Contrasting Financial and Risk Management Practices in Banking and Wealth Management

Robert Daly and Anton Kapel

Overview

- Banks and wealth managers have different financial and risk management practices
- A relatively high proportion of wealth managers are owned by banks
- Is one common framework possible?
- If not what are the best practices?

Financial Management Practices

- Many banking measures are equally applicable to funds management business
- Two features of life insurance products are not shared by banking products:
  - High up-front acquisition costs
  - High capital levels (related to these costs)
- Hence, banks measures tend not to fit insurance products
- We discuss each key financial measure in turn

Cost-to-income Ratio

- Universal measure of bank operational efficiency
  - A reducing ratio is expected with revenue growth to reflect scale efficiency gains
- Just as applicable to funds management business
  - For effective peer comparison, a standard definition is required
  - An approach derived from the published profit and loss account would be preferred for transparency reasons
- For life insurance, high acquisition costs distort the measure
  - In a growth period, the ratio will tend to increase
  - Hence the primary purpose of the measure in identifying scale benefits is lost

Return on Equity

- Universal measure of bank capital efficiency
  - Banks tend to target a ratio in the range 20-25%
- Also effective for funds management
  - However, funds management is a low capital business; hence, the importance of the measure is limited
- Less effective for life insurance
  - The RoE is low at policy commencement and then increases
  - The increase is due to reducing capital requirements
  - Hence, a mature company will tend to have improving RoE

Value Metrics

- Seldom used in banking
- Commonly used in life insurance and funds management
  - Allow for high acquisition costs and reducing capital needs
  - Profitable growth is measured by increases in the value of new business from year to year
  - Efficient management of in-force business is measured through the analysis of change in value
- Best practice for banks?
  - Would provide additional insights
    - E.g. mortgage products with high acquisition costs
  - May not be worth the implementation costs

Risk management practices

- Banking practices have changed radically due to Basel II
  - Internal models to measure risk and capital requirements
  - Risk management process to ensure that internal models drive business practices
- Could these innovations also be worthwhile for wealth managers?

Risk management process

- Modern bank risk management consists of:
  - A risk appetite that describes acceptable risks
  - A clear understanding of the nature of the risk
  - An internal capital model for all material risks
  - Risk management processes that are embedded in the business
  - Risk governance procedures that identify breaches
- LPS 220 requirements cover all of these except the requirement to have internal models
- Would the benefits of an internal capital model outweigh the costs?

Insurance product risk

- Persistency risk
  - Stochastic variance tends to be small
  - Need to understand how persistency changes with the operating environment
- Insurance claim risk
  - Significant stochastic variance
  - Significant estimation risk around claim rates
- An internal model can be used to allocate capital; optimising its financing; measure target surplus; measure exposures relative to risk appetite; optimise reinsurance
- Benefits outweigh costs

Operational Risk

- Wealth managers would benefit from improved measurement of operational risk:

Activity (and related costs)	**Benefits**
Maintain a register of past loss events	Identification of common causes Pressure to fix any increase in events
Develop extreme event scenarios	Enhanced ability to react to actual downside events when they occur
Implement risk measures	Set target surplus levels Measure risk-adjusted returns Prioritise risks for mitigation

Market risk

- Internal model worthwhile if risk is deemed significant
- If not significant (but material) then risk can be managed with ad-hoc measures of exposures under current investment policies
- If significant then apply a banking approach as follows:
  - Determine appetite for market risk
  - Design hedging program
  - Determine residual risk and perform stress testing
  - Actively monitor risk exposure
    - — Calculate exposure measures regularly
    - — Monitor exposure against pre-determined limits

Management of asset liability risk

- A bank treasury function provides central management of interest rate exposures
  - Hence, front-line business units can focus on operational issues not the interest rate market
- Conceivably the same advantages could be achieved for wealth managers:
  - Increased front-line business focus on operational issues
  - More transparency in impact of market movements on the business
- Appointed actuaries would need to maintain their oversight of asset liability risks