Global Regulatory Reform

# Risk management is changing. Act now.

## Risk Transformation

EY
Building a better working world

# The call to action

01

"It is time for transformational change and there are difficult choices to be made. Banks that dare will win."

Risk management cannot operate as it is. Radical changes are needed to ensure efficiency and reduce costs.

## Risk management has not met expectations

Banks have made considerable investments in risk management since the financial crisis. However, there is little evidence to suggest that material improvements have been achieved. Further efforts are required to ensure the effectiveness of risk management and decision-making processes across the banking industry.

In order to demonstrate progress to regulators and engineer a positive outcome, banks need to address issues such as:

- Poor quality of risk information
- High-cost operations
- Inability to quickly predict crisis situations and large exposures
- Insufficient focus on operational risk-related issues
- Inability to measure and monitor the effectiveness of risk control environments
- Fragmented risk management capabilities across divisions and regions

## The new environment will make it even more difficult for risk management

Banks face a challenging environment characterized by:

- Increased pace of new regulations
- Increased scrutiny from regulators on risk management operations and practices
- Relentless cost pressure on risk infrastructure, risk functions and risk processing
- Higher expectations from the board, top management and the business to improve risk management effectiveness and demonstrate value add to the business

Current bank operating models are not sustainable in this environment. It is time for transformational change and there are difficult choices to be made. Banks that dare will win.

## What is risk transformation?

Risk transformation is the process of ensuring risk functions are able to manage risk more efficiently and effectively. These programs are aligned with the strategic objectives of the firm and other business functions to achieve standards above basic regulatory compliance.

## The case for change

Banks have no choice but to react. Regulators are demanding a strategy and roadmap to ensure changes are delivered.

Banks need to minimize the cost of compliance and significantly improve the operational effectiveness of their risk organizations. There are a number of gaps to bridge and transformational programs to trigger, in order to develop the right governance, risk capabilities and supporting infrastructure. The shape and delivery of change should cut across all lines of business as well as risk, compliance, finance and technology.

First and foremost, banks need to identify a "risk owner" to drive transformational change, sponsor risk change and align efforts across risk, finance, treasury and the wider business.

## New world. New CRO.

# 02

As the move beyond universal banking becomes inevitable, the most obvious owner of the risk transformation agenda is the chief risk officer (CRO). But implementing the new risk organization places fresh demands on the CRO's role.

## CRO Pillars of Success

**Strategic**

Focus on direction setting and optimizing bank-wide risk profile.

- Establish the efficiency frontier (optimize risk vs. P&L profiles) and help direct business decisions on products, clients and markets
- Set risk appetite, thresholds and limits in line with strategic objectives
- Establish end-to-end risk management practices and standards to ensure alignment of risk exposures and strategy

**An authority on design**

Define end-to-end control standards across the risk management operating model.

- Set people, process, technology and data standards for the overall risk management operating and control model
- Promote and embed the right risk culture – with embedded controls and measures
- Align with industry practices and evolving regulatory landscape (stay ahead of the game and futureproof target state designs)
- Prioritize risk capabilities – direct investment into the right components of the "risk capability model" in line with strategic ambitions

**Challenger to process**

Assess the effectiveness of front-to-back control framework and core risk activities.

- Direct involvement in new business, products and counterparties
- Measure and monitor the effectiveness of the overall control environment against agreed standards
- Help resolve big risks and identified issues

**Engaged with regulators**

Maintain positive interaction with regulators to promote understanding and collaboration.

- Align risk ambitions to regulatory imperatives
- Direct regulatory change agendas and priorities
- Engage the regulators throughout the journey to the new risk organization — influence outcomes

**Cost conscious**

Develop risk utilities and change capabilities that reduce the spending on people, technology and data.

- Identify opportunities to contain or reduce costs
- Contribute to bank-wide operating cost goals
- Deliver more capability for less and demonstrate value to the business
- Benchmark the spend against peers

# The risk function must operate differently

03

Better risk management means better collaboration.

## Collaboration between the "C-suite" is required to ensure better connectivity of information

The CRO must collaborate more with the chief financial officer (CFO) and the wider business to establish clear ownership of risk management.

Risk, finance and compliance control need to be better connected and integrated to deal with the vast array of regulatory change and develop a competitive advantage.

The right information must be accessible by the right people at the right time to provide optimal access, provisioning and granularity. Risk culture must also be embedded into day-to-day business processes and controls.

## Upgrade skill sets from control to management

- Roles and accountabilities among the three lines of defense[1] must be clearly defined by the CRO.
- The CRO determines standards and then assesses the gap between existing controls and agreed standards.
- Effective risk governance ensures that the risk function contributes to overall bank strategy and group-wide transformation.
- Day-to-day risk activities should migrate from data production and processing, to design and management oversight.

## IT and data infrastructure must be strengthened

- Standards and service level agreements between data owners and consumers must be formalized across critical platforms and processes.
- Technology strategy should support global risk needs and should be aligned with risk change priorities.
- Technology and data infrastructure should support the aggregation and reporting of risk data in both business-as-usual and stressed conditions.
- Risk utilities should facilitate cost efficiency and the optimization of IT and data infrastructure.
- A robust data governance framework across the data life-cycle should be developed alongside the chief data officer (CDO) function.

## Risk leadership must be innovative and adaptable

- Offensive – lead design and development of risk strategy and capability objectives to maximize return on scarce resources
- Defensive – challenge controls and activities across all lines of defense
- Compliant – understand the evolving regulatory environment and optimize the operating model and the spend


**Key interactions**

| | |
|---|---|
| 1 | Alignment with strategy, risk appetite, revenues and risk<br>Standards and change priorities<br>Planning |
| 2 | Required capital from the risk position<br>Liquidity buffers<br>Standards and change priorities |
| 3 | Risk culture<br>Control and change priorities |
| 4 | P&L and Balance Sheet management<br>Financial planning |

*Lines of business

1 The Institute of Internal Auditors January 2013 paper: The Three Lines of Defense in Effective Risk Management and Control: Is Your Organization Positioned for Success?

# The ART of risk management

04

There is an ART (assess, rationalize and transform) to risk management and transformation.

Implementing risk transformation programs will be an ongoing process and will be technology intensive with a significant commitment of resources and senior management time. Without consensus on target risk and compliance capabilities and the right level of coordinated sponsorship, such change will not be delivered successfully.

## Successfully managing complex change

The stakes are high, but rewards can be increased and risks mitigated by combining top-down risk strategy from the board, with robust governance of change capabilities (bottom-up) across the organization. Banks that set clear risk maturity ambitions and risk capability objectives can achieve compliance and generate business benefits.

The ART to risk transformation provides a structured approach that links strategy to execution, and outlines clear delivery road maps to deal with the complex and fragmented technology and data landscapes.


Assess the current state of your risk operations against peers and best practices

Define your target risk capabilities

outcomes

Capabilities and vision

Operational effectiveness

Cost efficiency

Prioritize your core risk capabilities

Present the different operating model options and articulate the trade-offs

Define target model

outcomes

Prioritized risk capabilities

Optimal risk operations

Roadmap and planning

Change behavior and risk culture

Embed risk across the organization

Improve risk management process effectiveness

outcomes

Change management and deployment

Risk operations improvement

Embedding/enablement

## Path to the new risk organization

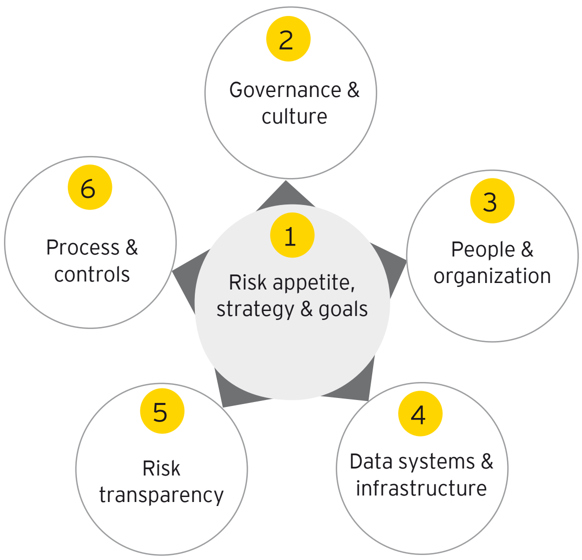
# 05

The magnitude of risk change required will demand a clear path to an agreed-upon target state with a transparent release of benefits along the way.

### Assess: establish risk ambitions

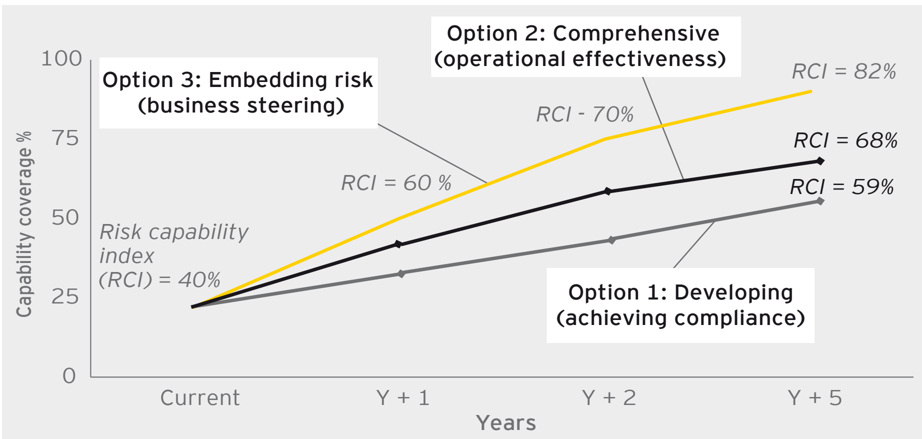
- Determine baseline efficiency and effectiveness across the risk management framework
- Benchmark against risk maturity models to understand what competitors are doing
- Identify priorities and opportunities across all components of the operating model
- Set strategic direction and guiding principles – objectives, investment appetite and design principles
- Develop robust business cases for change with clear ownership
- Set out the strategic principles for the transformation of the risk function and ensure alignment with organization-wide change objectives
- A risk assessment of core capabilities and ambitions could leverage EY's risk management framework based on six key dimensions (see diagram).

**EY risk management framework**




### Rationalize: prioritize risk capability objectives

- Prioritize capabilities in line with risk maturity ambitions
- Chart a transformational path to deliver against target risk-capability objectives (see below chart)
- Enable measurable progress against a risk maturity index
- Build on compliance foundation to realize strategic and operational benefits




*Data based on EY analysis 2014

## Transform: optimize approach to deliver target state

- Architect change to maximize efficiency and competitive advantage
- Identify change owners and entrust them with robust delivery, governance and oversight
- Adopt the optimal delivery approach for each transformational component
- Define and measure the success of each transition phase through clear metrics
- Shape and direct IT and data infrastructure investment to ensure alignment with agreed business outcomes
- Align risk transformation with other global initiatives and delivery partners
- Ensure the risk function becomes a central part of bank-wide strategic change

## Transformation outcomes

# Assess: establish risk ambitions

06

Banks must put first things first and assess where they really are. Adopting a risk and compliance capability model enables a like-for-like assessment of effectiveness and efficiency across all dimensions of the risk framework — all risk and compliance domains, businesses and geographies.

## Holistic approach to architecting risk change

Banks of tomorrow need the right information in the right place at the right time. They need to improve decision-making and develop more profitable relationships with their clients while dramatically reducing operating costs.

To meet these needs, a number of dimensions across the risk framework need to be assessed.

**Risk strategy**: are business impacts and opportunities arising from the changing environment understood?

**Governance and culture**: can governance be streamlined and effective lines of defense and accountabilities be established?

**People and organization**: how can the risk organization structure or headcount be rationalized while retaining talent?

**Data and systems**: how can data and systems be optimized to ensure timely, accurate and flexible risk and regulatory reporting or decision-making?

**Risk transparency**: can complete, accurate and timely information be delivered for decision-making?

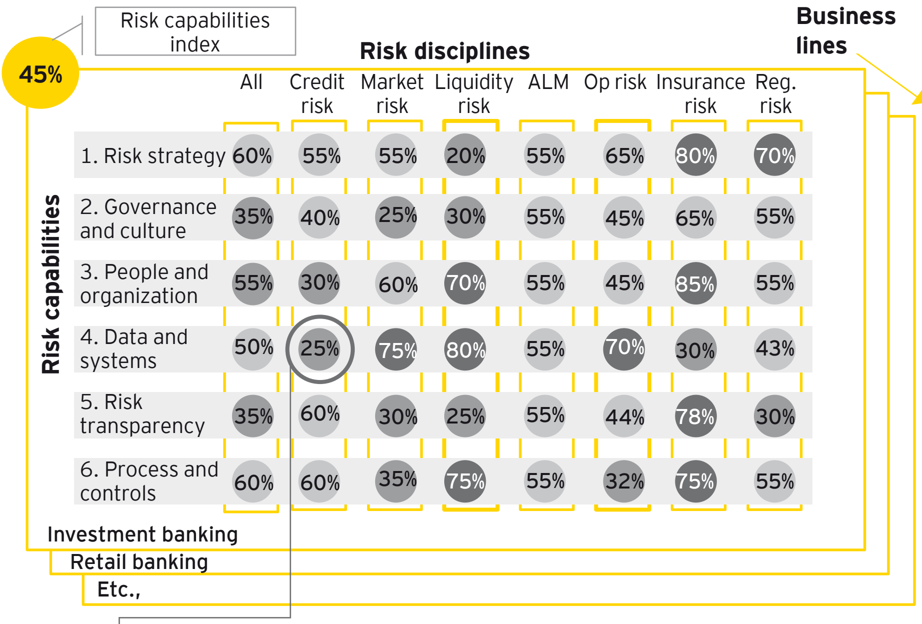
**Process and controls**: can an effective control framework be established that includes clear accountabilities and metrics to remove duplication and redundancy?

## Align assessments against risk and compliance capabilities

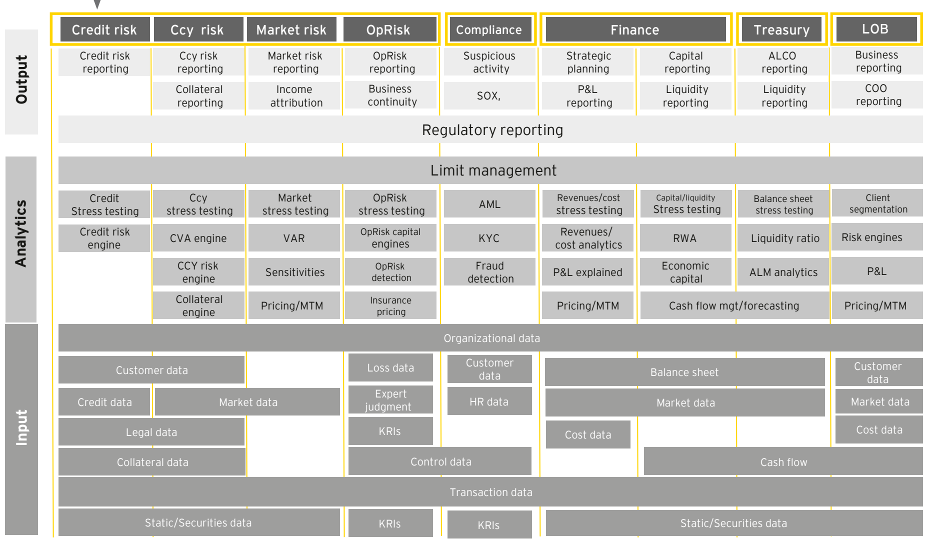
Improvement opportunities can be identified by reviewing each capability across the different operating model dimensions, such as credit risk data and systems. Steps to assess include:

- Review baseline cost and IT infrastructure
- Benchmark against peer groups
- Provide industry examples of rationalization/utility initiatives
- Develop improvement initiatives – align to market/regulatory design principles (e.g., BCBS)
- Review priority and importance of opportunities identified

## Overview of risk capability index




## Risk and compliance functional model



# Rationalize: prioritize risk capability objectives

07

Banks need to think beyond incremental change by applying robust transformational principles that will transform the business and advance risk management. By mapping existing capabilities against agreed target states, banks can identify key transformation components to meet their risk ambitions.

## Banks need to think big

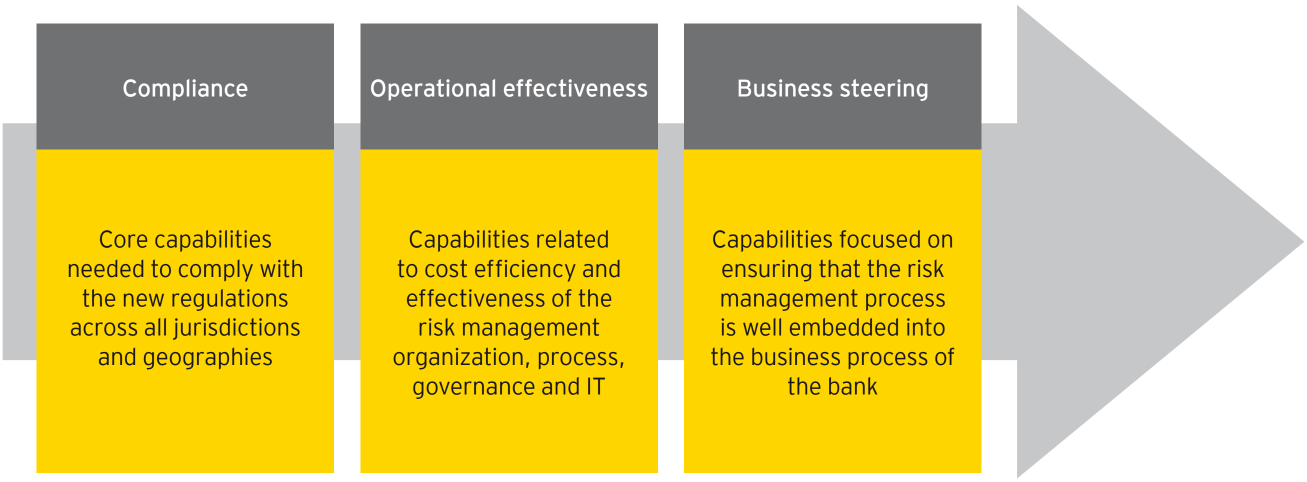
Banks need to set high efficiency targets to survive in the new environment. These targets will vary from bank to bank, with some banks targeting up to 50% cost reduction. Banks can achieve this through a combination of integrating capabilities, centralizing services, eliminating redundancy, removing duplication, outsourcing or offshoring non-core capabilities and establishing a common set of fit-for-purpose tools and services. A significant challenge to achieving this is adapting risk IT and data infrastructure and selecting the right approach.

Armed with the right level of baseline end-to-end information across the risk and compliance operating model, banks can identify risk capability priorities (such as below) and opportunities for improvement. Robust transformation programs will ensure risk functions support businesses rather than simply meeting basic regulatory compliance requirements.

### Risk capabilities to prioritize:

- Demonstrating compliance
- Strategic forecasting
- Real-time risk management
- Optimal allocation of capital and liquidity
- Collateral management
- Risk utilities
- Integrated operational risk and control framework
- Risk-based pricing
- Integrated risk and finance
- Effective reporting and data management process

**Key risk capabilities**



## Methods for adopting an optimal approach

**Build on existing capabilities**
This is often the right choice, but it should not be chosen solely on the basis of lower delivery risk or fears of writing off sunk investment.

**Start from scratch**
Big steps can deliver big rewards, but such change needs to be delivered with care.

**Rationalize existing capabilities**
Resource optimization and focusing on prioritized IT and data components may deliver a fit-for-purpose infrastructure, but banks will need to demonstrate to the regulator that they are doing more than simply cutting corners.

**Optimal approaches**

Risk management framework
- Risk strategy
- Governance & culture
- People & organization
- Risk transparency
- Data & systems
- Process & controls

| | Incremental (build on existing) | Greenfield (start from scratch) | Low cost (rationalize existing) |
|---|---|---|---|
| | Upgrade methods and integrate committees | Common methods and practices | Consolidate methods and simplify governance |
| | Integrated technology | Common technology | Streamlined and consolidate technology |
| | Shared data | Integrated business data | Prioritized data sets |
| | Cross-functional collaboration | Centralized business functions/teams | Optimal resource allocation |
| | Integrated risk activities | Common methodologies and processes | Rationalize processes |
| **Key drivers** | Low BAU impact, clear path to compliance | Radical change with long life expectancy, flexibility | Lowest immediate cost to deliver initial target wins |
| **To consider** | Less agility, integration complexities, not cost optimized | Requires strong change management, cost effective | Shorter life expectancy and lower future capacity |

# Transform: optimize approach to deliver target state

08

Plans and commitments to deliver the new risk organization are no longer theoretical or nice to have. They will represent a fixed contract between a bank and its regulators.

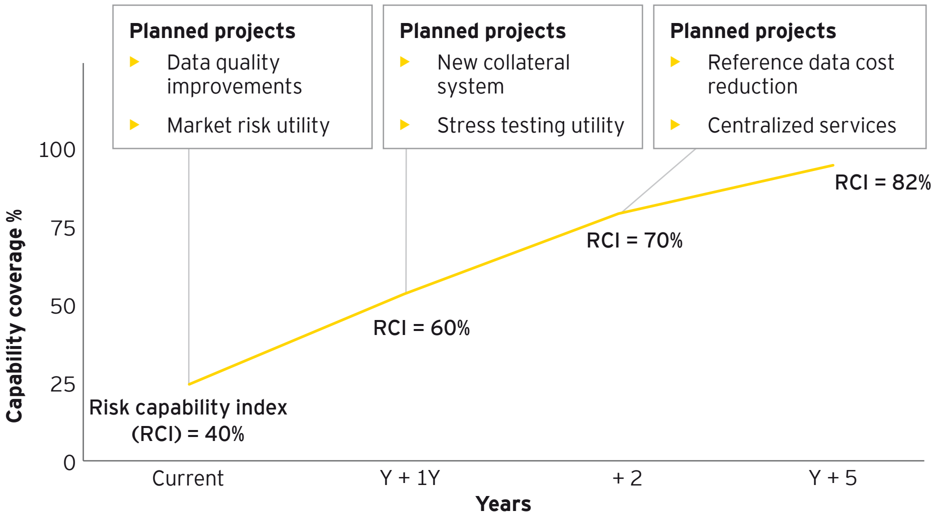
Complex change can be delivered successfully with clear risk ambitions, cohesive enterprise-wide delivery and committed governance oversight.

## Path to success

The steer from the top should be aligned with a holistic delivery and execution approach. That way, banks can deliver transformational change with confidence and once again view their technology and data as assets to leverage. Transformational spend can be seen as an investment and not as a cost to minimize. The following steps can lead banks to success:

- By defining and prioritizing foundational enterprise capabilities, banks can recognize what a good risk organization looks like.
- By aligning existing business, operational and program objectives, banks can categorize change components and support ownership and governance to expedite delivery.
- By assessing delivery options, banks can determine the suitability of "build on existing," "start from scratch" or "rationalize existing" approaches.
- By continuously measuring and monitoring benefit release, banks can chart a clear transformation trajectory.
- By understanding what the competition are doing and assessing where industry collaboration can help them, banks can improve their efficiency.

**Illustrative trajectory for delivering transformation change**




## The change imperative – why now?

- Reduce sunk cost on in-flight/planned programs not aligned to target state
- Increase optionality (this reduces the later you leave ambition setting and planning to compliance deadlines)
- Promote regulatory relationships (keep ahead of the game)
- Mitigate risk of additional capital charges due to delayed compliance/ non-compliance
- Develop competitive advantage

## Benefits beyond compliance

There are business-wide benefits to delivering an effective risk transformation program beyond regulatory compliance requirements. The potential benefits include:

- Real-time transaction or customer account level risk-based pricing, taking into account all material sources of risks, funding, capital and contingent exposures
- Optimization of capital, liquidity and leverage requirements by eliminating conservative assumptions resulting from missing or poor data quality
- Reduced need for manual intervention and ability to distill the universe of data into the core risk data elements. Use of end-user computing (EUCs) to achieve significant reductions in the cost of risk data and technology infrastructure
- Reduction in potential losses as a result of effective risk mitigation and increased management responsiveness to deal with crisis scenarios via timely and accurate risk reporting

## How EY can help

# 09

EY has extensive experience in helping organizations navigate through risk transformation challenges. Our network of former senior regulators is supported by global enterprise intelligence and risk technology enablement teams meaning EY brings a broad range of experience and skills to diagnose, design and implement risk change successfully.

EY's risk transformation offering helps banks ensure that risk management complies with regulation, becomes operationally effective, and is embedded into business steering. It provides a set of tools, techniques, methodologies and approaches that enable and accelerate such change.

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