The Art and Science of Risk Management: Corporate Values, Accountability and Customer Focus

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"One of the key elements of risk management is establishing a strong risk culture where the tone is set at the top, and then embedding that culture throughout the organization. It takes the right people, who are well trained, customer-focused, and who have strong personal and community values."

Thank you very much. I'm very pleased to be here.

I felt that it was a good time to have a discussion about risk management – given some of the news stories that have come out, as well as the broad changes taking place in the financial industry.

Today I'd like to spend a few minutes talking about what risk management means to me, to the banking industry, and particularly to Scotiabank, as well as how it's changing, and why it matters, or should matter, to everyone.

Why have this discussion now

It was four years ago that Lehman Brothers failed, and the massive scale of the crisis became very clear, very quickly.

I can tell you that for those of us in banking, the failure of Lehman is one of those things that you remember where you were when you first heard it. I was in Thailand. We had been worried about Lehman despite its 'single A' rating, and we had significantly brought down our exposure and held zero credit risk.

Despite that, we took a loss on Lehman, although we remained profitable for the year with a return on equity of over 16%.

There were good reasons for Scotiabank's profitability: our strong Canadian base and diversification in over 50 countries, as well as the sound supervision and policy here in Canada, and of course, good risk management.

Today, three years after a global recession, the world's economy remains weak. In the developed world, growth is slow if it's happening at all, and even the strong economies of Asia and Latin America have geared down.

The mixture of slow growth, high volatility and continued uncertainty has become the new normal, and will not soon go away.

The financial sector as a whole has shouldered much of the blame for the events of the past several years. Some of it was deserved, but certainly not all of it.

There were many factors that contributed to the crisis. Fundamental failures in risk management by some financial institutions were evident, but as the G20 pointed out, there were also "major failures of regulation and supervision", as well as government policies.

And we have to remember that many of the most significant failures, AIG, Bear Sterns, Lehman, Country Wide, GMAC, Fannie Mae and Freddie Mac, were actually non-banks or what we call 'near banks', not traditional, fully-regulated commercial banks.

Some banks did fail, RBS, Washington Mutual and Northern Rock, for example. And many banks - due to their interconnectivity in the global financial system – needed bailouts, largely because of the systemic risk that spread as liquidity dried up and the capital buffers of those who were overleveraged became threatened.

The financial industry has paid a heavy toll for this and for risk management mistakes, job losses, shareholder value and particularly reputation.

The financial system, especially banks, depend on trust, confidence and integrity more than any other market. Consumers must be able to trust their bank with their money. This is the real danger banks face, and the implications go far beyond banks themselves – to the entire payment system.

Whether it is banks or non-banks, whether it's cash, credit cards or internet payments, we all have to trust that our savings will be protected and our payments can be made in trust. This is the oil for the economic engine of our society.

Particularly with this level of economic uncertainty, it's more important than ever that banks re-build and maintain the trust of our customers, and work with them to grow and become financially better off.

That's what will help drive economic growth and job creation and to support the right fiscal and monetary policies that we need.

The reason banks exist in the first place is to help customers and transact their financial needs in safety and confidence, and we must never lose sight of that.

Whether you manage a small town branch or a hedge fund, here in Canada or, for us, in the 55 countries we operate in, this customer need is our first priority. That's the role we play, for our customers, our shareholders and for our economies.

However, recent bad judgement still shown by some suggests otherwise, and has not helped our case in the court of public opinion.

Quite frankly, it's frustrating, because these very public errors by a few banks give consumers the impression that all banks have learned nothing from the financial crisis, when in fact, that's not the case at all.

Over and above what's been asked by regulators, the global banking industry, on its own accord, has made major progress in restoring capital and improving risk management since the crisis, despite the high profile mistakes.

The banking sector, taken as a whole, is vastly improved from where it was, and the industry itself is continuing to lead further changes and monitor its progress.

The crisis the world is in today is not about liquidity or interbank funding, but about sovereign risks and lack of growth.

So, why is risk management important to consumers?

Why risk management is important to consumers

It’s important because, contrary to what you may have heard, banks and consumers share the same goals: a safe and well-functioning financial system that supports a strong economy.

Banks and consumers benefit from long-term relationships and both rely upon one another to succeed.

Banking has this critical role in an efficient economy. We put customer deposits, your savings, back to work in the system, which helps drive economic growth and innovation.

We face customers every day and extend them credit so that they can buy a home or a car, or so that their business can expand and hire more people or invest in new equipment. We give them advice on how to reach their financial goals.

Banks are also major employers, large taxpayers and strong supporters of local communities. Our shares are widely held, and Scotiabank shareholders have experienced some of the highest investor returns, both in absolute and relative terms, over not just years, but decades.

In order for banks to help economies grow, a certain level of risk must be taken.

It’s how those risks are managed - and how we find that balance - that makes all the difference, and determines our success or failure.

Those who get risk management right, thrive, those who don’t, falter. Canadian banks have shown that we’ve done extremely well at this.

But what does it take to “get risk management right”?

Getting risk management right

Risk management refers to all of the different parts that ensure a financial institution is run safely and soundly.

We’re talking not only about market and credit risk. It’s also operational, geo-political and reputational risk, and protecting the Bank and our customers from fraud and privacy violations, and doing all of this efficiently and effectively.

For an organization like Scotiabank, with four business lines and more than 80,000 employees in 55 countries, that’s a lot of moving parts.

One of the key elements of risk management is establishing a strong risk culture where the tone is set at the top, and then embedding that culture throughout the organization. It takes the right people, who are well trained, customer-focused, and who have strong personal and community values.

It’s also setting the right risk appetite, the balance of setting the right risk for the right amount of return.

A strongly embedded risk culture forms the foundation for the policies, processes and models which are needed to set limits, establish lines of responsibility and align to the right incentives.

All of this ensures that regulatory obligations are met, and that trust and confidence, and yes, profitability, is maintained.

Every large, modern financial institution has sophisticated risk models and rules, but – as we have seen, not all of us are good at managing risk and achieving these goals.

That's because the human element, the culture of the organization, our values and understanding our customers, plays an essential role.

It's about business judgement, having the right supervision, internally and externally, accountability, and taking responsibility for outcomes.

It's about knowing your customer.

It's about thoroughly understanding what you are providing to those customers, credit or advice and why it's suitable for them and for the Bank.

And it's about applying logic and common sense to arrive at good decisions.

It's an art, not a science, or a computer model.

It's really not much different than the way many of us approach decisions in our everyday lives:

- We question things that appear too good to be true
- We carefully choose who we do business with
- We look at the long-term effects of our decisions before we make them
- We make sure to always read the fine print
- And we don't put all our eggs in one basket – we diversify

Risk models are useful tools based on certain assumptions, but ultimately decisions are made by people, founded on personal values and the values of their organization, using their business judgement, experience, proven processes and discipline.

It does require independent checks and balances, both internal and external, but accountability rests on how we manage.

When I attend meetings with my counterparts around the world, I often remind myself, and them, that I have been fortunate to be one of the few CEOs in the world who has actually been a branch manager.

I know what it’s like to sit across from a customer and get a gut feeling about whether or not they will repay the loan I’m about to finalize with them.

Trusting that instinct, even when a target or a bonus is on the line, can mean the difference between a good decision and a disastrous one. In our business, we can’t afford too many wrong decisions.

That’s where values come in, because decisions are rarely black and white, they are usually grey, and we rely on our training, our values and our culture to guide us to the right decisions.

As I mentioned, a culture of strong conservative values has to come right from the top. It’s up to leaders to communicate and demonstrate that when it comes to making decisions, values and judgement trump everything.

So, what does progress look like?

Progress in risk management

The financial industry has long been proactive about improving risk management. Global industry associations like the Institute of International Finance which comprises almost 500 of the largest financial institutions have realized our obligation to correct ourselves.

Certainly, Canada’s policy makers and supervisors have played a significant role. Our unique strengths in financial services have given us international recognition and an ability to be a part of the development of solutions.

Shortly after the crisis, as a director and Vice-Chair of the IIF, I was asked to lead a task force to establish best practices and then to monitor the implementation with our membership.

We didn’t do it because anyone told us to, but because we understood the importance of it, and our responsibility, and we still do.

Now more than ever, I can assure you that most of us in financial services understand that over and above capital and liquidity, risk management is critical and must be a priority.

It doesn’t mean mistakes haven’t been made since the crisis, or that they won’t be made in the future. We are learning from them, and trying not to make the same mistakes again.

Let’s keep in mind that the global economy and financial markets have become far more complex and interconnected in a very short period of time, and risk management needed to catch up.

Crises have not, and will not, go away, but good risk management will ensure that the next crisis will not be as bad as this one.

Some of us manage risk better than others. As an industry, we're getting there. Let me give you some examples.

Summary of select findings of IIF report

The IIF has been tracking progress on risk management since the financial crisis and our 2008 report on recommended best practices. We have reported annually now for three years. Our progress is detailed in a co-sponsored report by the IIF and Ernst & Young which shows that banks around the world have made major strides.

Banks have invested huge amounts to build their teams and upgrade their systems. It should be noted that this is taking place in addition to the sharply rising costs of compliance with new regulation, and significant deleveraging.

I'll just name a few of the study's findings:

- Boards of directors are more involved in nearly all aspects of risk. They are spending more time on it, and the composition of boards is changing in favour of directors with strong banking and risk backgrounds.

- The role of the Chief Risk Officer has grown. The scope of responsibility has expanded far beyond traditional areas of credit and market risk to operational and reputational risk and others. More than 80% of CROs now report directly to the CEO – allowing them to challenge business heads on matters of risk.

- Risk teams are bigger and more skilled. Risk expertise has become a highly sought-after skill, and universities around the world are establishing programs to keep up with demand. In Canada, we have created the Global Risk Institute through the support of both the government and banks.

- In the report's findings, 92% of firms had made changes to how they manage liquidity – one of the biggest lessons learned from the financial crisis. Firms have increased buffers of liquid assets that can be used in the case of emergency, and liquidity risk has been strengthened and elevated as a key focus. This is even before the forthcoming new rules by regulators.

- Enterprise-wide stress tests, using extreme hypothetical scenarios, are now viewed as central to improving risk governance, and nearly all firms have strengthened this tool.

- Perhaps most importantly, embedding an effective risk culture across the organization has become a priority. This is perhaps the most difficult aspect of risk management to implement and measure – but it's absolutely crucial.

These achievements as well as many others reported in the study are encouraging, but there is still more to do.

For example, only just over a quarter of firms feel as though they've embedded their risk appetite into their business, and only 37% reported a link between risk appetite and day-to-day decision-making. This has to improve.

Our IIF group will be producing a further report at our next meeting in Japan in October that addresses some of these gaps and gives direction and practical examples to help firms overcome challenges of implementation.

Scotiabank's approach

I'd like to touch briefly on Scotiabank's experience.

Prudent risk management and appetite is part of Scotiabank's five-point strategy, which we've managed under for several years, and has been continually outlined in our annual reports.

It's a traditional strength of our Bank, something we've been focused on since the beginning and it remains a very important part of our brand, particularly in international markets.

Our level of credit, market and operational losses rank us amongst the best in the world over several years, even before the crisis.

Good risk management has underpinned this performance and is critical to our long term viability. That's why our entire organization is geared to manage risk well – from our structure to our values.

That's the essence of a strong risk culture, one that reaches all corners of the organization. That's also why it's so difficult to establish and it's not done overnight.

- It starts with our highly diversified and carefully balanced business model. We are roughly split 50/50 between Canadian and international, and our four business lines are more evenly divided than any of our peers. Diversification means stability.

- We maintain strong capital levels, and always have, well above regulatory minimums, so that it's there in case we need it. But we never have.

- Our stated core purpose is directly linked to customers' financial well-being: To be the best at helping customers become financially better off. That keeps our whole organization focused on what's most important.

- We have long term relationships with our customers, and we understand that our continued success is tied to theirs.

- We've never been interested in investors who buy our shares to flip for a quick buck, that's why we don't give quarterly predictions on earnings. We want investors who demand strong, consistent performance, and hold us accountable for delivering it, both short and long term.

- Scotiabankers embrace a philosophy that we call One Team One Goal – where we all work together for the benefit of customers, not for our own department or business line.

- Underpinning everything are Scotiabank's core values: Respect, Integrity, Commitment, Insight and Spirit. These values are known to every employee, and are on display in every branch and senior management office, including my own. They guide our decisions, as well as our hiring practices. All 80,000 of us sign a code of conduct each year and have since well before the crisis.

- We take a top-to-bottom approach to managing our risks, with clear lines of accountability that flow right up to me and the Board. As have my predecessors, I lead the top risk committee, which meets at least twice a week. At the same time, every employee is held accountable for risk management, and we ensure that for all important risks, we have a second or even third set of eyes on them.

- A number of years ago, we successfully implemented an enterprise-wide risk appetite framework that's aligned with our objectives and our risk culture, and that covers not only credit risk, but also market risk, operational risk and others.

- Our processes are constantly evolving because so are the risks themselves. We expect the unexpected and adjust and adapt to manage new risks as they surface.

- And while we use models and stress tests as tools, judgement always counts. It's the hand and mind that guides the tool – not the other way around.

Canadian system

Our approach to risk is rooted in the strengths of the Canadian system, the soundest in the world, based on principles rather than rules, with sound supervision and government policies, good business judgement and quality risk management.

We work very closely with governments and regulators not only to strengthen risk management at the enterprise level, but also to address systemic risks – which is why we continue to advocate for a national securities regulator in Canada.

Working together was a hallmark of the Canadian system during the crisis, a hands-on, proactive, consultative approach amongst all the players.

Canada's system has many other strengths, our unique approach to mortgage financing, which has proven to be very efficient and prudent for both customers and banks, our strong and productive supervisory relationship – our conservative approach to leverage, and little proprietary trading or securitization of our assets.

The result is strong and stable banks with sustained profitability, the best defence against further crises and, most importantly, the best able to support customers in a sustained slow economy.

Canadian banks have increased lending and offered new products, services and banking channels during this period which is not the case in many other jurisdictions. It's something I'm proud of, and all Canadians should be as well.

Conclusion

In conclusion, to tackle the big challenges ahead of us to restore stability, job creation and strong growth to the global economy it's going to take the continued effort, dialogue and co-operation of all parties.

My humble advice to our leaders, particularly in Europe and the United States is that yes, banks were part of the problem, but now we must also be part of the solution.

Particularly right now, governments are in no shape to tackle these issues alone.

Huge progress has been made by financial institutions to correct the mistakes of the past and build a stronger, safer and more resilient global financial system that supports and drives economic growth.

There is still a lot of work to be done, which is why we're focused on keeping the momentum going, and working to make things better.

Developing and implementing a strong culture around risk management involves changing the behaviour of often of tens of thousands of people spread throughout the globe and it's not something accomplished overnight.

But the financial industry understands the importance of it, which is why we are leading these changes ourselves, as well as responding to policy makers and supervisors.

It's absolutely critical that we earn back the trust that's been lost by staying focused on customers, and continuing to advise and lend to them, to help them succeed.

We have unique challenges in banking because of the scale and complexity of our business and our prominent role in the economy.

But the foundation for our long term success is the same as it is in any business. It begins with a culture of strong values and good business judgement.

And the only way it works is when it comes from the very top, and becomes embedded in the organization.

It's up to us – the leaders of our organizations – to set the tone. Leadership is more than making the big decisions. It's modelling the behaviour you want to see in your organization – leading by example – and holding others accountable for doing the same.

We’ve got to walk the talk.

It’s not easy. Sometimes you have to bite the bullet and say “no” even when you really want to say “yes” because you know deep down it’s the right thing to do.

At those times we need to remind ourselves that we’re not just making one decision. We’re influencing many decisions by those around us and throughout our organizations. And by doing that, we’re building a strong culture that is an enduring foundation that ultimately makes us more successful in the long run.

It’s why Scotiabank is around to celebrate our 180^{th} anniversary of consistent profitability and dividends and the confidence and trust of our customers.

Thank you.