

***Raising the bar for
risk management***
Benchmarking risk
management practices
in the banking
industry in EMEAI

*Harnessing more effective
risk management to
sharpen decision-making
and deliver better and more
sustainable returns.*

December 2011



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About this survey

The survey sought to benchmark the performance of risk management functions at banks and inform best practice by comparing risk management trends and capabilities in 78 banks from Europe, the Middle East, Africa and India (EMEAI). Areas examined included:

Influencing factors: A review of the impact of the regulatory and macroeconomic environment

Governance and strategy

Performance management and incentives

Risk function organisation

Risk management sophistication and effectiveness

Plans for the future

We have prepared, for our participants, analysis covering EMEAI overall and regional analysis for Central and Eastern Europe, the Middle East and Western Europe. By charting how our benchmarking survey results develop in the future, we will be able to track progress and highlight opportunities for further progress and enhancements.

We would like to thank each and every one of the 78 banks across 20 countries, which provided their valuable time and input.

We would also like to thank our territory FS Risk leaders and the report team comprising of Raymond D'Silva and Monika Gosiewska.

Please contact us if you would like our team to benchmark your risk management function.

Foreword

We are delighted to present the findings and insights from our inaugural 2011 Risk Management Benchmarking Survey.

Following the problems in risk management exposed by the financial crisis, we wanted to examine how the crisis has influenced the way financial institutions manage and think about risk. In particular, the survey explored how, and to what extent, banks have embedded risk management into their strategies and operations.

While the banks taking part in our survey believe that they have robust risk structures and strategies in place, they realise that risk management should play a stronger role in the business planning and management of their organisations. The survey also suggests that risk management is still viewed from the perspective of the risk function rather than being integral to the

broader business processes, operations and behaviour of the organisation. Banks' views of their exposures is still incomplete as they struggle with poor data quality and the siloed way risk is monitored and managed.

We hope that the survey findings will stimulate debate and encourage banks to take action. We are aware that banks do face challenges related to increased credit risk and new regulatory requirements. However, they shouldn't miss the opportunity to revisit their strategies and operating models and to embed risk-based decision-making at the core of their business processes. This will allow them to improve performance and profitability on a sustainable basis.



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So how can your bank step up to the mark by turning risk management into a key source of competitive advantage?

Stepping up to the mark

Banks have stepped up investment in risk management in the wake of the financial crisis. Yet, our inaugural risk management benchmarking survey reveals that most institutions are missing the opportunity to use their risk management capabilities to provide a more informed basis for decision-making.

Sharpening decision-making

Effective decision-making demands timely, accurate and consistent information about risk exposures, the capital and liquidity needed to support them, and the resulting impact on present and future profitability. The better a bank understands its risks and the impact on its capital and liquidity, the better its ability to safeguard its franchise, deploy funds in the most effective way and capitalise on opportunities more quickly and decisively than its competitors.

Around 30% of the banks taking part in our benchmarking survey believe that risk management is fully aligned with their business model and a further 50% describe it as generally aligned. Yet, embedding risk into the forefront of the business may be proving harder than these findings would suggest. The underlying problem is that risk management still tends to operate in isolation rather than being integral to the broader business processes, operations and behaviour of the organisation. This requires banks to change the way they think about managing risk. The foundation has always been a clearly defined risk appetite that informs strategy and business planning, providing transparency over the constraints on the bank's risk-taking activities over its planning horizon.

While most banks recognise the importance of risk appetite, many still find it difficult to articulate in ways that can be translated into tangible priorities and actions on the ground.

Seeing the complete picture

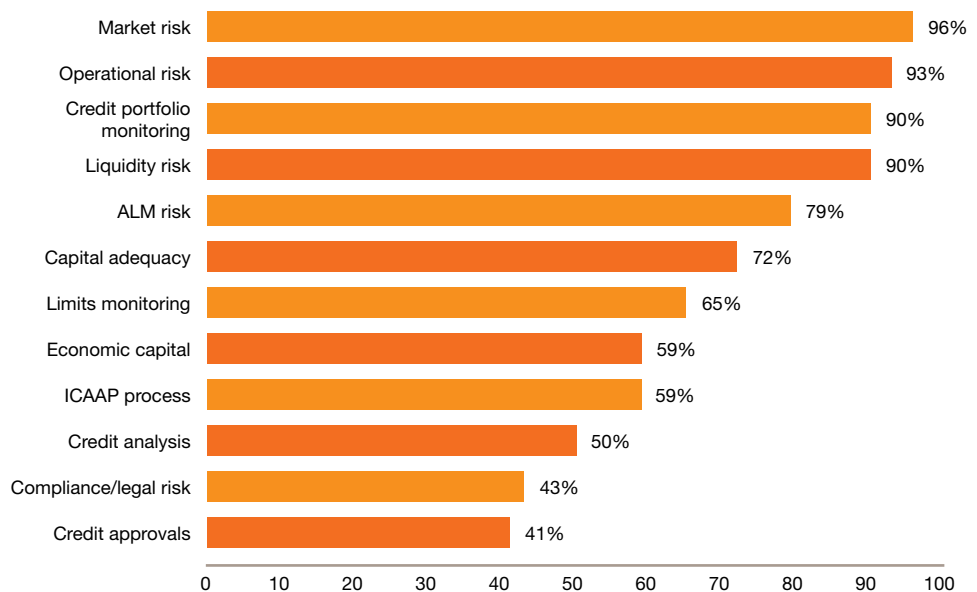
Most participating banks believe they have robust risk management structures in place. Yet, each risk type is still generally managed in isolation. This impedes their ability to develop an aggregated view of their risk exposures. Figure 1 highlights the difficulties many banks face in gaining an holistic view of their exposures. Regular reports are generally effective in covering

'traditional' market, credit and operational risks. Yet, many fail to capture newer areas of focus such as the quality of credit approval and credit processes, along with compliance, legal and underlying reputational risks, which are now recognised as being integral to business performance and the sustainability of earnings.

The siloed view of risk is often exacerbated by the lack of integration between risk and finance functions. In nearly 60% of participants, the interaction between the risk and finance functions is described as limited. This impedes the banks' ability to develop a risk-adjusted view of its performance, understand the capital implications and take account of the potential impact of market stresses and other future risks.

Figure 1: Scope of risk reporting

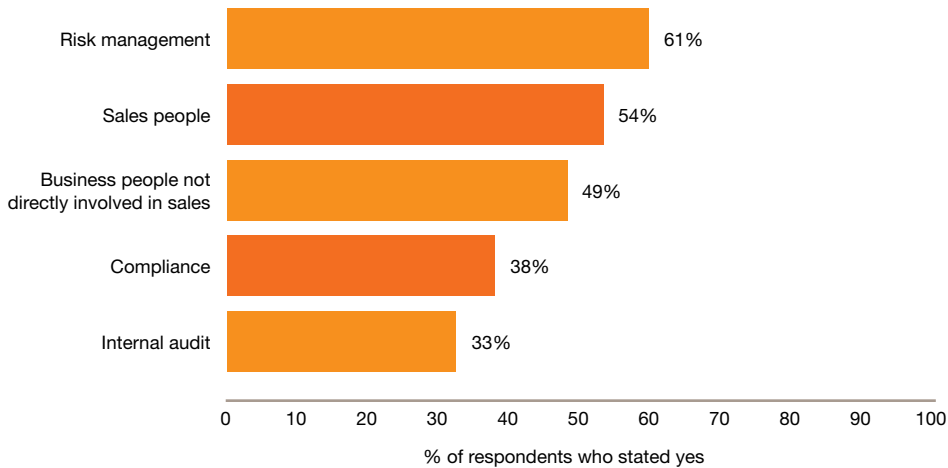
What specific areas of risk function responsibility are covered in the risk reporting package?



Source: PwC

Figure 2: Risk taken into account in incentive plans

Is risk taken into account in the incentive plans of other employees, as compared to top executives?



Source: PwC

Balancing risk and reward

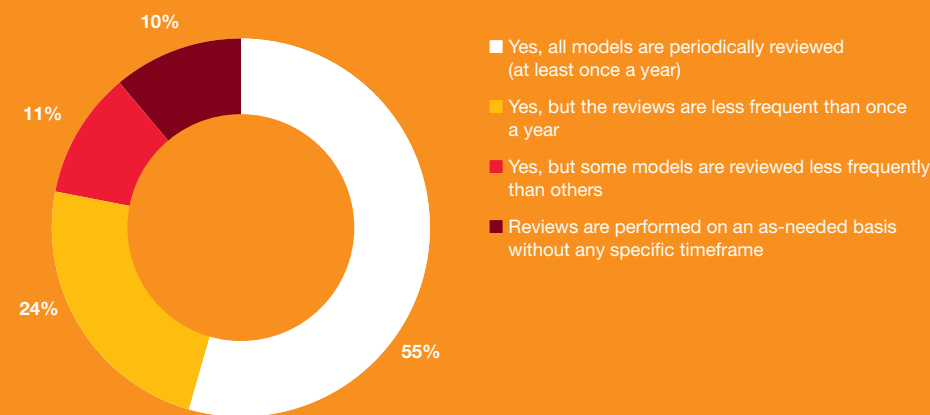
Our benchmarking survey suggests that most banks are striving to link risk and reward more effectively, with 70% including risk measures in the incentive packages of top executives. Yet, to instil a strong risk management culture and drive the right behaviour throughout the organisation, banks need to go further by fully integrating risk measures into the performance management and objectives of all frontline teams. It is noticeable that only around 50% of participating banks evaluate the performance of their sales' teams against risk measures (Figure 2).

The application of risk-adjusted measures to longer term returns and deferred bonuses requires considerable further development. Measures such as economic profit may also exclude critical risk factors and the sustainability of earnings. It is therefore important to overlay these measures with qualitative stress and scenario analysis to make sure bonus payments reflect a broader and forward-looking view of the potential risks facing the business. Building a qualitative assessment into the incentive framework can also help to promote desired behaviour and instil risk awareness into the culture of the business.



Figure 3: Frequency of model review and adjustment

Does your bank have regular reviews in place in respect of the models and approaches used?



Source: PwC

Honing modelling capabilities

Most participants have adjusted their risk models following the crisis. Yet, only around a half review their models at least once a year (Figure 3). In a turbulent and fast-moving market environment, banks should be reviewing their models on a regular basis to make sure the models in use are consistent with their risk appetite and strategy. The financial crisis highlights the particular importance of backtesting and stress and scenario analysis in refining the outputs of the model, validating the underlying assumptions and understanding its potential limitations.

Data quality

Quality of data is clearly critical in sustaining the effectiveness of the model outputs and underpinning sound risk management and decision-making within the business. It is therefore a cause for concern that only around 40% of participating banks believe that the quality and governance of their data is high (Figure 4). If banks don't have confidence in the data coming into the model, they can't be confident about the information coming out, and neither will their board, supervisors and investors.

A number of banks are adopting a systematic approach to data quality by defining clear expectations, setting timelines for delivery and imposing greater consistency, in many cases supported by the development of a centralised data warehouse for risk and finance, and articulating data

governance principles based on the risk appetite. This is also an issue for the business as a whole, rather than just risk, or finance. Aligning business and risk is, in practice, also dependent on the quality and consistency of the data used by business and risk (e.g. customer relationship management and scoring/rating models). Assigning data 'owners' within the business, ideally the people who use the information, will help to sustain and improve data quality and strengthen data governance.

From compliance to competitive edge

The fallout from the financial crisis has ushered in a wave of new and increased regulatory demands. Risk teams are not only being called upon to provide more information, but deliver it faster than before. This ranges from risk analysis to inform capital evaluations to ad hoc supervisory demands for information on exposures to sovereign debt, or potential market stresses such as changes in counterparty credit worthiness. It is therefore perhaps unsurprising that participants say that their biggest priorities for the future are how to deal with new regulatory requirements and credit risk.

Yet, the financial crisis underlines the importance of making sure that risk management is not just seen as a backward-looking compliance activity, but as a key consideration for all risk-takers and decision-makers within the bank. Forward-looking institutions are using the systems developed for compliance as a foundation for more effective business insights. The investment in risk analytics provides an

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opportunity to revisit their strategy and operating model and embed risk-based decision-making in the core of their business processes. This will allow them to improve performance and profitability, while making risk awareness a central part of how they operate, sustain their franchise and judge their strategies for the future. The extent to which risk and business are aligned is tied with the risk appetite and risk strategy.

Drawing on our benchmarking survey and our work with clients, we believe that all banks need to address the following questions to make sure their risk management is fit for purpose and delivering competitive value to the business:

To what extent do risk considerations and your risk appetite influence strategy and business planning?

Are your risk function and risk modelling capabilities set up to support business decisions in the most effective way?

Does your risk reporting provide a sufficiently timely, reliable and comprehensive view of your exposures and how effectively is this information used?

Have you set up an appropriate framework for ensuring appropriate governance, review and adjustment of your model?

To what extent are risk measures integrated into the reward structures of risk-taking teams?

Are incentives used to reward the right risk behaviour and promote a strong risk culture?

Contact



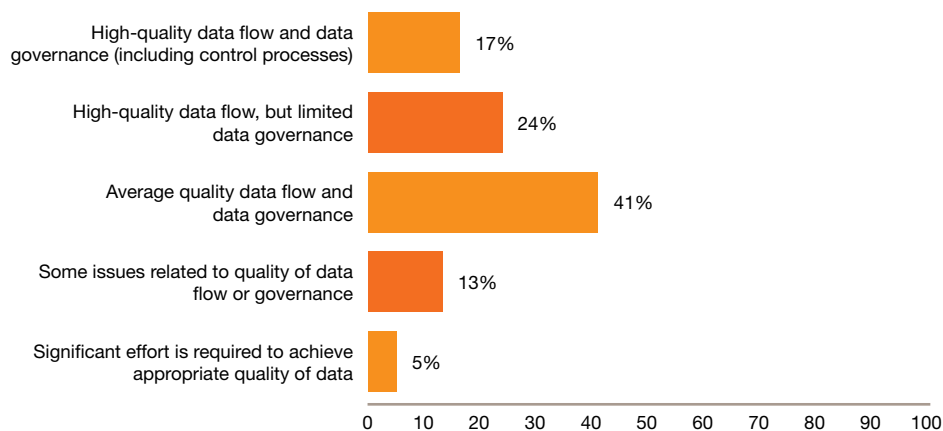
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Figure 4: Data quality and governance

How would you assess the quality and relevance of data used in your bank's risk management?



Source: PwC

www.pwc.com/banking

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