

Risk & Finance Integration Part 1: Bridging the Gap between Ambitions and New Realities

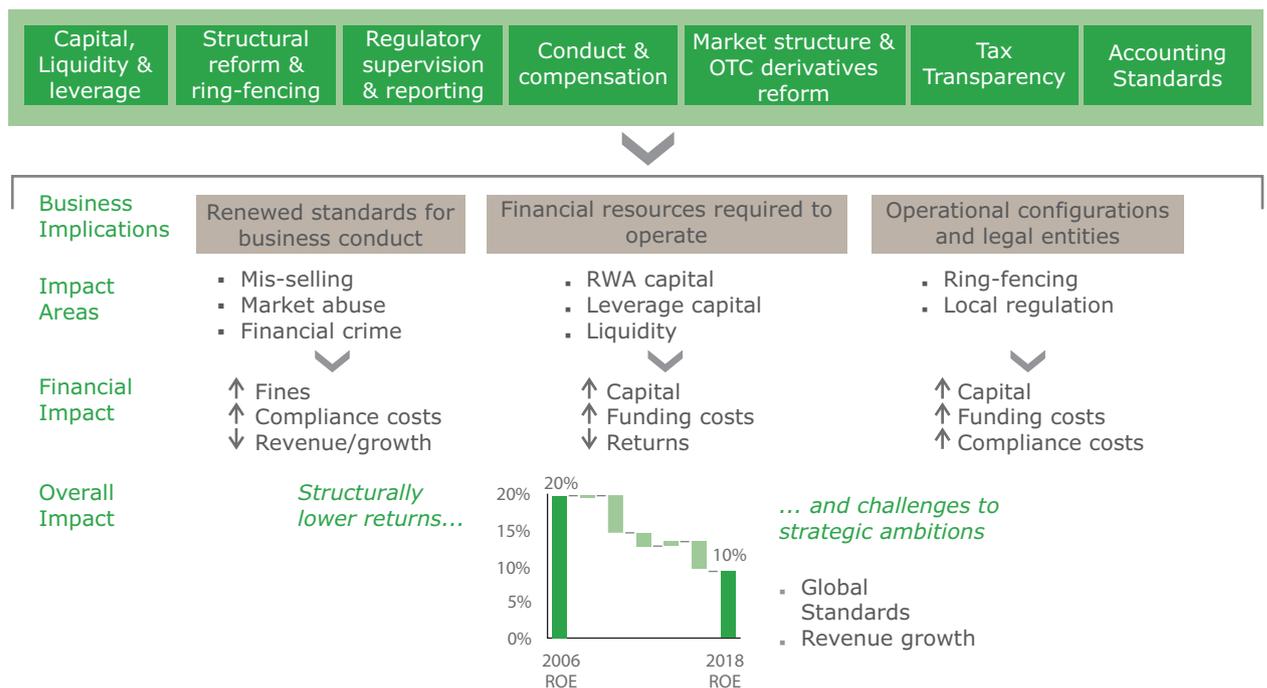
Abstract

As authorities continue to curb the excessive risk-taking nature of the financial industry, some firms are adjusting to the ultra-low interest rate environment. However, the return on equity (ROE) and overall economics of financial firms, both large and small—has taken a hit. Firms of the future must raise the bar, and carefully manage and execute initiatives to mitigate cost impact and complexities.

Introduction

Market and regulatory changes continue to drive and shape the financial industry's search for sustainable business models. In a post crisis era, especially, financial institutions are faced with reduced access to cheap funding, and are weighed down by new capital requirements for the risks they carry on their balance sheet and in operations.

Regulatory Dynamics



Risk management and related regulatory compliance spend in 2019 is expected to exceed \$74bn globally¹, with the average expenditures of a tier 1 bank standing at over \$0.5 BN for post-crisis regulatory reforms².

Banks have to be smarter in being able to understand and triangulate the multifaceted risk and capital-related drivers that play into the profitability and cost equation. These include around collateral, valuation adjustments, funding, leverage, and risk-weighted assets (RWA) in relation to the P&L targets—in both business as usual conditions and stressed scenarios.

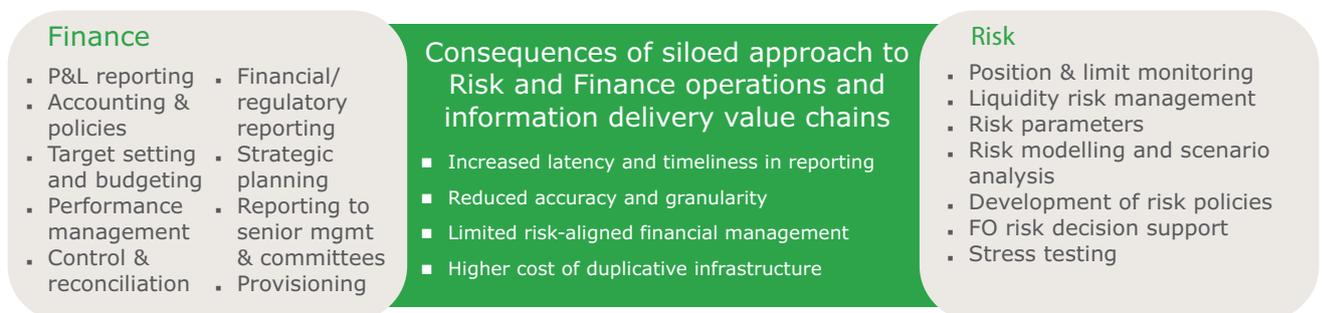
To differentiate themselves, respond, reposition, and eventually thrive in the coming times, leaders can adopt these strategic capabilities in risk management operations:

- Cohesive risk and finance decision-making
- Real-time risk management capabilities as a paradigm
- Risk management digitization and enablement

This paper will discuss on strategic imperatives and tactical steps required to align risk and finance capabilities to make cohesive risk-enabled financial decisions

Cohesive Risk and Finance Decision-Making: Issues and Pain points

- Their legacy risk and finance IT and operations
- Sourcing and maintaining high quality data to enable effective decision-making across both front and back offices, especially for firms that have undergone multiple iterations of M&A activity.
- Their risk and finance operations are typically distinct, siloed, or driven by process-specific delivery chains, limiting data sharing, and promoting inconsistencies.



Gaps and Inefficiencies in Misaligned Financial and Risk Management Operations Source: Celent³

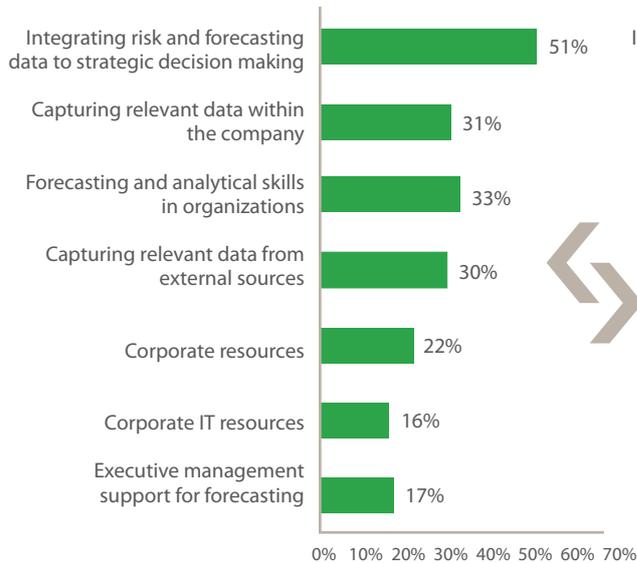
Drivers for Change

Some of the external pressures bank are facing include:

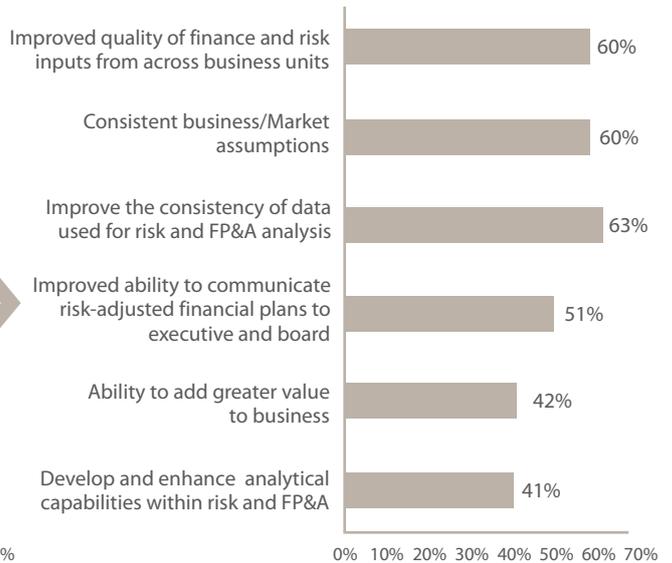
- Capital rules and reporting, which increasing in scope and depth, based on the evolution of Basel (2.5 & III) regulations that require firms to allocate buffer capital based on risk-taking activities of specific lines of business, as well as product , client segments
- Regulators need firms to demonstrate stronger data management practices and approaches to integrated risk and finance data based on stringent standards.
- Financial stability concerns are also driving industry-wide regulatory assessments such as US Fed's Comprehensive Capital Assessment and Review (CCAR), and EU's Comprehensive Assessment exercise.

Key Challenges in Forecasting and Managing Risk

Primary Challenges of Financial Services Firm's Ability to Forecast and Manage Risks



Perceived Benefits of Better Coordination between Finance and Risk



Risk and Finance: Challenges, Drivers, and Expectations toward Greater Alignment
 Source: AFP and Oliver Wyman 2014 Survey, Celent³

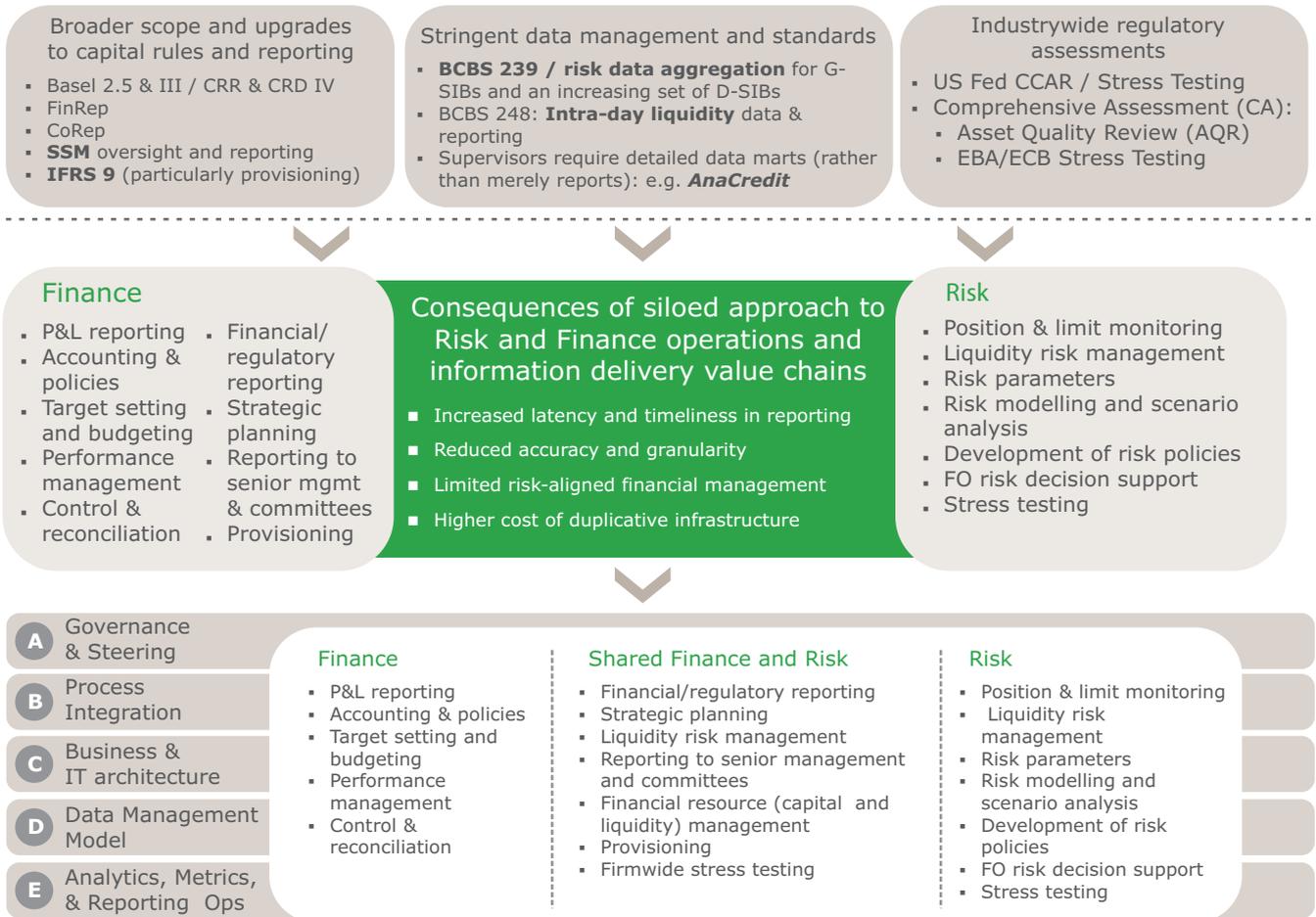
Beyond the regulatory lens, senior management of financial firms will require aligned risk and financial management processes to answer the following questions:

- How do we sustain, manage, and control escalating costs associated with regulatory and risk management initiatives?
- How will our strategic plan impact the risk and return of our bank's business portfolio under onerous regulatory regimes that we operate in?
- Is our institution's plan for capital deployment realistic under different economic and industry scenarios, or will it endanger our financial obligations?
- Should we reduce the capital budget or let it stay the same to provide a buffer?

Action Points and Recommendations

To address these strategic questions, firms must coordinate across business, risk, and finance activities to ensure the layers of change are planned for and managed.

With supervisory demands continuing to rise across jurisdictions, we believe that now is the time to make the business case for a more integrated risk and finance approach.



Risk and Finance Transformation: A Strategic Approach is Required Source: Celent³

Recommend Actions for Firms

Let's unpack each layer and highlight pertinent considerations.

Layer#1: Governance and Steering

Ensure alignment between business processes, governance, IT. Governance and steering mechanisms for first, second, and third lines of defense need to be clarified and confirmed, and accountabilities need to be elevated to the senior management.

Layer#2: Process Integration

Risk and finance process integration across the group will not only need to be well-defined, but collaborative activities and data handover points will also have to be redesigned and integrated.

Layer#3: Business and IT Architecture

Firms need to ensure that adopted business and IT architecture strategies reflect a high degree of alignment across front office business units, with risk and finance application architecture,

data integration architecture, and technical infrastructure. The focus should be on simplification, with more nimble, platform-based architecture methodologies.

Layer#4: Data Management Model

Firms must ensure that data architecture and data management models present a single version of the truth.

Layer#5: Analytics, Metrics and Reporting Operations

Analytics, metrics, and reporting operations will need to be designed for greater flexibility and timeliness, in particular, to accommodate ad-hoc what-if analysis, integrated stress scenario modeling and testing, as well as finer grained data outputs, and a wider range of data aggregation and analyses.

Conclusion: Looking Forward

Leaders, with ambitions to thrive in the new world, will drive better risk-enabled financial management to counter the erosion of returns from regulatory developments, and to focus on profitably sustaining the right businesses and client segments.

Forward-thinking firms that understand the profound impact of emerging regulatory regimes and future competitive requirements will adopt a strategic stance (beyond regulatory compliance) to deploy capabilities for integrated balance sheet and financial resource management paradigms.

This will help them achieve financial efficiency when weighing risk-reward considerations. Only then can firms break away from merely complying, toward actually thriving in the emerging regulatory landscape.

References

[1] Celent, "Navigating the Risk and Regulatory Maze with a Clearer 20/20 Vision" (May 2016), <http://www.celent.com/reports/navigating-risk-and-regulatory-mazeclearer-2020-vision>

[2] Oliver Wyman, "Adding 5% to RoE: How Banks Can Do More With Less", <http://www.oliverwyman.com/insights/publications/2012/aug/adding-5--to-roe--howbanks-can-do-more-with-less.html#.Va9gLqSqqko>

[3] Figures are illustrative and projected ROE figures are based on the wholesale banking sector, with expected average around 10%. From Celent report, "Back to the Future for Risk: Risk-enabled Financial Management", <http://www.celent.com/reports/back-future-risk-management-realizing-promise-true-riskreward-decisions>

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