The Changing Face of Risk Management

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Steve Culp, Christophe Mouille and Karsten Ebersbach discuss the latest technological and business trends in risk management practices

Risk management continues to advance into the mainstream of business life. Until recently it was often positioned largely as a compliance necessity and viewed as a cost of doing business. Increasingly we see financial institutions (FIs) associating risk management much more with innovation and striving to enable sources of competitive differentiation.

For example, according to the 2011 Accenture Global Risk Management Study[1], 98% of respondents said that risk management is a higher priority today than it was two years ago. More than 80% of companies surveyed also consider their risk area to be a key management function that helps them deal with marketplace volatility and organizational complexity.

What has changed? There is a significant challenge from the dual effects of depressed profitability combined with an increasingly demanding regulatory agenda. Accenture research looking at the past decade shows the industry achieving RoE in the region of 24%-26%, which has now been reduced in many organizations to single digits (or less) over the past three years. Looking at the earnings announcements and communicated business plans from industry leaders over the recent quarters, rates of 12% or 14% are considered a good industry norm. That pressure on margins in combination with the amount and complexity of the regulatory agenda and a more intrusive approach by regulators changes the nature of the game.

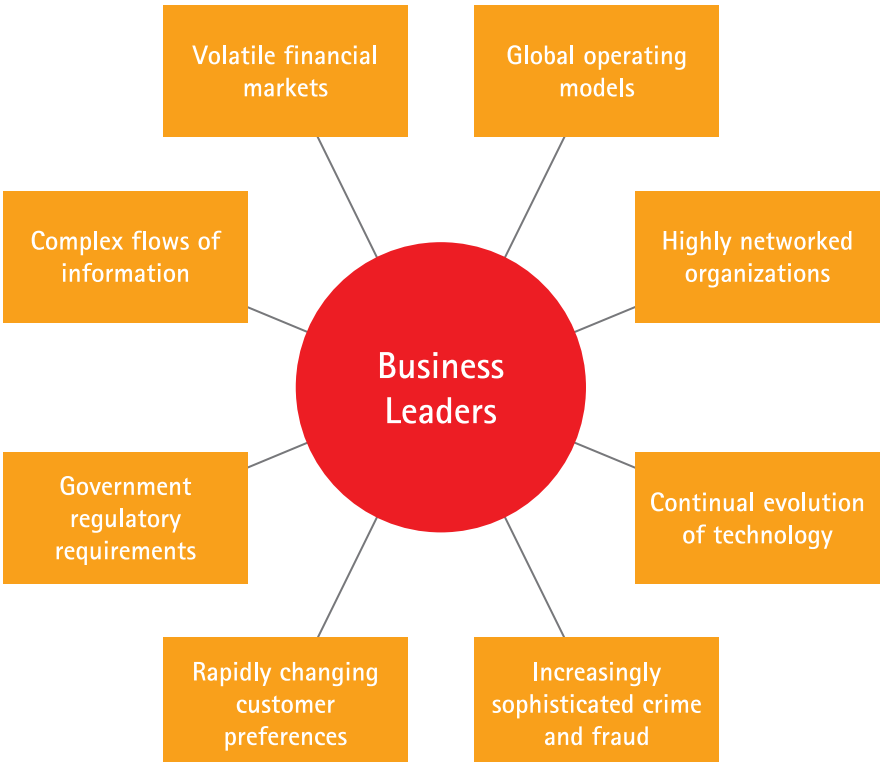
As a result, instead of viewing the suite of regulatory challenges as tactical one off efforts, leading FIs are increasingly viewing the regulatory agenda as a key input to work out where the organization should focus its capital and which parts of the business can be profitable post 2015, when the majority of regulatory requirements take effect. Risk management in this context becomes a strategic input to the business as opposed to being a separate stream of activity.

Looking beyond FIs, Risk Management is also undergoing a significant repositioning. As companies in all industries look to outperform their peers, the competitive differentiators around technology, global operating models, access to talent, even around business models themselves, are rapidly decreasing.

In order to win in the market place they have to out-innovate and out-execute, and that means moving faster, entering new markets, being more accessible to clients, launching new products and pricing more effectively. Those are ultimately the levers that every business has. Figure 1 summarizes a number of the forces and complexities that business leaders must deal with as part of managing their companies.

Therefore, as businesses innovate and compete, by default they must take on more risk. So the only way for them to succeed in that high innovation environment is by having better risk

Figure 1: Factors Contributing to the Need for Sophisticated and Integrated Risk Management Solutions



management capabilities to enable the new ventures and extensions to be successful over the long term. Consequently, across industries there is a movement of Risk Management activities and focus from the back office to the front office, from compliance and cost control to differentiation. That creates a much more tangible, and ultimately healthy, connectivity between risk management, as a function, and the strategic growth drivers or business plans for the organization.

Historically, risk management has been a defensive discipline, but its movement into the mainstream means that it is helping the organization play offense more frequently as part of its role. In other words, businesses are beginning to do things with risk that add value rather than simply limiting it or protecting the business from "risk". Recently, one Chief Risk Officer (CRO) made a striking analogy involving a high level tightrope walker and a safety net. He said that risk management is about providing that net, enabling the business executives to have the confidence to execute their vision but that ultimately the walker should never have to use the net. Knowing that a robust risk management system is in place in this way therefore turns a potentially defensive stance into an offensive confidence to take the business forward and take the steps necessary to push ahead even when the path is complicated or unproven. Taking risks are part of everyday business, taking unmanaged risks is where troubles arise.

CROs and CFOs

One of the consequences of the move by risk management into the mainstream is that the roles of Chief Risk Officers have grown in importance and influence and have helped to drive some of the strategic direction. In 2009, Accenture's Global Risk Management Study, comprised of research conducted among different industries, showed that 33% of firms had a CRO who owned risk management in the organization. In 2011 that figure had risen to 45%. Figures for financial services firms were even higher with 84% having a CRO on board.

Prior to the financial crisis, there was often a lack of consistency between CROs and Chief Financial Officers (CFOs) across process, systems and data. In many FIs the two sides were talking a different language and unintentionally creating challenges for the organization with conflicting priorities and messages. Today, some aspects of the crisis have helped to push the agendas together and the trend is towards tighter alignment and collaboration between the CRO and CFO and as a result more consistency across finance and risk.

The Importance of Culture

One challenge faced by many businesses is addressing the people dimension and getting the right risk management culture embedded. Safety critical industries such as air travel and nuclear energy have always embedded formal approaches for managing risk through culture and people. We are now seeing these concepts being more broadly embraced by financial services as well.

Businesses need to communicate a clear set of guidelines and expectations from the top down on appropriate risk taking and decision making. Too many organizations leave risk appetite as a concept and fail to translate this into limits and/or specific direction.

Both CROs and Chief Human Resource Officers (CHROs) are becoming much more aware of the need to put measures in place around individual understanding and engagement and the overall level of risk awareness in organizations. As a result, there is often a need for training to be put in place to ensure that all employees understand their specific roles in managing risk in the organization.

In our client work we are seeing an increasing need (and drive) for more stringent and transparent allocation of responsibilities for functions and tasks in many organizations. Having more clear accountability across the areas finance-risk-operations and ensuring that the interconnections are well understood and managed holistically is one of many change outcomes resulting from the crisis, as many of the issues were due (or at least supported) by unclear responsibilities.

Finally, businesses need to ensure that their compensation and reward systems align with the organization's risk and compliance rules. By running these sorts of programs and embedding them in their performance management systems, firms are creating a level of awareness and re-inforcing the importance of effective risk management enabling the basis for continued conversation and providing the means to influence the right behaviors.

More Complex

As they seek to operate more quickly in an increasingly interconnected world, FIs are realizing that they need risk management to play a different role. Events over the past few years have really accelerated that trend.

It would be hard to find an industry or large-scale organization that does not see its business model today as more volatile and more complex than it was only three years ago. All firms are trying to discover where profitability and growth will come from in the future.

To manage the business going forward they need the risk management capabilities to support scenario planning and risk mitigation and information based on more than just a finance or a process perspective. They need to be able to look at different markets, customers and product lines in a more sophisticated manner and ultimately to be able to adjust the dials as they try to take business forward in a more complex environment.

As a result, businesses are starting to demand better information and insight in new dimensions, faster, and in a more predictive manner, and they need risk analytics to meet the complexities that they face. This need has created a technology and risk response, but the underpinning architectures and tools most have in place today are not sufficiently aligned to meet the demands coming from the top down. For example, Accenture asked more than 397 C-level executives with responsibility for Risk Management, what they intended to invest in over the next two years. The top answers were: data quality, management and architecture; analytics and risk modeling; and better integration of risk processes with finance processes. Financial institutions understand all too well that to manage their risks better, they need first to be able to quantify them.

Geographical Shift

Another change that has taken place is that risk management best practice is no longer concentrated in the usual regional centres. Instead of there being a west-to-east, or north-to-south flow of leading practice, the discussions and flow of information have become much more bilateral. It is no longer the case that London, New York or Frankfurt is the sole proprietors of the most advanced, the most sophisticated and the best risk capabilities. As became clear in the economic downturn, they no longer hold that mantle. Interestingly, Accenture's 2011 Global Risk Management research shows that more than 90% of Latin American firms have existing ERM programs in place, compared to only 52% of European companies and 60% of North American ones. Also, 90% of Latin American firms foresee significant or moderate increases in risk management spending, compared to only 82% of companies in North America and Asia Pacific.

Technology as an Enabler for Risk Management

None of these requirements – the analytics, the shift from back to front office, the geographic scope, the connectedness and pace of business – could be met without advancing the technology environment. From an industry standpoint the providers as well as the buyers have continued to become more sophisticated and articulate about the challenges they face and are trying to solve. That has caused a plethora of new ideas, tools and capabilities to enter the market faster than ever before.

A significant challenge facing virtually all FIs is the need to integrate, align and harness the technologies in a way which will better serve the business and deliver the outputs and insights required to outpace the competition.

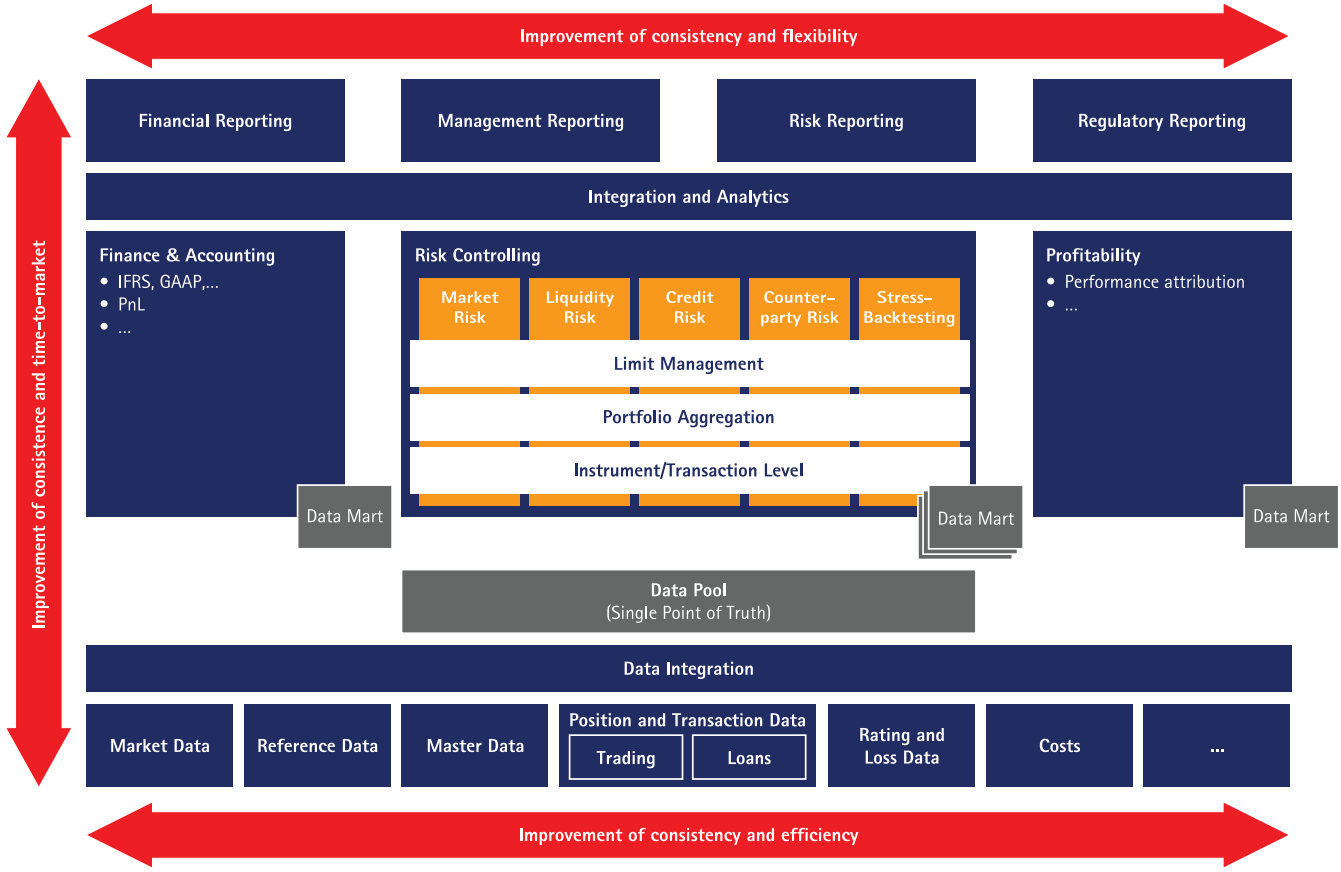
However, while the underpinning structures add the ability to integrate data, systems and processes quickly, keeping up with all these advancements in tools and technologies is nearly impossible. Many FIs experience a gulf between what they desire and what is actually possible. The challenge is to connect or enable through what is technologically brilliant or innovative and to do so in a way that is more agile, modular and cost effective.

Over the years, data volumes along with regulatory and business requirements have driven FIs to take a leading position in technology, developing new features, new automated solutions, more sophistication and complexity covering more countries and more business activities. However, these requirements have also progressively contributed to a dramatic increase in IT costs as demands have become more complex and the resulting systems more diverse.

Nevertheless, that position has remained largely unchallenged as the underpinning environments are highly customized and extremely complex. That in itself has provided a natural barrier to change for the industry.

One important technological change designed to meet the increasing demands is in the way that the application architecture is built. Traditionally, the application landscape was built layer upon horizontal layer. So each layer carried a function and interfaced with the other layers through transformational rules, lead times, short cuts, complex reporting rules, and so on. However, that horizontal structure is changing to something much more vertical. Consequently, individual pieces of information will be able to be gathered from the bottom up, elevating the reporting lines and data governance where necessary ("reconnect the shop floor to the Board Room"). See figure 2.

Figure 2: The Verticalization of Data Architecture



This vertical orientation of data is vital to the success of FIs and fundamentally changes how they will procure their IT programs and initiatives in the future. There have been some early adopters – mostly small to middle-sized institutions – that have been able to move comparably faster than the global mega institutions to combine data, processes, people and organizations. However, this is still very limited and the complexity in terms of organization makes these changes more difficult for larger FIs to undertake.

There are a number of key technologies that will enable these changes over the coming years. There are dramatic software changes happening in database technology. For example, we see many clients investing in vast databases to improve both processing and data warehousing capabilities. As a result, financial institutions are now able to manage significantly greater amounts of data in a unified software environment.

The developments in hardware have been equally dramatic. The advent of in-memory capability means that businesses will be able to treat online within a day vast amounts of data which traditionally they might have processed at the end of the month or the end of the week.

Ultimately, there are a number of critical trends identifiable over the next three to five years. These include:

- Data as a vital platform, able to be distributed wherever it is needed
- Analytics at the heart of achieving enhanced customer insight and more efficient business processes
- Service-centric rather than server-centric architecture to create flexible, responsive and agile business models and capabilities
- Cloud computing creating value higher up the business through applications and services
- A risk based approach to data privacy.

In the past, faced with increased pressures on margins, technology and resources, process-based industries such as manufacturing industry segments took the opportunity to transform themselves by implementing enterprise resource planning (ERP) solutions to serve as a standardization lever. It is now time for the financial services industry to adopt similar platform technologies to achieve their goals of more risk management with fewer resources.

These developments are putting pressure on the IT architecture by fundamentally changing its usage. It is not possible for this to change instantly but FIs will be able to take these changes as an opportunity to transform themselves. The current economic downturn provides a clear impetus for change and a commercial focus to get it right. The issue is ultimately one of survival. As a result it probably affords them a good opportunity to see what steps other industry segments have taken in the past. Many are looking outside their own sector to learn how to manage that complexity in the future. The next few years will be very interesting as they look to adapt.

Partnerships

How FIs will drive the necessary changes will be interesting to see. This is beyond the traditional in-house versus outsourcing debate. Given the levels of complexity faced by FIs they are likely to have little choice other than to partner in new ways, whether that be

with traditional competitors and peers as well as with IT and change specialists. The basic components and building blocks to enable these firms to change already appear to be in place. The level and speed of adoption will be highly dependent on the internal capacity to change and also the degree of ambition to act globally and across activities.

Another pressure on FIs is the sheer cost of technology and its associated services. In the future, they are not only going to have to do more with less but to do much more with much less. According to Accenture's research, spending on risk management investment over the last two years is already fairly significant. Risk management investment includes salary and benefits for risk employees, professional services, technology costs, facilities and travel. More than half of the companies surveyed invested at least USD $25 million, 15% have invested between USD $50 million and USD $100 million and about 1 in 10 has invested more than USD $250 million. Given these levels of investment, it is critical that the CRO can demonstrate the benefits from these investments and tie the outcomes from risk management more directly to business outcomes and tangible cost reductions. To achieve these outcomes organizations are more actively seeking collaboration and partnerships or to reuse some aspects in a "utility sense" for the industry and also seeking ways to accelerate how new solutions are taken to market.

Regulation as a Strategic Business Input

Compliance and regulation have always been key drivers in terms of defining budgets. However, a fixation with compliance has resulted in many organizations, particularly in financial services, making significant investments in projects for specific regulations. Their return on investment calculation has often been based on achieving a tick in the box, not looking at the total cost outlay over a multi-year period, or the cost of maintenance and impacts on complementary systems and processes. Instead they are too often focused only on getting the compliance right and meeting the deadline. Having done that for four or five different regulatory waves, FIs have suddenly found that after three or four years none of those different systems can communicate effectively with each other and there is no sense of a common architecture.

Many of the risk compliance and regulatory programs that were put in place in response to previous regulatory waves such as Markets in Financial Instruments Directive Level 1 (MiFID 1) and Basel II were exactly like this. Some FIs started out with good intentions about changing their business process, using these programs to be more specific around their capital positions and ultimately driving different components together. But reality quickly set that these programs, run by a combination of risk and IT, were not part of the mainstream day-to-day operation and that the core of the organization was still focused on launching new products, making mergers and acquisitions and growing the business. As a result, these compliance based regulatory programs served primarily a tactical agenda, not building towards a more efficient or effective operations future landscape.

Harmonization of Risk Technology

Another likely trend amongst FIs is that there will be more harmonization of software systems as well as a reduction of the number of systems and applications being used. Many FIs are moving towards some level of rationalization in terms of the number of different vendor applications they use. Three specific areas in the architecture chain where businesses are trying to harmonize include: data warehousing, the applications themselves (e.g., the risk calculation engines) and the reporting or business intelligence environments.

In trying to reduce the number of data warehouses, FIs are seeking to move into a kind of architectural "single point of truth". They aim to implement architecture for the entire group or for the global operation and to move all the transaction and positional data into one source and from that source, provide data for the various calculations.

As for the calculation engines, many firms have different software packages in place, some standard and some custom built. Financial institutions are beginning to think about the added value of each calculation and to try to focus on those areas where they definitely gain value from the specific information and then implement standard software for the rest. They will be more inclined to implement custom built applications for those areas which are specific to them. So, there is a trend to use broader applications, which offer a wider range of functionality.

Finally, there is also a trend towards harmonization in the reporting and business intelligence (BI) environment. Financial institutions are looking to reduce the number of applications being used and are also trying to implement tools that allow them to do the BI in a more modern or sophisticated way.

There is a trend in risk management to use specific tools which are placed directly in the hands of business lines (e.g., front office decision makers). This falls in with the trend of moving the risk management responsibility and ownership to the front line and embedding it into day-to-day activities.

The Vendors

So what characterizes the most successful risk technology vendors? While many of the more traditional ones with a "black box" approach have a strong grip on the market, it is the so called "white box" and tool box vendors that are beginning to gain market share. The tool box allows risk management departments to apply their own algorithms or to develop their own methods and build them into their systems. Many of the units that are analyzing data are not only in IT but also in the business departments. The people working there tend to be specialists and are eager to apply their own knowledge and methodologies. Typically, they are looking for tools that allow them a certain degree of freedom.

The most successful vendors recognize that they need to provide their business users with an easy to use interface so that users will be able to do any ad-hoc reporting and analysis that they need right away, to be able to build up reports quickly. What is important is that software is easy to use, allowing for speedier data analysis. Five or six years ago risk management functionality in software products was in the hands of only a relatively few risk management experts. Since the financial crisis, however, the need to access risk management systems has passed from a small number of users to senior managers. Consequently, the technology is different; the system used by the PhD analyst is different from that used by the business analyst in a local bank branch. Usability is becoming a key differentiator.

Ultimately, vendors' success will depend on their ability to meet the needs of FIs for technological help and support. Their role is to provide strategic tools that will help FIs to address the complexity, compliance and regulatory demands, the pressures on margins as well as the technical challenges that they face. At the same time they need to help them develop and promote leading risk management practices appropriate in the current business and economic context so that they add value rather than simply becoming an additional cost.

It may require considerable R & D expenditure on the part of vendors to ensure that they are familiar with the issues facing FIs and how best to meet their needs. However, there is no doubt that the challenges that lie ahead for FIs are significant and that technology alone will not be able to meet the needs. Better and more strategic risk management practices are equally important for FIs' success.

Conclusion

In the wake of the recent financial crisis organizations are looking to transform the way that they manage risks. Pressures on margins, the high cost of technology and burgeoning regulation mean that firms are searching for competitive differentiation by moving from compliance to performance and adopting more effective and efficient risk management practices. Technology is playing a key role as an enabler for this transformation driving demand for new architectures and high performance computing. However, technology alone is not going to deliver the desired outcomes. Culture and collaboration are also critical success factors.

Ultimately, successful organizations will look beyond regulation and cost-reduction and view risk management as a strategic element of their value chain, delivering sustainable growth and innovation.

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References

[1] "2011 Accenture Global Risk Management Research"

For more information about the research visit the Accenture Risk Management Research microsite:

www.accenture.com/GlobalRiskManagementResearch2011

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