PwC Advisory
Performance Improvement

Leveraging compliance: Standardization and simplification of risk adjusted performance reporting*

Leveraging compliance—standardization and simplification of risk adjusted performance reporting

These are tumultuous times for Finance leaders. Investors, board members, senior management, rating agencies, regulators and other stakeholders continue to seek ways to better evaluate and execute on financial services organization's activities, performance, risks and strategies. They are looking for more timely, pertinent, and readily accessible financial, market and business information. Meeting these information expectations in increasingly shorter timeframes puts a premium on the effectiveness of the Finance Function and its dedicated resources.

Finance has had to react to rapid commercial and regulatory change and the burdens have been significant in terms of long hours, high recurring reporting production requirements with limited time for analysis and substantial penalties for mis-reporting. It is in this climate that Finance leaders and some stakeholders are asking can Finance be more than merely the stakeholders' scorekeeper?

In fact, Finance leaders are well positioned to help their organizations get the most from their financial and compliance data—to standardize and simplify the myriad of data points for meaningful integrated snapshots and forecasts. Finance leaders need to leverage the considerable investment and architecture of the Sarbox 302 and 404 processes and the developments in risk and regulatory reporting and compliance initiatives – such as arising from Basel 2, Solvency 2 and the Patriot Act.

The additional burden undertaken in recent years in terms of pressure on resources, longer working hours /costs, as well as, the perceived need to be the strategic partner to the business rather than merely the scorekeeper that together have many finance professionals frazzled! As financial services organizations have begun to internalize and make "business-as-usual" these formative efforts there are significant benefits and opportunities which remain to be gained.

It may be helpful to examine whether these substantive process changes, current and planned investments in technology and systems constitute merely an increase in just the cost of doing business or can be viewed as a potential source of significant benefits and opportunities.

We believe there are a number of areas where the CFO can leverage existing data to assist the businesses in producing a better economic result. In this article we examine how Finance chiefs of the largest internationally active financial institutions are starting to take advantage of the data advances including greater granularity, frequency and retention and relational capacity which have taken place in recent years in risk management and which have been further formalized and legitimized via recent regulatory imperatives.

Economic Capital is one such advance. A number of top-tier banks switched to a system which began to recognize the importance of economic capital for risk management and resource allocation purposes.

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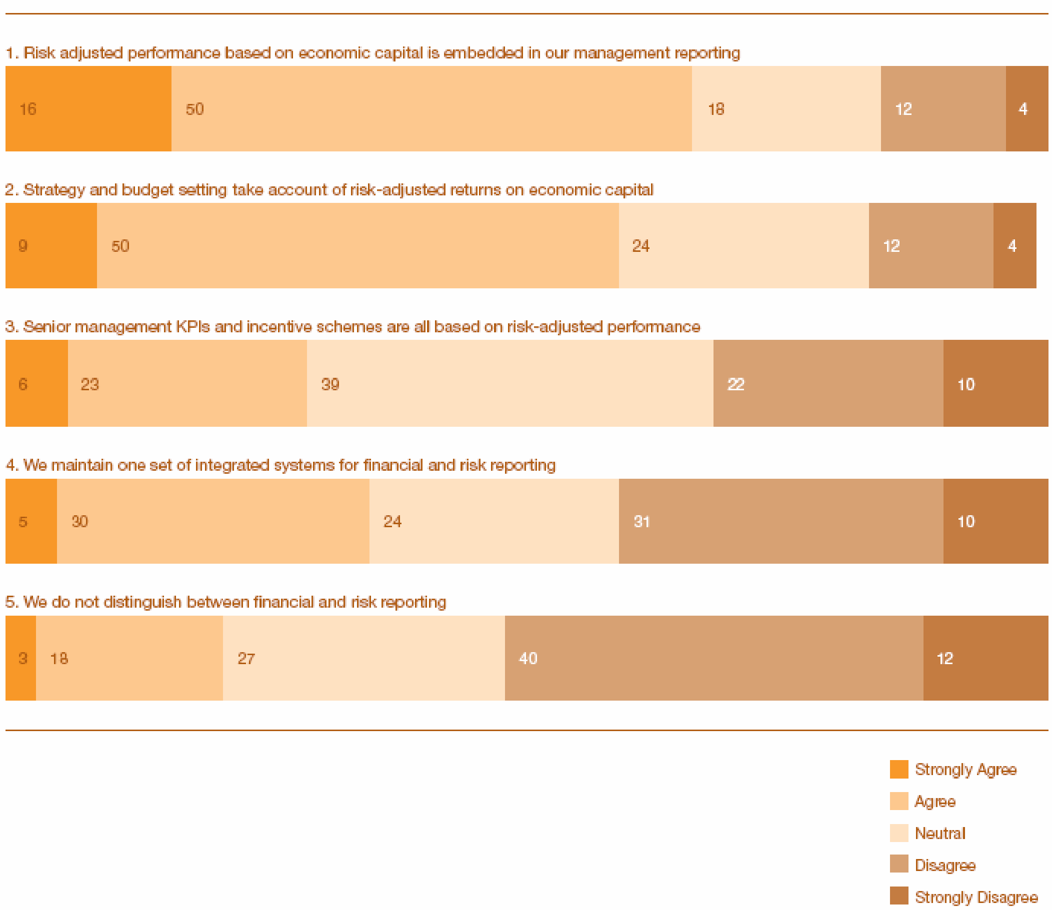
As these large complex banking institutions refined their economic capital methods to provide a suitable yardstick by which to allocate capital and a reasonable way to run a forward looking business there arose a growing recognition for greater alignment with regulatory capital requirements. The evolution of Basel 2 and other regulatory developments, however, have provided a favorable tailwind to the development of risk capital techniques throughout the Financial sector. A recent PwC/EIU survey of over 200 financial institutions globally showed that 57% of those surveyed had or would implement within 12 months, some form of Economic Capital process. 90% believed that Economic Capital was at least being encouraged by their Regulator. However, few believed that Economic Capital was well understood outside of the risk function (per table 2) and as such was not being extensively used in measuring business unit performance and even less in determining compensation.[1] While 66% agreed that risk adjusted performance is embedded in their management reporting, only 29% of survey respondents agreed that senior management KPIs and incentive schemes are all based on risk adjusted performance (see table 1 below).

Table 1

Please state whether you agree or disagree with the following statements reading the role of economic capital in performance management? [2]



[1] *As noted on page 2 of PwC EIU Briefing: Effective capital management: Economic capital as an industry standard?* December 2005*

[2] *As noted on page 20 of PwC EIU Briefing: Effective capital management: Economic capital as an industry standard?* December 2005*

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There are continuing efforts by banking institutions and their regulators to ensure appropriate alignment of economic and regulatory capital measures. Institutions that will be subject to the advanced internal regulatory capital approaches are mandated to reflect these measures in the daily management of risk. To accomplish this, institutions will need to integrate these measures into the performance metrics of the business. We believe the CFO is in the best position to shepherd a change in behavior to take advantage of the considerable investment in information, systems and people to introduce regulatory and economic capital measures and fully use the data that drive them into a powerful management and compensation tool.

As stores of customer data proliferate to satisfy various corporate initiatives, such as single obligor view and product cross-sell, to the consternation of many; financial institutions are at risk too of developing multiple models and associated processes to address broadly coherent business requirements that may well be satisfied by a single application. If risk capital processes are providing us with 'regulation quality' information on our assets and product portfolios, then surely the next logical step is to integrate this into our business processes. Apart from the obvious benefit of eliminating a parallel process, Mark Lawrence (Risk Magazine's Risk Manager of the year in 2002) says "…regardless of the accuracy or not of the model, unless the results of the analysis are integrated into the bank's performance management system, and the remuneration of key executives, it won't make a blind bit of difference."[3]

Clearly, any changes to the manner in which business unit heads are evaluated and compensated needs to be driven from the top down and needs active and aggressive CEO sponsorship. Additionally, Finance, as the custodian of performance reporting data, is particularly well positioned to be the driver of the change process. What should Finance be doing to effect that change?

[3]As noted on page 11 of PwC EIU Briefing: Effective capital management: Economic capital as an industry standard?* December 2005

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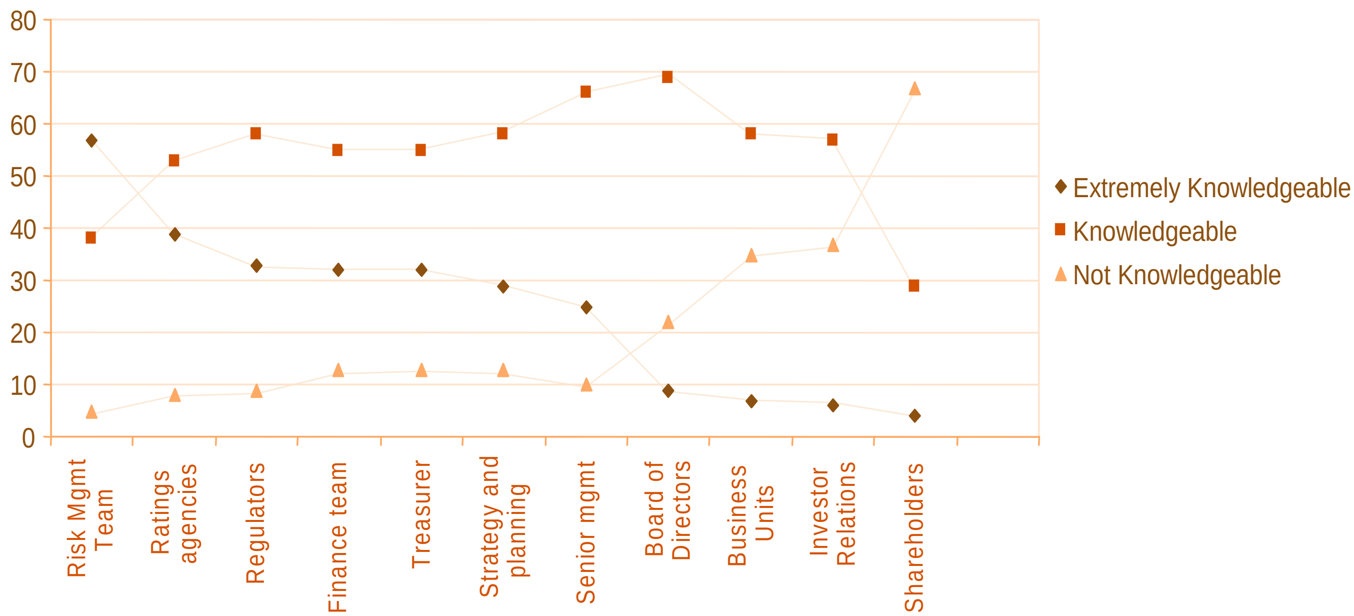
Educate the board

As shown in the chart below, the EIU / PWC survey indicated that the two principle reasons for implementing economic capital are for strategic planning and setting risk appetite, yet only 9% of respondents believed their board of directors were very knowledgeable about Economic Capital and 22% considered they were not knowledgeable at all.[4]

Table 2

How knowledgeable are the following parties about the methodology behind economic capital?[5]



Whilst these numbers are damning and suggest capital allocation may remain at the whim of executive intuition, the “use test” requirements associated with Basel 2 will mandate that the risk capital calculations are embedded into the strategic goal setting processes. Finance is clearly best placed to educate all the key constituents. The board needs to understand, in a more granulated manner, why $.80 of profit on a lower risk/lower capital line of business can be better than a $1 of profit on a higher risk, higher capital line of business. Optics can be deceiving and it is a lot easier to explain that to board members in an education session rather than in executive session, after the fact, explaining catastrophic coastal property losses after a Katrina like event.

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Redefine key performance indicators

Finance is most ideally placed to interpret the results of the integration of risk adjustment into the performance reporting of the various businesses. However they will need to work closely with other departments of the financial institution in order to manage the significant change that is required to redefine the Key Performance Indicators (KPIs). Only by embedding the results into BU and product profitability analysis and applying risk capital assumptions into the budgeting process can risk appetite truly be set with degrees of confidence and capital allocated to meet the performance goals of the business

KPIs and compensation need to reflect risk-adjusted returns rather than absolute returns. Changing compensation structures in this way is no easy task. In our survey, respondents saw the integration of economic capital results into management decision-making processes as the biggest implementation challenge they face. Finance will have to work closely with other functions such as HR and IT, in order to act as change agent and re-engineer and rollout revised performance metrics.

Educate the business

Addressing the implementation challenge above requires establishing revised KPIs that are widely accepted within the organization and linking pay to that risk adjusted performance. Finance will face a tough job in educating the business on how and why the new performance measures will work and will need to migrate aggressively to a single integrated risk-adjusted performance reporting system. Additionally, and as importantly the businesses need to see the benefit of understanding what pricing is necessary to justify the risks being underwritten. Whilst the need for transparency will be paramount, there can be no room for parallel processes. The Board and the rest of senior management can play its part here too by driving the strategic process in the same manner and communicating with all stakeholders on a ‘risk adjusted’ basis. By driving this forcefully from the top, business unit leaders will be vitally interested in how the risks are modeled and quantified and will provide valid input to whether this accurately reflects the degree of risk in their particular business. This discussion will stress test whether businesses are getting enough of a premium in their pricing of higher risk business to sustain the higher losses expected to result from that higher risk business. Crucially they will seek to understand what actions they can take to reduce the costs or increase charges needed to get returns for the capital they are consuming.

Integrate systems

By consolidating the information on economic capital and embedding that into the management reporting of absolute performance, Finance is able to simplify and standardize performance reporting and start to promote its role as the strategic partner to the business and source of unequivocal high quality consistent information for decision making. By this sort of initiative, compliance processes can come to be embedded value adding elements to traditional processes that had become a little worn and routine with age.

In conclusion

Finance leaders in Financial Institutions should not default into the role of the reactive scorekeeper for the stakeholders. Rather Finance has a strategic role to play in how corporate performance is measured and how that performance is rewarded and analyzed. Regulatory and Compliance requirements in recent years have provided Finance with a lot of the tools to refresh and invigorate performance management. However, the value of this will not be fully realized unless processes are simplified, standardized and transparent. Those organizations that can answer the following questions in the affirmative are most like to be on the right path.

- Do I know how far I need to adjust product pricing to make adequate returns for the risks undertaken?
- Do I invest or divest based on formally calculated risk adjusted returns?
- Are the returns I make, commensurate with the economic risk taken?
- Do I compensate businesses on their true economic contributions?
- Do I use a clearly understood single state of performance statements for all key constituents?

For more information, please contact:

Bob Ross
312.298.2042
robert.m.ross@us.pwc.com

Greg Galeaz
617.530.6203
gregory.r.galeaz@us.pwc.com

Dan Weiss
703.918.1431
dan.weiss@us.pwc.com