Risk & Finance Integration Part 2: Leveraging Digital Technologies for Effective Risk Management

Abstract

The financial industry's efforts to comply with regulation and structural reforms have led to several changes in risk management practices. Risk organizations need to find effective ways to consolidate, optimize, and innovate—to sustainably operate in the evolving regulatory terrain for strategic advantage.

Introduction

Risk and compliance costs are skyrocketing—catalyzed by a combination of prudential regulation, strict conduct supervision, and structural market changes. This 'perfect storm' is creating a transient environment that is potentially destabilizing (at least in the near-term), and at the same time, it also opens latent sources of risk and exposes operational vulnerabilities.

New threats and risks	Operational inefficiencies	Imperatives for change
$104 BN at stake in cumulative bills associated with European bank conduct risk and litigation activities in 2014 *Source: FT*	**64%** of industry participants are concerned about operational robustness of collateral management operations *Source: Oliver Wyman*	**30 - 50%** potential cost savings by embracing emerging KYC industry utilities *Source: Celent estimates*
23% growth p.a. in registered cyber-attacks around the world since 2010 *Source: Oliver Wyman*	**100 - 500 persons per bank** potentially involved in US regulatory stress testing and CCAR exercises during peak seasons *Source: Celent, market interviews*	**79%** believe that innovation is critically important due to customer expectations changing rapidly, so the industry is under pressure to keep up *Source: Celent*
>$56 BN in fines imposed for misconduct by US regulators in 2014 *Source: FT*	**67%** believe that heightened regulatory scrutiny and compliance requirements are a source of operational complexity *Source: Oliver Wyman*	**<45%** indicate that sources and symptoms of complexity is well managed today within their organizations *Source: Oliver Wyman*

Figure 1: Market and Regulatory Dynamics That Expose Vulnerabilities to Latent Risk

Source: Celent[1] , FT Alphaville[2] , FT[3] , Oliver Wyman[4,5] , Market Interviews

In a new world where there are shifts towards costly, more intrusive and data-intensive regulatory regimes, the ability to achieve scale, reliability and transparency at the right operational economics will be a winning factor for financial services business models

– Celent

Risk organizations need to radically envision and rethink their risk management and regulatory compliance and technology strategies.

Besides cohesive risk and finance decision-making, leaders can focus on:

- Real-time risk management capabilities as a paradigm
- Risk management digitization and enablement

Toward Real-time Risk Management Paradigm

Against the backdrop of round-the-clock, real-time (or near real-time) transactions in frontline web and digital channels, the existing paradigm of batch processing in middle and back offices represents an operational disconnect between risk-taking and risk control activities.

Drivers for Change

Investments choices and the adoption for real-time capabilities are determined by business and domain-specific regulations, applications, and market dynamics—depending on the line of business, products, and regulatory environment.

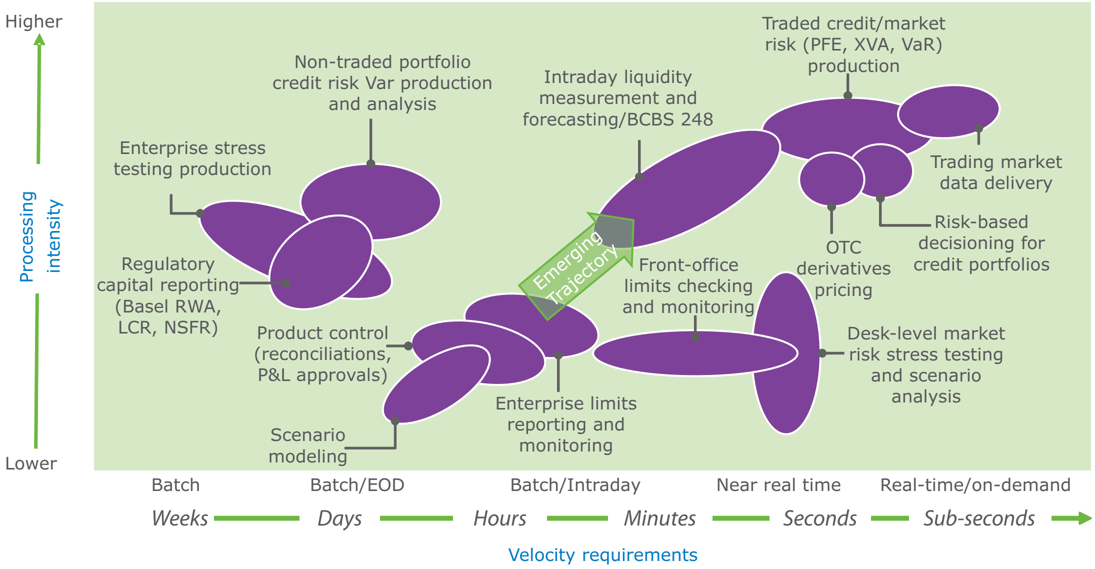


Figure 2: Aligning velocity and processing requirements withemerging demands (Illustrative)
Source: Celent6

As firms architect NextGen risk ecosystems, they must chalk out and develop business use cases to understand how latency requirements feature in new capabilities where there is a disparity between risk taking and risk control activities.

Action Points and Recommendations

The notion of real-time is not merely one of being instantaneous in a specific part of a transaction chain. Instead, it encompasses an end-to-end approach where a transaction lifecycle, both within a financial firm and across external parts of the chain, needs to be compressed in terms of latency.

To enable this shift financial services firms need to look at:

- Aligning velocity requirements and processing intensity.
- Mapping out and tracing the efficiency of existing risk data or information production chains in reacting to 'latency' demands.
- Enhancing architectural foundations for the right performance levels.
- Driving a flexible and agile data integration and middleware strategy for risk management technology.

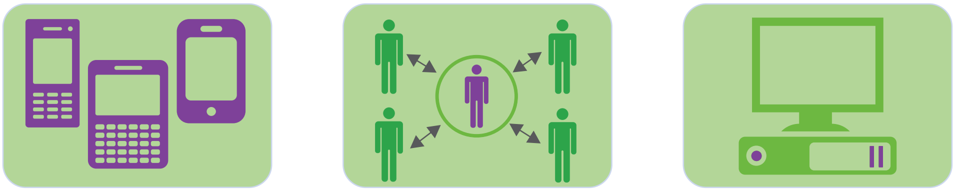
Risk Management Digitization and Enablement

In a digital banking ecosystem, front line risk takers and risk controllers will need to respond to the evolving nature of how risk is originated, assessed, transformed, and managed.

In order to define digital strategy for their risk functions, we believe that risk organizations need to consider three strategically pertinent implications around evolving digitization themes in relation to risk management effectiveness and efficiency.

Digital Business Drivers and Trends

Mobility, social media and cloud | Internal and external client-centricity | Data and analytics



Omni-channel beyond branch, call center and website: online access, always on, anywhere, anytime

The rise of "digitally migrated", more empowered consumers that leave digital footprints

A quantum leap in insight, driven by big data and analytics dynamically delivered

Figure 3: Digitization drivers and trends

Source: Celent6

This 'hyper speed paradigm' of transactional delivery and risk-taking requires comparable capabilities for limits, risk, and compliance monitoring and control. These are already stretching the limits of the current end-of day (batch-oriented) operations inherent in today's financial services firms.

Drivers for Change

In a hyper speed, interconnected digital world, firms can get influenced by:

- The proliferation of anytime, anywhere omnichannels, their impact on how firms operate, and the associated increased risks of cyber-attacks and fraud.
- The rise of digitally migrated, more empowered prospects and customers leaving digital footprints, which lets firms apply advanced risk profiling or segmentation techniques around customers, counterparties, and prospects
- Technological innovations such as Big data powered approaches that exploit the digital information ecosystem, and yield more accurate insights delivered in (near) realtime.

Strategic Options and Approaches

In looking at the risk value chain, we see opportunities for financial services firms to draw out the greatest value for digitizing their business models in various areas. Firms must begin exploring options and use cases for digitization of risk, regulatory, and compliance processes.

Here are some notable examples.

Credit underwriting

- Use client interactions, social media, and peer-to-peer data to augment traditional approaches for underwriting and risk assessment (for example, in retail credit underwriting, for counterparty risk assessments).
- Build capabilities around digitally enabled risk segmentations of prospects to enable effective marketing campaigns, and to create a more accurate pricing of risk to drive revenues and enhance profitability.

Reputational risk management

- Develop enhanced, data-driven reputational risk monitoring and mitigation approaches that can handle the increased velocity of information through social media in the digital world.
- Incorporate news and commentary about the firm's and counterparties' reputation profiles to supplement risk reports.

Additionally, firms can report conduct risk, centralize risk data utilities, and digitize risk management operations.

Action Points and Recommendations

Firms must bear in mind these factors for success[6]:

- Focus on experiences of both internal and external clients.
- Digitize internal risk, audit, and compliance management operating models to improve process orchestration and STP from the outside in.
- Build and strengthen digitally-oriented risk data and analytics Centre of Excellence (CoE).
- Incorporate flexibility and agility in both business and technology operating models.
- Implement a cohesive applications strategy to overcome legacy constraints.
- Ensure that the data middleware layer is fit for purpose.
- Be clear about the context of how economic value will be derived.

Digital value levers

1	2	3
REVENUE UPLIFT	RISK COST MITIGATION	OPERATIONAL COST REDUCTION
Stabilised or increasing revenue pool driven by a. Customer satisfaction (customer loyalty/retention) b. Customer interaction more frequent c. Customer penetration (better cross- and upsell / improved lead into sales conversion) d. Customised pricing e. New products/revenue streams	More informed decision making and portfolio management leading to a. Lower credit losses b. Reduced fraud costs c. Optimized liquidity, operating, and conduct risk management	Shrinking or stable operational cost base driven by a. Redesign of the branch network (smaller and more differentiated between advisory and transaction) b. Lower transaction and service costs c. Streamlined regulatory reporting

"Digital" needs to create profit rather than purely a retention strategy to justify scale and frequency of investment

Figure 4: Digital levers driving demonstrable and sustainable economic value
Source: Celent8

Digital risk management initiatives need to be thought through, planned, and implemented in the context of a profit-driven approach, rather than purely a retention-based strategy.

Conclusion: **Looking Forward**

Regulatory-led risk management alone will not automatically translate into a source of competitive advantage. Firms must stimulate and infuse innovative ideas and build strategic foundations in the midst of mandatory business and regulatory investments.

This will give enterprises the ability to discern threat signals earlier, and formulate preemptive responses—leading to increased chances to seize the right opportunities and protect a financial firm's franchise. Now is the time to prepare.

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About The Authors

Vijayaraghavan Venkatraman

Vijayaraghavan Venkatraman (Vijay) is a Senior Consultant and the Global Head of the Risk Management practice within the BFS, totaling 17 years of experience in the IT industry with focus on banking, risk management, and regulatory compliance.

Raghunandan M

Raghunandan Mahadev is a Domain Consultant with the Risk Management practice of the BFS, with a focus in risk management capabilities and solutions covering transformational and regulatory programs for global banks and financial institutions.

Contact

Visit TCS' Banking and Financial Services unit page for more information

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