

SUMMARY OF KEY RISKS 2017



GLOBAL
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INITIAL PERSPECTIVES ON 2017 AND SO LONG TO 2016!

It's that time of year where we start to set our eyes on what the next 12 months has in store for us. Along with the continued slow recovery from the financial crisis, 2016 was a year fraught with political surprises and market volatility. With Italy's recent 'no' vote on political reforms, the forthcoming referendums and elections in France and Germany and more than \$10 tn in public debt outstanding, the risk of further heightened Eurozone instability is cause for elevated concern. It is safe to say that 2017 will be yet another wild geopolitical ride. Emerging market economies continue to struggle with the mix of low commodity prices, high debt levels, the stronger US dollar (which causes stress on those with US\$ denominated debt), and threats of trade disruption. Furthermore, analysts around the globe are beginning to report on the risk of stagflation, where growth stagnates but debt monetization drives inflation higher, which may present close to a worst case scenario for financial institutions. So with all of that, 2017 looks to be another challenging year.

This view is consistent with the consensus of our members, who participated in our key risk survey (thanks to all who participated). Not surprisingly members identified Consumer Debt / Canadian Housing Market, Rising Interest Rates and Cyber Risk amongst their top concerns again this year. Also near the top is Geopolitical Risk, as the string of surprise results and upcoming elections cause concern. Figures 1-3 present a summary of our survey results to questions on risks to the Canadian Financial System.

Risk Prevalence



Figure 1: Top Ten Risks Identified by Members

Risk Impact



Figure 2: Top Ten Risks Weighted by Impact



Figure 3: Top Ten Risks Weighted by Imminence

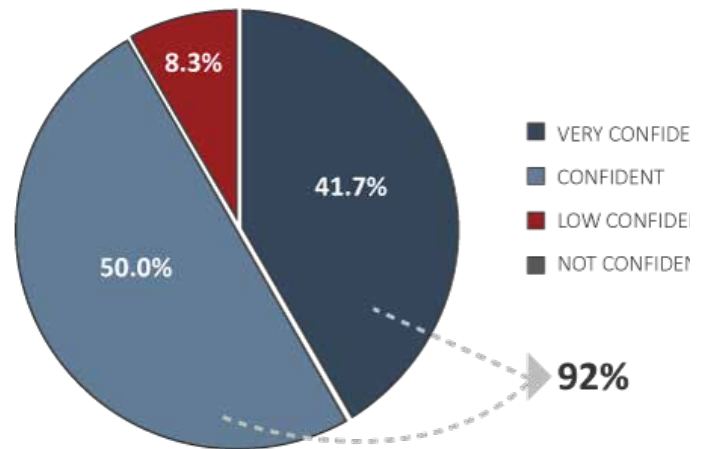


Figure 4: Confidence in the Canadian Financial System's Ability to withstand Risk

Still, our members ranked the Canadian financial system's ability to withstand these risks as very high, particularly in the near term (members tend to see these more as medium to long term risks).

In terms of geopolitical risk, the populist wave that drove the Brexit referendum and US election results shows little sign of abating. Italy's recent rejection of political reforms brings new political uncertainty and has made the election of a right-nationalist coalition government who supports leaving the Euro a very real possibility. It is now conceivable that Italy or France (albeit unlikely) may be next to consider leaving the Eurozone. This would no-doubt retrigger the Eurozone crisis, where both sovereigns and banks are still weak and significantly over leveraged. A scenario which re-opens those wounds would risk a contagion more severe than that precipitated by Lehman, and would likely kick off the second wave of the global banking crisis. It is time for financial institutions to consider this possible scenario; in particular, the counterparty credit exposure they would face.

Emerging markets have been suffering through a volatile couple of years, with low growth, and, in some cases, outright recession. With the strengthening US Dollar, and with US rates about to rise, capital is flowing back into the fixed income market. It follows that countries

with US\$ denominated debt who are exporting lower priced commodities will get hit twice as hard. With the explosion of debt over the past seven years, many of the emerging market countries and banks may well be sitting on a mountain of bad debts. For example, China has quadrupled its debt since 2006 to over \$28tn, and it is estimated that they could have as much as \$3tn of bad debt that would need to be restructured and managed. Couple all this with the renewed risk of a trade war, driven by the populist trend noted above, and one could be forgiven for adding emerging market countries and their banks to your worry list (although members tend to have these further down the list of risks for 2017).

While European and emerging markets have been on our list of risks for years now, the prospects of a trade war has come back into the spotlight. Disenchanted electorates are screaming frustration from their polling booths, resulting in unprecedented shocks at the polls. Globalization has left many behind, and so politicians who harken back to the good old days are resonating with voters. But we wonder how many US voters dream of having their children give up their pursuit of a (high technology) higher education, and get in line to work in one of Trump's promised returning steel plants or textile mills; and how happy will they be to pay the higher prices that come directly from tariffs on Mexico and China? The potential for disruption in the global supply chain

is elevated just at a time when the global economy is teetering from debt and the beginning of rising interest rates.

In addition to the extensive list of risks to manage in 2017, there are long term risks whose mitigation should begin promptly if not yet addressed. Climate change and environmental risk, for one, will become increasingly difficult and costly to manage if left unchecked. Leading climate scientists have come to the consensus that immediate action is necessary to forestall the most devastating effects of climate change, and governments and policymakers around the world are responding with increasingly stringent environmental regulations. Climate change and policy responses will bring new challenges and new opportunities, and it is vital that financial institutions take note. Quantum computers, for another, will severely disrupt the cryptographic systems on which financial institutions rely, and while they are still 5-10 years away according to experts, development of mitigation strategies and technologies must begin now. GRI is focusing on both these topics and will be providing continued guidance in these fields as we push through 2017.

In the New Year, there will be a detailed follow up article on emerging risks and threats. The author, Lois Tullo, is just completing her Global Risk and Threat (GRAFT) framework, which explores in detail the most significant emerging risks and threats. We think this will be a very helpful publication for those looking for a formalized framework for managing emerging risks. In addition to this framework, over the coming months GRI's researchers and expert advisors will be delivering several insightful articles on a range of risk-related topics including:

- *Pension performance management report (jointly with ICPM)*
- *Using big data in anti-money laundering efforts*
- *The growing importance of shadow banking*
- *Systemic risk in the insurance industry*

Of course, as the year progresses GRI will continue to provide reports and articles on emerging risks and how to manage them.

So we say good riddance to 2016, but keep our eyes on the risks that may well be most prominent in 2017. We conclude with a repeat of the message from our October article [“Low Interest Rates and Ever Higher Debt”](#): it is time for financial institutions to strengthen their balance sheets and prepare for the coming storm...

ABOUT THE AUTHORS



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Brian is an Executive in Residence at the Global Risk Institute, after retiring from CIBC in 2015. Most recently Brian was CIBC's Executive Vice President and Chief Data Officer, where he developed their data strategy and governance framework. Prior to the CDO position Brian lead the Bank's Enterprise Risk Management group, including balance sheet and capital management.



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Alex LaPlante is the Research Manager at GRI. She holds a BAsC in mechanical engineering from the University of Windsor and earned her MASc and PhD in operations research from the University of Toronto, where she studied the operational efficiency and growth potential of bank branch networks. Prior to joining GRI, she held the position of Director of Enterprise Analytics at CIBC. Her current research interests are machine learning, big data, and ESG risks with a focus on climate changerelated risks in the financial sector.