

South Wales & SW of England IRM Meeting

Meeting Notes

Date:	24/10/2007	Location	Marsh Offices, Victoria Street, Bristol
Chairman	Fergus Dolan, Marsh		
Secretary (acting)	Mark Swabey, Risk Reasoning Ltd		
Attendees:			
Name	Company	Name	Company
Dave Kaye	Risk Reality	Ailsa Collins	SWH Ltd
Steve Fowler	IRM	Alex Coombes	Mitie Group
Mat Hobbs	Mitie Group	Tony Cherry	Beachcroft LLP
Mike Jones	Principality Building Society	Ben Davies	MACE Ltd
Jai Mahadeshwar	Rio Tinto	Éadaoin Mac Donagh	Davis Langdon

1 Introduction

Chairman welcomed all those attending

2 Agenda

- Steve Fowler will be providing the IRM news.
- A photograph session is also planned.
- Due to the O2 risk manager being called overseas, the planned presentation is Supply Chain Risk Management.
- Mike Jones will be providing a discussion on the sub-prime effects on the financial sector

3 IRM News – Steve Fowler, IRM

3.1 Diplomas and certificates

Last month IRM launched its brand new international diploma which will be coming into use in 2008.

The diploma is based upon international practice and law of the student's relevant country. It is pitched at a slightly higher level than the existing diploma as a result of feedback from other professions, and consequently will now be equivalent standard to other professional qualifications.

2 years ago, the Certificate was introduced, a lower level introduction to risk management.

If you want to know more and/or apply then look at the IRM website. The deadline for signing up onto the courses is now the 14th December.

3.2 We want you!

The IRM is on the lookout for more examiners, particularly in:

- Corporate governance
- Regulation
- Operational risk issues – especially risk & organisation

Both assistant examiners and senior examiners are required, and workload can be tailored to your availability. The rates for examiners are going up too! Anyone interested should contact Steve Fowler.

3.3 IRM Risk Forum

For those who didn't attend the IRM Forum, you missed an excellent event with plenty of opportunity for networking – *OK, the view of Mark & Fergus anyway!* The next IRM Forum will again be at Hatfield next September.

Volunteers are needed to join the team moulding next year's event. Discussions will take place by audio conference.

3.4 IRM AGM

The IRM AGM takes place on 5th December. Part of the AGM will include the election of new directors. One third of the board stand down each year, and there are a good number of candidates for election this year. MIRM and FIRM members can and should vote to ensure that you get the representation that you want.

The Annual accounts will be available in November.

3.5 International News

International agreements have been signed with Sweden and Poland, and discussions are proceeding with Finland, Denmark, Norway and the Czech Republic. A key aspect

of this is that English is the predominant business language in these countries. In contrast, there is far less interest in Western and Southern Europe.

Agreement to promote the IRM qualification has been reached with the Malaysian Insurance Institute, whose scope is far wider than insurance and encompasses risk management.

3.6 Online knowledge library

For the new diploma, all materials will be available online, as a result of the setting up of a new knowledge library. This library will be available to members of the IRM and should grow in time to be a comprehensive resource.

4 Fergus Dolan – a new FIRM

Fergus has just achieved the prestigious fellowship of the institute. This was celebrated by a photo session for mutual embarrassment and publicity.

Congratulations Fergus!

5 Presentation – The Supply Chain by David Kaye FCII FRSA FBCI MIRM

David concentrated on the special exposures of outsourcing and the critical dependencies that are created, bringing a whole raft of risk and impact surprises.

The presentation slides will be available on the website

Points coming out of this presentation included:

Outsourcing to third parties may be a risk spreading opportunity as well as a threat..

Reliance on 3rd party business continuity plans is not sufficient – they have different agendas and objectives to your organisation, and their concept of business continuity management may be very different to yours.

The concept of the hollow company is possible, containing:-

- Brand
- Intellectual Assets
- Value chain contracts including ‘front-office’
- Legality & control
- Stakeholder confidence
- New financial and business expectations

The problem is the management and control of the supply chain (which includes distribution) and the retention of that chain. Note that if competitors pinch your supply chain and distribution, they have effectively pinched your business!

So the supply chain project is where risk management begins.

Beware the supply chain project engineered by a career-building director – you may only be called in to ratify the deals he is setting up, and will be deeply unpopular when you raise risks at that point. Risk should be considered as soon as outsourcing starts being discussed.

Risk management in supply chain, as in any other area, is the application of common sense and GETTING HEARD. Supply Chain issues measures include volume, spend, specifications and quality.

But be warned – if the sole purpose of outsourcing is to save money, surveys have shown that it rarely works out that way, but often increases business risk.

SLA's define what happens when things are going well – but how many have you seen that define what happens when things don't work or go badly?

Relationship management is a critical part of risk management in the supply chain, but it is well worth defining an Exit Strategy and 'pre-nuptials' before entering into an agreement.

47% companies experience supply chain losses. When things go wrong, the skill is in maintaining the balance of power throughout an Exit Strategy, to minimise loss.

In summary:

- Outsourcing is much more than subcontracting
- Wide-area relationship management is key
- Prevention vs. cure equation must be different
- Suppliers will always retain their own objectives first
- Whose problem is it?
- Plan interfaces

Questions

Fergus Dolan: Business Continuity planning is claimed by many suppliers – what is your experience of the situation?

David Kaye: BCP needs to evolve as risk management has done from the role of only purchasing insurance products. BC still shows its roots of IT and workplace replacement, but is showing definite signs of growing far wider than that now. The problem is that with BS 25999 and certification, there is a danger of assuming

resilience and thus that your organisation has been identified in their BIA as one of the suppliers key customers. This may not be so.

6 Round Table Discussion – The Sub-Prime Crisis

Fergus Dolan introduced the session by pointing out that:-

- sub-prime losses currently stood at some \$49B
- there are currently 10 class actions against financial institution directors. A lot of the companies concerned don't buy (or buy very low) Director & Officer Liability (DLO) units.
- Regulatory investigation and action can lead to officers own liability
- There is potential for derivative action by shareholders against directors
- This is having a direct impact in the south west with some funds drying up.

Mike Jones, Head of Risk, Principality Building Society has agreed to guide the session. Mike has worked in credit risk for many years, formerly with a high street bank, and currently with a regional Building Society..

Mike Jones:

The US markets over the last year have seen:

- falling house prices,
- rising consumer indebtedness,
- volatile interest rates and
- increasingly complex institutional funding vehicles [Securitisations/CDO's/SIV's].

Globally, this has impacted on other markets due to:

- International liquidity & funding issues – risk appetite
- Global reach of US Investment Banks
- Relationship between US & UK money markets

• Gross Margin/Treasury Management - [Pricing Risk]

- Hedging versus judgemental Balance Sheet Risk management
- Swaps – insurance against impact of interest rate movements on product profitability

Regarding the recent problems of Northern Rock – Were these Generic Risks and were there any early signs?

Some first signs were apparent from the half year results, around pricing risks; where the impact of interest rate movement could have been insured/hedged but an element of this exposure was taken as a risk on the balance sheet. This can lead to a mismatch in interest rate risks which can be difficult to pass on to customers.

Alex Coombes: This can happen in other areas as well – even in cleaning services on a fixed price contract where the impact of the introduction of minimum wage legislation

David Kaye: Risk has a price. If lending to sub-primes the borrower must need a higher return to cover the risk.

Ben Davies: The construction sector is now waking up to risks within contracts and consequently modelling risk in more detail.

Tony Cherry: Another volatile area is in raw materials pricing, especially metals recently, which can substantially affect supply costs.

Mike Jones:

• **Liquidity Shock – [Supplier/ Concentration Risk]**

- Retail versus wholesale funding
- High dependence on supply of wholesale money
- Supply short & price high

Building Societies are governed by different legislation from Banks. These are generally more conservative, which reflects their underlying ethos and it is possible that some Societies de-mutualised in order to benefit from more flexible rules relating to funding & capital management. There are inherent dangers which can result from over-reliance on wholesale funds, as opposed to Retail savings deposits.

Dave Kaye: Why didn't they stop new lending and just exist on current lending?

Mike Jones: They used securitisation – selling on future revenue streams to finance current lending. This is off balance sheet. But as market froze, so couldn't sell forward. They now have lines of credit etc but future negotiations will be very tough.

Dave Kaye: So they were strangled by the business that they had already done.

Mike Jones

• **Housing Recession – [Diversification Risk]**

- Non diversified business
- Demand for Retail Mortgages linked to housing market

- ‘High LTV’ lending- dependence on ‘First Time Buyer’ market

Diversification risk – if economic variables affect one product they also have knockon effects on others – rising interest rates affect house pricing and cause a drop in the 1st time buyer market, which can result in increased pressure on lenders to relax salary multipliers.

Fergus Dolan: So a building society might diversify into estate agency but still get hit there as well as the risks are still closely related and, when aggregated, diversification hasn’t reduced risk as intended, but might even have increased it.

Dave Kaye: An interesting aspect is how they handled the situation and created conflicting messages. They went to the Bank of England for expensive emergency funds saying “we are in trouble”. However, to customers they said there was no problem, and their website became overpowered as worries increased, increasing worry and inducing panic.

Dave Kaye: Where do the key responsibilities lie?

Mike Jones: Well, the media have ‘scapegoated’ a number of potential candidates, ranging from the Bank of England, FSA, Northern Rock, the press, customers, without necessarily reflecting on the impact of a highly improbable set of circumstances materialising! The FSA, as regulator is entitled to expect that firms have in place systems and controls which would enable them to mitigate ‘known’ risks.

Ailsa Collins: Also the fact that Virgin, while looking at buying the bank in question, stated that its brand was dead, can’t have helped.

Mark Swabey: The press acted as a somewhat distorted magnifier, exacerbating the situation in a very short timescale.

Steve Fowler,: Townsend Thorenson is a case in point here. The press gets hold of somebody who doesn’t have access to all the facts and inadvertently gives the wrong messages

Mike Jones

• Consumer Default – [Credit Risk]

- Deteriorating conditions – successive base rate increases
- Increased default risk

Aggressive pricing at very high income multiples could still pose difficulties for any lender in deteriorating market conditions.

Steve Fowler: If they had had another major branch elsewhere in the EU, they could have got cover from European funds and this might not have ever been visible.

Ben Davies: Was their risk appetite greater than with other lenders? Was their appetite and culture different?

Mike Jones: The cultural aspect is interesting. Key figures on the main board joined the company early in their careers and had grown with the company. Management needs challenging with views from outside, which is often provided by non-executive directors. The regulators now place great emphasis on the role of non-executive directors in providing strategic & technical challenge to the aims and methods of firms' Senior Management.

Mike Jones:

• **Stress Testing – [Liquidity & Capital Adequacy Risks]**

- Business model ['stake/liquidity/profit']

• **Strategic Direction – [Governance]**

- Understanding & 'Challenge' - Non Executive Directors
- Succession Planning

• **Brand Damage - [Reputation Risk]**

- Restoring confidence in the firm
- Impact on industry
- External Ratings Agencies

Had stress testing been undertaken? The reputational brand damage was extensive but could this have been anticipated in business modelling?

• **FSA - [Regulatory Risk]**

- Complying with legislation and 'rules'
- Fines/sanctions

There can be severe sanctions and penalties for breaching legislation and FSA rules. Companies need to share information with the FSA, who will assess the effectiveness of the company's financial risk models.

Dave Kaye: What about BASEL II as a risk measuring tool in Northern Rock's case?

Mike Jones: Basel 2 is concerned primarily with the assessment of regulatory capital requirements, and whilst great emphasis is placed upon the development of credit risk modelling, firms are also expected to consider liquidity & funding requirements as a part of a stress testing programme. I understand that Northern Rock had been granted permission to use their internal risk modelling framework to assess capital requirements, although it is difficult to tell how challenging the scenarios may have been for purpose of stress testing.

Fergus Dolan: Do you see improvements being made in the regulations?

Mike Jones: Its all there already really – its more a case of how the existing regulations are used, and this may need further consideration in future.

Fergus Dolan: Are we likely to see more regulation/audit control around liquidity?
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Mike Jones: Firms generally review their risk registers each month and the problem is being able to spot what's missing. This is where non-executive directors and experts can help to advise the board. It is important that they have that level of challenge.

David Kaye: The FSA have some very professional people but dealing with the professionalism, agendas and spin of large and multinational financial organisations cannot be easy.

Mike Jones: The FSA's resources are limited and they are entitled to expect firms to adopt suitable principles for risk management. In many instances the FSA appears to have adopted more stringent rules than other European States when considering the implementation of Basel II.

Fergus Dolan: What about the litigation fallout?

Mike Jones: Problem is that advanced credit risk management involves the use of complex maths models. It would be unreasonable for all Board members to understand the derivation and weaknesses of these models, and typically you would expect the firm to seek periodic independent external advice to gain assurance that these were accurate.

As far as borrowers are concerned the FSA expects lenders to treat all customers 'fairly' and act responsibly when deciding how much to lend to an individual. If, in the future, lenders are deemed to have acted recklessly, by, for instance, lending at extremely high income multipliers without due regard for an assessment of true 'affordability' then it is not beyond the realms of possibility that some loans could be viewed as being unenforceable, if the borrower defaults.

David Kaye: This is exactly what happened with endowment policies. Insurers were instructed by the FSA to write to customers to ask them if they felt that they had been mis-sold. Professional indemnity insurance contracts precluded soliciting claims!

Mike Jones: The consumer benefits from much greater regulatory protection than during the recession of the early 1990's. This will, in the long run, improve the reputation of the financial services industry, but firms need to be acutely aware of the changing legislative & regulatory climate when designing and selling products.

Conclusions

None of these risks are unique to the Financial Services sector. Mitigating the impact of an unprecedented 'market shock' is clearly a significant challenge for even the most sophisticated of organisations, but understanding the link between strategy & risk appetite is critical. **R.M. Jones, Head of Group Risk, Principality Building Society**

7 AOB

7.1 *Regional Planning Meeting 2008*

There will be a webex/phone conference in the first week of December between regular attendees to discuss plans for regional meetings next year.

The aim is to have 3-4 meetings around the Bristol area. Points of discussion will be venues and speakers.