Contrasting Financial and Risk Management Practices in Banking and Wealth Management

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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:

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