



European Risk Management Council

Risk Landscape Review

March 2018



- **Message from the World Economic Forum**
- **China's political leadership**
- **Cyber security score**
- **Risk Management Survey**



DEAR READER,

I am delighted to present the Q1 2018 edition of the Risk Landscape Review. This time the Review is linked to two Council's events: 2018 European Leadership Meeting that took place in March and an inaugural Risk Council's meeting in Hong Kong which will take place in May and will be dedicated to China's political and economic risks.

Dr Lee Howell, Managing Director, Head of Global Programming and Member of Managing Board of the World Economic Forum, delivered his keynote address at 2018 European Leadership Meeting. He kindly agreed to include a text of his speech to this publication. His main message is about tectonic changes that are happening in our society and about the leadership that the modern society is required to address risks and challenges of the fast-changing world.

In the global economy of 21 century, China plays a role of an engine which drives the global economic growth. At the same time, recent political changes raise reasonable concerns in Europe and the US. Humphrey Hawksley, the BBC's former China Bureau Chief and the author of the acclaimed "Dragon Strike", discusses in his article potential consequences of the new China's political leadership style.

We also include a monthly update of cyber security scores for a sample of organisations, Council's members. The assessment suggests that in the last 30 days the cyber protection has deteriorated for most organisations included to the sample.

Finally, we would like to present results of a survey that the European Risk Management Council conducted at 2018 European Leadership Meeting. The survey was focused on main trends in the risk management as well as "hot" areas like financial regulation, fast technological changes and cyber security that senior leaders in risk management have to deal with.

My huge thanks to all contributors.

Enjoy the reading.

Yours sincerely,

Dr Evgueni Ivantsov

Chairman of European Risk Management Council



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Adapting as Leaders to a Fractured World Keynote Speech at 2018 European Leadership Meeting

*By Dr Lee Howell, Managing Director, Head of Global Programming
and Member of Managing Board, World Economic Forum*

Good morning Ladies and Gentlemen –

When Evgueni invited me to speak, he suggested that I first share some reflections from the recent Annual Meeting of the World Economic Forum in Davos, Switzerland. Hardly an easy task to sum up the Zeitgeist where 3000 leaders participated in over 600 working sessions related to various Forum initiatives or communities.

That said, it was an indeed historic event – notable at least for me for the biggest snowfall in over 20 years but also for the presence of over 70 heads of state or government, including the Prime Minister of India at the opening as well as six world leaders from the G7 – and for what many in the public noticed and appreciated perhaps the most of all, was an exceptional cohort of Co-Chairs who happen to all be women. Fitting to share this point I think on International Women’s Day.

This last point is also particularly salient because the Annual Meeting in Davos is a creative force for engaging the world’s top leaders in collaborative activities to shape the global, regional and industry agendas at the beginning of each year. It’s clear we need more diversity of thinking to fulfil the World Economic Forum’s mission – improving the state of the world.

This mission also drives the design and development of the Annual Meeting.

Participants come together in an exceptional atmosphere – which we term the “Spirit of Davos” that comes from interdisciplinary thinking and informal interaction among peers and with key stakeholders. This “software” is something I believe we share in common with the European Risk Management Council.

But in fairness to Evgeni, I will call out one topic as standing out in Davos for me and a conversation yesterday has further convinced me of its importance.

Data was something that stood out in Davos as many leaders, including the Prime Minister of India, President of France and the UK Prime Minister, highlighted its increased importance – some going as far as to equate data as replacing oil in terms of its importance to the global economy. And indeed, the importance of data is obvious in our everyday lives.

I teach a course each spring on disruption and innovation in international business at the University of St. Gallen (which the FT just recently has ranked once again as the top Master in International Management program in Europe). I start each course with a slide of the five largest companies globally in terms of market capitalization (eg. Amazon, Alphabet, Apple Facebook and Microsoft) – and my students yesterday were quick to pick out that the companies are all data driven platforms. But they were also concerned that none of them were European companies and that their likely future competitors were more



likely to be Chinese firms like Alibaba and Tencent. Data is now one of many fault lines in the context of the theme in Davos which was “creating a shared future in a fractured world”.

Indeed, I think most of us here today would agree that the global context has changed dramatically: geostrategic competition have re-emerged on multiple fronts with wide-ranging political, economic and social consequences. The use of tactical nuclear weapons is no longer just a relic of the Cold War. Economic prosperity and social cohesion are not one and the same. The global commons cannot protect or heal itself.

Politically, new and divisive narratives are transforming governance; policies are being formulated to preserve the benefits of global integration while limiting shared obligations such as achieving the sustainable development goals or ensuring that the Fourth Industrial Revolution promotes inclusive growth. Socially, citizens yearn for responsive leadership; yet, a collective purpose remains elusive despite ever-expanding social networks. All the while, the social contract between states and their citizens continues to erode.

One could infer from this notion of a fractured world, and many have, that Realpolitik has also returned to world affairs. As King’s College historian John Bew observed in his 2016 history of the term, the pendulum swing is to be expected: “Our foreign policy debates follow cycles, in which policymakers declare themselves more idealistic, or more realistic.”

But Bew’s survey also reminds us that the singular pursuit of national interests – the type of worldview championed by certain countries – is not Realpolitik at all if it is uncoupled from a transformative idea or normative purpose. Severing norms from global affairs only weakens global governance.

In fact, the concept of Realpolitik emerged from the mixed outcomes of the European revolutions of 1848, when Germany’s future unification had many possible permutations, but the larger political goal – an international order comprising of strong nation-states – was nonetheless clear. In the wake of the “America First” doctrine, the challenge for the world today is to discern what is the purpose of political realism.

One clue as to what it should be was shared a year ago in Davos when Chinese President Xi Jinping offered a robust defence of globalization and emphasized his view that in pursuing national agendas, countries should place objectives “in the broader context” and “refrain from pursuing their own interests at the expense of others.”

If leaders of the world’s two most powerful economies differ fundamentally in their approach to international relations, what are the prospects for strengthening cooperation globally?

History is replete with examples of conflicts stemming from a rising power challenging the influence and interests of an incumbent. How China and the US avoid what Harvard’s Graham Allison has termed the “Thucydides Trap” is of great importance to the world, as is ensuring that geostrategic disputes elsewhere don’t lead to violence. During the Peloponnesian War, according to the Greek historian Thucydides, “It was the rise of Athens and the fear that this instilled in Sparta that made war inevitable.”

But Stanford biologist Robert Sapolsky has argued, behavioural dichotomies that might seem inevitable and crucial one minute can, under the right circumstances, “evaporate in an instant.” For Sapolsky, “contact theory,” which was developed in the 1950s by psychologist Gordon Allport, can foster reconciliation among rivals, and help bridge the “us-them” divide. “Contact,” whether



between kids at a summer camp or negotiators around a table, can lead to greater understanding if engagement is lengthy and on neutral territory, outcome-oriented, informal, personal, and avoids anxiety or competition. Perhaps this came into play at the Winter Olympics in South Korea — or perhaps not.

But what is said during these engagements is crucial. As the Nobel laureate economist Robert J. Shiller has noted, stories, whether true or not, are drivers of major decisions, especially economic choices. In his study of “narrative economics,” Shiller highlights the effects that “viral” stories can have on the global economy. He points out that people’s choices and assessments of current events are partly based on the stories they have heard about past events. For example, the 2007-2009 global financial crisis is called the “Great Recession” because the traumatic tales of the Great Depression persist in our collective memory.

Words and narratives affect international affairs in similar ways. Narratives that have emerged in response to – or as a result of – national, regional, and global divisions are often structured by an “us-them” dichotomy. But these national narratives, as appealing as they may be to some, must not be confused with Realpolitik, as they remain bereft of the innovation, inspiration, and idealism needed for transformational change.

Stories that seek to preserve the singular benefits of global integration, while limiting shared obligations, may in fact go “viral” domestically, because citizens yearn for responsive leadership that addresses local and national concerns. But a shared identity and collective purpose remains elusive, despite the fact that we are living in an age of social networks.

However, a fractured world does not absolve governments of their regional and global

responsibilities – hence the theme of Davos this year. The political, economic, and social fractures that have emerged must not foster intolerance, indecision, or inaction – if so, then we will face even greater uncertainty. And unlike risk, true uncertainty does not allow for us to assign a probability or mode of occurrence.

Most people today were either born during or after the Cold War when US leadership in world affairs was taken for granted to some degree. I am certain that the emergence of a multi-polar, multi-conceptual world will present many adaptive challenges going forward with respect to global governance. What do I mean by adaptive challenges?

Harvard University Professor Ronald Heifetz, who is a psychiatrist researching leadership, argues that the single biggest failure of leadership is treating adaptive challenges like technical problems. His research suggests two types of leadership challenges: adaptive and technical change. When the problem definition, solution and implementation are clear, we can categorize this as a technical change. In contrast, an adaptive change requires a novel solution and new learning. His conclusion is that adaptive change must come from the collective intelligence of an organization not just its leader. It also requires an organization to learn its way towards new solutions rather than simply search for known solutions.

However, leaders still run the risk of treating a problem as already having a known solution when the challenge is in fact a novel one. And in this regard hindsight bias is particularly pernicious. Safety expert Sidney Dekker warns that hindsight bias can lead us to be:

- *Counterfactual* by laying out in detail “what people could or should have done to prevent the mishap.”
- To be *Judgmental* by “judging people (e.g. not taking enough time, not paying enough attention, not being sufficiently



motivated) for supposed personal shortcomings.”

- And to be *Linear* in our analysis by seeing “a sequence of events as linear, leading nicely and uninterruptedly to the outcome we now know about. Had we seen the same situation from the inside, we would have recognized the possible confusion of multiple possible pathways...”

- Which means *Oversimplification*: “as we are able to trace a sequence of events backwards (which is the opposite of how people experienced it at the time) we easily couple “effects” to preceding “causes” (and only those causes)...”

But in the absence of a novel hypothesis or an original paradigm, leaders will need to learn new means and methods, but also, possibly, engage in experimentation in global governance. This is another source of anxiety as the prospect of muddling through such adaptive challenges as climate change, cybersecurity or the Fourth Industrial Revolution is disconcerting to say the least.

Our aim here today clearly should not be to predict the future. It is worth noting that a decade ago the political scientist Philip Tetlock demonstrated that it is nearly

impossible to achieve accurate, long-term political forecasting.

From a behavioural perspective, his key insight was in showing that political analysts were not only overconfident about what they know about the future but were also reluctant to change their minds in response to new evidence. Therefore, it was not surprising that the accuracy of long-term forecasts was no better than chance. Put another way, political forecasters who are self-critical and avoid simple heuristics are relatively better at assigning probabilities to future outcomes than their opposite. Tetlock’s research has also found that people who are younger and of lower status in an organization (versus older and higher status) are more enthusiastic about assessing the accuracy of probability judgement.

Umberto Eco, the late Italian academic and novelist, came to see the world as a harmless enigma. But he also observed that it was an enigma “made terrible by our own attempt to interpret it as though it had an underlying truth.” This snippet of philosophical wisdom is perhaps as important to heed when dealing with uncertainty in the year ahead.



Caution on Branding China's New-Style Dictatorship*

By Humphrey Hawksley, the BBC's former China Bureau Chief and the author of the acclaimed "Dragon Strike"

** Originally published by The Ambassador Partnership on 22 March 2018*

The recent vote by China's National People's Congress allowing President Xi Jinping to remain in office indefinitely caps a period in which China has propelled itself robustly onto the world stage. Since 2013, Xi has implemented his massive trade and development Belt and Road Initiative across Asia and Europe, while simultaneously turning reefs and islands in the South China Sea into military bases which are illegal under international law and could threaten global shipping.

In many respects, Xi can be viewed as an archetypal dictator, projecting power, creating a cult of himself and using a rubber stamp parliament to do his bidding. But such stereotyping carries high risk, particularly among Western democracies dealing with the simplistic narratives of the 24-hour news cycle. All too easily they can conflate Xi into a Mugabe, Assad or Putin whose actions must be stopped.

A confidently authoritarian China has now created a situation whereby the extent to which any government can exercise leverage depends largely on its economic and military muscle.

Cambodia, Laos and other weak Asian countries are now little more than client states and even the United States must balance priorities. Long gone are the days when Western leaders lectured China about its democratic deficit and a

row over an airbase on a remote island should not prevent cooperation in preventing nuclear war with North Korea.

Beijing's seven new bases in the South China Sea have become a high-profile fault line between China and Western democracies, symbolizing international law against illegal hegemony. The US regularly carries out Freedom of Navigation operations to test Chinese military resolve.

Any confrontation would have global consequences and, should this happen, whether by intent or miscalculation, it is crucial that the response is not driven by media-headlines, but remains calm, fact-based and measured.

The US and its allies carry immense leverage with China. European and American trade is the bedrock of China's success meaning that Beijing needs them more than they need Beijing.

In the starkest terms, a 2016 Rand Corporation report estimated that a year-long Sino-American conflict would lead to only a 5-10 per cent loss of US gross domestic product, but a 25-30 percent drop for China. This would risk civil unrest and challenge the Communist Party leadership that Xi Jinping wishes to hold for many more years.

Unless he becomes riddled with hubris, Xi will avoid such a scenario at all costs, and there are already signs that he is rowing back from his previous stance of openly challenging the current US-led world order.



In two key speeches last year, in Davos and then in Beijing for the Belt and Road summit, Xi made no mention at all of international law, the bedrock of the current rules-based system that he had been dismissing as invalid.

Yet, in January this year, when announcing its policy in the Arctic, that new frontier for shipping and fossil fuel extraction, China cites international law fifteen times with ten direct references to the United Nations Convention of

the Law of the Sea, the very statute that Beijing has violated over the South China Sea.

It may then be the case that China is adopting a time-honoured practice among rising powers. In the South China Sea, Xi is securing his own back yard with guns while opting for trade and diplomacy in the wider world. Unlike the US and European colonialism before it, China has so far achieved its global expansion without a shot being fired in anger. Xi's intention, for the time being at least, is that this track record continues.



Cyber Protection Through the Lens of a Hacker

European Risk Management Council works with Cyber Rescue Alliance and SSC to provide crucial information for Boards and CROs on cyber vulnerabilities visible for hackers. As an initial step, in February 2018 we performed an analysis of a random sample of organisations - Council's members (about 1/3 of banks, insurers and asset managers who participate in Risk Council's activity). We used the SSC methodology of a comprehensive scan of company's cyber ecosystem and assigned "hacker's scores". The technology is non-intrusive which allows to monitor and detect system vulnerabilities without getting an access to the system.

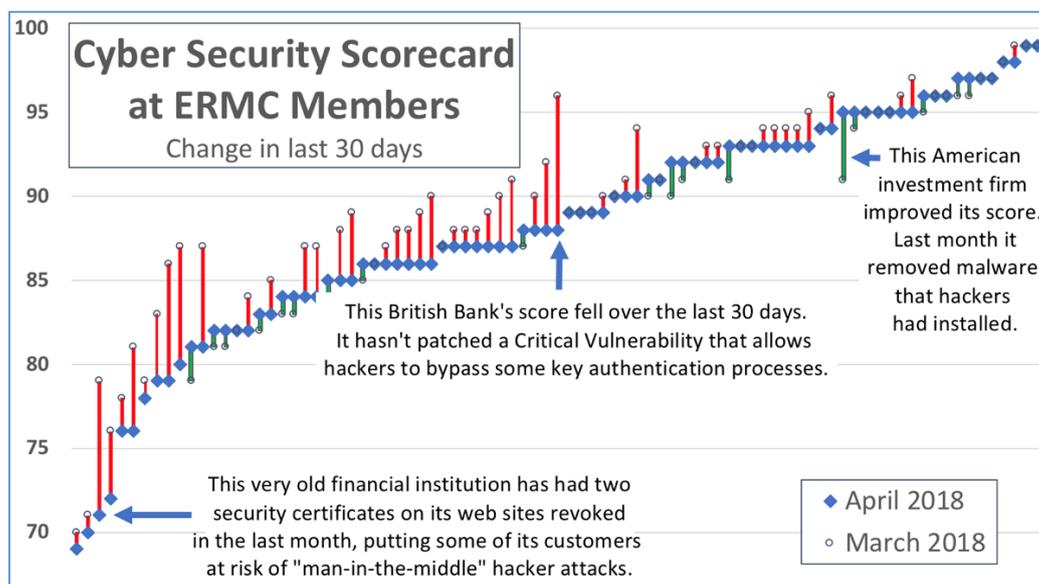
At the start of April 2018, we have re-assessed the cyber risk of the portfolio and found that:

- 73% of organisations in the sample display critical vulnerabilities in at least one part of their network

- 59% of organisations are still running software that is no longer supported by suppliers
- 11% of organisations are running websites where encryption has failed.

The graph below shows how the cyber security posture of each Council member in the sample has changed over the last 30 days.

Overall, the cyber protection of organisations in the sample has deteriorated and the cyber security score of the portfolio has gone down. Some firms experienced a significant change of their security score. For example, one British bank included in the sample has failed to patch software that allows hackers to bypass authentication processes. A smaller number of firms in the sample have improved their scores (e.g. American investment firm has improved its security by removing malware).





Risk Management Survey

We are pleased to present results of a survey that the European Risk Management Council conducted at 2018 European Leadership Meeting on 8 March 2018. During the day, our session moderators asked Meeting delegates to answer various questions on risk management using the audience voting system.

The survey findings are based on responses of 162 delegates – senior decision-makers of which 93 delegates were from C-suite (CROs, CEOs, Chairmen, other C-level) or Board members. The delegates represented 113 organisations of which 84 were financial services companies and 15 regulatory bodies, government organisations, industry associations and NGOs. We wish to express appreciation to all Leadership Meeting delegates who participated in the survey.

The survey results suggest that a risk landscape of the financial services industry is becoming more complex. New risks that did not play a visible role several years ago have emerged and started its domination. They interplay with traditional risks. As a result, financial institutions are facing a variety of emerging trends that introduce greater uncertainty than ever before.

One of the key questions that we asked our respondents was about challenges that their organisations faced. Growing regulatory requirements and regulatory uncertainty were named as a number one concern. Failure to implement digital innovations and political risks came as the second and third most serious challenges respectively.

These answers match to some extent with answers of respondents to a question about causes of the next major shock to the financial services industry. A major political risk event (e.g. Brexit) was mentioned by 21% of respondents, while a massive cyber-attack was selected by 19%. Interestingly, unintended consequences of regulation were mentioned by respondents least as a potential cause of the next crisis despite respondents' opinion that the regulatory uncertainty was a No 1 challenge for their organisations.

The increase in regulation is considering as a serious burden. Answering questions about the regulation, respondents highlighted that cost of implementation of regulatory changes and resources required to demonstrate compliance with rules were their biggest challenge.

One of the most worrying messages of the survey was that almost one third of respondents admitted that their organisations had insufficient capability to monitor, identify and manage extreme systemic risks. Only 2% agreed that their organisations had advanced capability.

Respondents were quite positive about the future of a CRO role. Only 4% believed that in the next 10 years, a CRO role would diminish. Majority expected that a CRO role would become more strategic, more business-decision oriented and a CRO would become a risk advisor to the business and the Board.

Answering questions on digital innovations in risk management, respondents selected more often cyber security and data analytics as two areas where their organisations would invest



in the next 12 months. Interestingly that blockchain was not selected often as an area for investment, in spite of all publicity that blockchain has had in the last several years.

Answers to cyber security questions revealed that decision-makers were struggling to agree on how best to respond when hackers break through. For example, when the first sign of data breach appears, half respondents would inform the Police, while half wouldn't.

An unrehearsed desire to do the right thing risks making a cyber crisis much worse. For

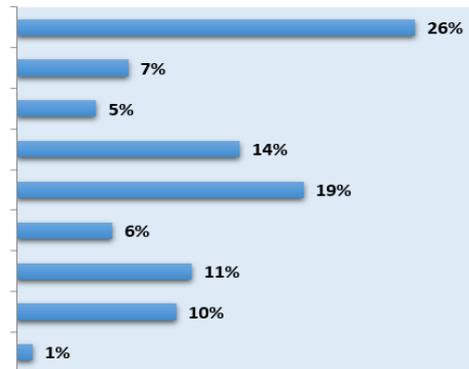
example, 67% of respondents voted to inform customers of a data breach "immediately". Only 9% recognised that 72 hours of preparation could make such notification much safer.

A lack of a coherent and robust approach among decision-makers on a cyber breach mitigation is a serious warning signal for the industry, especially in the light of fast-growing risk of cyber-attacks.

Survey Questions

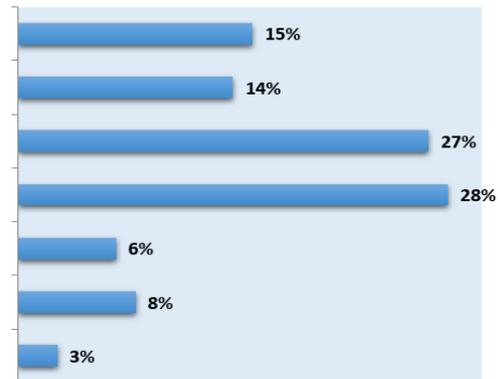
What are the most serious challenges for your organisation?

	%
1. Growing regulatory requirements and regulatory uncertainty	26%
2. Increasing competition	7%
3. Unfavourable macroeconomic climate	5%
4. Political risks and uncertainties	14%
5. Failure to implement digital innovations	19%
6. Failure to meet changing customer needs	6%
7. Failure to change corporate culture	11%
8. Failure to attract and retain talents	10%
9. None of the above	1%
	100.00%



What is your current expectation on Brexit ultimate outcome?

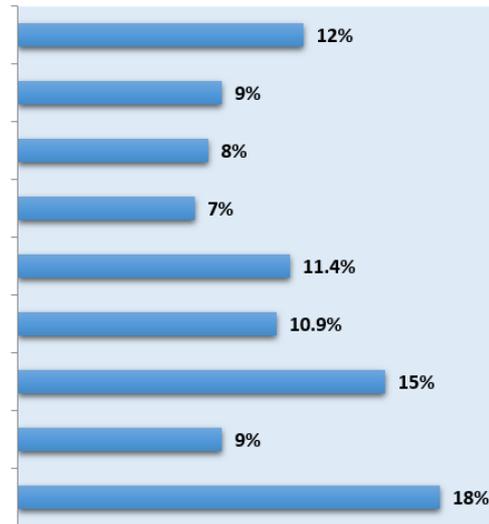
	%
1. Hard Brexit - no deal with EU	15%
2. Clean Brexit – UK has a "divorce deal" only and no tariff-free access to the single market and customs union	14%
3. Limited Brexit – tariff-free trade in goods but no access for services markets	27%
4. Creative Brexit – tariff-free trade in goods and bespoke deals for services	28%
5. Soft Brexit - UK stays in the single market and the customs union	6%
6. No Brexit – Brexit process will be stopped and UK will remain in EU	8%
7. None of the above	3%
	100.00%





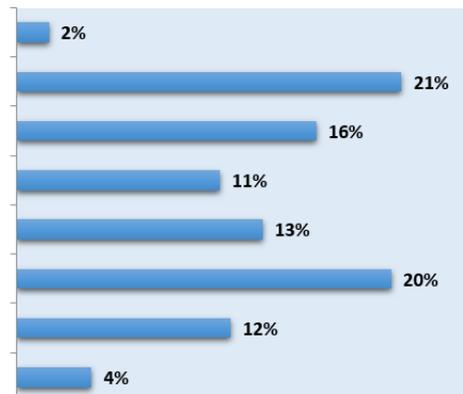
Which of the following areas still require further enhancement?

	%
1. Tone at the top	12%
2. Role of the Board and Board Risk Committee	9%
3. Common risk language	8%
4. Customer-centric thinking	7%
5. Consistent application of risk management principles	11.4%
6. Timely, transparent and honest communication	10.9%
7. Accountability of senior managers	15%
8. Risk reporting and whistle-blowing	9%
9. Aligning compensation with risk-adjusted performance	18%
Total	100.00%



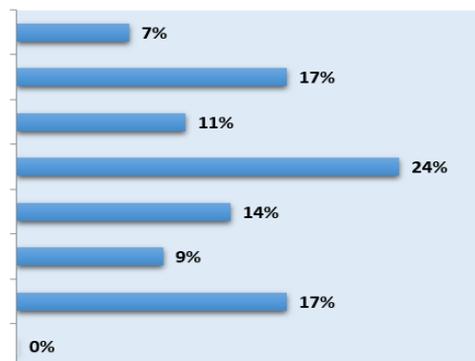
How will the CRO role change in the next 10 years?

	%
1. Not much change	2%
2. Become more strategic	21%
3. Become more of a risk advisory role to the business and the Board	16%
4. It will merge with the Chief Technology Officer's (CTO's) role	11%
5. Become more analytic and quantitative	13%
6. Become more business-decision oriented	20%
7. Will be focused more on regulation and compliance	12%
8. Will diminish and be replaced by artificial intelligence	4%
Total	100.00%



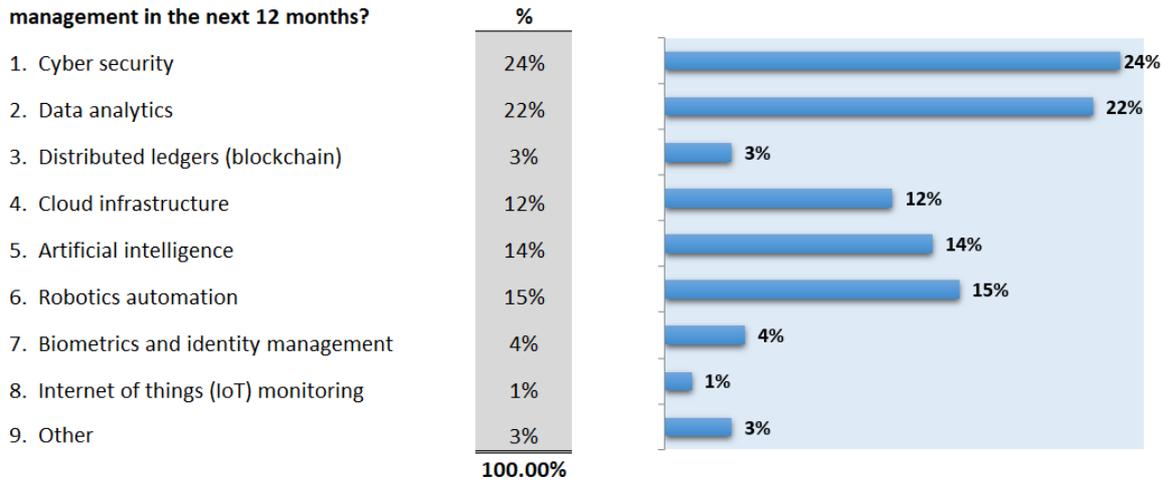
What are the biggest challenges that the risk management function faces when implementing new technology?

	%
1. Regulatory uncertainty	7%
2. Insufficient knowledge, skills and expertise	17%
3. The culture of the organisation	11%
4. IT infrastructure and IT resources	24%
5. Lack of funding	14%
6. Fintech incompatibility with existing operational processes	9%
7. Time pressure due to other priorities	17%
8. None of the above	0%
Total	100.00%

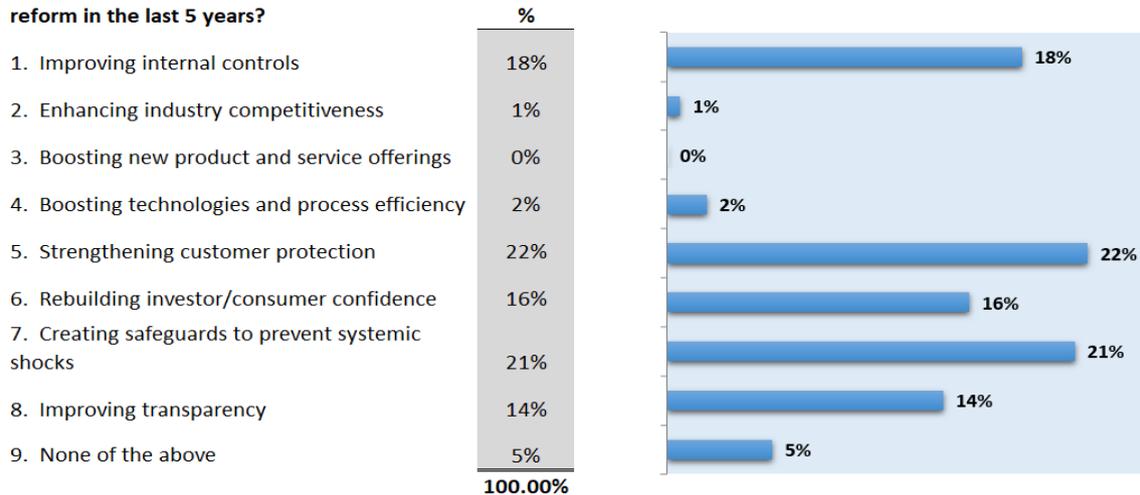




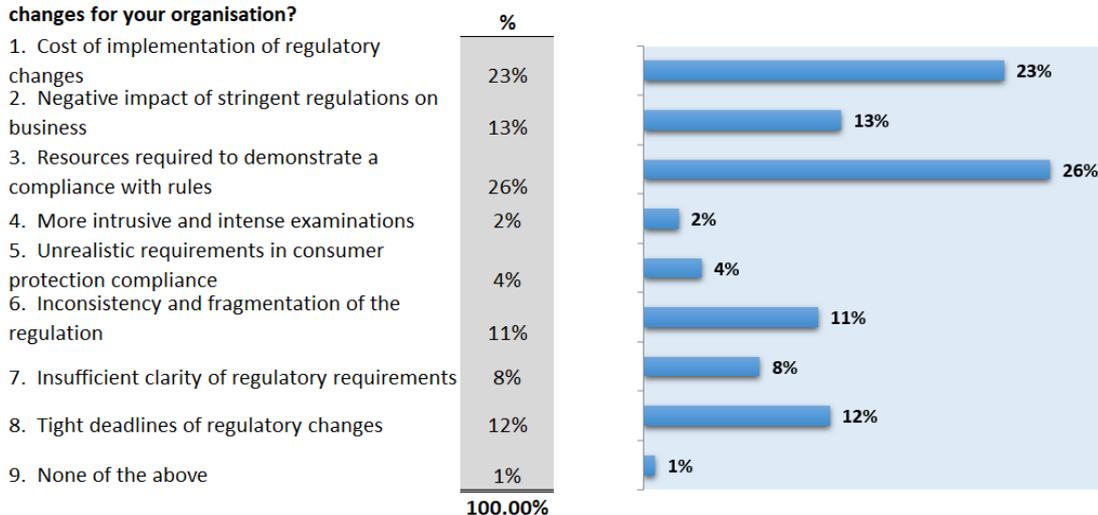
Which digital technologies is your organisation planning to implement to enhance risk management in the next 12 months?



What are the biggest benefits of the regulatory reform in the last 5 years?



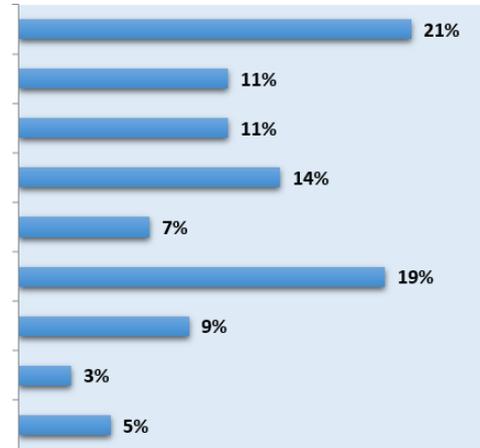
What are the biggest concerns about regulatory changes for your organisation?





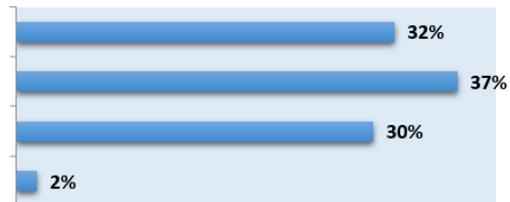
In your opinion, what might cause the next major shock to the financial services industry?

	%
1. Geo-political event (e.g. Brexit)	21%
2. Interest rate shock	11%
3. Government debt crisis	11%
4. Asset bubble	14%
5. Rise of populism	7%
6. Massive cyber attack (cyber war)	19%
7. Major technology failure	9%
8. Unintended consequence of regulation	3%
9. Unintended consequences of AI	5%
	100.00%



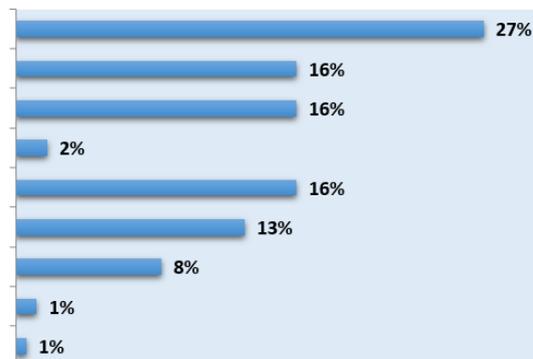
How would you characterise your firm's capability to monitor, identify and manage extreme systemic risks?

	%
1. Insufficient	32%
2. Developing	37%
3. Adequate	30%
4. Advanced	2%
	100.00%



When some indications of a data breach appear, who do you inform?

	%
1. Key executives	27%
2. Regulators	16%
3. Police	16%
4. Customers	2%
5. IT Department	16%
6. CiSP	13%
7. Forensics	8%
8. Other	1%
9. No One	1%
	100.00%





**If there are indications of customer data breaching,
when should you inform your customers?**

	%
1. Immediately	67%
2. In 24 hours	15%
3. In 48 hours	4%
4. In 72 hours	9%
5. In 7 days	0%
6. In 28 days	0%
7. Don't inform customers	4%
	100.00%

