

# *The Journal*

## Too good to fail

*How financial institutions can re-engineer their risk management capabilities to make them a more active contributor to business decisions and a valuable source of strategic insight and competitive advantage.*

September 2011



## Rapidly evolving market and regulatory demands are spurring banks and other financial institutions to fundamentally re-examine the way they govern and manage risk.



### **Miles Everson**

PwC (US)  
+1 (646) 471 8620  
miles.everson@us.pwc.com



### **Kurtis Babczenko**

PwC (US)  
+1 (312) 298 3559  
kurtis.babczenko@us.pwc.com



### **Rick Heathcote**

PwC (Hong Kong)  
+852 2289 1155  
rick.heathcote@hk.pwc.com



### **Richard Barfield**

PwC (UK)  
+44 (0)20 7804 6658  
richard.barfield@uk.pwc.com

Regulators want banks to sharpen oversight and control over the risk concentrations, risk aggregations and other potential threats to the business highlighted by the financial crisis. Institutions are also facing tighter capital and liquidity rules, which are forcing them to more closely analyse their risks, capital efficiency and risk-adjusted returns.

As banks look to new and potentially unfamiliar markets and product areas for growth, their businesses are becoming more complex and diffuse. This is making it harder to fully understand their risks and leaving them open to an inadvertent increase in undetected risks and financial exposures.

While clearly challenging, these developments are an opportunity to strengthen the quality and reliability of risk information and make risk considerations a more explicit and upfront element of decision-making within the business.

Yet, despite considerable attention and investment since the financial crisis, many bank boards still have question marks over the reliability, usability and competitive value of their risk analysis. The way risk is monitored and managed often fails to reflect the way the business is structured and run. Within the business, risk management is often seen as an 'after the fact' compliance function rather than a source of competitive insight into how to generate more favourable and sustainable returns. As a result, risk management teams can often find themselves having limited or belated input into strategic planning.

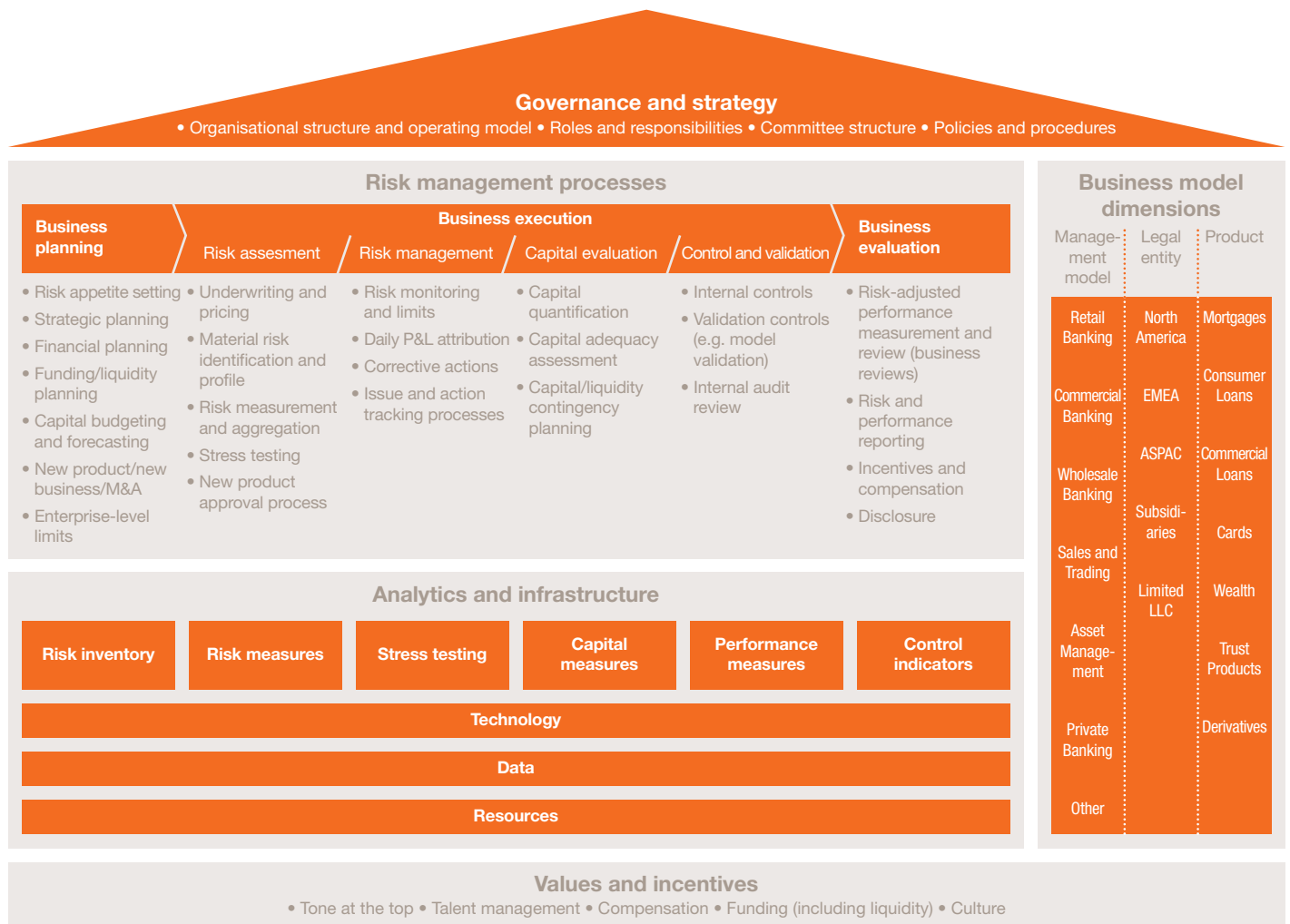
As we outline in this article, turning risk management into a key source of competitive advantage is therefore likely to require a major overhaul of how risk management is organised, perceived and works with the business. There is no one-size-fits-all solution as each business has different characteristics and objectives. However, it is important to make sure that the way risk is managed and governed is tailored to, and aligned with, the business model (see Figure 1).

### **Defining goals: Strategy**

While the business is the first line of defence and risk management the second, the latter should not be just a passive scorekeeper. Risk management teams should make an explicit contribution to strategic decisions and make sure they are in keeping with risk appetite. To strengthen the partnership between business and risk management, it is therefore important to provide the risk function with the necessary mandate, equality of status with frontline teams and backing from the board to contribute to strategic decisions and, where necessary, challenge risk positions and the assumptions that underlie them. Key questions risk management teams should be asking include: 'Do we agree with the strategic risk/reward trade-offs that come with this particular business?' For the enterprise as a whole, they should be asking: 'What is the inherent risk in our risk profile, business mix, business environment, processes and technology and deployment of people?'

**Figure 1: Key components of the enterprise risk management framework**

The risk management framework extends the governance, processes and analytics of managing risk into how the business is executed along the multiple dimensions of the business model.



Source: PwC

**Defining goals: Governance and organisation**

Risk still tends to be managed within market, credit and other single risk silos, which impedes risk understanding at an aggregated business level, and could ultimately allow dangerous exposures to fall between the cracks. To make sure risk management reflects the business model and plays a more active role in decision-making, it will be important to break down these silos and align risk monitoring, management and reporting more closely with business activities. This realignment would allow banks to develop a more informed view of their aggregate exposures and reduce risks relating to specific asset classes as necessary.

**Defining goals: Risk management processes**

A clear and balanced view of risk and return demands an integrated reporting framework that cuts across the silos of risk, finance and compliance. The linchpin will be bringing together customer and product data elements across the institution. These data elements are typically collected independently, which creates inconsistencies and increases the risk of error. Creating a common data model would improve efficiency and allow for the monthly reconciliation of risk, finance and compliance reporting. This would in turn allow firms to generate risk-adjusted returns at a more granular level and provide a more revealing and reliable basis for scenario analysis.

The extent of collaboration between the risk and finance functions varies along a continuum of independence, alignment and full integration. Independence tends to reinforce silos and make it more difficult to generate a single version of the truth. Alignment is an important step forward. It would include a common data dictionary, coordinated production of risk and finance reports, and joint consideration of both risk and reward metrics, which is supported by combined risk and finance input in the business review process. If functions are fully integrated, there would be no requirement to reconcile data, as it is drawn from a single 'golden source' and analysed within a common systems' architecture. This would pave the way for full integration of performance metrics to ensure that risk and rewards are considered on a dynamic basis. Underpinning greater alignment and eventual integration are shared governance and management, along with opportunities to expand experience and understanding by crossing over between risk and finance.

### **Defining goals: Analytics and infrastructure**

To foster greater accountability and ownership of risk within the business, performance should ideally be measured on a risk-adjusted basis at individual, business unit and territory level. Monitoring risk-adjusted performance will in turn help oversight functions to develop a fuller picture of the business and a first-hand sense of its rhythms.

Expanding stress-testing capabilities into a day-to-day management tool will help banks to assess whether their business model is consistent with their risk appetite and develop contingency plans for adverse developments. Incorporating stress testing into business as usual can also help to make the risks faced by the organisation, a more tangible and therefore more manageable element of business strategy.

### **Defining goals: Value and incentives**

Changes in incentive plans are more than just a response to public opinion. Aligning incentive plans with long-term risk-adjusted performance across both the P&L and balance sheet can help to foster a culture of responsible risk-taking, accountability and ownership. Ideally, compensation plans should include vesting periods for options and mechanisms under which bonuses could be forfeited if risk-taking is reckless or if performance lags. In turn, separate funding of incentive plans for control functions can help to sustain independence and objectivity.

### **How you can make the move**

Closer alignment between business and risk management is going to require significant re-engineering within many organisations. As Figure 2 highlights, the first key stage is a systematic evaluation of the strengths and weaknesses in the way risk is governed and managed across the enterprise. Such an analysis will need to be more comprehensive than the traditional reviews conducted by internal audit. It should consider the adequacy of governance and organisation, culture and incentives, risk management and measurement processes, as well as the resources and supporting risk infrastructure. The review should ideally

**Figure 2: Framework for transition**



Source: PwC

draw on comparisons with industry best practice and the performance of other firms in the financial crisis.

Identified weaknesses should then be targeted for remediation as part of a co-ordinated action plan, drawn up and sponsored by executive management and the board. In many cases, the resulting initiatives will require fundamental changes in the areas outlined earlier. This includes rebalancing of the role of the corporate risk function relative to the business, the implementation of risk-adjusted performance measurement tools and turning stress testing into a business-as-usual management tool. Executing these initiatives will take time, stamina and coordination, and brings with it its own set of risks. Companies that have been most successful have dedicated programme management resources to these initiatives and focused on the long-term benefits.

Once in place, the risk management capabilities should be reassessed regularly. Complex financial institutions do not stand still and nor should their risk management. Businesses that fared better during the financial crisis are characterised by their ability to recognise and act upon the need for continuous reappraisal and improvement. The assessment should ideally be carried out at least annually or after any significant changes in the size and complexity of the organisation. The results should be reported to, and evaluated by, the board's risk or audit committee.

### ***A culture of risk awareness***

Changes to risk governance and management can provide a long overdue opportunity to shift behaviour and perceptions within the organisation. By coming to the forefront of decision-making, risk management will be viewed as an active partner within the business. The emphasis on risk-adjusted metrics and incentives will make risk a more decisive factor in the way frontline teams think and operate – what gets paid, gets done.

Businesses with a positive and ingrained risk culture tended to weather the financial crisis better than others. These are the main determinants and characteristics of this risk culture, which



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would provide a good basis for how other firms view and deal with risk:

**Clear accountability:** Clearly defined roles and responsibilities, from the top down within the institution

**Full transparency:** Willingness to admit and address mistakes quickly, evidenced by the rapid escalation of issues

**Continual improvement:** Implementation of changes based on lessons learned, both positive and negative

**Effective change management:** Ability to recognise the need for, then the execution of, change

**Collegial tension:** Culture in which challenging colleagues within the organisation is an expected behaviour

**Equal stature:** Neither risk and control functions nor the business has override authority.

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### **Gold standard risk management**

Regulators expect financial institutions to have risk management capabilities that allow boards and senior management to develop a timely, reliable and actionable understanding of the risk profile of the business and its implications. This understanding is also a key source of competitive advantage in an increasingly complex and uncertain risk environment. Companies that regularly evaluate, emphasise and update their risk management capabilities will be best placed to meet stakeholder expectations and sustain consistent high-level returns. These capabilities should be aligned and fully leveraged within the business to make sure that risk management teams can play a full and decisive role in strategic management; risk management reflects the way the business is being run and allows frontline teams to benefit from a more informed risk-adjusted view of decision-making and performance.



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