A Brave New World: Redefining Regulation for the Connected era

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Russell

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Redefining Regulation for the Connected era

Regulation is the foundation on which a successful and thriving economy is built. A world without regulation, would be a world where the likes of Al Capone or Gordon Gekko would make huge profits by swindling money out of innocent individuals. Without regulation, there would be no Elliott Ness to keep the peace.

In today's interconnected world, regulation is needed now more than ever, for insurers and risk managers are sizing up a landscape that is riddled with new risks. Risks are not contained in siloes but rather flow and spread across business-business relationships, wreaking havoc on anything or anyone connected to them. These new risks will create both balance sheet and brand loss for both corporates and insurers.

Image: Pinterest

What is required is a refocusing of regulation, symbolised in a shift away from 'old-world' regulation towards new-world regulation'.

Regulation in the old-world considered the when and what of a risk. How the financial crisis started or when did the banks overleverage themselves were questions that regulators were grappling with during the 2008 financial crisis.

With the rise of new powerful and developed risks, in other words, "connected risks", the question for regulators in the new-world to address is whether. Whether a risk is severe or benign, whether a risk will entail catastrophic losses and become systemic for insurers or whether a risk will entail minimal losses.

Yet, regulators seem to be behind the curve when it comes to dealing with this new reality. The pace of technological disruption is driving great transformative leaps in areas like Big Data and the Internet of Things so fast that regulators can't keep up. This is creating a level of unease that is trickling down to insurers and risk managers who are struggling to deal with the brave new world of Connected Risk.

The Iron Regulatory Curtain

So, before we examine what 'new world' regulation looks like, let us examine what exactly 'old-world regulation' was.

The old-world regulation was born in the 2008 financial crisis. The crisis caught regulators off guard, for in the lead up to the crisis, regulation was 'light-touch'. Rather than intervening to prevent asset bubbles or reckless investments by banks, regulators got out of the way. The biggest fear for regulators and politicians alike was that heavy regulation would hurt the 'goose that laid the golden eggs', i.e. all the revenue from the banks would dry-up, denying politicians the money to invest in successful policies which would help to win elections.

After the shock of 2008, with the subsequent collapse of the likes of Northern Rock and Lehman Brothers, central bankers and policymakers vowed 'never again'.

Out went the 'light-touch' approach and in came the iron fist. Regular stress tests were introduced and the solvency margins of banks were increased. Thus, the era of global regulatory harmonisation was born, with governments across the globe introducing similar regulatory changes.

The USA kicked off this trend with the Obama Administration introducing the Dodd Frank Act in 2010 and the UK followed suit in 2011 with the Vickers reform. Both reforms split bank's operations from 'casino banking' and 'retail banking', to prevent the 'too-big-to-fail-issue' that nearly brought the financial sector to its knees.

In the frenzy of activity, there were small signs of the weakness of the old-world regulation. For the goal of regulators was to correct the when and what of the financial crisis but once again they overlooked the whether, ignoring the underlying causes of events such as the connected relationship between lower UK interest rates and sky-high house prices.

A tale of Seed and Soil

To understand connected risk and its power on regulation, let us dip briefly into the realm of science, for it holds the key to understanding why Connected Risk will be a game changer for regulators.

Scientists when discussing the causes of Cancer, refer to a process known as the "Seed and Soil", the ecological relationship between the cancer and its host. The term was coined by an English doctor named Stephen Paget in 1889, to describe the cancer's primary growth and the situation of the secondary growths derived from it.

In Paget's time, it was widely believed that Cancer spread outwards like an 'inkblot' from a primary source or central mass. Therefore, surgical techniques were designed to treat the source of the disease and any contaminations. During Paget's research, he discovered a revelation. For he discovered that cancerous growth favoured certain sites within the organ systems over other areas. For example, the liver was prone to the disease but not the spleen, despite the similar features. Consequently, his conclusion was clear, cancer, ('the seed') only developed when in the right environment ('the soil).

This same approach can be applied to new-world regulators when dealing with connected risk. In the past, regulators firmly believed that risk was triggered by an event, which spread outwards and could be contained at the source, 'the seed'. Regulators when responding to events like the 2008 financial crisis, simply treated the issue at the source, whether it be through stress tests or Quantitative Easing. Yet, the rise of "connected risk"

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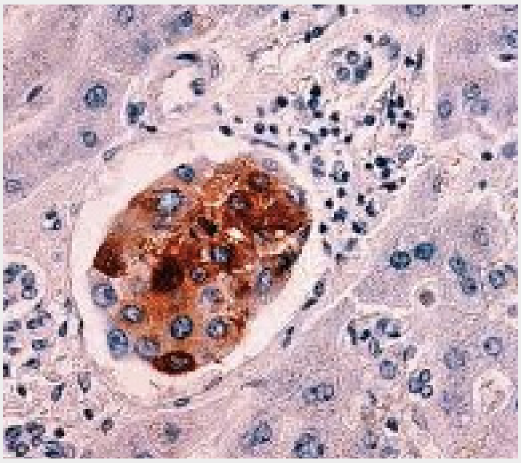

Seed and Soil Theory

Dr. Stephen Paget

poses a significant challenge for regulators. How do you deal with a risk from a single event that in the right environment, affects not only a commercial organisation, but their partners and suppliers and clients all together at the same time?

WannaCry was the perfect example of this. It was a single digital event that exponentially spread disruption, paralysis and wreaked severe economic damage to Government, Businesses, their suppliers, and all at the same time.

Driving Risk

The focus of regulators when considering this new risk landscape need to consider two crucial areas: whether a risk contains the drivers of political violence, supply chain, cyber and credit and whether they are combining to cause financial, operational and reputational loss.

By focusing on this interconnected environment, regulators will be better placed to create practices and procedures to control the growing number of 'black swan' events like WannaCry that are becoming a staple of our connected world.

Yet, redefining regulation is not only restricted to both the Prudential Regulation Authority (PRA) or Financial Conduct Authority (FRA), a redefining of regulation also forces a redefining of the role of a risk manager and (re)insurer.

Risky Business

By taking leadership on the issue of Connected Risk, regulators will provide the guidance for the risk managers of today. For the growing issue for risk managers today is how on earth do they quantify the risks that exist outside their organisation and immediate supply chain?

The answer is context. A risk manager should not only understand who their organisation is connected directly with but also indirectly. For instance, do risk managers consider who supplies their key supplier?

Sadly, as a report of Ernst & Young (EY), The Corporate Risk Factor Disclosure Landscape points out, many risk managers are not displaying this thinking at all.

The risk factor disclosures provided by companies in their Form 10-K and other Securities and Exchange Commission (SEC) fillings should offer investors an understanding of the risks faced by organisation.

Yet according to the EY's findings, many annual reports are simply a box ticking exercise. The disclosures typically are not tailored to the specific company. Instead, they tend to represent a listing of generic risks, with little to help investors distinguish between the relative importance of each risk to the company. In addition, the language is often repetitive and written in legalese and a compliance-oriented approach (instead of using plain English to help investors better understand and evaluate company-specific risks).

As EY explains: "Based on our study, there is an opportunity for companies to streamline language around common risk factors and to offer more insightful, company-specific information. For risks that are particularly important, a company could enhance its disclosures by providing more descriptions of its risk mitigation efforts."

Risk Management in Practice (COSO ERM framework)

Companies could also consider including more company-specific detail; descriptions of how the nature, intensity and likelihood of key risks have changed or might change; and explanations of how significant risks can affect the company's business. Such changes could go a long way toward providing investors with more effective risk factor disclosures.

ERM – Evolving Risk Management?

Yet, hope remains in the form of COSO (Committee of Sponsoring Organisations of the Treadway Commission), who have commissioned an update to their hugely popular Enterprise Risk Management – Integrated Framework published in 2004. The framework was a blueprint for numerous organisations across the globe in institutionalising their efforts to manage risk.

Now, COSO have published an updated sequel, Enterprise Risk Management – Integrating with Strategy and Performance. The updated framework reflects what COSO identifies as the "evolution of enterprise risk management and the need for organisations to improve their approach to managing risk to meet the demands of an evolving business environment".

In the foreword, one of the reasons that warranted an updated framework was the "globalisation of market and operations, requiring the need to apply a common, albeit tailored, approach across geographies".

The framework is not just focused on developing a good risk culture. For the key to succeeding in a changing risk landscape, is to redefine the role of shareholders and an organisation's strategic positioning.

Shareholders need to become more engaged, seeking not just greater transparency on the risks identified in an Annual Report or 10-K but casting a critical eye on an organisation's leadership ability. An active shareholder will feed into the Organisation becoming more strategic about how they manage an increasingly complex and volatile world.

By embedding enterprise risk management at the heart of an organisation, the COSO argues that numerous benefits can be gained. One of which is the identifying and managing risk entity-wide. COSO define this as follows: ‘Every entity faces myriad risks that can affect many parts of the organisation. Sometimes a risk can originate in one part of the entity but impact a different part. Consequently, management identifies and manages these entity-wide risks to sustain and improve performance”.

The message from the COSO is coming out loud and clear. Risk managers need to shift their risk focus from being ‘inside-out’, focusing on their known risks to an ‘outside-in’ focus, where hidden risks are identified which exist deep within their organisation’s supply chain or are connected to their organisation through their business-business relationships.

Insuring the uninsurable?

For many insurers, Connected Risk would be classed as a fundamental or systemic risk. Such a risk is widespread in its effect and arises from an amalgam of social, technological, political, environmental, legal and economic issues. Insurers regard this risk as uninsurable because they do not have the capacity or understanding to take on the risk that they

view as a ‘black swan’ event, i.e. random in their cause and timing.

However, what if these risks formed a pattern, that repeated itself over time in different manifestations? Surely, then the event becomes mainstream rather than a freak occurrence, this would give insurers a data history to effectively map, not how the risks arise but also how they form. An insurer would be more ‘risk-seeking’ than risk adverse when it comes to dealing with Connected Risk.

Regulatory Revolution

Connected Risk is at the forefront of two revolutions. Regulation is being transformed from being a reactive player, less focused on the when and what, and being more focused on the whether a risk contains ‘the risk drivers’ that will combine to create financial, operational and reputational loss for both insurers and corporates.

Secondly, Connected Risk is revolutionising risk management. Far from simply being focused on identifying risks that affect their line of business or their organisation’s supply chain, connected risk has turned the art of risk management on its head. Insurers and risk managers will now have to know not only their organisation and their suppliers’ exposure but the exposure of everyone within their business network. This may range from their suppliers’ suppliers, to their customer’s customers, through to other organisations that are all connected through business-business relationships.

But rather than projecting an ever-increasing doom environment, the real winners in this brave new world will be the switched-on organisations and individuals who spot and act upon the opportunities that are inherent in risk itself.

Connect with Russell

Russell Group is a leading risk management software and service company that provides a truly integrated risk management platform for corporate risk managers and (re)insurance clients operating in an increasingly connected world.

Connected risk refers to the growth in companies which are increasingly integrating across industrial sectors and geographies, and creating greater levels of risk. This exposes corporates and (re)insurers to a broader range of inter-related perils, which requires a risk management approach built upon deep business intelligence and analytics.

Russell through its trusted ALPS solution enables clients whether they are risk managers or underwriters to quantify exposure, manage risk and deliver superior return on equity.

If you would like to learn more about Russell Group Limited and its risk management solutions, please contact rborg@russell.co.uk or visit www.russell.co.uk/contactus