Minimizing the risk of market change
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FTSE Global Markets

Clearly definitions and approaches to risk management are becoming more nuanced and complex as the world works through this challenging decade. Greg Case, chief executive officer of Aon says that understanding and managing risk is a key component in the ability of corporations to sustain growth and profitability. That understanding "should be based on a comprehensive analysis focused on internal risk at a specific institution, and identifying any potential risk, which can be achieved by evaluating external data as well as loss scenarios," he says. In this detailed Q&A, Case outlines the lessons learned from market disruption in recent years and the steps that financial institutions/corporations should put in place as a matter of course to help them navigate a rapidly changing business environment.

FTSE GLOBAL MARKETS: What are the lessons learned from the market disruption of the last few years?

GREG CASE, CEO, AON: It has shown global CEOs, CFOs and risk managers that understanding and managing risk is a critical component to their ability to achieve sustained growth and profitability in today's market. It also is essential for financial institutions and corporations to have a clear focus on quantifying and mitigating both current and emerging risk issues, and then embedding that in the culture of the firm. Key lessons have been learned by using a sound, scenario-based approach to examine corporate business practices, focusing on key and emerging risks (including external points of view) and embracing a culture of risk management. Once a firm has this risk management framework in place, they can adapt the analysis to remain prepared and responsive to the rapidly changing business environment.

FTSEGM: How has the financial crisis and subsequent recession irrevocably altered the global marketplace and the ways in which financial institutions now think about risk?

GREG CASE: Talking to clients and colleagues, I hear a constant theme: the magnitude, scope and complexity of risk continue to rise around the world. Questionable loan underwriting criteria and a broken securitisation market were clearly exposed by the financial crisis. In the course of a global correction, underwriting has gotten much tighter and the securitisation market, at least for mortgage-backed securities, has a noticeable limp.

Today, there is a clear focus on regulation and the resulting risk-related requirements have increased the cost of banking. While many bankers had a sophisticated pre-crisis appreciation of risk, there were limited regulatory penalties associated with excessive risk taking. That is no longer the case. Financial institutions have revamped their business and place a stronger focus on risk and regulatory compliance. Mechanisms such as stress-tests and robust risk-based capital management plans (mandated by Dodd Frank) have been introduced. They also face new corporate governance requirements, including executive compensation and rules related to whistleblowers and other internal controls.

There's certainly a lot for corporate management to contemplate from a risk perspective, which makes an operational or enterprise approach to risk assessment and mitigation all the more important for financial - institutions. Financial institutions increasingly come to us to help them find new ways to manage their systemic risk while remaining in compliance with regulation.

FTSEGM: How must the insurance and reinsurance industry change to meet these new requirements?

GREG CASE: Longer term, we anticipate a growing trend toward institutions utilising insurance as more of a capital tool where they can align their insurance programs with their underlying risk profiles to demonstrate insurance more as an effective hedge and potentially offset regulatory and/or economic capital requirements.

From a reinsurance perspective, the financial crisis revealed the relative strength of the insurance model over the banking models that led in many instances to a magnification of economic problems. By 2008, the industry had achieved consistency across the globe in modeling insurance enterprise risk, led by the top rating agencies for insurers and reinsurers. While the banking industry in 2008 was taking on more risk per unit of capital than they ever had, in contrast the insurance and reinsurance industry had reached new lows in their levels of risk per unit of capital.

Back then, no-one knew what model would be most durable. Now though it is clear that insurers and reinsurers were correct to assume that risk—no matter how well modelled or stress-tested—and high levels of leverage were a bad combination. Properly matching risk and financing durations were also well executed by insurers and reinsurers; very few insurers or reinsurers held many structured finance assets given the unpredictable nature of the timing of the underlying cash flows. They simply understood that these asset classes were not a match for insurance liabilities that are subject to variability in both timing and amount. However, areas where insurers and reinsurers did struggle were those where they began to adopt bank-like operations and practices.

The insurance and reinsurance sectors learned a lot from the financial crisis and subsequent recession. The lessons include greater respect for correlated tails across multiple asset and liability classes; the impact of a recession on the municipal bond sector (US insurers for tax reasons have invested heavily in these sectors); the multitude of problems associated with mixed life and non-life platforms during any financial crisis (including several instances of highly leveraged life insurers bringing strong non-life operations near collapse through common ownership); and the potential ramifications of overconfidence in stochastic modeling.

FTSEGM: How are large corporations re-writing their approaches to risk management?

GREG CASE: To sustain continued growth and profitability, organisations must respond to ever-changing risks, such as social media and cyber liability, by keeping on top of and assessing the latest information available, and implementing innovative risk management solutions.

Social media has intensified the level of complexity in terms of how risk needs to be treated. Social media has eliminated the 24-hour news cycle but created instead a 24-second news cycle where everyone around the world is instantly aware of any potential issues. A company might have a fire at one of their factories which is captured on video and immediately posted on numerous social media platforms. So what was traditionally an operational or supply chain risk now has been transmuted into reputational risk. Aon helps its clients use social media as an effective risk management tool to solve supply chain problems. There's a big difference between passively monitoring social media and actively gathering intelligence on social media and analysing the findings. We can examine what is happening to a firm's suppliers all over the world, capture and analyse data and distill risk-related intelligence so that our clients can address problems more quickly and apply innovative solutions. This type of intelligence, used the right way, is extremely useful in turning social media into an ally.

FTSEGM: Large global catastrophes, such as Hurricane Sandy, invariably impact on the capacity of insurance firms. How ready is the industry to cope with these recurring events?

GREG CASE: It is in very good shape. According to Aon Benfield's analytics team, reinsurer capital grew by more than 10% in 2012 to reach record levels of around $500bn, and reinsurance supply continues to exceed demand in most, if not all, parts of the world. With their own strong capital position insurers are positioned well to absorb larger retentions, and this, as well as co-participations, puts further downward pressure on reinsurance pricing, which is good for our clients. Demand for reinsurance continues to be flat to slightly down in peak zones with insurers continuing to retain more risk as capital increases. Across US insurers, the ratio of ceded-to-gross written premium declined in 2011 for all lines, with the exception of property. Insurance continues to decrease its participation in the US economy—the largest insurance market—and we think it is representative of other mature economic regions. Insurer capital increased through the first three quarters of 2012 by 9%, an annual growth rate in line of historical norms for the industry.

The insurance and reinsurance industries have faced several significant catastrophe events in the past two years. However, despite paying many billions of dollars in claims over this period, insurers and reinsurers still have very strong capital positions. This is supported by the fact that 2012 on the whole was a light year from a global catastrophe perspective, with insurers and reinsurers having more capacity than was being demanded following loss events.

FTSEGM: What risks does regulation throw up for corporations and financial institutions and what can be done to help mitigate these risks?

GREG CASE: Banks are working to better understand and quantify their exposure to risk, especially in areas where an unknown vulnerability could expose the consumer. Cyber risk is a good example, where regulatory oversight from the US Consumer Financial Protection Bureau, the US Securities and Exchange Commission and others, makes it more important than ever for financial institutions to understand and mitigate their breach vulnerabilities.

Generally speaking, the public perception is that financial institutions were heavily involved in causing the global economic crisis and regulators were, by implication, associated with this. As a result, regulators are now focusing on the business practices of financial institutions and fines for bad practices or poor controls are now being levied at levels that would have been unimaginable before the crisis. The recent $2bn anti-money laundering fine for HSBC is one such example. Basel II regulations, to some extent, anticipated this but many banks approached compliance as a ‘tick-the-box exercise’. Today, liquidity, capital and operational risk must be taken more seriously. We have established a global practice specialising in operational risk and are helping many of our clients manage, mitigate or transfer these risks through bespoke structured solutions.

Basel III enforces a tightening of the liquidity rules. By looking inward to their own business practices, embracing good risk cultures and focusing on key and emerging risks with a sound scenario-based approach, financial institutions will not only reduce the need for more regulations but will ensure they are in a better position to weather the next storm.

FTSEGM: Aon produces an annual global political risk report. In your view is the world becoming a more or less dangerous place?

GREG CASE: In advance of the launch of our 2013 political risk map, it is fair to say that with the magnitude, scope and complexity of risk on the rise, the world continues to be a challenging environment for business. Latin America still carries potential risks for multinational firms in several countries, with Argentina and Venezuela leading the list. Political violence and instability remain as concerns in the Middle East and in North and Central Africa as the Arab spring and various insurgencies play out. Issues pertaining to sovereign debt also exist; the Maldives’ recent termination of a major construction contract is an example. The market perceptions of political risk have shifted somewhat as demand for coverage in some European countries has increased substantially. Concerns about economic and other risks in the Euro zone have spiked as investors contemplate some sort of economic catastrophe. In sum, without some kind of hedge, the world remains a risky place to do business.

FTSEGM: Market change is throwing up some entirely new risk sets: such as those related to social media; social disruption; high unemployment. How is Aon working with its clients to isolate and respond to some of these new challenges?

GREG CASE: Our clients want to increase their level of connectivity and have a one-stop shop for information. They are increasing their use of technology to support insurance activity and risk management. There's a tsunami of information out there and clients are seeking solutions to help them wade through all of this data and find the most accurate and reliable information.

We have provided clients with a variety of innovative and industry-leading data management tools, including Aon's Global Risk Insight Platform (GRIP). The platform includes data from more than 1,000 carriers across 169 countries, leverages our international database of placement information to provide clients with the most relevant and applicable data on market conditions, placements and rates to meet their needs. By monitoring the data and reporting the important findings to our clients, we're able to keep our finger on the pulse of the industry and emerging risks that our clients are facing.

FTSEGM: It has been almost a year since Aon relocated its corporate headquarters to London. Do you have any thoughts on it?

GREG CASE: Moving our headquarters to London was the logical next step in the evolution of our firm. In addition to being the centre of the insurance world and the birthplace of risk management, London is the traditional and contemporary hub for our work in the UK, Europe, the Middle East and Asia. Many of our clients in Asia and Latin America seek their risk solutions in London. We were looking to achieve a further strengthening of our business operations in order to meet and exceed the goals of our long-term global growth strategy.

The move has reinforced our ability to deliver superior value to clients and further differentiate Aon, and almost a year later, we already are seeing results in some of our key strategic growth initiatives, such as Aon Broking, Aon GRIP and Aon GRIP Solutions. The decision also is providing us with increased financial flexibility that is allowing us to make more significant investments in our global network, our broking capability, and in the continued development, retention and recruitment of key risk and HR - professionals around the world in each of our primary and developing markets.

On a personal level, I have been in London enough times to know to look right instead of left and to mind the gap. I have been using my umbrella more than my snow boots, and because of our sponsorship of Manchester United, I now understand the difference between overtime and extra time, and between the field and the pitch. So I am coping pretty well.