Economist Intelligence Unit

The Economist

Too good to fail?
New challenges for risk management in financial services

A report from the Economist Intelligence Unit

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Contents

About this research

Too good to fail? New challenges for risk management in financial services is an Economist Intelligence Unit report that examines the steps banks and insurers around the world are taking to reinforce their risk management capabilities against the backdrop of a stabilising economic environment. The report is sponsored by SAS. The Economist Intelligence Unit bears sole responsibility for the content of this report. The findings and views expressed in this report do not necessarily reflect the views of the sponsor.

Our research for this report drew on two main initiatives:

We conducted an online survey of 315 executives from around the world in March 2011. Approximately one-half of the respondents in the survey are C-level executives and nearly as many represent financial institutions with US $25 billion or more in assets under management. All respondents have a primary responsibility for risk management.

To complement the survey results, the Economist Intelligence Unit also conducted a programme of qualitative research that included in-depth interviews with a range of experts and senior executives. The report was written by Rob Mitchell. We would like to thank all those who cooperated with us on this research for their time and insight.

June 2011

Executive summary

Much has changed in the banking and insurance industries since the darkest days of the financial crisis. Today, it is almost unthinkable that any CEO would completely ignore warnings from a chief risk officer, as was the case at Lehman Brothers just before it collapsed in 2008. With regulators, management boards and investors scrutinising risk practices more closely than ever, the risk function at most financial services organisations has more teeth now.

Financial services firms everywhere have initiated at least some measures to address the most glaring deficiencies in risk management that were exposed by the crisis. But have they done enough? The organisational and structural changes that have taken place in the aftermath of the crisis send a clear signal about the value that the sector now places on risk management. But they are just one piece of the jigsaw. Inculcating and embedding a stronger enterprise-wide risk culture remains an ongoing challenge.

Perhaps the biggest challenge in risk management, as perceived by respondents in this year's Economist Intelligence Unit survey, is the prospect of institutional complacency. A nascent economic recovery and the relatively strong recent performance of the financial sector are encouraging many firms to become bolder, which is reflected in the key findings of the research.

Key findings include the following:

Financial institutions' appetite for risk is on the rise again. After three years of retrenchment, the competition for returns and profitability is intensifying. Just under 40% of the respondents to our survey say that the appetite for risk at their firms has increased in the past 12 months. Institutions in the Asia-Pacific region are more likely than those in other regions to take on greater risk.

Managing complexity is now one of the biggest challenges in financial services. Turbulence has been the dominant theme in the global economy in 2011, and it has been compounded by geo-political shocks. When it comes to threat perception, two-thirds of respondents think external risks pose a greater challenge than internal ones. More than three in five respondents also say that complexity is increasing the risk confronting their organisations. But the challenge posed by complexity is not always being met by a greater focus on risk management. For example, only 52% report that their employer's risk management processes are well placed to deal with volatility. In addition, only 34% of

all respondents say that they now have a better understanding of tail risks—an important capability, given the number and magnitude of unexpected shocks so far this year.

The risk function is finding it hard to increase its authority. While one-half of respondents say that the risk function at their firm has gained in authority over the past 12 months, this still leaves a sizeable proportion of risk managers who think their authority has stayed the same or, in some cases, has actually declined. A surprisingly high proportion of respondents—nearly one-quarter—report that the views of the risk function are more often than not overridden or ignored in their organisations.

There is much room for improvement in the relationship between the risk function and other parts of the business. The role of the risk function has been elevated somewhat in the past couple of years, but risk managers at many organisations still find it hard to build strong and open relationships with colleagues from other parts of the business. Respondents cite poor communication between departments as one of the main barriers to effective risk management; most in need of improvement is the relationship between the risk function and business units.

Progress on revamping and strengthening risk management has slowed. Previous surveys in this series have found firms steadily increasing their efforts to strengthen risk management. This year, there are signs that the momentum of those efforts may have peaked. The percentage of respondents who are confident their organisations have a clearly defined risk management strategy is broadly the same as a year ago. Year on year, the proportion of respondents who say their organisations are increasing investment in the risk function has fallen slightly across IT, data, training and recruitment.

Management boards at financial organisations are now paying a lot more attention to risk. More than two in five risk managers who participated in this year's survey indicate that their management boards have beefed up their risk expertise and over one-half of respondents report that their boards are demanding more rigorous risk reporting. Retail banks are particularly likely to be facing increased risk scrutiny from their boards. For those risk managers who are experiencing greater demands from the board, there is significant change in the level of detail and analysis that they are now expected to provide.

1. Not out of the woods yet

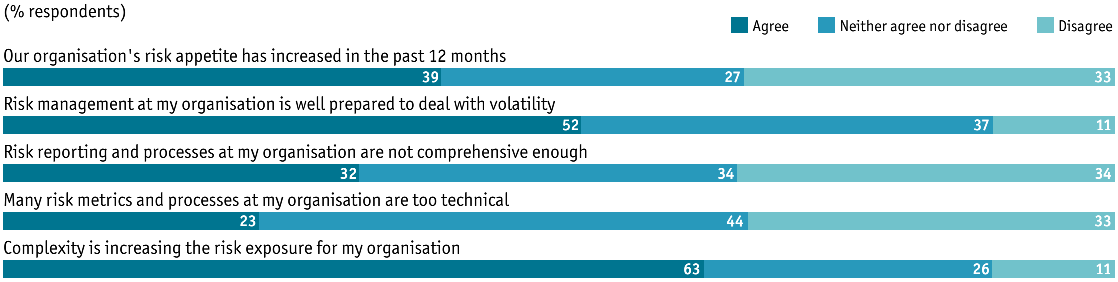
The worst of the financial crisis, it now appears, is behind us. Most organisations hit hardest by the crisis have turned or are turning the corner, helped in part by the improving economic environment and a helping hand from governments, central banks and regulators.

But, on the whole, the recovery is still a work in progress for the banking and insurance industries. Balance sheets still bear the scars of the crisis and risk appetites are still subdued. This year alone, the political turmoil in Arab countries has piled pressure on oil markets, compounding price increases and stoking inflation. The devastating earthquake and tsunami in Japan have rattled financial markets and global trade. And sovereign debt woes in the peripheral countries of the euro zone, which are closely intertwined with banking risks, are clearly a threat to the recovery.

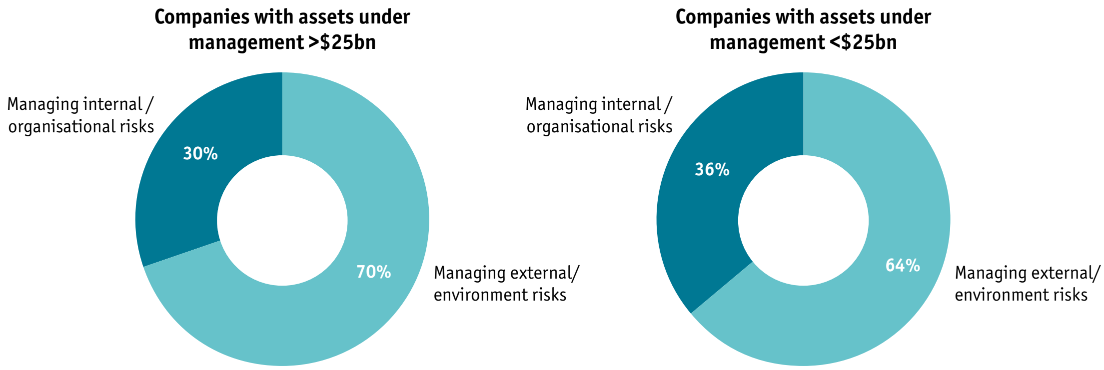
In addition to these geopolitical factors, new risks to the financial system are also emerging. Low interest rates are encouraging investors into higher-yielding, riskier assets that could increase exposure to liquidity risks. A tougher regulatory environment that threatens to dampen profitability could encourage some activities to migrate to the more opaque shadow banking sector. There are concerns, too, about the use of high-frequency trading, which is blamed for the “flash-crash” of May 6 2010, when the Dow Jones Industrial Average plunged nearly 700 points in minutes that afternoon, eliminating $1 trillion in paper value, before rebounding nearly as quickly.

This confluence of risks continues to place financial institutions under strain. More than six out of ten respondents to our survey say that complexity is increasing the risk exposure for their organisation (see chart below). A similar proportion worry more about external risks than they do about internal ones, with respondents at larger firms slightly more concerned about external risks (see chart on the next page).

Please indicate whether you agree or disagree with the following statements.
(% respondents)



Which of the following poses a greater challenge to your organisation currently?
(% respondents)

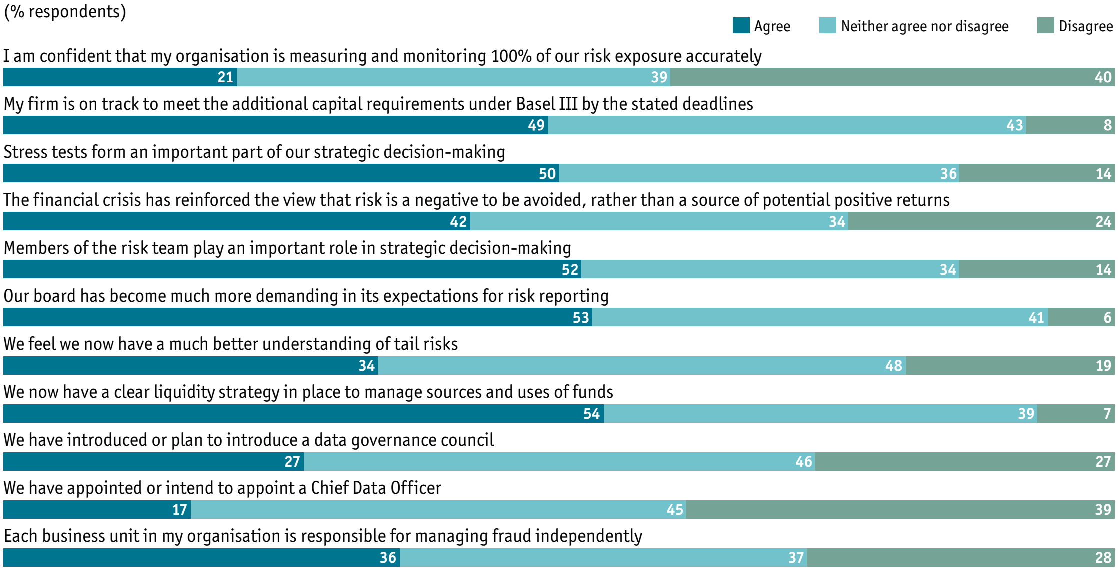


Source: Economist Intelligence Unit.

Yet these concerns do not always translate into an increased focus on risk management. Only 52% of respondents say that their employer is well placed to deal with volatility, although investment banks are more confident in this regard than their peers in either retail banking or insurance. Just 34% of respondents say that they now have a better understanding of tail risks, which suggests that many institutions are still dependent on traditional measures and models that do not take sufficient account of the most improbable risks (see chart below).

"Banks, in particular, are not doing enough to carry out what one might term financial weather forecasting," says Philip Treleaven, a professor of computer science at University College London (UCL). "They need to elevate their approach to risk so that it is more holistic, forward-looking and capable of managing risk across the entire institution."

Please indicate whether you agree with the following statements.
(% respondents)



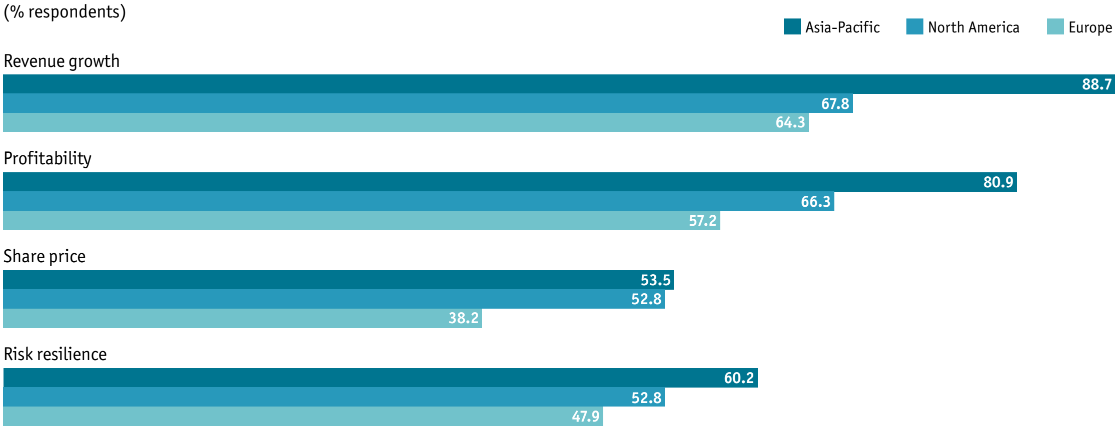
> "My concern is that people will have short memories. There's a danger they will become complacent"
>
> *Nick Turner*
> *Co-President, Global Business Network*

Risks may be increasing, but so are levels of optimism about business prospects. Almost three-quarters of respondents see the outlook for revenue growth over the next 12 months as positive, and 68% have the same view about the outlook for profitability. Respondents from Asia-Pacific are particularly bullish, with 89% seeing prospects for revenue growth as positive, and 81% for profitability (see chart below).The optimism is very clearly a reflection of the rapid pace of economic growth in the region.

After three years of retrenchment, many financial institutions are sharpening their risk profile to shore up profitability and return to an expansionary mode. In April, Bob Diamond, CEO of Barclays Plc, one of the largest universal banks based in the UK, said that he was considering an increase in the bank's risk profile in order to meet a target return on equity of 13% by 2013. Oswald Grübel, CEO of UBS, one of the largest banks based in Switzerland, made a similar announcement, underlining the view of many in the banking industry that the time has come to signficantly raise the stakes. In the survey done for this report, a sizeable minority of respondents say their organisations have increased their risk appetite over the past year (see chart on page 6). Investment banks and respondents from Asia-Pacific are especially likely to have increased their risk appetite.

Of course, increased risk-taking in itself is not a problem. Financial institutions are supposed to take measured risks in order to generate returns. But the question from a risk management perspective is whether the sector has done enough to learn from the almost catastrophic failures of the recent past and whether changes made in response to the financial crisis will be sufficient to withstand the renewed thirst and competition for returns. "My concern is that people will have short memories," says Nick Turner, co-president of Global Business Network, a member of the Monitor Group. "Because their organisation has survived the crisis, there's a danger that they will become complacent, and that the profit motive and incentives will override risk restraint."

How do you currently rate the prospects for your organisation in the following areas over the next year? chart shows proportion from major regions that expect positive prospects.
(% respondents)

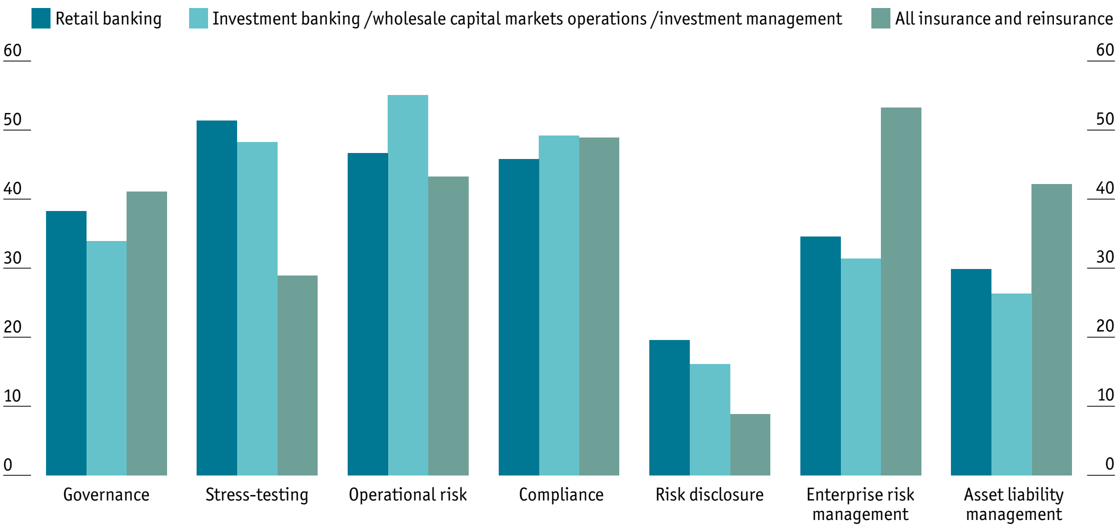


2. The risk pendulum

Over the past three years, financial institutions have done much to address the shortcomings in their risk management. They have strengthened governance, tightened controls and invested in risk processes, teams and technology. The risk function is increasingly consulted in key business decisions. And as the Senior Supervisors Group (SSG), a collection of regulatory bodies, concluded in a recent report[1], many financial institutions have made significant progress in strengthening their IT infrastructure and policies for setting and monitoring risk appetites.

While this is undoubtedly a positive change, the question remains whether this strengthened risk framework is now a permanent fixture. "When you look back through the history of banking crises, there's an unfortunate pattern that emerges of a pendulum swinging back and forth between tight and loose risk management," says Mike Baxter, a partner in the Global Financial Services practice at Bain & Company, a management consultancy. "And what inevitably happens when the good times come back

Which of the following risk categories are currently attracting the greatest level of attention from the risk function and top management in your organisation? Select up to three
(% respondents)



Source: Economist Intelligence Unit.

[1] *SSG, Observations on Developments in Risk Appetite Frameworks and IT Infrastructure,* December 2010

CASE STUDY RSA

Crisis is not the only driver of investment in risk management. For the insurance industry, which largely weathered the financial crisis well, risk management has been rising on the agenda for a number of years, driven by the increasing demands of stakeholders and, for European insurers, regulation in the shape of the Solvency II directive. Indeed, among our survey respondents, two-thirds of insurers say that they have a clearly defined risk management strategy in place, compared with 61% of retail banks and 57% of investment banks.

For RSA, a FTSE 100 property and casualty insurer formerly known as Royal and Sun Alliance, risk management has long been central to the management agenda. "In addition to the underwriting risk that is core to our business, there is an increasing trend for insurers to look at their own systems of risk management to make sure that they identify issues as early as possible, then take steps to manage, mitigate and deal with residual risk," says David Weymouth, group operations and risk director at RSA. "What really matters is that we deal with the risks that could get in the way of the execution of our strategy."

Operational risk has become a key area of focus, and has been driven in part by an increasing reliance on technology to deliver services to customers. "As more and more of the interaction with customers and intermediaries is dependent on online services, you have to come back to managing issues such as fraud as well as the whole business continuity management agenda," explains Mr Weymouth. "Our shareholders need to know that we are managing all of our risk and not just part of it."

Like all European insurers, RSA is also grappling with Solvency II, a new capital adequacy framework that will need to be implemented by early 2013. In addition to establishing an EU-wide set of capital requirements, the new rules will require insurers to embed risk models in their decision-making processes. Although he admits that the implementation is complex and time-consuming, Mr Weymouth is generally supportive of the new rules. "In principle, Solvency II is a positive development because it is a more rational, a more quantified approach to the management of solvency and risk within the business," he says.

However, although regulation is encouraging a greater focus on risk management, it is only one factor that determines effective risk management. More important, according to Mr Weymouth, is the quality of the risk team. "Structure and processes are important, but they are certainly not everything," he says. "You need risk professionals who have the capability, the experience and the respect to be independent and to challenge management. You can change governance structures all you like, but if you're not competent and not respected, you won't get your voice heard."

and money begins to roll in again, is that people gradually start to sideline risk from their decision-making or find ways of circumventing the limits that have been imposed."

Our survey suggests that there has been an increase in the authority and clout of risk management within the financial sector, although it is far from universal. One-half of respondents say that the risk function has become much more powerful in their organisation after the crisis, but this still leaves a sizeable proportion for whom there has been no change or even a slight decrease in authority (see chart below). Almost one-third of respondents say that the risk function does not have adequate

Please indicate whether you agree or disagree with the following statements.
(% respondents)

resources or authority and just over one in five says that the function's views are more often than not overridden or ignored. At a time when the risk function ought to be at the peak of its powers, this is a worrying finding.

"There's no question that firms take risk management more seriously now than they did ten years ago," says Professor John Board, dean of Henley Business School in the UK. "But the big danger is that you tend to focus on what happened last time. So people might be more alert to the factors that caused the previous crisis, but the trouble is that the next crisis will pop up somewhere else."

World financial services outlook

World financial services industry

	2006[a]	2007[a]	2008[a]	2009[a]	2010[a]	2011[b]	2012[b]	2013[b]	2014[b]	2015[b]
Total deposits with financial industry (US$ trn)	61.6	71.9	74.6	76.9	81.4	85.9	93.6	101.9	110.9	121.8
Total loans by financial industry (US$ trn)	67.3	78.9	80.8	82.0	86.9	92.0	100.3	108.8	118.0	128.8
Financial industry lending per household (US$ '000)	49.1	56.7	57.4	57.8	60.5	63.2	67.9	72.7	77.9	83.8
Loans by financial industry (% of GDP)	144.9	151.7	142.2	151.8	149.4	149.5	154.3	157.1	159.4	162.1
Deposits in banking system (US$ trn)	40.3	47.3	49.7	54.3	57.0	60.0	65.2	70.8	77.1	84.7
Bank loans outstanding (US$ trn)	207.6	299.0	319.3	302.3	349.1	396.5	456.7	524.6	602.4	689.1
Bank loans (% of bank assets)	261.7	311.6	316.2	288.1	319.7	348.4	368.9	389.2	408.7	424.5
Bank loans (% of bank deposits)	515.6	631.7	642.1	556.6	612.1	660.4	701.0	741.1	781.1	813.6
Total personal disposable income (US$ trn)	29.1	32.2	35.2	34.7	36.8	38.5	40.2	42.5	45.0	47.8
Number of high net worth households (m)	11.9	13.4	8.9	7.3	7.9	8.7	9.6	10.5	11.6	12.8
Number of bankable households (m)	492.4	529.5	562.1	566.4	610.7	655.5	702.5	758.2	818.0	881.4

[a] Economist Intelligence Unit estimates. [b] Economist Intelligence Unit forecasts.
Source: Economist Intelligence Unit

Key forecasts

- The global economy will register growth of 4.3% in 2011, following expansion of an estimated 4.9% in 2010. Growth in developed economies will continue to be fuelled by very relaxed monetary policy even as governments reduce fiscal stimulus. Interest rates will remain low by historical standards, but both the supply of and demand for financing will remain subdued. By contrast, key emerging markets are showing signs of overheating and will require sharper hikes in interest rates.

- Banks in most developed economies face difficult conditions in the coming years. They will continue to suffer losses on loans and securities, even as credit markets remain subdued. Regulation and capital rules will become tighter. Lenders in most developing countries enjoy much more attractive markets for expansion, with scope for growth through bringing services to underserved populations and boosting investment levels.

- Both life as well as property and casualty insurers will suffer from weak demand in sluggish developed economies in the coming years, following outright declines in global business volumes in 2008-09. Emerging insurance markets are still very small but will grow much more quickly. Adventurous, well-capitalised insurers will target the leading developing economies.

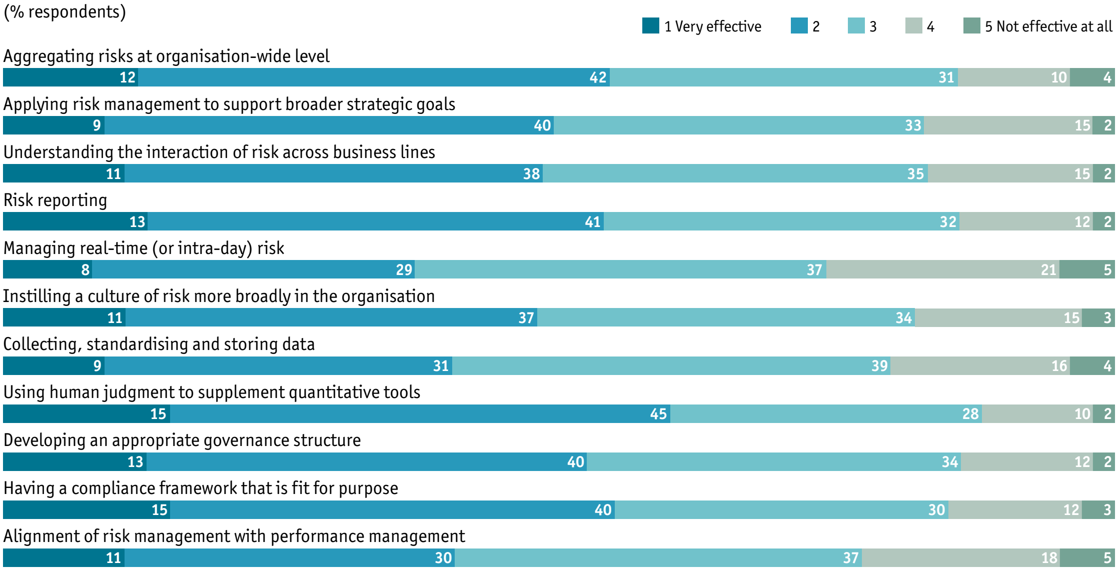
3. Seeing the big picture

Financial institutions may have implemented structural reforms in risk management, but it is much more challenging to bring about a change in organisational culture. Risk management is still far too often perceived as a support function that does not have sufficient influence at a strategic level. "Even though the CRO may now be reporting to the chairman, there is still a perception that risk should be focused on a particular silo of activity," says Mr Turner of Global Business Network. "Risk officers aren't necessarily involved in thinking about strategic opportunity for the institution more broadly."

This dissonance between risk and strategy stems in part from an outdated view of risk management's role and remit. A focus on mathematical models and technical expertise means that risk has been regarded as an input to decision-making, rather than an intrinsic part of the strategy development process. Among our survey respondents, just less than one-half say that their firm is effective at applying risk management to support broader strategic goals (see chart below).

While the quantitative aspects of risk management remain important, the financial crisis has

How effective is your organisation in each of the following areas?
Please rate 1 to 5 where 1 is very effective and 5 is not effective at all.
(% respondents)



exposed the folly of relying too much on automated processes or data-driven methods, which can lead to poor business decisions, financial losses or damage to reputation. As risk officers gain a more prominent seat at the top table, there is now an opportunity to accelerate the move to make risk a more strategic and holistic discipline that requires a synthesis of quantitative analysis with qualitative insights and judgment calls. "Financial institutions need to start a dialogue between risk and strategy that is more qualitative and holistic rather than being quantitative or model-based," says Mr Turner. "They need to break down the silos between risk and strategy, and recognise that they should be part of the same conversation."

"A combination of quantitative and qualitative inputs in risk management is becoming more important"

David Weymouth
Group Operations and Risk Director, RSA

A combination of quantitative and qualitative inputs in risk management is becoming more important to the insurance industry, says Mr Weymouth of RSA. "We're seeing a blend of people trying to attach a value to an individual risk or portfolio of risks but also making people aware of and evaluating that risk more consciously to make sure it is understood and managed appropriately."

This more holistic view depends on gaining a broader, enterprise-wide view of risk. Although enterprise risk management continues to be an area of investment for many firms, they still find it a challenge to gain a comprehensive view of risk. Less than one-half of respondents in the survey for this report think that their institution is effective at aggregating risks (see chart on previous page). Part of the problem is a shortage of skills and the tendency for risk professionals to specialise in one particular area. The ability to see the connections between risk categories is most often seen as the area where risk professionals most need to improve their skills (see chart below).

In which of the following areas do you think the skills of your risk professionals need to be improved the most?
(% respondents)

CASE STUDY Metro Bank

Launched in the slipstream of the global financial crisis in 2010, Metro Bank is the UK's first new high street bank for 100 years. By keeping its branches on the high street open almost round the clock, Metro Bank has emphatically prioritised customer convenience. From the outset, the bank has also sought to involve the risk management function at all levels of the business. By putting in place senior risk management professionals with long-standing experience in banking, Metro has ensured that their influence and input has been central to the development of the bank.

"The risk management function plays a core role in our strategic decision-making," says Keith Binley, head of credit risk and fraud at Metro Bank. "There are two key ways in which it influences decision-making. The first is through direct input at the executive management and board levels. The second is through the successful implementation of an enterprise risk management framework that provides structure for all key organisational decision-makers to assess and monitor all forms of risk throughout the decision-making process."

As a bank that was founded in the wake of the financial crisis, Metro has not been through the reorganisation that many other firms have experienced. "In our case, it's not so much that the authority has been increased, but more that we've tried to put in place a holistic focus on risk management, which has the effect of raising awareness about the importance of managing risks."

Clear accountability has been crucial to ensure that there is certainty around the ownership and responsibility for risk. "A problem in some other organisations is that it was always someone else's job to identify and manage risk," says Mr Binley. "Our approach is to embed risk management into each and every role within the bank, which means we are more confident of identifying and managing the risks across the business."

Rather than being hived off into a dedicated function, responsibility for risk is decentralised throughout the organisation, which means that is shared by everyone. "By managing risks close to the business, we find that our subject experts are better able to identify, understand and manage the risks than if it was solely the responsibility of the risk management team," says Mr Binley.

Along with the focus on organisational issues must come a clear commitment to developing the expertise of risk professionals. Metro Bank stresses that it is not just the risk professionals that are receiving training to bolster their expertise—risk management plays a part in all employees' development. Key decision-makers in the bank have to spend time enhancing their risks skills, which involves working closely with the risk management team to gain a deeper understanding of the risk factors.

A credible risk management strategy also demands a close relationship with the supervisory authorities. "Metro Bank has had a very close relationship with the regulators over the past three years while preparing for launch and while running the bank. The Financial Services Authority did a good job in challenging us to ensure that all aspects of risk were considered and managed, especially through the Internal Capital Adequacy Assessment Process (ICAAP) and the Individual Liquidity Adequacy Assessment (ILAA) process," says Mr Binley. "The regulators have provided a good framework from which it's possible to develop a risk management framework that is both proportionate and effective for our organisation."

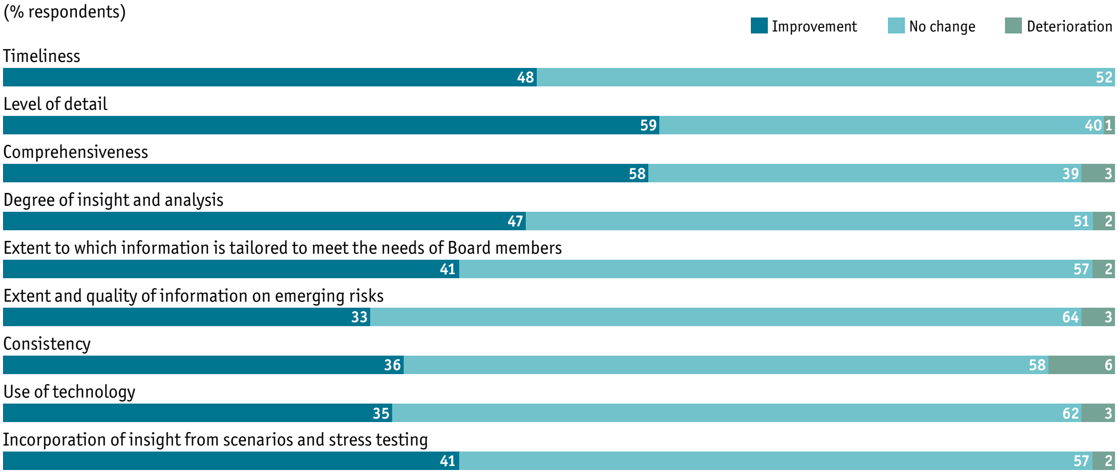
4. Relationships matter

Many boards, concerned that they are not getting a consistent and complete picture of risk exposure, are applying pressure on executives to improve risk reporting practices, while also bolstering the level of risk expertise within their own ranks. As a result, financial institutions are increasingly re-thinking how they gather information and report on risks so that boards receive a more accurate, timely and comprehensive view from the risk function to guide their decision-making.

In place of lengthy, impenetrable risk reports, boards are expecting much more concise and pertinent documents that can be easily digested and acted upon. “There’s been a fairly universal cry for improved quality, simplicity and clarity of reporting,” says Mr Baxter of Bain & Company. “The best institutions are getting their risk reports down to short, pithy, comprehensive documents that put issues on the table to be discussed.”

Just over one-half of respondents say that their board has become much more demanding in its expectations for risk reporting (see chart below). Retail banks, in particular, are likely to have seen an increase in demand for information from their non-executive directors. In addition, more than four in ten indicate an increase in the level of risk expertise of the board. The boards that are exerting

Over the past year, what changes have there been to the following aspects of risk reporting in your organisation that are provided to the Board?
(% respondents)



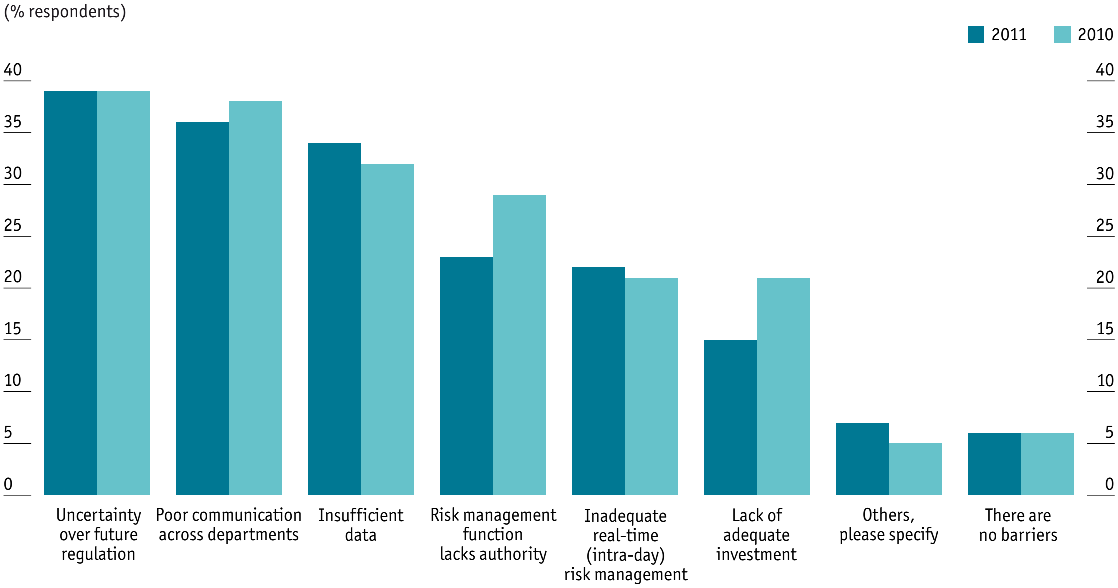
this kind of pressure have been more effective in driving changes in risk reporting, particularly in improving the level of detail and comprehensiveness in risk reports. This is not universal, however. For example, taking the survey results in aggregate, only around one-third are making their risk reports more consistent or are providing better information on emerging risks.

The importance of this dialogue between the risk function and the board means that strong communication skills are becoming core to the risk professional's skills set. "Being able to deliver information about risk in a format that the audience will understand is becoming increasingly desirable in a candidate," says Neil Owen, regional director at Robert Half Financial Services Group, a recruitment consultancy. "At the same time, companies still do need people with strong analytical skills. A high-performing risk team will be made up of individuals with different strengths—both commercial and technical."

Communication skills can also help to build stronger relationships between the risk function and other lines of business. This is a common weakness for financial institutions, with respondents citing poor communication between departments as one of the top two barriers to effective risk management (see chart below). They also point to the relationship between the risk function and business units as the one that is most in need of improvement (see chart on next page).

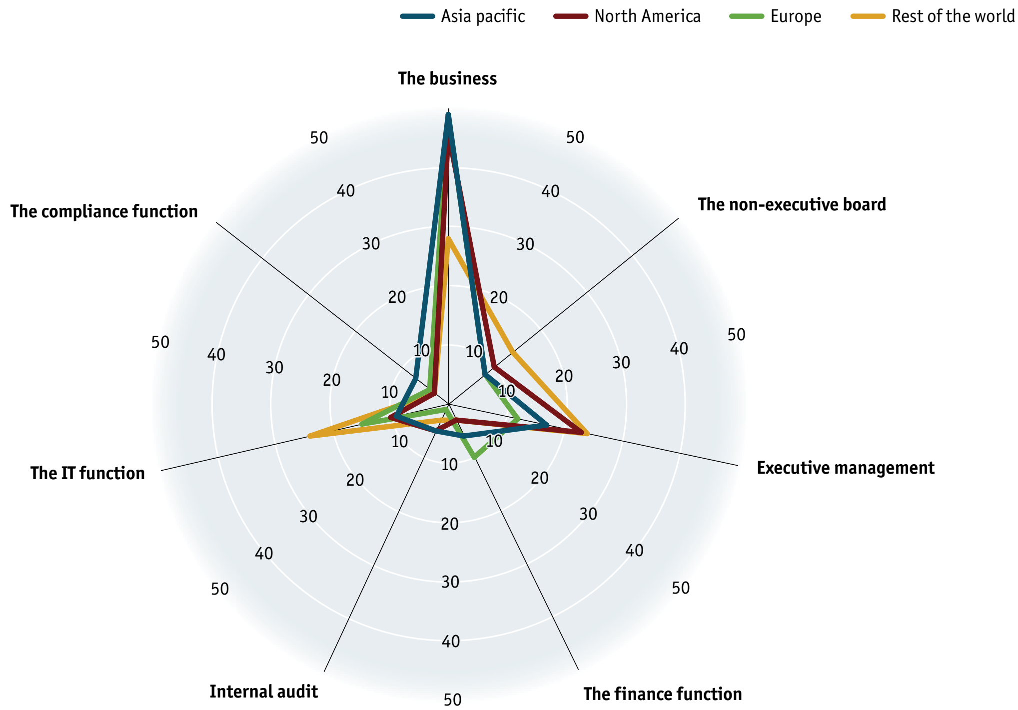
Improving this relationship will require both a re-positioning of the risk function and the development of a more risk-aware culture across the business. "The business should be in a position where it's not taking gratuitous risks and doesn't want to do so," says Professor Board of Henley Business School. "Ideally, there should be an autonomous, risk-aware culture in the business that requires only limited intervention from the risk function."

What do you consider to be currently the main barriers to effective risk management in your organisation? Select up to three.
(% respondents)



Source: Economist Intelligence Unit.

With which of the following parts of your organisation does the risk function most need to improve its relationship?
(% respondents)



Basel III and its impact on risk management

Uncertainty over the shape of regulation in the future continues to be seen as a key barrier to risk management. In September 2010, the Basel Committee on Banking Supervision reached agreement on global regulatory standards for bank capital adequacy and liquidity. The new Basel III rules will require banks to hold minimum common equity of 7%, which includes a counter-cyclical buffer of 2.5% that can be drawn upon during times of stress.

The industry succeeded in pushing back implementation of the new requirements until 2019 on the grounds that earlier action could have an adverse impact on the economy by reducing lending capacity. But for the largest institutions, the regulatory environment remains less clear. There is still no agreement over the treatment of systemically important financial institutions (or SIFIs) or indeed, over the criteria that might require an institution to be labelled as a SIFI.

It seems likely, however, that the very largest firms will be required to hold an additional capital buffer—something that the biggest banks are lobbying hard against on the grounds that it will hurt their competitiveness. It is, therefore, not surprising that uncertainty over regulation is a bigger concern among the largest financial institutions in the survey for this report. Speaking at a US Chamber of Commerce conference in March this year, Jamie Dimon, the CEO of JP Morgan Chase, went so far as to call the new rules "the nail in the coffin for big American banks".

A lot of bankers are concerned that the new rules will make certain lines of business unprofitable. But according to Professor Board, the regulatory changes merely illustrate the fact that banks were underpricing some risks in the past. "There's a lot of evidence that banks didn't get the risks right and therefore were under-provisioned in capital terms," he notes. "That doesn't mean banks should withdraw some products and services. What it means is that they should be more realistic in the way they price and sell them."

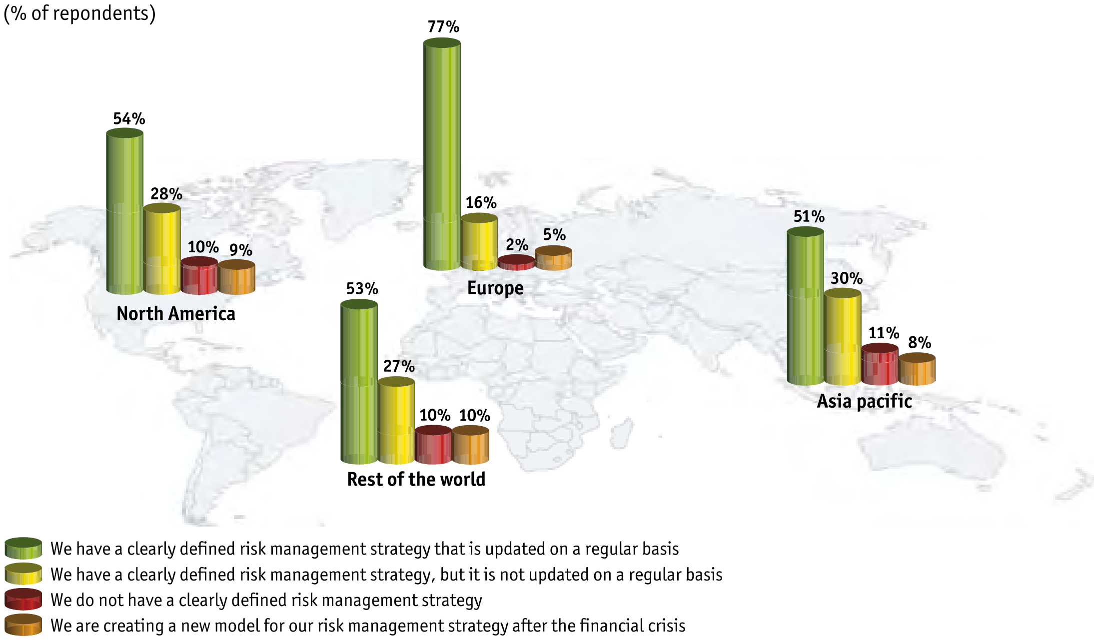
The tighter capital requirements under Basel III—and similar provisions under Solvency II for insurers—will require financial institutions to pay much closer attention to the links between capital and risk management. This will necessitate closer co-operation between the risk, finance and treasury functions to enable much greater transparency in liquidity and capital management. "The voice of capital and liquidity in decision-making needs to be much louder than it was before the crisis," says Mr Baxter of Bain & Company.

5. Investing in change

Previous reports in this series explained how financial institutions have in the past few years made substantial investments in risk management to address perceived shortcomings. While these investments continue to take place, there is some evidence that the urgency associated with these initiatives may have peaked. For example, on a worldwide basis, the proportion of firms with a clearly defined risk management strategy that is updated on a regular basis remains largely unchanged from last year's figure at around 60% (see chart below).

There are, however, considerable regional variations in the reported maturity of risk management. More than three-quarters of respondents from Europe say that their organisations have a clearly defined risk management strategy that is updated on a regular basis, compared with 54% of respondents from North America and 51% from Asia-Pacific. Regulation is likely to be part of the reason for this divergence—banks in Europe have typically been quicker to comply with the Basel II

Which of the following statements best describes the risk management strategy at your organisation?
(% of repondents)



accord than their peers in North America, while insurers in Europe have been focused on Solvency II, which sets out formal requirements for risk management.

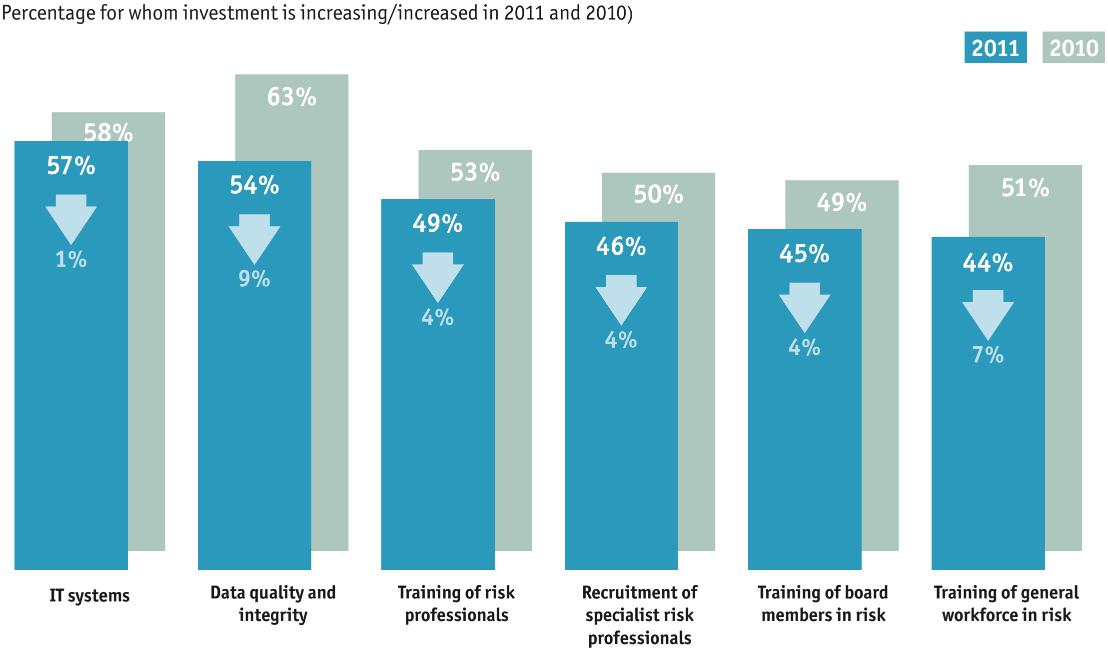
Although more than one-half of respondents continue to increase their investment in IT systems and data, the proportion reporting an increase has fallen slightly compared with last year (see chart below). Investment in training and recruitment also seems to be dropping off compared with 2010. In general, this may reflect the view that much of the necessary investments have now been made, or it could be a signal that the importance of risk management is on the wane as other priorities emerge.

Respondents from North America are more likely to report an increase in investment risk compared to their peers in either Asia-Pacific or Europe. For example, 56% of North American respondents say their firms are increasing investment in the training of risk professionals, compared with 36% of respondents from Europe. The North Americans are also most likely to be increasing their investment in risk training for the workforce as well as board members. IT investments, however, are most likely to be on the rise among respondents from Asia-Pacific. Two-thirds say that they are increasing investment in IT systems, compared with 58% of Europeans and 52% of North Americans. This requirement probably reflects the dynamism of economies in the Asia-Pacific region,where demand for consumer and commercial financial services is growing by leaps and bounds.

> "Investment in risk is still in evidence, but I also sense that the focus is returning to revenue growth, profit growth and opportunity"
>
> *Tim Brooke*
> *Managing Director, Protiviti*

"Investment in risk is still in evidence, particularly on management information and good quality data for decision-making, but I also sense that the focus is returning to revenue growth, profit growth and opportunity," says Tim Brooke, managing director at Protiviti, a risk advisory firm. "This may indicate that some organisations are ramping up risk appetite despite not having fully completed their upgrade programmes for risk and internal audit capabilities, and all at a time when the regulator is in transition."

In the past 12 months, what change has there been to the amount of investment your organisation has made in the following areas?
(Percentage for whom investment is increasing/increased in 2011 and 2010)



Despite this continuing investment in data and IT, the problems are far from being addressed. Most institutions have a patchwork of systems, often as a legacy of mergers and acquisitions, which are incompatible with each other. “It is difficult to point to a bank that has a really cohesive technology infrastructure,” says Mr Brooke. “Most organisations, particularly large ones, have very dispersed technology that is spread across multiple platforms. The whole management of that infrastructure is a major headache for bank CIOs and CROs. It is hard to imagine how non-executive directors get their heads around it at all.”

This patchwork of technology systems is compounded by ongoing problems with data. Just 40% of respondents say that their firm is effective at collecting, standardising and storing data (see chart on page 13). Insufficient data is also seen as one of the key barriers to effective risk management after regulatory uncertainty and poor communication between departments. Speaking recently at an advisory board meeting of the Financial Services Technology Summit, Neil Buckley, CEO of Fintrans, a technology company, pointed out that this was an industry-wide problem. “Until financial institutions get to the stage where there’s real clarity around the data they’re using for their risk modelling and

CASE STUDY Wells Fargo

For most banks and insurers, the financial crisis has been the catalyst that has forced them to rethink their approach to risk management. New reporting lines and structures have been introduced that give risk managers greater authority and responsibility. But not every organisation has seen the need to make wholesale changes. For Wells Fargo, the second-largest lender in the United States, the changes have been more incremental and merely complement the solid foundation that was laid well before the crisis.

At the heart of this approach is an organisational culture that puts the emphasis on robust risk management. According to Caryl Athanasiu, head of operational risk at Wells Fargo, the bank has consistently tried to instil a risk-aware culture that relies much more on embedding principles across the business than it does on imposing a rigid set of rules. “Operational risk is largely embedded in our business processes throughout the company,” she explains. “And if you think of the many millions of decisions that are made that might be subject to operational risks, you can’t create rules or policies for everything. It has to start with principles.”

Business managers at Wells Fargo are fully accountable for the risks they run and this feeds through into how they are measured and incentivised. New business opportunities are put through a rigorous process to ensure that there is an appropriate risk management structure underpinning them. “We tell people as they are growing the business that there is a very basic principle for how you manage growth—and that is control first, then profitability and then growth,” says Ms Athanasiu. “If you mess with that order, there will be problems.”

But although principles guide the majority of business activities, not every risk can be managed in this way. In some cases, it will be necessary to put in place hard and fast rules. For Ms Athanasiu, the distinction is between those activities where the incentives of customers and the business are aligned and those where they are not. “If you take fraud as an example, that not only creates a problem for the customer, it also damages the business, so there is a clear alignment of incentives which can be managed using a principles-based approach,” she explains. “On the other hand, a business manager may be inclined to put off spending on business continuity because they don’t think an earthquake is likely, and spend that money on hiring salespeople instead. That’s an example where principles don’t work because there isn’t a natural alignment of incentives. In that instance, you need rules.”

In addition to a largely principles-driven approach, Ms Athanasiu credits the organisational structure at Wells Fargo as a key factor driving the bank’s risk culture. Although there is a central risk function, which monitors issues such as regulation and capital modelling, much of the day-to-day risk management takes place close to the business. Each unit has its own dedicated risk managers, who work alongside the business managers and have a dual reporting line into the head of the business and the central risk function. “We want risks managed as close as possible to where they happen,” says Ms Athanasiu. “If you can get the right business head and the right risk management head supporting them, then you have 70% to 80% of your risk culture problems solved.”

their analytics, completeness and consistency will always be a problem," he said.

One way in which institutions are tackling the challenge of data management is through the creation of a new senior role to spearhead the transformation process. In 2006 , Citigroup became one of the first major financial institutions to put in place a chief data officer (CDO). The CDO has responsibility for managing data as a strategic asset and ensuring the quality of the data that is used or presented to the board. To date, however, few institutions have followed this lead. Just 17% of respondents say that their institution has appointed a CDO, although a slightly higher proportion say that their organisation has introduced or plans to introduce a data governance council—a committee of individuals from across the business that is tasked with establishing group-wide standards and best practice for data management, governance and control.

Conclusion

Our fourth annual study on risk management in financial services indicates that the sector is rebounding from the setbacks it has suffered in recent years but it still has some way to go to regain full fitness. For sure, risk management is undergoing reform and, in many cases, the changes are being orchestrated from the top. Boards are demanding more detail, accuracy and context from their risk functions, and are devoting more time and attention to assessing risk. The CRO is now a powerful figure in most organisations, while the risk function as a whole is much more integral to decision-making across business lines.

This is good news. But a lot of work still needs to be done to ensure that these enhancements in risk management become a permanent feature in the sector and the momentum for change is sustained. As businesses turn their attention from survival to growth, many financial institutions are itching to increase their risk appetite. At the same time, new risks are emerging that are compounding the challenges posed by a more stringent regulatory environment.

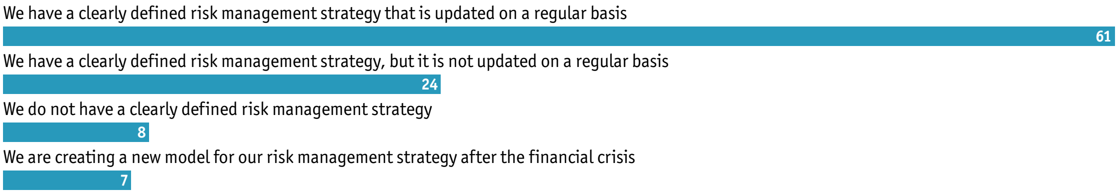
Banks and insurers are, in one sense, utilities: they provide the ballast that keeps the wheels of the economy moving. But they are also businesses that need to provide returns for their investors by taking risks in the marketplace. So as the sector enters a new phase in the business cycle, financial institutions must strike a careful balance between the quest for returns and the need for prudent risk management. From now on, they will have to bear in mind at every step that their decisions can affect much more than just their own balance sheets.

And for their part, risk managers must continue to dispel their image as backroom operators or support staff by demonstrating more clearly the immense value they can add to almost all aspects of their organisations.

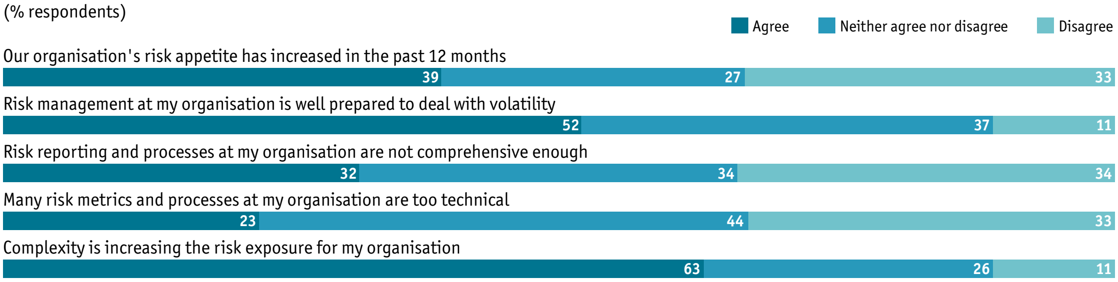
Appendix: Survey results

Do you have responsibility for, or influence over, risk management in the part of the organisation for which you work?
(% respondents)

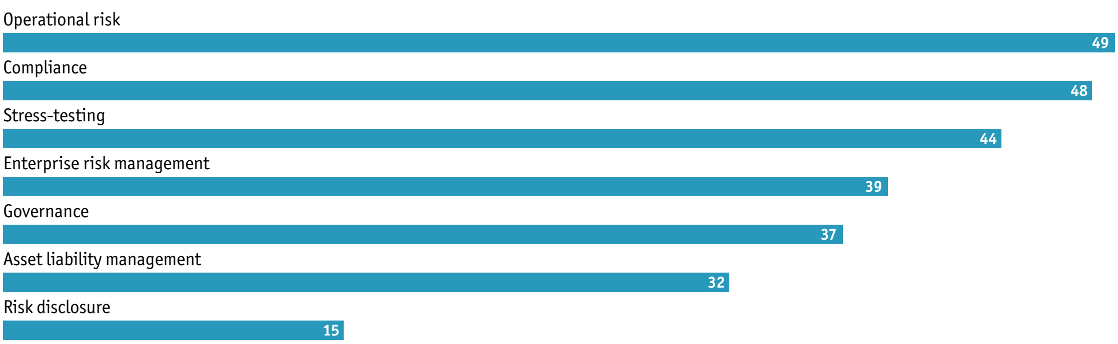
Which of the following statements best describes the risk management strategy at your organisation?
(% respondents)



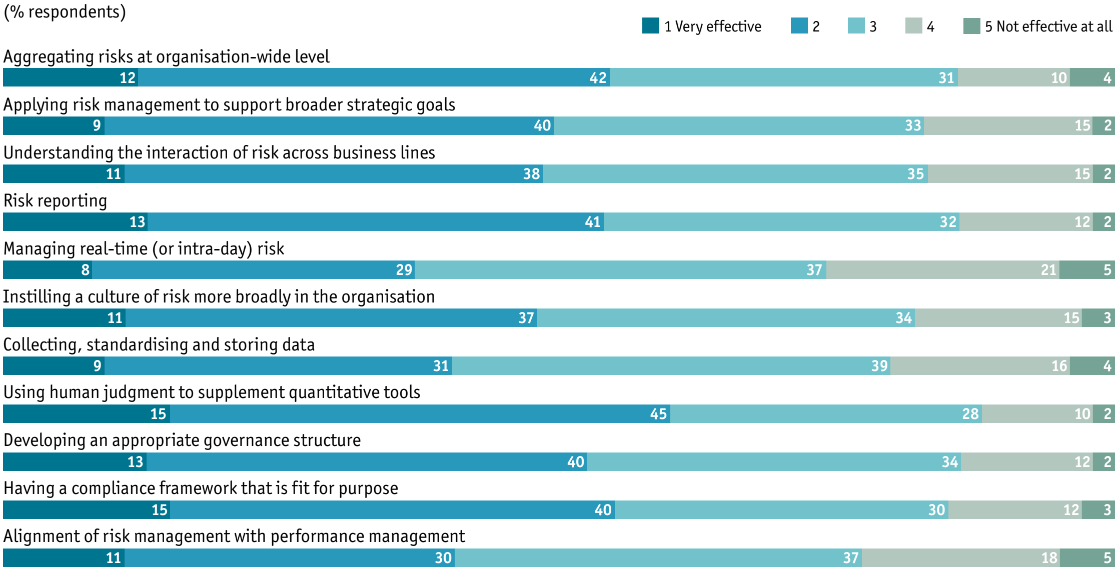
Please indicate whether you agree or disagree with the following statements.
(% respondents)



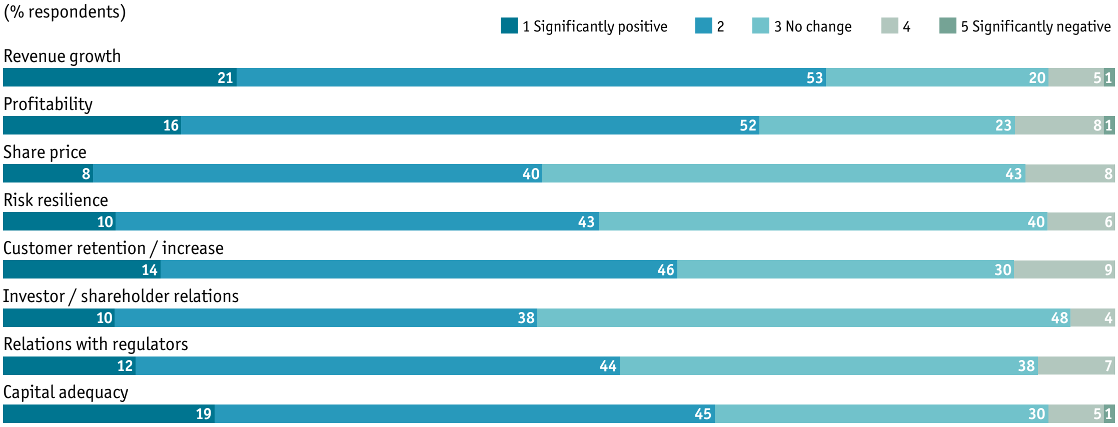
Which of the following risk categories are currently attracting the greatest level of attention from the risk function and top management in your organisation? Select up to three.
(% respondents)



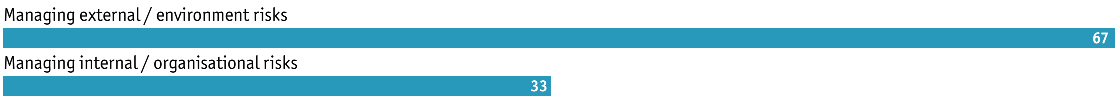
How effective is your organisation in each of the following areas?
Please rate 1 to 5 where 1 is very effective and 5 is not effective at all.
(% respondents)



How do you currently rate the prospects for your organisation in the following areas over the next year?
Please rate on a scale from 1 to 5, where 1=Significantly positive, 3=No change and 5=Significantly negative.
(% respondents)

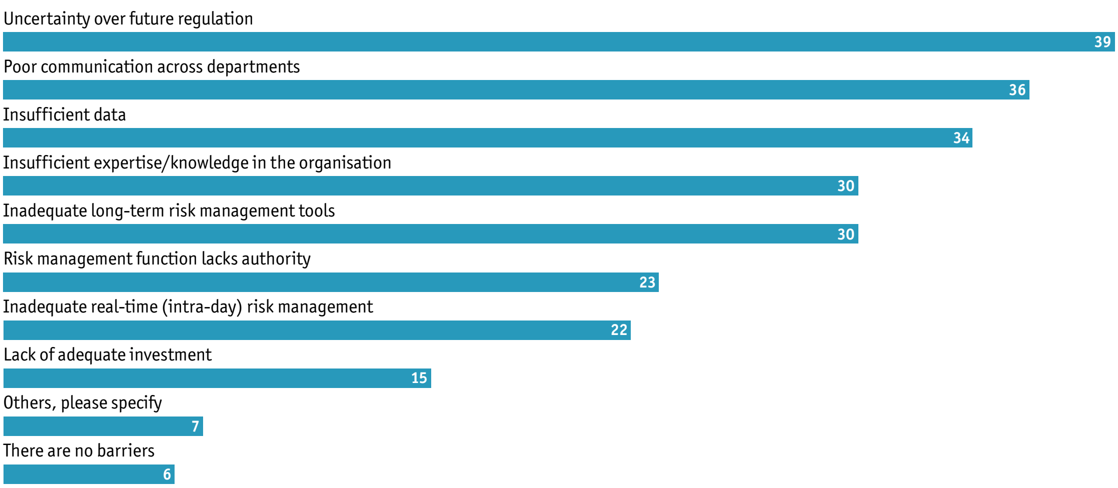


Which of the following poses a greater challenge to your organisation currently?
(% respondents)

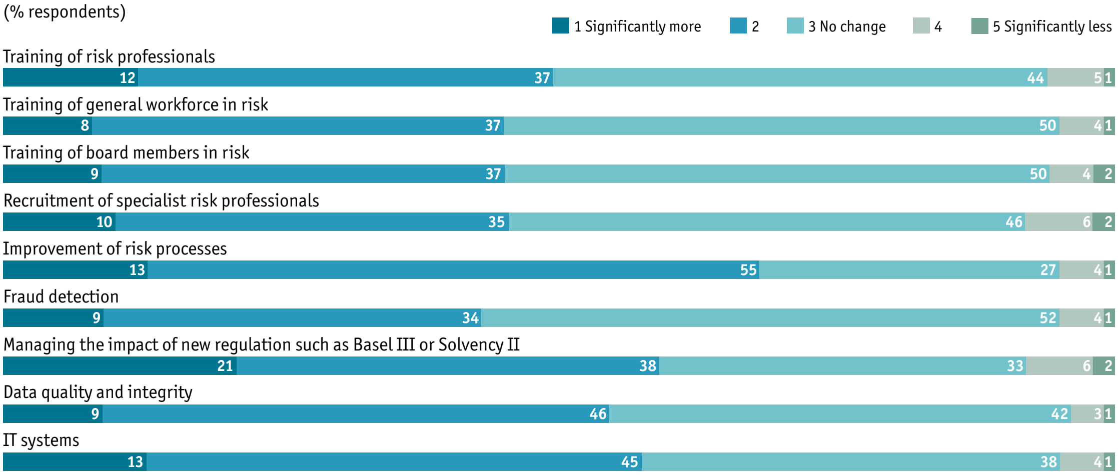


Please indicate whether you agree or disagree with the following statements.
(% respondents)

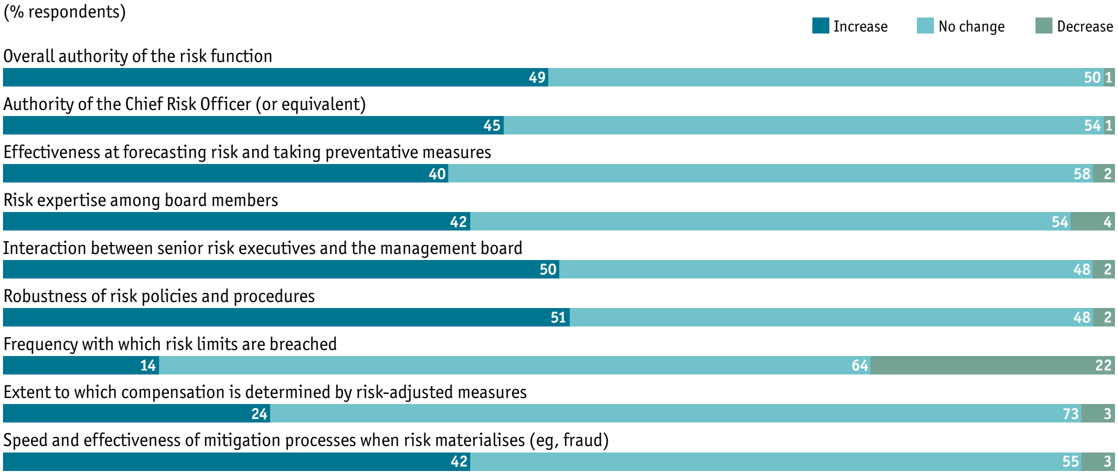
What do you consider to be currently the main barriers to effective risk management in your organisation? Select up to three.
(% respondents)



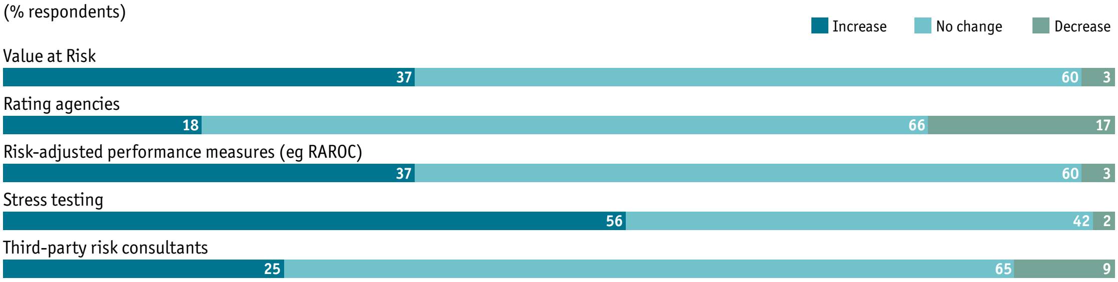
In the past 12 months, what change has there been to the amount of investment your organisation has made in the following areas? Please rate on a scale from 1 to 5, where 1=Significantly more, 3=No change and 5=Significantly less.
(% respondents)



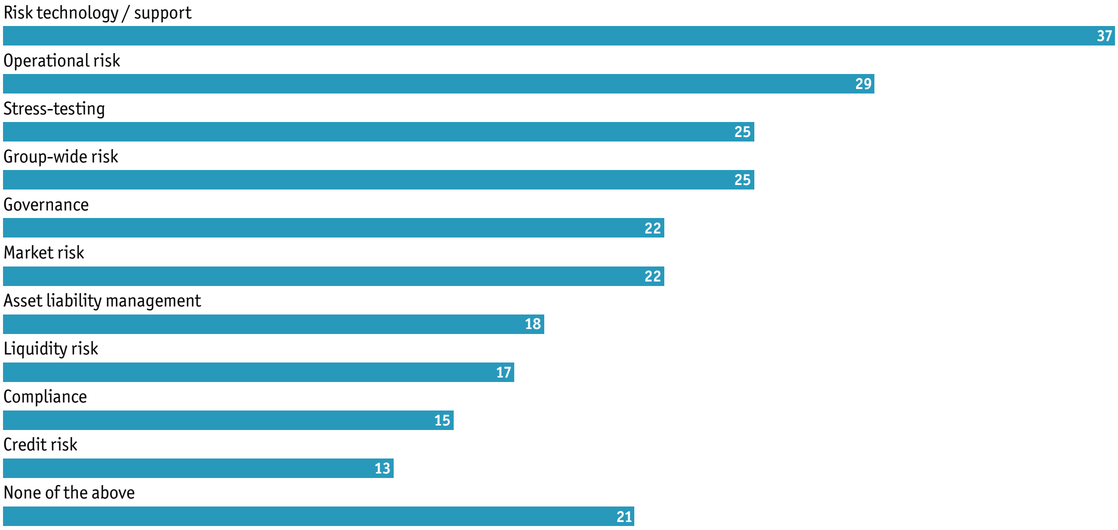
Over the past year, what change has there been to the following aspects of risk management in your organisation?
(% respondents)



Over the past year, what change has there been to the degree of reliance on the following in your organisation?
(% respondents)

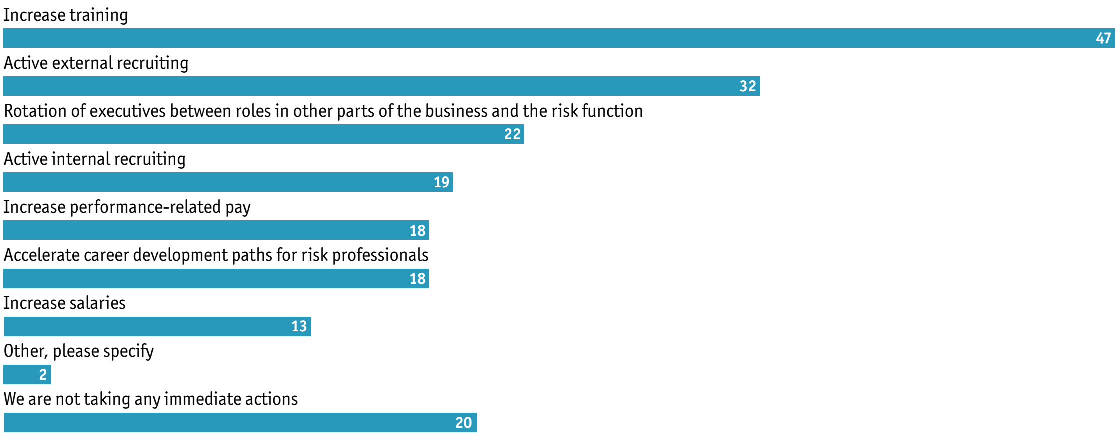


In which of the following areas of risk management (if any) does your organisation currently not have adequate expertise?
Select all that apply.
(% respondents)

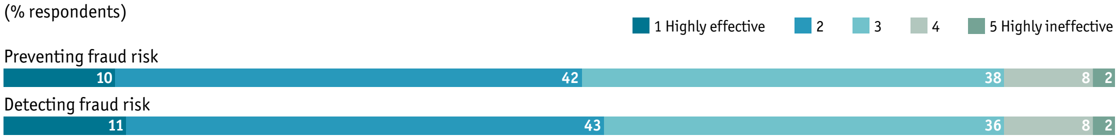


In which of the following areas do you think the skills of your risk professionals need to be improved the most?
(% respondents)

Which of the following steps is your firm currently taking to address skills shortages in risk management? Select all that apply.
(% respondents)

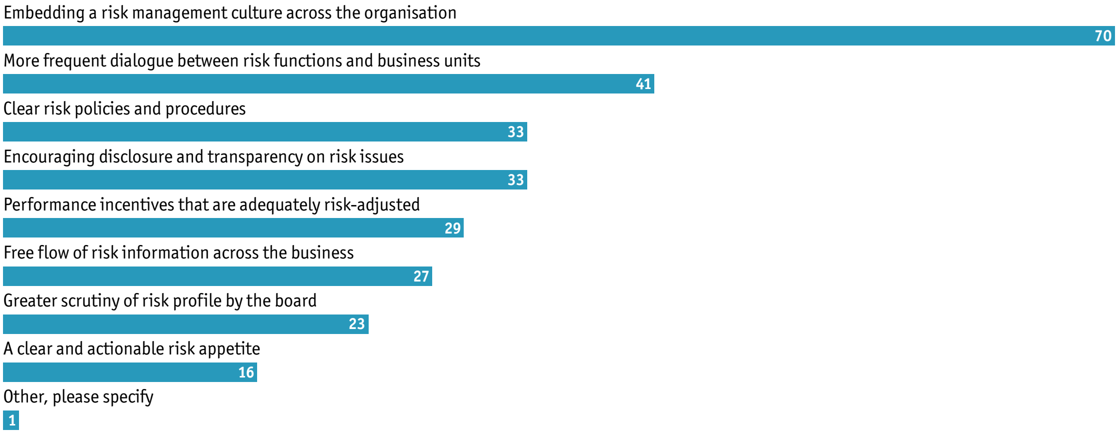


How skilled are risk professionals in your organisation in preventing and detecting fraud risk?
Please rate from 1 to 5, where 1=Highly effective and 5=Highly ineffective.
(% respondents)

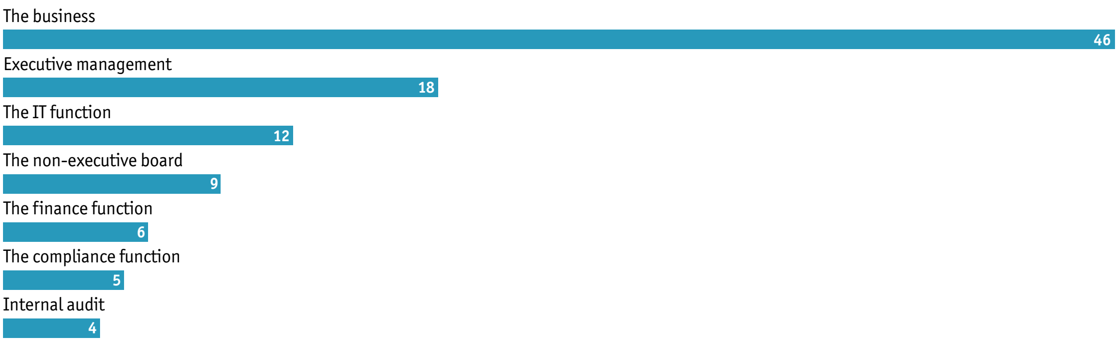


Please indicate whether you agree with the following statements.
(% respondents)

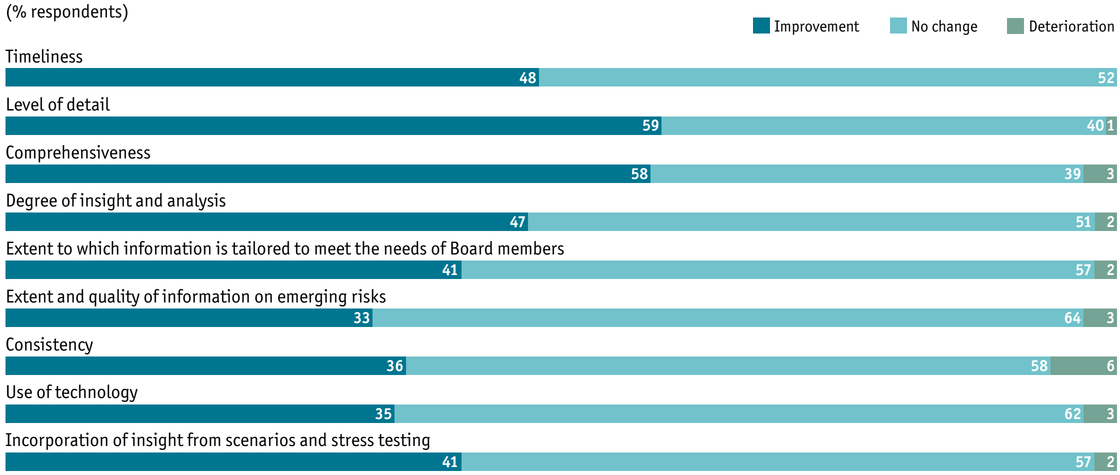
Which of the following ingredients do you think are most important in creating a robust and organisation-wide risk culture? Select up to three.
(% respondents)



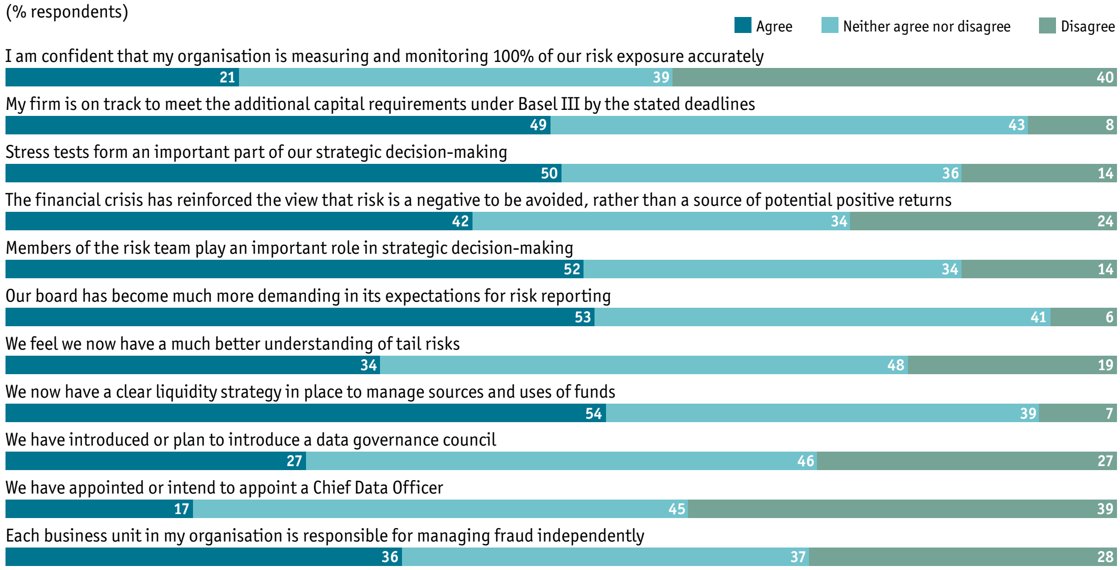
With which of the following parts of your organisation does the risk function most need to improve its relationship?
(% respondents)



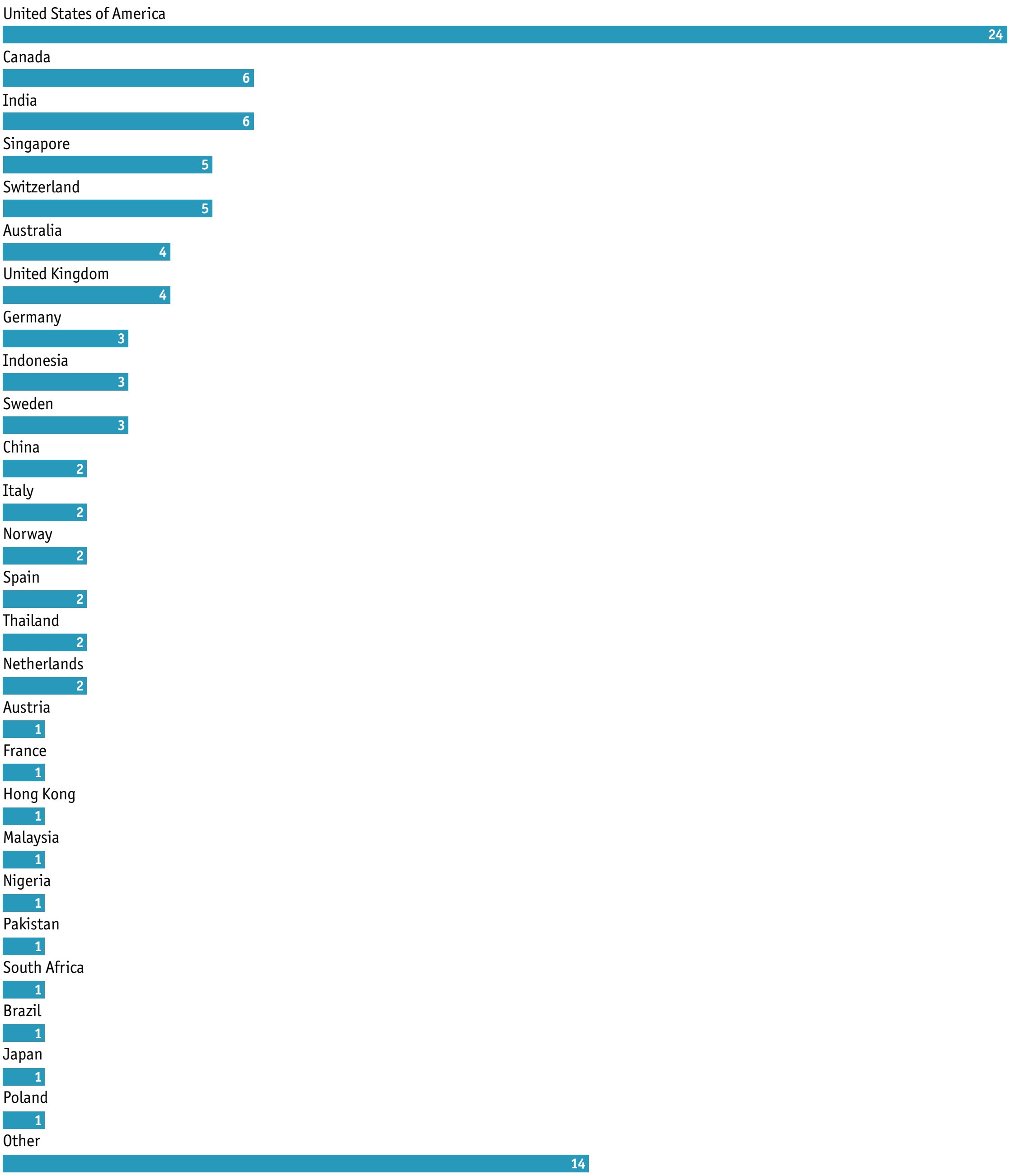
Over the past year, what changes have there been to the following aspects of risk reporting in your organisation that are provided to the Board?
(% respondents)



Please indicate whether you agree with the following statements.
(% respondents)

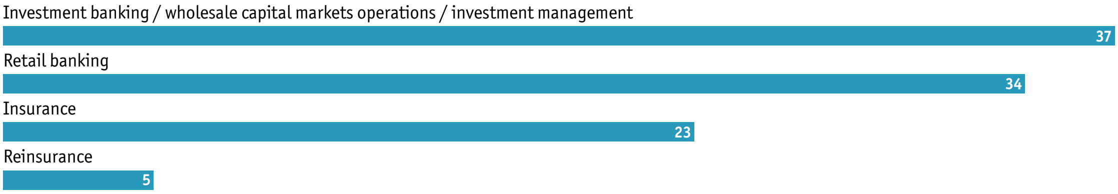


Where is your company headquartered?
(% respondents)

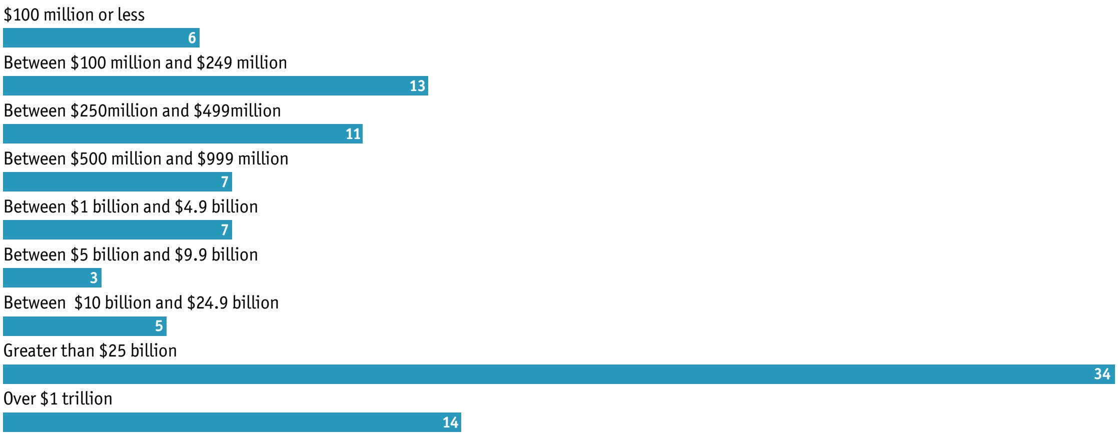


In which region is your company headquartered?
(% respondents)

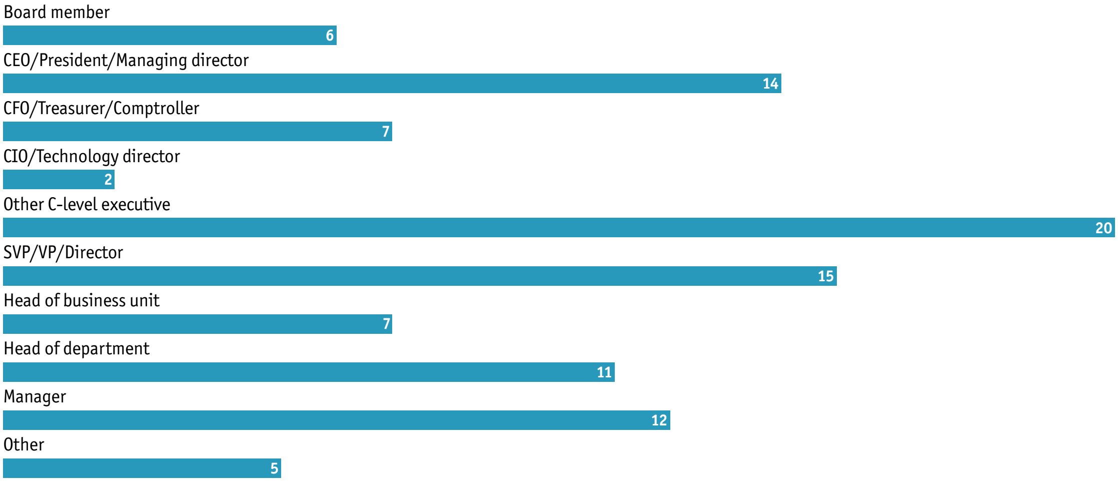
What is your primary industry / sector?
(% respondents)



What are your organisation's global assets under management (in US dollars)?
(% respondents)



Which of the following best describes your title?
(% respondents)



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