Risk Management

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Humbled financiers reassess their culture

Misjudgment of human factors, the failure of technology and rogue traders have caused huge reputational damage, writes *Patrick Jenkins*

Technical glitch: Royal Bank of Scotland customers were left without cash for days Getty

Geoff Taylor has been round the block. He used to monitor the production line risks facing sportswear group Nike and jeans maker Levi Strauss – checking the solidity of trainer soles and the sturdiness of denim seams.

These days, as a risk solutions expert at Willis, an insurance broker, he is more focused on making sense of the financial crisis – but is convinced "real economy" companies have valuable lessons to teach the risk experts in the banking industry, many of whom misread the danger signs in the boom before the 2008 bust.

"Seven or eight years ago," Mr Taylor recalls, "I remember sitting in a strategic risk council meeting with representatives from different industries. The banks there were very cocky. I remember them saying they had a 99.9 per cent confidence level about their risk modelling."

Within a couple of years, Wall Street and the City of London had experienced an unprecedented collapse, as the fallibility of their credit and market risk models was exposed in ghastly fashion.

For the banks and other financial institutions that were battered by the crisis, the natural response has been to elevate the importance they attach to risk. The chief risk officer (CRO) is no longer the irritating geek drafted in to sign off clever deals. The role, particularly in the US, is now often a board-level position and has become far more integral to the way financial institutions operate.

The CRO's focus has also changed. Bankers, as Mr Taylor's anecdote suggests, traditionally thought of themselves as the smartest people in the room. Bank risk managers would model the default risk of the most obscure credit derivatives, or the trading risk of the most abstruse currency forward, confident that the better the model, the more money they and their employer would make.

'The trouble with operational risk is that it's about human error . . . a lot more difficult to measure' Charles Beresford-Davies

As all the risk experts now recognise, models are only as good as the information fed into them. And the extreme volatility in market prices – and the swift evaporation of trading liquidity – were largely absent from models because they were both unprecedented and unimaginable, even for seasoned hands.

But if the crisis exposed the naivety of banks' assessment of credit and market risk parameters, its aftermath – characterised by a persistent regulatory and legal crackdown on boom-time excesses and misdeeds – has shone an even harsher light on a third shortcoming of the financial sector: a bad misjudgment of operational risk.

"The trouble with operational risk is that it's about human error," says Charles Beresford-Davies, head of risk management for the UK and Ireland at Marsh, the insurance broker. "It's about events that life throws at us. It's a lot more difficult to measure."

That has made many aspects of operational risk alien concepts to bankers and their traditional processes. But the humdrum dangers of everyday operations have for many financial services companies become just as important an area of risk as their core credit and trading operations.

Much of the work of risk consultants is now focused on transferring the operations applied at non-financial clients into the risk frameworks of financial groups.

Even those who have built their careers within the financial industry express frustration at the lack of attention banks have traditionally paid to the gamut of operational risk.

"The trouble with the term is that it sounds as though you should be able to fix it with a screwdriver," says Carol Sergeant, a former UK regulator and Lloyds' chief risk officer who is now a non-executive at Denmark's Danske Bank. "But it's crucial to so much of what a company does: how it serves customers, how its staff behave, how they are paid, the reputational risk that all this poses."

Although the financial crisis is likely to be remembered most for the hundreds of billions of dollars lost on bad loans and the havoc wreaked on lenders' capital and funding, most of their woes these days are operational, as pre-crisis greed and underinvestment come home to roost, rogue operators become more sophisticated, and policy makers pursue a mission to clean up the system.

Technology shortcomings are a prime example. "Banks are effectively tech companies these days," says Mr Beresford-Davies. "The failure of their technology has caused huge reputational damage."

Problems have been manifested in a variety of ways. Royal Bank of Scotland has suffered the most embarrassing glitches with the hardware and software that underpin its retail banking services, leaving customers without access to cash for hours, days and on one occasion weeks at a time.

Back-office technology has also come up short: failing to spot and stop money laundering, sanctions breaches, and rogue trading perpetrated within the banking system.

Hacking and other forms of high-tech theft have become ever more sophisticated, posing challenges not just to banks but to a vast chunk of the global economy.

Reformers agree that poor remuneration structures underpinned much of what went wrong at the banks, with traders incentivised to take far more risk than was sensible. The same can be said of mis-sold retail and small business products, such as PPI loan insurance, and interest rate swaps across a sweep of countries, particularly in Europe. Many of these examples fall outside banks' traditional ways of thinking about risk, says Ms Sergeant, and need new approaches.

Certainly, as more and more evidence has emerged of sharp and shady practice across the financial industry, reputational damage has been inflicted on some of the world's biggest institutions, from Goldman Sachs to Barclays.

One traditional fallback – insurance cover – is probably not the answer, admits Mr Beresford-Davies. In areas, such as mis-selling, where traditional professional indemnity policies would have provided protection, mass blow-ups such as PPI have scared off underwriting capacity.

"Some of banks' operational risks are outstripping the insurance industry's ability to cover them, in the areas of technology failure, mis-selling, data security for example. The conventional approach isn't fit for purpose – the scale is just too large."

So, if it is impossible to model and hedge against all these risks, and increasingly difficult to insure them, what should financial companies do? The answer, risk experts agree, must be to devise better ways to catch problems early. Governance needs to improve, with better management of all kinds of risk, and a fostered culture of whistleblowing. Stress testing needs to become a routine continuous process, focused on realistic gradations of downside risk, not just disaster scenarios. Most of all, management priorities need to shift from short-termist risk-taking and reward.

Inside »

Gambling on a winning hand
Investors often bank on skill and luck
Page 2

Upheavals are global concern
Political unrest in Europe poses problems
Page 3

Infrastructure funding
Big projects require a delicate balancing act
Page 4

Europe's leaders warn currency volatility could harm the recovery

Currencies

The euro's strength poses problems for business, reports *Delphine Strauss*

Two years ago, European businesses were worrying about whether the euro would survive. Today, a bigger problem for many of them is its strength.

With the single currency at its highest level since mid-2011 on a trade-weighted measure, politicians are warning that adverse exchange rates could stall the eurozone's fragile recovery.

While the euro's rise against the dollar has been fairly moderate, turmoil in emerging currencies has stung many multinationals – which had bet heavily on growth in emerging economies in recent years to compensate for the lack of activity in their home markets, but now find themselves exposed to swings of as much as 20 per cent between the worst-hit local currencies and the resurgent euro.

"The most obvious [concern for 2014] is volatility in exchange rates," says Carlos Ghosn, chief executive of Renault, which suffered a €600m loss from emerging market currency weakness last year.

Adidas, whose euro-denominated revenues were hit last year by a slide in the Argentine peso and Brazilian real, warned this month that it would suffer from weakness in the rouble, with political risk afflicting a region where it leads rivals.

Siemens, the German conglomerate, Electrolux, Lafarge and Pernod Ricard have also reported a negative impact from exchange rate movements.

In the UK, manufacturers face similar headwinds, as sterling has risen almost 10 per cent in trade-weighted terms over the past year.

The reason this is proving so problematic is that multinationals – while accustomed to hedging against movements in major currencies – have tended not to hedge exchange rate risk in emerging markets that now account for a growing proportion of revenues.

Treasurers find it expensive and at times impossible to protect against fluctuations in volatile and relatively illiquid currencies that may lack developed derivatives markets.

"If a company is going into an emerging market, it's a very big risk and the currency is a huge component of that," says Martin O'Donovan, deputy policy and technical director at the Association of Corporate Treasurers.

He adds: "Many people decide to run that risk as part of the hazards of being in that country."

He believes treasurers had an inherent bias to under-hedge, because overshooting in the other direction would make them seem to be speculating on currencies – and "that is deemed less acceptable".

Moreover, the recent sell-offs in emerging market currencies followed a couple of years of very low volatility in the euro-dollar exchange rate, the one that usually matters most for corporate hedging strategies. This has tempted many companies to cut hedge ratios.

Now, however, corporate sales executives are reporting a surge in demand for protection against emerging market currency risk.

> Companies find themselves exposed to swings of as much as 20 per cent

Fabrice Famery, head of European corporate rates and foreign exchange at BNP Paribas, says that companies were able to absorb the first bout of turbulence in emerging markets, last July and August, but a second sell-off early this year had prompted a "significant increase" in the number seeking to hedge currency risk.

"It puts clients in a dilemma, because if they hedge a currency with high carry long term, it's very expensive for them," he says.

BNP Paribas has been exploring ways to offer "discontinuous" hedges – ones that can be interrupted – as a way round the problem, as well as suggesting greater use of options – which are more expensive but "could make sense if you're a bit late in hedging a currency that has already moved".

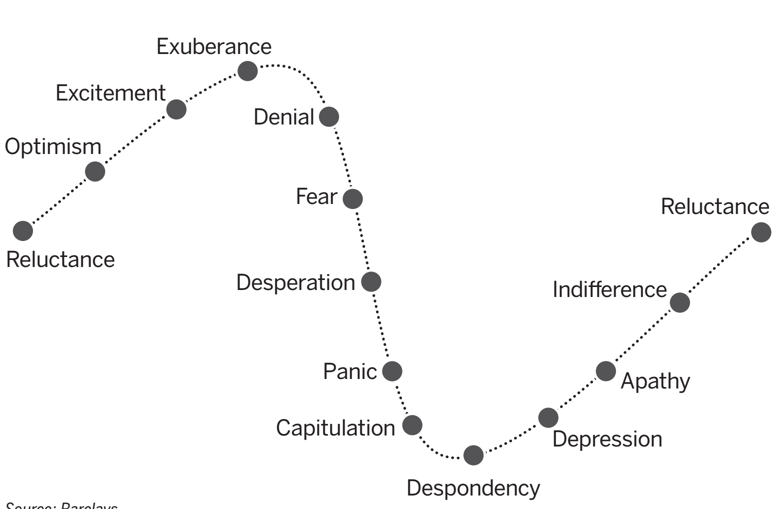
Much smaller companies are also trying to assess and mitigate their currency exposure, says Tony Crivelli, head of global hedging strategy at Western Union Business Solutions. Its UK business handled 15 per cent more forward payments for small and medium-sized companies in the second half of 2013 that in the first half.

Wherever possible, however, multinationals would seek to create "natural" hedges – aiming to have production costs in the same currency as revenues, for example, or raising local currency debt.

A survey published last year by the Bank for International Settlements, the Basel-based organisation that serves as a bank for central banks, notes a long-term decline in non-financial customers' hedging needs, partly because of the stability of major currency pairs, but also driven by multinationals' growing sophistication in managing currency exposures, centralising corporate treasury functions, so positions can be netted off internally.

That would also suit the instinct of many executives to steer clear of financial markets. "I've spoke to a number of corporates about hedging and they're a very conservative bunch," says Jane Foley, a currency strategist at Rabobank. "There is a perception that derivative instruments are by their nature very risky and there is a reluctance by some boards to use them . . . If there was a period of low volatility, it would seem likely that many boards would see that as an excuse not to [hedge]."

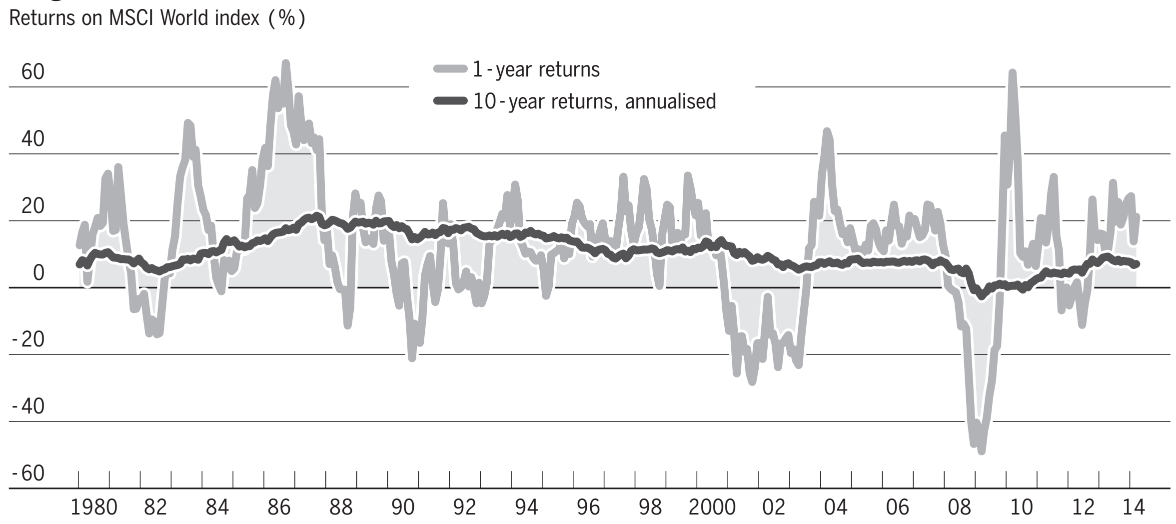
Cycle of investor emotions



Source: Barclays

Long- and short-term investment returns

Returns on MSCI World index (%)



Need to balance caution and will to win

Investment But excessive timidity can turn out to be an expensive way of sleeping better, writes *Chris Flood*

The $120m poker match between James Bond and the villainous Le Chiffre in the film *Casino Royale* demonstrates the fictional British spy's inexhaustible capacity to embrace risk in pursuit of huge stakes and glamorous women.

But in reality, no one enjoys Bond's endless good fortune. Calculating possible outcomes of games of dice and cards has intrigued mathematicians since the Renaissance, laying the foundations for modern ideas about risk management that play a vital role in investing today.

In his classic book *Against the Gods*, Peter Bernstein explores the deep connections between gambling and investing and shows how analysing games eventually transformed the perception of risk from "chance of loss into opportunity for gain".

Just as a gambler tries to win a bet, so investors hope to profit from staking their money in financial markets, basing their choices on a combination of skill and luck.

Winning a poker hand or closing a profitable trade is often accompanied by a rush of "feel good" hormones.

However, rising levels of adrenalin, testosterone and dopamine during a winning streak can turbocharge risk appetite to dangerous levels. But spikes in market volatility are also associated with higher levels of psychological stress that can raise cortisol levels and lead even sophisticated traders to become irrationally risk-averse.

Jekyll and Hyde traits are also evident in the attitudes of many ordinary savers, who see the financial crisis as confirming their prejudice that investing and gambling are virtually identical risks in "casino capitalism".

This fear of risk means many retail investors fail to act in their own best interests and exhibit behaviour at odds with their stated goals.

An analysis by State Street, the US financial services group, in 2012 found that two-fifths of retail investors said they wanted to become "more aggressive" in preparing for retirement. But 30 per cent said that their largest allocation in 10 years' time would still be in cash.

Worryingly, nearly two-thirds of retail investors also rated their financial sophistication as "advanced", a Bond-like display of confidence that suggests unrealistic expectations about their likelihood of success.

Suzanne Duncan, global head of research for the State Street Center for Applied Research says financial industry participants should develop measures of "personal" performance to help clients achieve their goals.

Barclays has developed a proprietary "financial personality assessment" that allows it to tailor advice to clients. Greg Davies, head of behavioural finance at Barclays, says investors want the best returns possible relative to the anxiety, discomfort and stress they have to endure.

Face off: not all investors have a James Bond-style appetite for risk
Alamy

> Closing a profitable trade is often accompanied by a rush of 'feel good' hormones

A reluctance to get involved, driven by fear of making mistakes (loss aversion), is the "default" state in the cycle of emotions experienced by investors, Mr Davies says.

Since losses loom larger than gains in investors' minds, some choose to leave large amounts of cash sitting idle, an "immensely expensive way to sleep better at night" when a moderate risk multi-asset portfolio can deliver returns of 4 to 5 per cent annually over the long term, says Mr Davies.

But while short-term fluctuations in stock markets can lead to losses, long-term returns measured over 10 years for the MSCI World index only briefly turned negative in the worst period of the financial crisis.

Barclays has carried out more than 40,000 interviews as part of its FPA programme and Mr Davies says differences between gender, age and culture in financial personalities tend to be smaller than often presumed.

Asian investors are widely assumed to be more risk-tolerant, but this is not true of Japanese investors who share a more "European" attitude to risk, says Mr Davies, adding that it is vital to avoid providing advice based on stereotypical assessments.

Barclays' approach combines three measures of risk attitude. Scores for financial expertise, belief in skill, and willingness to delegate build a framework to help clients remain committed to a long-term strategy.

Mr Davies says it was notable that scores for delegation and belief in skill dropped in the aftermath of the 2007-08 crisis, as confidence in financial institutions weakened.

Those scores have now recovered, while measures of risk tolerance have remained extremely stable in spite of the volatility seen in financial markets over the past five years.

Yogi Dewan, chief executive of Hassium Asset Management, tells clients to take risks in areas they understand best, usually the sector in which they created their wealth, rather than in financial markets.

Wealthy families tend to be overly sensitive to short-term geopolitical events, so Hassium spends time educating clients to think more broadly and more long-term.

Mr Dewan says that preservation of capital, rather than pursuing growth, is the first priority of wealthy clients who generally feel losses much more acutely than gains.

UK employees prepare for auto enrolment

Pensions
PATRICK McCOY

As part of the automatic enrolment of many employees into new UK workplace pension schemes, individuals will soon have to decide on their appetite for risk.

Companies are starting to consider how to help employees determine what level is appropriate for them.

The emerging best practice is for employers to understand their employees' objectives, tailor available investment options, personalise employee communications to guide them into the right funds, and then monitor individuals' progress against the objectives.

To help guide employees appropriately, it is essential to understand their wants and needs. It is impossible to achieve this on an individual basis, but it can be done for groups by means of segmentation.

For example, the objective of a group of low paid employees may be for their income in retirement to be about two-thirds of their working income, including the state pension.

Categorising staff by demographics, investment understanding, and level of engagement helps identify groups with similar risk tolerance.

The next stage is to build on the understanding of each segment of the workforce and tailor investment options to meet their objectives.

There is a balance between taking enough risk to allow the assets to grow sufficiently to produce adequate retirement income and behavioural traits such as loss aversion.

Employees typically need the long-term growth potential – in excess of inflation and annuity prices – that is generally associated with equities or similar volatile investments.

However, employees can now receive instant updates of their savings balances and are dismayed by big falls in asset values.

High growth investments are the ones that are prone to suffer short-term falls. Seeing the value of the savings balance decline, employees may decide to switch to less volatile investments such as cash or stop contributing altogether.

Both are likely to have a devastating impact on their retirement income.

Investment options should look to manage short-term declines to avoid this situation by spreading funds between a variety of assets classes. Longer term more illiquid assets can sit alongside equities to provide diversification and the potential for long-term growth.

KPMG has been working with a number of providers to develop suitable funds. The downside is that these investments tend to be relatively expensive.

It is likely that organisations will contain some people who have the understanding to make their own investment choices. Their needs can be met by having a simplified range of options that offers a spread of outcomes and liquidity.

But it is important to avoid the "paralysis of choice" that has beset many investment platform providers.

Having designed a suitable range of investment funds for each segment of the workforce, the next step is to engage with them and guide them through the options.

Technology allows for communication to be tailored to each individual. For example, information regarding pension limits should only be sent to those with high salaries, long service or large fund values.

Providing relevant information, communicated in a manner suitable for the employee segment in question, enhances engagement and action from scheme members.

> It is important to avoid the 'paralysis of choice' that has beset some providers

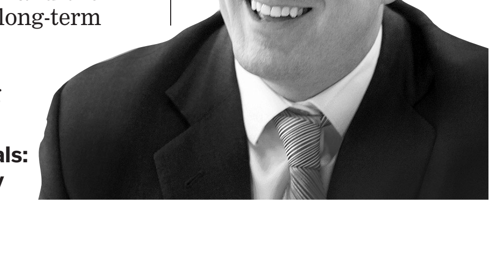
In this way, employees can be guided into an appropriate investment option. It is important that employees participate in the decision, rather than "defaulting" into a preselected option.

People are more likely to understand the decision they have made and stick with it, even if fund values should fall. Guiding employees also allows the right funds to be put in front of them.

Reporting of performance should be framed relative to an employee's long-term goals, rather than just showing short-term movements.

This personalised reporting can also encourage a member to increase contributions or set a more realistic retirement age, should it emerge that they are unlikely to meet their objective.

The writer is head of investment advisory at KPMG



Long-term goals: Patrick McCoy

Crisis point: the EU and US have drawn up sanctions against Moscow EPA

Unrest in Europe raises concerns around the globe

Politics Possible fresh upheaval in the eurozone could threaten recovery as much as turmoil in Ukraine and Turkey, writes *Gideon Rachman*

Rising markets and reviving economies have contributed to the most optimistic business climate in the west since the collapse of Lehman Brothers in September, 2008. But, just as economic risk has declined, so political risk is on the rise.

The Ukrainian upheavals have created the worst crisis in relations between Russia and the west since the end of the cold war.

The US and the European Union are talking about imposing economic sanctions on Russia. The initial measures involved are likely to be limited, but the risks of a tit-for-tat escalation are high – and will be making big western investors in Russia, such as BP, very nervous.

Russia provides a good case-study of the two sorts of political risk that investors have to consider: the macro and the micro. Macro political risks involve large-scale changes – either in the form of internal upheaval or international conflict – which can seriously destabilise the business environment. Micro political risk takes in the sort of events that do not necessarily make world headlines – a change of ministers, a capricious presidential decision, an unexpected court ruling.

In its prospectus for a share offering in London in 2006, Rosneft, a large Russian oil company, had stated frankly: "Crime and corruption could create a difficult business climate in Russia." Now, investors also have to factor in the risk of an international political crisis.

Julian Macey-Dare, who heads the international political risk business for Marsh, a global insurance broker, says that the classic definitions of political risk centre round the threats of war, or the expropriation of assets.

However, Mr Macey-Dare notes that the nature of the political risks that businesses are worrying about is broadening, both in terms of the kind of assets that need protecting, and the kind of markets that are deemed risky.

The common assumption is still that the riskiest political environments are found in emerging markets and that it is physical assets – such as a mine or a factory – that are most at risk of destruction, or confiscation.

Increasingly, however, it is just as likely to be a non-physical asset – such as a licence to operate, or a debt-holding – that can be placed at risk by an unexpected political change.

Political risks are also no longer confined to emerging markets. On the contrary, the threat of political upheaval in Europe is still one of the main macro political risks facing the world.

At the moment, investors generally seem to assume that the worst of the eurozone crisis is over. The return of confidence is reflected in the fact that countries such as Italy and Spain can now borrow at lower interest rates. Private-equity investors are also on the prowl in Europe. However, it is entirely possible that political events over the next year will reignite the euro-crisis.

Two things in particular need watching. The first is the likelihood of a surge in votes for populist and anti-EU parties in the elections for the European Parliament in May. If, for example, the far-right National Front tops the polls in France – a result that is entirely possible – mainstream politicians will face a crisis of confidence that could transmit to the markets. If the far left wins in Greece, the spectre of a Greek default on its debt could also re-emerge.

The political situation in Italy – which owns the fourth-largest debt stock of any nation in the world – also remains fragile. Many businesspeople are hoping that Matteo Renzi, the energetic new prime minister, will force through much-needed reforms. But the Italian political and social system has defeated many reformers in the past. And, if Mr Renzi also fails, a sense of political crisis would return to Italy.

The year has also seen a revived awareness of the fragility of emerging markets, with a particular focus on political risk. Put simply, those markets that look most risky are also often those with the most troubled political environment.

So, in Latin America, the current optimism about Mexico is closely correlated to the impressive political leadership of President Pena Nieto. By contrast, the decline in investor confidence about the prospects of Brazil has coincided with the surge in street protests that threaten to peak, during the World Cup, later this year.

Turkey is also an emerging market that is making investors nervous – and, once again, the threat of political upheaval is central to these concerns.

> Trouble in one country can lead to contagious nervousness about an entire group of nations

For the past decade, the country has grown rapidly and was widely perceived to be benefiting from the strong and confident leadership of prime minister, Recep Tayyip Erdogan. But he now faces multiple challenges, including recurrent street protests in Istanbul, a corruption probe and a row with the powerful "Gulenist" movement, that has split the forces of political Islam.

Given Turkey's dependence on short-term capital, rising political turbulence could spell economic trouble.

In an ideal world, investors would be able to make calm assessments of the circumstances of individual countries, without necessarily leaping to conclusions about their neighbours.

In reality, a political upheaval in one country can lead to contagious nervousness about an entire group of nations, whether it is "emerging markets" or the eurozone.

That is why political risk is likely to be one of the main threats to the global economic recovery, over the coming year.

Contributors »

Patrick Jenkins
Financial editor

Gideon Rachman
Chief foreign affairs commentator

Steve Johnson
Deputy editor of FTfm

Chris Flood
FT correspondent

Gill Plimmer
FT correspondent

Delphine Strauss
Currencies correspondent

Patrick McCoy
Head, investment advisory pension funds, KPMG

Rose Jacobs
FT contributor

Brian Bollen
FT contributor

Aban Contractor
Commissioning editor

Andy Mears
Picture editor

Steven Bird
Designer

Chris Campbell
Graphics

For advertising details, contact **Peter Cammidge** on +44 (0)20 7775 6321, or peter.cammidge@ft.com,

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New hotspots increase concerns

Kidnap and ransom

About 30,000 to 40,000 abductions occur every year, *Brian Bollen* learns

Kidnap and ransom are an increasing threat for businesses operating in dangerous parts of the world.

Commonly cited as contributory factors are such diverse elements as population growth, the spread of militancy backed by the availability of heavy weaponry, and the creation of a kidnap chain along which a person can be readily sold.

In a briefing on his company's website, Peter Dobbs, a kidnap, ransom and piracy underwriter at Catlin Group in London, notes that kidnap insurance was introduced after the abduction of the baby son of aviator Charles Lindbergh in the US in 1932 brought to wide attention the possibility of kidnapping valuable individuals for financial gain.

Today, there are an estimated 30,000 to 40,000 kidnaps a year, but many go unreported, making a more accurate figure difficult to determine, says Mr Dobbs.

Of these, only a small percentage of victims are insured in any way against the risk – insurance does not necessarily just cover ransom reimbursement but also other expenses that frequently total far more than any ransom payment.

Kidnap is constantly evolving around the world, he adds. New hotspots pose greater levels of risk to businesses operating within them.

Many companies seek to expand into developing countries, but doing so often entails significant risk.

One area that looks set to see operational risks increase radically is the Sahel region of sub-Saharan Africa. It comprises areas of the Gambia, Senegal, Mauritania, Mali, Burkina Faso, Algeria, Niger, Nigeria, Cameroon, Chad, Sudan, South Sudan and Eritrea.

The region's instability has recently spread south to the Central African Republic and may extend further.

Al-Qaeda affiliates are increasingly adopting kidnap-for-ransom as a financing method as much as a political strategy, says Alexander Evans, New York-based co-ordinator of the UN's al-Qaeda-Taliban monitoring team.

He says: "The evidence includes: an uptick in kidnaps and ransom income for al-Qaeda affiliates in the Sahel and Yemen in recent years; released al-Qaeda correspondence; and postings on al-Qaeda-inspired internet forums."

However, other informed observers caution against overstating the terrorist element. Pushed hard on the point, one insider estimates the split of kidnap for ransom as 90 per cent criminal, 10 per cent terrorist.

"And that is being generous to the terrorists," he adds.

Indigenous rich people are considered more vulnerable to kidnap because of the greater predictability of their daily routine. Foreigners can be prized because of the perceived larger ransom they might fetch, but can be awkwardly high maintenance and attract publicity that a terrorist organisation might relish but would be anathema to criminals.

Returning to his dissection of Africa, Mr Dobbs notes that since the fall of the Gaddafi regime in Libya, large numbers of stockpiled weapons are thought to have made their way into the traditionally nomadic Sahel region.

The French government has stationed troops in the area in an attempt to contain the problem, but, he says, the next decade could see significant activity.

> 'There is no substitute for having on your side people who are of the community'

With many boasting significant energy reserves, these nations have proved popular with oil and gas companies. This environment has in turn spurred the growth of specialist providers of advisory and security services.

Terra Firma Risk Management, identifies four elements to the business: Prevention, Preparedness, Response and Recovery.

Steve McCann, a provider of security advice and on-the-ground services to non-governmental organisations and humanitarian groups, divides security measures into three broad categories: acceptance, deterrence, and protection.

Acceptance is built on explaining to local communities the context of an organisation and its individual missions.

Deterrence is based on the deployment of armed guards.

Protection involves procedural moves such as imposition by an organisation of a curfew on its staff (in Darfur generally fixed at sunset) and the erection of physical barriers against perceived threats.

Each has its advantages and disadvantages, explains Mr McCann, co-founder of the SaferEdge consultancy – motto: not all 'security' makes you safer.

A bandit determined to rob would probably not be influenced by the acceptance approach although it can offer a degree of protection if influential figures in a community in effect endorse an organisation and its activities.

Deterrence, by contrast, can contain within it the seeds of its own failure; the more people who know about planned movements the more potential there is for leaks of information. Taking the barbed wire route delivers instant insulation, mutual misunderstanding and local suspicion, he believes.

"There is no substitute for having on your side people who are of the community and know the space, the culture and the stakeholders," he says.

"They will know how to introduce you and your work so you are understood and the vast majority of threats can be neutralised."

Risk Management

Spending on big projects is a delicate balancing act

Infrastructure Governments are the primary source of funding but austerity measures have made money very tight, reports *Rose Jacobs*

The title of the first panel session of the world's biggest annual infrastructure conference, held in Berlin this month, spoke to a top concern among the industry's professionals: 45 minutes at 9.30am devoted to "bubble trouble".

Granted, the title was adorned with a question mark. But the facts are undisputed, in the western world, at least. Funding for infrastructure – where the government is almost always the ultimate guarantor – has yet to return to anything close to pre-recession levels, despite infrastructure's recognised multiplier effect in the wider economy.

"You can underspend for a decade or so before this stuff completely falls apart, and in times of austerity it's tempting to do that," says Paul Davies, infrastructure partner at PwC, of the lack of deal flow.

Yet financing for such projects as airports, roads, water and energy systems is abundant, and available from a range of sources: pension funds, sovereign wealth funds, even banks, although post-credit crisis capital adequacy rules have curbed their appetite.

That has meant that governments and private sellers are getting better prices and investors accepting smaller returns. Privatised UK airports are currently selling for 16-17 times earnings before interest, tax, depreciation and amortisation, compared with 12-13 times a few years ago. That still pales in comparison with the 25-30 times seen in 2007 . . . but then again, that was a bubble.

Nor does Michael McGhee, head of transport at Global Infrastructure Partners, a $15bn fund, see the equation changing in the near future.

"In Europe, in the current low interest rate environment, regulators [who often determine what concession-holders can charge users of infrastructure assets] are saying that means the returns we're allowed should be reduced. But if you want us to invest, you have to recognise that the nature of our return is that it comes from long-term assets, and interest rates are eventually going to go up."

The danger here for governments and their citizens, he argues, is that capital is mobile, and regulatory arbitrage inevitable. Mr McGhee points to Portugal and Australia as among the capital magnets, thanks to playing their hand wisely. Lisbon, for example, sold a 50-year concession for 10 Portuguese airports to the French group Vinci last year, for about €3bn, or a little more than 11 times 2012 Ebitda, but with long-term investment requirements built into the deal.

"If you can incentivise the owners of the infrastructure to operate it more efficiently, then that has a big advantage for consumers, and the economy as a whole," he says.

Australia's new government, meanwhile, is actively courting infrastructure investors with the aim of recycling capital. Both the federal and state governments are selling off relatively low-risk assets with stable returns, such as ports, and then using that money to fund riskier or lower-yielding – but necessary – projects, such as non-toll road upgrades.

That strategy, says Manish Gupta, head of Ernst & Young's transport infrastructure practice, takes advantage of a further twist to the current oversupply of capital: the fact that much of the money available is only available for developed assets.

In his view, the glut of financing constitutes just one of three risks associated with infrastructure investment. Political risk is another, including everything from neighbours resisting expansion of an airport to governments nationalising assets.

Economic risks are the third danger in Mr Gupta's breakdown, and centre round the fact that most infrastructure projects have long life cycles and do not always mirror the wider economy. Some airports, for example, saw traffic decline by as much as 25 per cent in 2008-09, compared with economies that shrank by 5 per cent.

But economic risks can also include capital controls – as instituted by Cyprus last year – and, more prosaically, exchange rate risk.

For governments, citizens and business communities, the trick is to find the right balance between spending and saving. Too little spending, as the US has seen over the past three or so decades, results in crumbling assets which, aside from diminishing quality of life, can also influence what Mr Gupta calls the "hygiene factor" in a company's decision of where to locate.

However, PwC's Mr Davies questions how much this influences industry. "The taxation regime and the ease of doing business in a place will both be much more important."

Project management: long lead times often make it difficult to mirror the wider economy
Dreamstime

'What's the priority? Everything'
Michael McGhee, Head of transport, Global Infrastructure Partners

And too much spending has its own pitfalls, as demonstrated by the likes of Ireland, Spain or Japan. That is certainly the risk the developing world currently runs, particularly in countries where continued steep economic growth is far from a given.

This touches on a central question that Mr Davies believes has not been properly answered in any part of the world: What is a sustainable level of infrastructure investment? In other words, what can citizens ultimately afford? For it is they who fund the vast majority of projects, through general tax, road tax, utility bills and more.

From there, the task is for governments to prioritise. The UK, with its national infrastructure plan, is doing this relatively well, Mr Davies says.

Mr Gupta agrees: "There seems to be a rational allocation." But big signature projects tend to dominate, with more mundane but vital work sometimes falling by the wayside.

And there is good reason that prioritising might be difficult, says Mr McGhee: "What's the priority? Everything. Name me a sector in the US or UK where we are actually over-invested."

Funding old promises is proving costly

Longevity
Steve Johnson looks at the struggle to meet pension needs

When state pensions were introduced in the UK in 1909, the retirement age was set at 70, a grand old age that only a third of men then aged 20 lived to see. Indeed, average male life expectancy was just 48 and critics complained workers would spend their life contributing to a benefit they would never receive.

Roll forward a little more than a century and the retirement age has fallen to just 65 for men and, until 2018, will be lower still for women. Yet 80 per cent of today's 20-year-olds are expected to see their 70th birthday, and life expectancy has risen to 78.5 for men and 82.4 for women, according to the OECD.

Moreover, life expectancy is still rising, by about 2.5 years a decade.

This is an uplifting tale of human progress, one repeated, to a greater or lesser degree, worldwide. But there is downside; the rising cost to governments and companies alike of paying pensions and meeting retirees' long-term health and care needs.

Private sector companies, at least, are plotting an escape route from this morass, although they will not be out of the mire for decades.

The vast majority of companies have closed their defined benefit (or final salary) pension schemes to new members, while many have also been closed to further accrual for existing members.

Instead, private sector workers are being funnelled into defined contribution (money purchase) pension schemes, where they bear the "longevity risk" associated with living to a ripe old age, as well as investment and interest rate risk for good measure.

However, companies are still on the hook for the promises they have made to date, and rising longevity is making those promises ever more expensive.

According to David Blake, professor of pension economics at London's Cass Business School, companies started to focus on the issue in 2006, when global accounting changes meant pension deficits had to be recognised on corporate balance sheets.

But relatively few companies have offloaded their longevity risk. There are three main ways this can be done: a pension buyout, where an insurer is paid to take the entire scheme on to its own books; a buy-in, where part of a scheme is passed to an insurer; or a longevity swap, where just the longevity risk is offloaded.

There has been a reasonably steady stream of buy-outs and buy-ins in the UK, but few elsewhere, primarily in the US and Canada.

'There is a massive concentration of longevity risk with a small number of insurers'

One problem is cost. Scheme sponsors typically have to pay an insurance company a premium of 20-25 per cent over the accounting value of their liabilities in order to offload the risk.

And, although many insurers are keen to take on longevity risk, as it partially balances the mortality risk they are exposed to from selling life assurance, their appetite is not limitless.

Dan Mikulskis, co-head of asset liability management and investment strategy at Redington, a consultant, says: "The [insurance industry's] capacity for that kind of risk is never going to be sufficient to absorb all the corporate pension risk out there, but it does have a role to play in reducing longevity risk for some funds."

Age concern: most people will need to save more

Prof Blake adds: "There is now a massive concentration of longevity risk with a small number of insurers."

He notes that investment banks, which had shown interest in entering the market, have been put off by tighter regulation in the wake of the financial crisis.

The take-up for longevity swaps has been lower still, with UK companies having hedged just £31bn of their total liabilities, estimated at £1.16tn by the Pension Protection Fund.

Mr Mikulskis says that for most schemes, longevity risk is still relatively minor. It becomes more important however when equity or interest rate risk diminish as funding levels improve.

Governments are responding to rising life expectancy by raising retirement ages. The OECD says most of its member states will have retirement ages of at least 67 by 2050, a typical rise of 3.5 years for men and 4.5 years for women. Yet it argues governments "need to do more to encourage people to work longer and save more".

Prof Blake lauds two recent developments in the UK as potential solutions. First, the advent of "auto-enrolment" will ensure most of the 8m to 9m workers currently without private pension provision are enrolled in a scheme, unless they choose to opt out.

Second, the current government has explicitly tied rises in the pension age to movements in life expectancy.

"The idea is that the state pension age will rise so that every generation spends two-thirds of their adult life in work and one-third in retirement," he says. "We now, for the first time, have a kind of measure of intergenerational equality."

But other problems remain. "The thing that we haven't really confronted is long-term care," says Prof Blake. "I speak to a lot of people in local government and they say the two things that will overwhelm local authorities are the cost of adult social care – which is an uncontrolled item of expenditure in their budget – and their pension plans."

Mr Mikulskis sees little scope for governments to offload this healthcare-related risk.

"There are very few natural hedges; [there is a] shortage of people to take the other side of the trade," he says. "To some degree it's part of governments' role to take on this risk."

Serco pays high price for lax controls and poor culture

Company profile

The group has its work cut out to repair the damage to its reputation, writes *Gill Plimmer*

Serco is a case study in what happens when risks are not properly managed.

The outsourcing giant has lost its veteran chief executive, seen millions of pounds wiped off its share price and issued two profit warnings in a turbulent year that left it facing serious reputational damage and in trouble with one of its biggest clients – the British government.

In January, the company was told that it would be allowed again to take on fresh central government contracts in the UK after six months in purdah.

Serco had been barred from being awarded work after it was referred to the City of London police for manipulating figures on a prison van escorting contract, and to the Serious Fraud Office for overcharging on the electronic monitoring of offenders.

The FTSE-listed company remains closely watched by officials in Britain. And the reputational damage inflicted will leave Rupert Soames, who takes over as chief executive in June, with a tough job restoring its battered fortunes.

Serco employs 122,000 staff in 30 countries, running services including air-traffic control towers, prisons and hospitals.

But about a quarter of its £4.9bn annual revenues come from work with the UK government, so the group has a strong incentive to improve its risk management quickly.

In Serco's case, this involves a tighter watch on hundreds of contracts and management staff, many of whom may have transferred from public sector employers.

Julian Birkinshaw, professor of strategy and entrepreneurship at London Business School, says that cultures can take years to change. However, there are also clear things the company can do.

"You can do all the contracting you like, but ultimately it comes down to the moral fibre of the people involved in negotiating and implementing the contract, and whether they honour the spirit of the agreement or the actual contract," he says.

"These people are being asked to deliver on thin margins and some companies push a culture where doing things the right way is the norm and in others, penny pinching and cost squeezing are condoned."

A National Audit Office report last year listed five separate reviews into problematic contracts run by Serco. Chief among these is an ongoing investigation by the Serious Fraud Office for overcharging by millions of pounds for electronic tagging of offenders, including for people who were dead.

A number of employees at the company have also been referred to the City of London police after being accused of altering records on the transport of prisoners in London and the southeast.

It has in addition faced criticism for its management of accommodation for asylum seekers, and over its running of an out-of-hours medical service in Cornwall. Nevertheless, Serco has been keen to demonstrate that it is tightening its processes.

'Serco allowed a culture to prevail in which a little bit of shaving round the edges was allowed'

In the wake of the revelations over electronic monitoring, the company established a "crisis management" task force, with about 60 staff, led by the chairman Alastair Lyons.

They helped PwC, the professional services firm, carry out the electronic tagging audit, trawling through emails, and helping to find any evidence of overbilling on other government contracts.

Serco appointed Lord Gold, a senior City lawyer, to conduct a review of its business practices. It has also brought in a variety of other advisers, with Ernst & Young examining management processes and identifying why front-line staff on electronic monitoring contracts, for example, decided to make a false record of information.

Ethical Leadership Group, a US company, is also delivering a new code of conduct and ethics, which has already been taught to 1,300 staff and will be transferred to employees worldwide over the next few years.

While an underlying shift in business behaviour is likely to take time, Prof Birkinshaw says transformation is possible.

"It seems clear that Serco allowed a culture to prevail in which a little bit of shaving round the edges was allowed," he says.

"The chief executive has his or her work cut out to change that. There are two pathways: formalisation and personalisation.

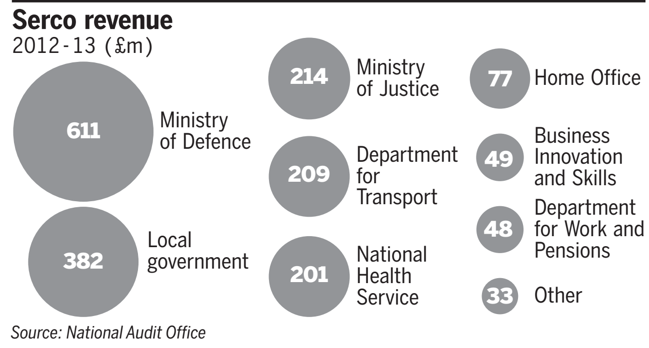
"On the one hand, you can create rules and procedures for checking up on staff, and making sure things are done by the book. But smart people can always find a way around rules," he adds.

Prof Birkinshaw says the other way is the personal approach, where you get people to understand the rationale for why they should do the right thing.

"Ultimately this is the better approach, but you are never going to get 100 per cent take up. There will always be some people who want to rebel against authority," he says.

"But you can get most people wanting to do the right thing. Some combination of the two models is therefore what I would usually recommend."

Serco revenue
2012-13 (£m)



Source: National Audit Office