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"De-risking – A Different Perspective on Risk Management"

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ABSTRACT

This paper examines the phenomenon of de-risking. According to the definition provided by the Financial Action Task Force (FATF), the term "**De-risking**," refers to the practice of financial institutions exiting relationships with and closing the accounts of clients perceived to be "high risk." Rather than manage these risky clients, financial institutions opt to end the relationship altogether, consequently minimizing their own risk exposure while leaving clients bank-less. This exploratory study was designed to understand the process of De-risking and to identify the core drivers of this practice and its implications for financial inclusion goals, particularly as they affect vulnerable communities. It provides a number of relevant case studies highlighting innovative approaches to, and lessons learned from, addressing de-banking challenges across six different sectors with varying degrees of banking incentives, as well as a set of recommendations about how invested stakeholders can better address de-risking challenges.

Key Words: De-risking, Risk Management, Key Drivers of De-risking, Financial Institutions, Corporate

Introduction to the study

Risk is the potential for uncontrolled loss of something of value. Values (such as physical health, social status, emotional well-being, or financial wealth) can be gained or lost when taking risk resulting from a given action or inaction, foreseen or unforeseen (planned or not planned). Risk can also be defined as the intentional interaction with uncertainty. Uncertainty is a potential, unpredictable, and uncontrollable outcome; risk is an aspect of action taken in spite of uncertainty.

Overall, it is possible and prudent to manage investing risks by understanding the basics of risk and how it is measured. Learning the risks that can apply to different scenarios and some of the ways to manage them holistically will help all types of investors and business managers to avoid unnecessary and costly losses.

Risk management is the identification, evaluation, and prioritization of risks (defined in ISO 31000 as *the effect of uncertainty on objectives*) followed by coordinated and economical application of resources to minimize, monitor, and control the probability or impact of unfortunate events or maximize the realization of opportunities.

Risk can mean different things in different contexts: in banking and insurance, risk management tends to be a purely financial process for exposing and measuring financial exposure; to the manager of a nuclear power plant, risk management is about avoiding physical disaster; to the manager of a change project, it's making sure that delivery is on time, within budget and ensuring that the project meets its stated objectives. In every case, risk is inevitable.

Why do you need risk management?

Whatever the context, risk management is essential, especially in a global, competitive marketplace where business processes are increasingly complex and transparent.

Essentially, increased complexity = increased risk.

If the risks inherent in business processes and business strategies aren't captured, analyzed and managed, organizations will operate at sub-optimal levels. When this happens, and risks become full-grown problems (or "Issues"), this costs an organization time, money, reputation and jobs. Many organizations approach risk management on an informal, ad-hoc basis which is ineffective in complex business scenarios. This is why a formal risk management process is essential.

The problems with "Traditional Risk Management "

These days, most organizations will have some form of "formal" risk management process. A traditional risk management framework will normally involve:

- Identifying the risks to your strategy/programme/operations
- Analysing the impact and probability of these risks.
- Prioritising risks, from highest to lowest risk exposure.
- Risk management planning & setting objectives.
- Risk monitoring – deciding on the governance of these risks i.e. how risk management will be monitored by management and major stakeholders.

However, traditional risk management frameworks can often fall short or fail, for a number of reasons.

1. Risk is inevitably seen as negative concept
2. Issue management, not risk management
3. Risk statements are too generic
4. Risk actions are insufficiently proactive

A different Perspective on Risk Management.

Many of the disasters associated with large scale programs (i.e. over-runs, escalating costs and inability to deliver objectives) are ultimately caused by the failure of the traditional risk management approaches used widely in industry today.

De-RISK will:

- Identify significant risks that would not be identified by traditional approaches
- Create a clear, detailed, and rigorous picture of the risks within your organization that can be efficiently communicated.
- Avoid being 'sucked into the noise' – maintain a strategic view of the risks without unnecessary distractions.
- Create a "roadmap" to show you how to go from where you are predicted to be to where you want to be.

What is De-risking?

Especially in a business context take steps to make (something) less risky or less likely to involve a financial loss.

Derisking: **"the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk." (*As defined by the World Bank*)**

Banks and financial institutions do the same thing sometimes. For them, de-risking means cutting ties and lessening relationships with categories of customers that are considered 'high-risk'. The bank may stop offering financial services to 'high-risk' customers (termination of services), and may choose to close their existing accounts. The bank may also choose to restrict the services provided to 'high-risk' customers, carefully monitoring them and subjecting them to special stipulations. Such customers may be companies, persons, whole countries, or other banks themselves.

According to the Financial Action Task Force (FATF), de-risking is defined as "the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk". The risk referred to in "de-risking" is a customer or client who could pose a higher than average risk of Money Laundering (ML) or Terrorism Financing (TF) or that processing transactions might result in a breach of sanctions regulation. De-risking can be caused by economic and regulatory concerns.

Economic concerns center around profitability, low risk appetite and excessive compliance cost. Regulatory concerns focus on perceived high risk; whether it is a country or a customer. It also deals with the possible breach of AML/CFT international/regional sanctions.

When de-risking occurs, it drives financial transactions underground to less regulated or unregulated channels. It creates financial exclusion and there is reduced transparency. These all lead to increased risk of AML/CFT.

What's driving De-Risking?

- Reputational Risk
- Compliance Risk
- Complexity of Financial Products, and Complexity of Sanction & AML Compliance Rules
- Hefty Fines
- Change in Policy and/or Risk Appetite
- Perceived Risk is greater than the expected value of the business
- Inadequate Budget to Support Increased Due Diligence and Monitoring Activities
- Unfavourable Remarks from Regulatory Examination
- High-Risk Categories Designated by Regulatory and Government Agencies.

Potential Benefits of De-risking:

1. Improved Strategic decision-making due to the ability to identify risks and cost of doing business in different jurisdictions.
2. Increased visibility into the company's processes along with increased business efficiency.
3. More transparency and clearer accountability.
4. Reduction of surprises faced by organizations due to clear ownership of controls and a better understanding of inherent and residual control risks.
5. Possibility to use effective regulatory and compliance risk management as a differentiator in the market.
6. Dynamic risk assessment framework to continuously identify emerging risk.
7. Robust early warning mechanism to alert the management on significant issues at an early stage.
8. Strong change management framework to stay current and upbeat with the emerging trends.

Aniruddha Bose, Director & Business Head, FinEdge Advisory, says,

"De-risking is a critical aspect of the financial planning process. Without a proper de-risking strategy in place, one could end up losing hard earned goal-based capital at the penultimate moment due to market fluctuations."

Problems with De-Risking:

In adopting blanket de-risking practices, firms often generate new AML problems and challenges for the wider financial system.

- When customer relationships are terminated, the need those customers have for financial services remains. If they are unable to access services from larger providers, they may move on to banks with less stringent AML controls. These banks may be unaware of or unable to safely manage the money laundering risk certain customers present.
- Large banks often operate with a complex administrative infrastructure in which certain systems lack mutual integration. When a bank terminates a relationship for de-risking purposes, customers may be able to simply re-enter the bank through a different business vector.
- De-risking often frustrates the ultimate goals of AML/CFT programs to share information and reduce crime since the practice pushes criminal organizations into less regulated territory where they become harder to monitor.
- When several banks de-risk entire sectors, there may be a significant impact on the financial system. That collective action may also create the appearance of banks acting in collusion and, therefore, generate potential legal consequences.
- In some cases, de-risking ends up harming humanitarian organizations or charities that rely on certain financial services to get supplies and other types of critical assistance to vulnerable people in developing countries.
- De-risking customers en masse requires a coordinated exit program, which can be both expensive to manage and difficult to implement consistently.
- De-risking tends to disadvantage smaller countries since customers in these countries may not represent attractive financial prospects for larger banks.

Objectives of the study

1. To study the concept & driving factors of De-risking
2. To Understand the challenges and Impact of implementing De-risking
3. To understand the benefits after implementing De-risking.
4. Summarize relevant case studies to highlight innovative approaches and lessons learned to address challenges across a variety of diverse sectors.

Literature review

(October 2014 Basel Institute on Governance) This paper has been prepared jointly with contributions from a number of parties including the Basel Institute on Governance, BAFT, the BBA, ICC, the IIF and the Wolfsberg Group. Its purpose is to examine concerns about why money laundering, terrorist financing and other financial crime risks are causing banks to withdraw from or reduce their exposure to certain countries, customer sectors, products, business lines, and markets. It further examines the potential consequences and conflicts that may arise from such actions in respect of the effective achievement of overall anti-money laundering, counter terrorist financing, sanctions and Anti-Bribery and Corruption goals against wider economic financial inclusion initiatives and the stability of the financial services system. The report concludes by considering how governments, regulators and the private sector can work more effectively to their common goals.

(November 2015 Durner and LiatShetret) This report is based on a four-month exploratory study on the impacts of bank de-risking practices on financial inclusion, carried out between November 2014 and February 2015. This exploratory study was designed to identify the core drivers of this practice and its implications for financial inclusion goals, particularly as they affect vulnerable communities. It provides a number of relevant case studies highlighting innovative approaches to, and lessons learned from, addressing de-banking challenges across six different sectors with varying degrees of banking incentives, as well as a set of recommendations about how invested stakeholders can better address de-risking challenges.

(February 2016 David Artingstall, Nick Dove, John Howell, Michael Levi)

The study looked at questions posed by the FCA in four broad areas – the drivers of de-risking, the exclusion costs of de-risking; the costs of triage (i.e. the costs for banks of on boarding customers and costs to customers of meeting AML obligations); and mitigations of de-risking programmes.

Sectors at risk from de-risking highlighted by the FCA for the purposes of this study include Money Service Businesses (MSBs), charities and Financial Technology (FinTech) companies.

(April 2016 Deloitte)

In this paper, the team has identified the biggest threat of Cyber-attacks on financial services companies. It has also given the solution as when the attack severity increases, it may be likely that only a resilient and flexible cyber security model can prepare financial services companies to survive the inevitable cyber risks. According to paper, financial services firms should consider raising their level of preparedness and evolve into a new cyber risk management paradigm that strives to achieve three fundamental qualities:

1. Being secure against known threats through risk-driven investment in foundational, preventive controls, and policies
2. Being vigilant by improving the ability to detect emerging threats and anomalous patterns amid the highly complex and data-saturated environment; and
3. Being resilient to enable the organization to recover from attacks as quickly as possible and minimize both direct and indirect damages

(August 2016 KPMG, CII)

In this paper, the author has made an attempt to analyze the potential of risk management strategies as an effective tool for riding the growth wave for Indian industries using technology in its favor and be a part of a larger success story.

The report analyses management strategies in various areas including financial services, globalization, multiple taxation risks, future risks in smart technologies and robotics, cyber security risks, crisis management, risks in acquisitions and joint ventures, regulatory risks and human capital risks amongst others.

According to the report, an in-depth study of these critical areas can help organizations develop a perspective on effective risk management, mitigating risks, analyzing risks and consequently, devise the way forward.

(July 2017 James A. Haley)

This paper examines the phenomenon of de-risking or the loss of financial services as large international banks close or curtail CBRs with banks in smaller jurisdictions. It outlines the effects of de-risking and identifies a range of possible measures to mitigate them. While affected jurisdictions bear the financial costs, de-risking is a shared problem, requiring a shared response. This response includes efforts by affected countries to comply with international AML and CFT standards

Research methodology

This study is based on secondary data collected from various sources. The major source of information is news articles. The Case Study approach has been used as it allows in depth multifaceted explorations of complex issues in their real life settings. Two cases of corporate has been analysed to get valuable insights about de-risking practices adopted by the corporate and the reasons behind the same.

Case-1

Tata Elxsi to de-risk business model; focus on rail communication

In the June quarter, the Tata group company reported a 31% decline in net profit to Rs 48.79 crore

DebasisMohapatra | Bengaluru Last Updated at August 10, 2019 22:17 IST

Tata Elxsi, the design and engineering services firm based in Bengaluru, is looking to de-risk its business model and focus more on areas such as aerospace and rail communication. The shift in strategy has come at a time when Jaguar Land Rover (JLR), its largest client accounting for a quarter of its revenue, is going through a rough patch.

In the June quarter, the Tata group company reported a 31 per cent decline in net profit to Rs 48.79 crore, owing to general slowdown in the automotive sector, which contributes above half of its total revenues. Since its earnings announcement, the share price of the firm has already declined close to 14 per cent.

"As a strategy to de-risk the automotive, we have started some initiatives in both rail and aerospace (segments), and have already (signed) some good logos (clients). In that sense, we have started winning those deals and just have to make those deals sizeable," said Manoj Raghavan, executive vice-president and CEO-designate of Tata Elxsi. Raghavan will take over the mantle as chief executive in October this year, from incumbent Madhukar Dev.

With an objective to reduce its concentration risk in automotive, the company has already put together a focus team consisting of close to a 100 engineers.

Raghavan said that the company is also looking to increase contribution of the other two verticals — medical, and media & communication. “Medical is a relatively smaller business for us and in a three-year timeframe, we would like to make it almost the same size of other verticals. So, my hope is that we have three major pillars (verticals), with each contributing close to 30 per cent of business, which will eventually de-risk our business,” he added.

As part of its strategic focus, the firm plans to increase its level of engagement start-ups to drive innovation. “We may also look at acquisitions to add new capabilities, apart from boosting growth. Sub-optimal captives of multinational corporations with less than 1,000 people could be a good fit (for acquisition),” said Madhukar Dev, CEO and MD of Tata Elxsi.

Despite the slump in the first quarter, the company hopes to regain momentum in the third and fourth quarter. “In the near term, we have an issue, from which we have to recover. However, by Q3 and Q4, we should be back to our run rates and hope to end this financial year with close to double-digit revenue growth,” Dev added.

In the June quarter, the company posted a 31 per cent fall in its net profit year-on-year to Rs 48.79 crore, while its revenue from operations stood at Rs 361.71 crore, down 5.3 per cent.

Case-1 Analysis: The automotive industry continues to be Tata Elxsi’s largest revenue generator and an overall slowdown in the sector has impacted its first quarter growth. Hence, Tata Elxsi is looking to increase contribution of the other two verticals — medical, and media & communication and hopes that they have three major pillars (verticals), with each contributing close to 30 per cent of business, which will eventually de-risk their business.

Case-2

India to become Apple's key production hub as part of China de-risking strategy Companies

Updated Oct 15, 2019 | 15:18 IST | ET Now Digital

Apple is also preparing to set up company-owned retail stores and start direct online sales in India after the government relaxed foreign direct investment (FDI) norms for single-brand retail in August

KEY HIGHLIGHTS

- Currently, the bulk of Apple's production is done in China, which is currently in a trade war with the United States
- The company has started production of iPhone XR model locally at the Foxconn facility near Chennai
- The Foxconn plant in India has the capabilities to manufacture the top iPhone models that sell for more than Rs 1 lakh each.

New Delhi: iPhone maker Apple Inc plans to make India one of its key global production hubs as part of its de-risking strategy as currently, the bulk of its production is done in China, which is currently in a trade war with the United States.

After undertaking trials for several weeks, the Cupertino, California-based company has started production of iPhone XR model locally at the Foxconn facility near Chennai. This reflects a move up the manufacturing value chain in India and the company's commitment to the country. Apple also has plans to start manufacturing iPhone 11 series in India.

A leading business daily citing people having knowledge of the matter said making the iPhone XR involves a higher level of technical skill and the company will export the devices to other markets after having success with the export of iPhone 6s and 7 models to Europe in the past few months. However, the executive said that manufacturing of iPhone XR in India will not lead to any price cut for the model in the country even if the company will able to save 20% in import duty. Worth mentioning here is that Apple hasn’t cut prices on any of its locally made iPhones.

Two of Apple's big global contract manufacturers -- Foxconn, Taiwan’s Wistron -- are already operating in India. Both these companies have started assembly in India near Bengaluru in 2017 but this was limited to older models.

The ramp-up of India manufacturing will allow Apple to have an alternative base and de-risk its production strategy; the publication mentioned citing the executive.

The Foxconn plant is Apple’s biggest manufacturing bet in India since it will have the capability to manufacture the top iPhone models that sell for more than Rs 1 lakh each. Earlier this year, Foxconn Technology Group founder Terry Gou had said the i-Phone will go into mass production in India this year and will include newer models.

The government is reportedly pushing Apple to manufacture its entire line-up of smart phones in India, especially the newer ones, since this would help the Make in India initiative win over more investors. Apple is also preparing to set up company-owned retail stores and start direct online sales in India after the government relaxed foreign direct investment (FDI) norms for single-brand retail in August.

Apple's global suppliers such as Flex Ltd, Salcomp Plc, Sunwoda Electronic Co, CCL Design (Suzhou) and Shenzhen Yuto Packaging Technology Co. have set up production bases in India and are manufacturing parts and accessories such as chargers and battery packs locally.

Incidentally, the iPhone XR has been Apple's top-selling smartphone in India in the past six months after prices were cut, helping the company revive flagging sales in the country. The latest iPhone 11 series too has sold record numbers in India due to aggressive pricing, the daily mentioned. Although the Cupertino-based company has around 2% share of the overall Indian smartphone market, in the premium segment it competes aggressively against Samsung and China's OnePlus.

Case-2 Analysis:

The US and China are said to be entering into a trade deal under which Washington is to suspend a proposed tariff escalation on Chinese imports that would have hit Apple, which assembles most its iPhones in that country. The ramp-up of India manufacturing will allow Apple to have an alternative base and de-risk its production strategy

Findings

1. In case-1, the automotive industry continues to be Tata Elxsi's largest revenue generator and an overall slowdown in the sector has impacted its first quarter growth, hence Tata Elxi's, the design and engineering services firm based in Bengaluru, started looking to de-risk its business model and focus more on areas such as aerospace and rail communication.
2. In Case-2, Apple aims to make India one of its key global production hubs. This will include assembly of the latest flagship iPhones in sync with worldwide release schedules and help as a de-risking strategy against the bulk of its production being located in China, currently in a trade spat with the US.

Recommendations

- Good corporate governance is recognized as crucial element for upholding and sustaining investment climate for aspiring companies and well organized financial markets.
- Organizations must keep fine tuning the Risk Management plan at all times so the effects are curbed to the maximum extent possible by way of De-risking.
- Evaluating tax structures on regular basis, to reduce the quantum of tax liabilities.
- Companies should simplify and standardize processes, effectively leveraging technology for real–time status tracking.

- Heterogeneous pool of resources for managing the day to day operations, to bring in a wider perspective for quick problem solving.

Conclusion

De-Risking is a way of "Muting or Shifting the Risk" NOT Managing it; and it would have the effect of driving the development of alternative financial markets and payment mechanism. Understand your Risk before you De-Risk.

Ironic result of De-risking is Re-risking.

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