital observation of new data feeds now, before a problem arises, so the appropriate risk teams can start to measure cause and effect. It's good for Risk to continue to be the "smartest team in the room"!

Disruption always happens faster – at a lost more consequentially – than it is expected.

Even in regulated industries.

Integrity Has No Need of Rules *(Albert Camus)*

By Peter Neville Lewis, the Founder of Principled Consulting; a Hon Research Fellow at Brunel University and a Patron of Tomorrows Company.

Managing conduct risk is mostly about people making – and taking - the best decisions. It is not just about strategy and tactics – it is even more about the judgements and behaviours of people.

- A business should have a moral purpose
- A business should be a community of belonging for all who work there
- A business should allow and encourage its people to bring their humanity to work
- A business must have a strong ethic of Care – care about the outcomes of its decisions and their impact on all stakeholders.

People fundamentally want to do the right thing. It is therefore highly desirable for organisations to create a decent, open and respectful Culture which allows human beings to interact at work as they would in their home/social environment. There should exist a proper balance between Rules & Regulations, Experience & Common Sense, Care & Empathy.

This is the Culture which mitigates risk and reputational damage, encourages higher performance (and the profitability which

follows), thereby developing a sustainable and ethical business model.

It is found in many of the most respected and successful business models in the world today - the ability to do the right thing consistently, to the best of their ability, in a fair and decent way; and it has won them their reputations. Sadly, the Financial Services industry has fallen well short in many instances of these standards and has acquired a poor image in the eyes of most consumers, regulators and commentators.

Restoring trust in banking for example has become a well-worn record, so much so that one wonders if the will to make things better has evaporated in the hoped for return to BAU? How might one therefore go about assessing the risk culture of an organisation, given that so many executives tell us that "culture is too difficult to assess"?

Firstly, if we accept a simple premise that all risk/reward is driven by decision making and behaviour, we need to understand the prime drivers. A cause and effect flow chart would show that the decisions which result in action and behaviours derive from the judgements made. These in turn are largely determined by individual character, how we evaluate circumstances, experiences and people based on our personal interpretation of deeply rooted core moral values such as courage, fairness, trust, excellence, wisdom and humility.

"Character, judgement and behaviour are connected stages in a process. Character or Integrity is the sum total of all our moral values and informs the behaviour of trusted adults. Good collective judgements and decisions are made when we consider not only legal rules and obligations (the "letter" of the law) but also how our values (the "spirit" of the law) help us to decide fair and reasonable outcomes for all stakeholders (Prof Roger Steare – Ethicability, 2010)

Secondly, we know the complex Culture of an organisation exists for sure, as it is represented by artefacts, language, traditions etc, but is not always easy to identify, pin down and explain. It is also influenced by the tone set by the senior executives. So how do we start to identify and measure it?

Preliminary enquiries at a senior level might include questions such as:

1. How well disciplined is your organisation to meet the emerging public and regulatory demand for demonstrating risk balanced and ethical decision making in the way you transact business with ALL your stakeholders in the global economy?

2. How clearly does your organisation articulate and communicate its values in order to guide risk balanced and ethical decision making at all levels? Where are the roadblocks to risk evaluation?

3. How well examined is your Values Statement to determine if these are based on true moral values like Courage, Self-Discipline, Fairness, Trust etc rather than desired outcomes (eg Reputation or Efficiency)?

4. How committed is your organisation to putting moral values and moral purpose, which affect ALL stakeholders, before just value for shareholders?

5. How strongly does your CEO (which might equally imply Chief Ethics Officer) champion a culture for balanced risk taking and decision making – A Culture of Enlightened Integrity?

6. How well emphasised in your Risk Register are RIGHT (see model) decision-making and effective measures to mitigate reputational risk caused by careless thinking? Is there a clear framework?

7. How open and properly supported at grass roots are your whistle blowing culture and speak-up processes, to encourage people at all levels to speak the truth?

8. Have you identified or appointed independent Risk and Ethics Ambassadors at all levels to advise on and monitor risk and ethical dilemmas and to report to appropriate line managers (HR/Legal/Risk if appropriate)?

9. How clearly articulated is your organisation's remuneration and reward structure to encourage and reward balanced risk taking and ethical decision making?

10. How firmly is your organisation opposed to individual gain and corporate excess in its relations with ALL its stakeholders?

The information collected from the Risk and Ethics Culture Assessment (and ideally, in addition, a customised Risk Pulse Survey), will be based on verbal feedback, anecdotal evidence and individual perceptions – all useful but not precise.

Secondly, in order to give additional credibility to the investigative process it will be desirable to provide "hard" evidence about the actual values being displayed, their links to risk balanced decision making and the reported differences in how people (and by extension the organisations they work for) behave at work compared with their more "authentic" self in a home or social environment.

One such measuring tool is MoralLDNA™ Profiling (MDNA). More than 150,000 people from over 170 countries have participated in this validated psychometric instrument. MDNA measures the following:

Ten moral values (eg Courage, Prudence, Self Discipline, Fairness , Trust, Hope, Love, Honesty, Humility and Excellence and) which underpin the 3 Ethical Consciences that help significantly to determine our decision making.

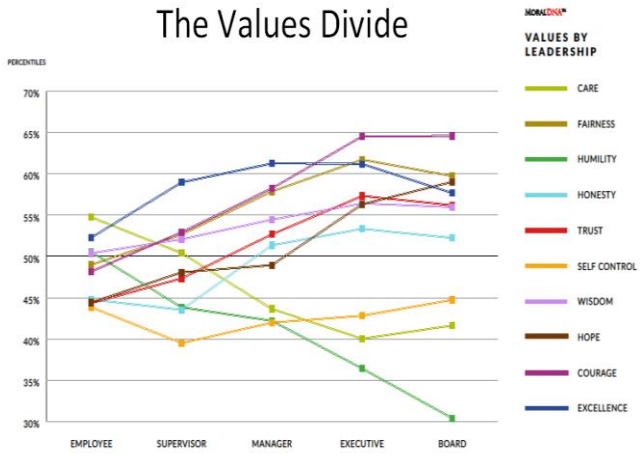
- Ethic of Obedience (eg Rule Compliance, spirit of the law etc)
- Ethic of Care (Empathy, Concern, Respect etc)
- Ethic of Reason (Wisdom, Experience, Prudence etc)

Measuring MoralDNA™ across an organisation makes it possible to assess the overall ethical and cultural biases.

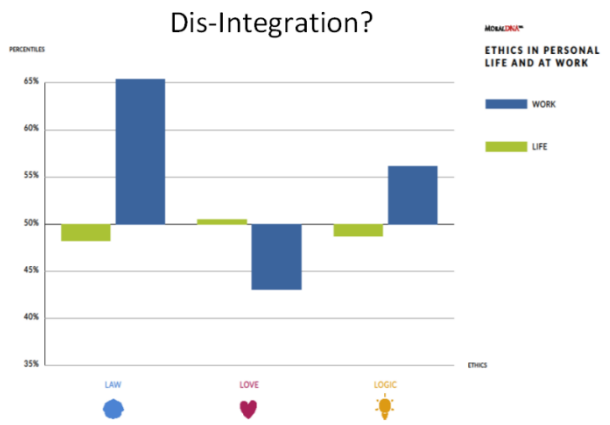
Individually it can also highlight the socio/psychopathic tendencies (noted by us, interestingly, in many analytics as being more prevalent in senior roles) which can lead to poor or even disastrous decisions, since they are often ego based rather than holistic.

These analytics can be further refined to measure age, gender, geographies, divisions, teams etc to establish if different groups have different ethical stances. Often critical insights are gained from these, which allow deeper questioning of internal behaviours and culture.

Two examples are given below:



Note how Humility, Self Control and Care fall away as executives climb the ladder. Lack of these three values leads to Arrogance, Greed and Care-lessness. Sound familiar?



Note the swing toward Rule Compliance (Law) at work and away from Caring (Love) justified by Reasoning (Logic). This happens much less with family and friends though, our natural social behaviour.

So what does it take to do the RIGHT™ thing?

The word RIGHT itself is a useful mnemonic – standing for:

- R-ules – do we know and operate within them (letter and spirit)?
- I-ntegrity – Do we act out ALL ten moral values that we call Integrity as a general term?
- G-ood – Is our decision making intended to do Good – for whom? (Stakeholders?)
- H-arm – Will our decision making cause unintentional harm - to whom? (Stakeholders?)
- T-ruth and T-ransparency. Can we stand behind our decision with a clear heart? Will it stand public scrutiny?

RIGHT is a straightforward principles driven decision making framework which can be used when faced with almost any risk or ethics dilemma, and it is based on a culture of decency and integrity.

It addresses a key question which all senior executives must ask themselves: "How do I know how all the people in my business unit make (and take) decisions?". Do you have a consistent methodology to prevent "rogue" decisions or ones which have not been fully shared and discussed?

If bankers had stopped to ask whether PPI was actually "fair" (what should be a core value for any organisation) for the consumer, they might have saved themselves tens of £billions of fines!