Strategic Risk Management: The Failure of HBOS

Session Outline

1. The rise and fall of HBOS

2. Introduction to Strategic Risk
   • What is Strategy?
   • What is Strategic Risk?
   • What is Strategic Risk Management?

3. What should regulators do?
**Joint Regulators’ Report**

- In late 2015, the UK Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) concluded that Halifax/Bank of Scotland (HBOS), had failed because

  "The Board placed inappropriate reliance on continuous growth without due regard to the risks involved

  The result was a flawed and unbalanced strategy and a business model with inherent vulnerabilities"

- The failure of HBOS has so far cost the UK taxpayer some £20 billion (>AUD 37 billion)

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**Questions**

- The failure of HBOS raises some interesting questions:

  1) How was the HBOS strategy ‘flawed’?

  2) Why did no one (bankers, regulators, investors) pick up the implications of this flawed strategy until too late?

  3) Could it happen again?

- These questions are especially worrying because, in 2004, the Board of HBOS were warned by the regulator (at the time the FSA) that their aggressive growth strategy was an Accident waiting to happen!
**HBOS - Not Unique**

- Other banks have also come to grief as a result of flawed strategies:
  - Lehman Brothers,
  - Anglo Irish,
  - Royal Bank of Scotland,
  - Northern Rock, and others

- Bad strategies can be very dangerous but also difficult to detect because, in practice, most strategies are actually little more than vague aspirations which cannot really be evaluated by investors or regulators.

**The Rise and Fall of HBOS**
Strategic Risk Management

Bank of Scotland

- The Bank of Scotland (BOS) was founded in 1695, almost 100 years before the USA was formally established.

- It was known as the 'Old Bank', in contrast to Royal Bank of Scotland which became the 'New Bank'.

- BOS was efficient, innovative (especially as regards technology) and was a favourite of investors, constantly achieving annualised Return on Equity (ROE) above its peer group, the largest UK banks.

- And, towards the end of the 20th century, BOS was considered to be the “best performing bank” in the UK.

But BOS had a big Problem!

A Big Fish in a Small Pond

- Bank of Scotland made most of its profits from lending to large corporations, particularly in the oil exploration and entertainment industries.

- They were very competent lenders and had a happy set of business customers, such as UK retail billionaire Philip Green, developer of high street brands, such as Top Shop.

- However, BOS remained a Scottish bank with branches throughout Scotland, but a small presence elsewhere in the UK.

- That meant that BOS were held back by the size of their depositor base and had to seek the bulk their funding outside of Scotland. In 2000, their Ratio of Loans to Deposits was around 200%.
The Halifax

- The Halifax Permanent Benefit Building and Investment Society was formed in 1853
- Based in Halifax in West Yorkshire, it grew during the 20th century to become the UK’s biggest building society
- After legislation to demutualise building societies, it merged with the Leeds Building Society, in 1995, to become Halifax Bank
- In the late 1990s, the Halifax acquired a few more building societies and an insurance company to become the fifth biggest financial company, by market capitalisation, in the UK.
- But Halifax had a problem, it remained only a retail bank!

Marriage Made in Heaven

- In 2001, the Bank of Scotland and the Halifax agreed to merge to become Halifax/Bank of Scotland (HBOS).
- The combined entity became the fifth biggest bank in the UK (just after the Big 4) and was considered a marriage made in heaven:
  - BOS was strong in business banking and had a sizable retail presence;
  - Halifax was strong in retail, especially mortgage lending;
  - HBOS had a presence in Scotland, Ireland and England, although mainly in the North (and even in Australia – Bankwest);
  - The merger helped to reduce BOS’s perennial funding problem but the funding ratio was still high (>140%).
- Interestingly, given the stature of BOS, the top management of HBOS came from the same jobs in the Halifax
  - Chairman, Lord Stevenson of Coddenham, and
  - CEO, James Crosby.
A Stratospheric Start

- For the first few years, HBOS was stunningly successful outperforming the Big 4 banks
  - Share price rising by over 70% in just 5 years;
  - Double-digit profit growth in all but one of the years up to 2006 - HBOS was obsessed with ‘growth’;
  - Industry leading Cost to Income Ratio of 40% - HBOS was obsessed with ‘costs’, it was brutally efficient

- What could go wrong?

- HBOS was obsessed with ‘growth’, and had a fairly simple formula: grow assets, contain costs, and profits must grow

- And everyone bought into this ‘strategy’
  
  *But it wasn’t really a strategy - it was a mantra!*

The Growth Strategy

- HBOS did not fail because it gave out ‘sub-prime’ loans, in fact its mortgage book was *fairly* benign.

- The bank was doing what BOS had done well and was lending to large corporations, and it was holding its nerve, as other banks began to pull back their lending pre-GFC.

- The CEO of the HBOS Corporate division, Mr Peter Cummings, a long term BOS employee, was characteristically confident
  "Our decisive strength is assessing credit risk and assessing people. *We’re better at it.* [And, as the crisis grew he boasted] Some people look as if they are losing their nerve, beginning to panic even in today’s testing property environment; *not us*”.

- And as retail markets started to dry up in 2007, HBOS came to rely on the Corporate Division more and more for its growth.
Incompetent and Reckless

- In 2013, a UK parliamentary committee was scathing in its condemnation of the bank’s Board and management, characterising the firm’s strategy as "incompetent and reckless".

> "The history of HBOS provides a manual of bad banking which should be read alongside accounts of previous bank failures for the future leaders of banks, and their future regulators, who think they know better or that next time it will be different. ....."

Whatever may explain the problems of other banks, the downfall of HBOS was not the result of cultural contamination by investment banking. This was a traditional bank failure pure and simple. It was a case of a bank pursuing traditional banking activities and pursuing them badly.

- Paul Moore, the so-called HBOS 'whistle blower', stated "It is now clear that this disastrous ‘grow assets at all costs’ strategy was what led to HBOS's downfall".

What was the root cause of the failure?

- The FCA and PRA report released at the end of 2015, concluded “HBOS failed to establish a Group strategy, which was set in the context of clearly identified risks and measures to quantify and control these risks. Although some risks were identified during the strategic planning process, such as wholesale funding and the concentration in real estate, the significance at a Group level was not fully appreciated. Such risks were seen as constraints to the overriding pursuit of growth rather than something which needed to be addressed in its own right.

> As a result, fundamental weaknesses in HBOS's strategy were never adequately identified or addressed.”

- In other words, the Board of HBOS failed to manage their strategic risks.

- Why did investors not react? They were besotted by short-term growth and profit figures!
Strategic Risk Management

Dr Patrick McConnell

MAFC April 2016

Alarm bells were ringing but investors were deaf

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<td>Other income</td>
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<td>Total income</td>
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Group Expenses

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<td>Administrative expenses</td>
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<td>Depreciation, amortisation and goodwill</td>
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<td>-0.9</td>
<td>-1.2</td>
<td>-1.4</td>
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<td>Impairments</td>
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<td>-1.7</td>
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<td>-2.1</td>
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<td>Group pre-tax profit</td>
<td>4.6</td>
<td>4.8</td>
<td>5.7</td>
<td>5.5</td>
<td>20%</td>
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Who was managing the risks? **NO ONE!**

What was wrong with HBOS’s ‘growth strategy’

- HBOS’s *growth* strategy was a disaster, because
  - The strategy was strongly focused on revenue rather than on risk adjusted returns;
  - They just did not have the capital nor the funding to support their risky corporate lending;
  - Over-confidence and Illusion of Skill – this is way we have always done it; and
  - The new CEO and many of the Board and management were **NOT** banking experts (Andy Hornby, the last CEO, wasn’t even a banker but a retailer)

- To his credit, towards the end, Hornby admitted to colleagues that “We must ... be hard on ourselves in admitting *some of the self-inflicted actions that have made our strategic position even tougher*. In particular ... we did grow the business extremely strongly from 2002 through to 2007”.

**Much Too Little, Much Too Late!**
### Strategic Risk Management

**Growth Strategies are Dangerous**

- Like Jack in the Beanstalk story, the executives of HBOS (like those of Lehman, Anglo and RBS) thought they had found a Golden Goose and kept climbing the Beanstalk until disaster happened.

- In these cases, Boards and management thought they had found the secret of never-ending riches but they hadn’t!

- A Growth strategy is not itself unreasonable, and can be valid, *provided*
  - The growth rate is sensible, +20% per year is almost reckless;
  - **ALL** supporting capabilities are in place (capital, people, IT systems);
  - Growth is managed, if necessary by tuning down targets, as growth **WILL** run ahead of supporting capabilities;
  - Strategic Risks are **identified at the outset** and managed in Execution.

### Lesson - People are Important

- Strategies are **NOT** made by firms, they are made by People, especially the Board and Executives

- And People do not always make good decisions, in fact they **often make very bad decisions** based on so-called ‘cognitive biases’ and ‘conflicts of interest’.

- Case studies illustrate, again and again, that Board members and senior management are subject to a number of potential biases:
  - **Over-confidence**: people are hard-wired to be optimistic and are confident (sometimes too confident) in their abilities to predict/shape the future;
  - **Groupthink**: the tendency to conform to group beliefs, ‘go with the flow’, also called Herding or the Bandwagon effect.
  - **Confirmation bias**: the tendency to search for information that supports existing beliefs.
  - And many more

- The combination of Over-confidence, Groupthink and Confirmation Biases is particularly toxic.
Lesson - Strategies must be Balanced and Consistent

- Strategic Objectives must be *aligned* with Strategic Capabilities

*If you haven’t got the capabilities, especially capital, should you even start?*

- Strategic *assumptions* must be clearly articulated and importantly be questioned by Board directors

- Return and Risk are *asymmetric* in time
  Short term profitability could be a result of a temporary mismatch between strategic objectives and capabilities, i.e. short term profits as against long term risks.

- Strategic Risks must be identified *at the outset* and managed in execution.

What is Strategic Risk?
What is Strategy – Management Theory?

- In discussing strategy in terms of ‘competition’, Michael Porter defines ‘competitive strategy’ as:
  "A combination of the ends (goals) for which the firm is striving and the means (policies) by which it is seeking to get there."

  *Strategy is not only about objectives but also how you get there!*

- Among several definitions, George Steiner notes that ‘strategy’ answers the questions:
  "What should the organisation be doing?; and
  What are the ends we seek and how should we achieve them?"

- In a lengthy definition in The Concept of Corporate Strategy, Kenneth Andrews defines:
  "Corporate strategy is the pattern of decisions in a company that determines and reveals its objectives, purposes, or goals, produces the principal policies and plans for achieving those goals, and defines the range of business the company is to pursue, the kind of economic and human organisation it is or intends to be, and the nature of the economic and non-economic contribution it intends to make to its shareholders, employees, customers, and communities."

  *Again, Strategy is not only about objectives but also how you get there!*

What does a good Strategy look like?

A Strategy has two distinct components:

1. **Strategic Positioning**:  
   - Where *exactly* are we going?  
   - How will we *know* when we get there?

2. **Strategic Execution**:  
   - How are we *actually* going to get there?  
   - How *long* will it take?

A Good Strategy is about *specifics*, even if a little *rough*:

1. What are the rough objectives?  
   *E.g.* 20%-25% of local market
2. What are the rough means?  
   *E.g.* by new products and services
3. What is the rough timetable?  
   *E.g.* by 2017
4. What is the rough plan?  
   *E.g.* $100 million expense

*Example: The firm will invest $100 million in developing new mortgage products to gain 20%-25% of the local market by 2017*
What is Strategic Risk?

Why would a Strategy Fail?

- There are very many reasons why a Strategy might fail, for example

- Lack of Knowledge, we may not know exactly
  - where the industry is headed;
  - what our customers will want in the future;
  - what our competitors are going to do;
  - which technology is needed;
  We can guess, but we may be wrong!

- Given the possible strategic options, we don't know which one is best for us.

- We may not have the capabilities to achieve the objectives. For example,
  - Lack of Capital: Insufficient funds, generated from operations;
  - Lack of Expertise: Insufficient people with the skills necessary to maintain and change the business model;
  - Lack of Time: can we execute the strategy while still relevant?
  Very Important – can we execute the Strategy, while maintaining Business as Usual operations?
What is Strategic Risk?

- Strategic Risk is the risk that a
  *Strategy may fail to reach its Strategic Objectives on a sustainable basis*

1. **Strategic Positioning Risks:**
   - Are we **going to the right** place?
   - Are we **starting from the right** place?
   - Can we get there from here?
   - Can we get the **resources** we need to get there? (Capital, people, skills?)
   - Do we **know** when we get there?
   - What are the Objectives?
   - How **long** will it take to get there?
   - What is the plan?
   - Are we **afford the disruption**?
   - What about business as usual?
   - When we get there **will it be worth it**?
   - Is the risk worth the return?

   If ANY of these is unknown, should we even start?

2. **Strategic Execution Risks:**
   - Is the **plan** actually going to get us **where we want to be**?
   - Is the **plan still on target**?
   - Has anything **changed** so that the **objectives cannot be met**?
   - Has anything **changed** so that the **objectives are not worth achieving**?

   If ANY of these is unknown, should we give up?

What is Strategic Risk Management?

- Surprisingly, the discipline of Strategic Risk Management, is relatively new.

- In their 1995 master-work on the Strategy Process, which runs to 985 pages, Mintzberg, Quinn and Ghoshal, mention risk just once and that relates to “building a comfort factor for risk taking”, i.e. add a bit just in case!

  They noted correctly that “perceived risk is largely a function of one’s knowledge about a field”.

  They did not consider real risks that one does not perceive or that change over time!

- In a seminal article in 2005 in the Harvard Business Review, Slywotzky and Drzik described Strategic Risk Management as a:
  - “means to devise and deploy a systematic approach for managing strategic risk”.

  The real trick is defining that “systematic approach” and turning it into a robust, repeatable process!
Strategic Risk Management

Why is Strategic Risk Management Important?

• Strategic Risk Management is important because:
  – First and most important, banks are using the scarce funds of their stakeholders to embark on what may turn out to be a failed exercise.
  – Without a knowledge of the risks involved, front line managers cannot make rational and realistic decisions on risk and return to advance a bank’s strategy and may make the wrong decisions.
  – Failure to manage Strategic Risks is destructive not only of "shareholder value' but also of reputation and staff morale.
  – Failure to manage Strategic Risk imperils the bank’s long term viability (failure or becomes a take-over target).
  – Failure may imperil not only the bank but also the banking system, especially if the bank is ‘systemically important’.

• Development and management of corporate strategy and managing the strategic risks is probably the most important task of any Board!

Who is responsible for managing Strategic Risks?

• It is the fiduciary responsibility of every Board to protect the long-term value of the firm for its shareholders/stakeholders.

• In practice, this means that Directors must at a minimum monitor the performance of senior management, and the CEO in particular, and ensure that all relevant laws are being complied with.

• Corporate regulators and management theorists have realised that this cannot be done properly unless the Board is fully aware of the risks that the firm is running and ensures itself (and regulators) that those risk are being managed properly.

• Every firm faces a multitude of risks, all of which directors must be aware of, but in particular there is a special responsibility as regards Strategic Risks, since the Board is ultimately responsible for the firm's strategies and thus the risks in these strategies.
What Should Regulators do?

Regulators should first recognise the problem

- In discussing competitive strategies, Robert Simons pointed out that
  "Competing in any industry entails risk. However, the more aggressive and fast-paced the business and its management, the greater the potential for a misstep".

- Few industries face as many pressures as banking and financial services:
  - New technologies, a revolution in mobile technology - still more to come!
  - Changing customer preferences, a bifurcation of customers, baby boomers versus millennials;
  - Changing regulations (often resulting from prior missteps);
  - Changing investor preferences (stability versus volatility).

- There is a greater the potential for a misstep, and hence for systemic risk!
**New Regulations**

- The UK regulators’ joint report noted that FSA did not “define it as part of supervision’s role to criticise a firm’s business model”, and as a result
  
  “Supervisors did not always reach their own judgements on the key business challenges and strategic risks in firm’ business models, based on in-depth, rigorous review. Without in-depth analysis of a firm’s strategy, the supervision team’s ability to assess the adequacy of the underlying control framework was undermined”.

- The new SREP (supervisory review and evaluation process) regulations of the European Banking Authority (EBA) require supervisors to formally assess business and strategic risks.

- In future then regulators will have to understand each bank’s strategy and their ‘business model’, in a formal Business Model Assessment (BMA).

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**What needs to happen?**

- Banking regulators should require the Boards of Systemically Important Banks to develop and maintain a comprehensive Strategic Risk Management policy that is demonstrably:
  
  - Aligned with the firm’s strategic risk appetite;
  - Aligned with the firm’s stated and disclosed strategy;
  - Aligned with the firm’s strategic plans;
  - Signed off as “approved” by all Board members and executive management;
  - Subjected to independent expert review;
  - Subjected to formal audit as to governance processes;
  - Subjected to formal monitoring by responsible executives and independent functions;
  - Subjected to formal review on a regular (e.g. annual) basis;
  - Integrated with monitoring and review into Board deliberations on a regular basis.

- **Boards must actively manage Strategic Risk!**
Strategic Risk Management

Questions

References

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Strategic Risk Management

Deliberately Blank