

Putting the 'strategic' into risk management

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How institutions can increase profitability and performance, understand and manage present and future risk, and meet shifting regulatory requirements with strategic risk management

After the recent economic downturn, many institutions are expanding into new, less familiar or higher risk strategies to grow profitably, which often results in increased exposure to operational and financial risks. At the same time, low interest rates have caused many institutions to evolve their asset mixes and funding profiles, increasing the income, credit and liquidity risks associated with future rate rises.

In this challenging operating environment, solutions for strategic risk management go beyond existing approaches to risk management, providing a real-time, comprehensive view of risk analysis for all strategic elements.

Many financial institutions are trying to reduce spending on control functions as a way to lower overall operating costs. Other efficiency measures, such as office and branch closures, outsourcing policies and cloud-based computing solutions are continually changing business models, requiring institutions to understand and effectively manage the associated risks.

The old ways of managing risk are simply becoming obsolete. It is no longer adequate, for example, to identify and manage specific risks. Instead, institutions must view current and future risks in one comprehensive view. Strategic Risk management does just that, helping institutions predict the possible impact of future changes, build effective strategies and dramatically increase control over business outcomes and overall performance.

Strategic Risk Management

Financial institutions benefit in several key ways from adoption of strategic risk management,

including being able to:

- Build responsible, sustainable, stress-tested growth strategies which ensure all investments are properly risk-adjusted in a way that protects customers and stakeholders
- Track performance metrics in real time and rapidly refine strategies to increase agility and maximize profitability and returns
- Streamline regulatory compliance based on a full understanding of risks and how they could impact capital adequacy and liquidity in the future

Strategic risk management can help institutions achieve sustainable growth while enhancing performance across all business areas. Institutions must also consider how to best make the transition from a 'legacy' to a 'strategic' risk management approach.

Key Strategic Risk Management Challenges

The constant evolution of the financial sector requires ongoing tracking and management of all existing and emerging risks. However, most legacy risk management solutions focus on specific risks and regulatory requirements. This makes it difficult to quantify existing and emerging risks – and to understand the complex relationships between those risks.

For example, what is the likely impact of reputational risk on capital and liquidity? What is the impact of rising interest rates on income, credit and liquidity? What is the relationship between fraud or money laundering and credit risk – and the pressing risks associated with the implementation of new strategies?

With no clear view of interconnected risks across the business, the answers to these and other risk-related questions remain a mystery for many

institutions. This makes it difficult to refine and optimize strategies to increase performance, leverage a competitive advantage and meet growth targets.

Legacy risk management solutions can also negatively impact regulatory compliance, especially as new requirements emerge for stress testing institutional strategies across a range of potential market scenarios. In particular, the inability to understand all of the risks facing an institution may make accurate risk assessments – and regulatory compliance – impossible to achieve.

All of these challenges can be daunting for financial institutions' personnel, who may lack the specialized data integration and analytics skills needed to successfully implement strategic risk management.

This is not only the case in small institutions, which are typically constrained by budgets and staff, but also for departments in large financial institutions, which traditionally operate independently with very little support for cross-departmental data sharing or decision making.

Key requirements for Strategic Risk Management

The concept of strategic risk management is simple: Consider all types of risks that could potentially impact the institution, understand the relationships between those risks, and proactively manage risk to effectively risk-adjust strategies and optimize delivery.

Institutions must take a forward-looking approach to risk management and stress test their strategies against a range of possible market scenarios. This approach increases an institution's ability to predict the risk/return trade off associated with new strategies, as well as their potential impact on capital, liquidity, compliance and general institutional health to support sustainable growth and protect stakeholders.

While the concepts may be simple, implementation of strategic risk management can be complex for institutions. Significant changes are needed to support strategic risk management, including changes to institutions' organizational structures, technology systems and internal decision-making processes. However, institutions can take a number of key steps to further their strategic risk management agenda.

1. Take an Integrated Risk-Management Approach

To fine-tune their strategies – and increase profitability and resilience – institutions need to bring data together from all areas of the business. This can be achieved by deploying a single, fully integrated technology environment for analyzing the full range of institutional risks, from capital analysis and liquidity management to fraud, money laundering, credit loss, threats to income and other risk management activities.

By integrating risk management functions in this way, institutions can fully understand interrelated risks – a key requirement for optimization of risk-adjusted return on capital (RAROC). This also makes it easier to align strategic plans to the needs of the institution and its stakeholders, as well as the regulator.

2. Appoint a CRO and Make Everyone in the Organization a Risk Manager

While some institutions share risk management responsibilities between executives in different divisions or business areas, organizations increasingly appoint a chief risk officer (CRO) to take overall responsibility for risk.

CROs carry out a number of critical strategic risk management functions, such as assessing risks across an institution and linkages between risk areas, overseeing how employees incorporate risk management into their daily jobs, and advising boards and CEOs about key risks.

Risk and financial performance frameworks can be optimized most effectively at institutions that foster close collaboration between the CFO, the board of directors, senior management and business-line leaders.

One of the CRO's key responsibilities is to cascade the board's expectations for risk appetite and financial performance objectives to staff across the business – and to ensure risk management strategies are reflected in the way day-to-day activities are carried out.

3. Deploy Systems that are Fit for the Purpose

Some large banks and credit unions are using technology tools that are unable to provide an integrated view of risk and performance data, from Excel® spreadsheets to legacy general ledger and risk management systems. The fragmented nature of these systems makes it difficult or

impossible to achieve a clear view of interrelated risks and to assess their potential impact on future performance. Many legacy risk systems also require manual data input, which can introduce errors and cause data integrity issues, leading to a misleading view of risk across the business.

To address these issues, many institutions choose to integrate risk systems with key financial accounting, budgeting, planning, profitability and core banking systems. This approach ensures data used for decision making is comprehensive and accurate, increases auditability, and reduces the risk of data integrity issues. Data can also be automatically fed across the full range of risk and business systems, reducing the risk of human error and ensuring the analysis is timely and trustworthy.

4. Look to the Past, Present and Future

Risk analysis based on historical data from accounting systems is no longer adequate in the current operationally challenging environment. As regulatory controls are extended, institutions must also accurately assess the likely impact of their strategies on capital and liquidity in the future. In several high-profile cases, acquisitions have been put on hold by the regulator due to insufficient due diligence and risk management provisions.

To effectively understand and manage current and future risks, historical data from financial accounting and other core systems should be supplemented with broader institutional and market data – and used as the basis for future-looking analysis. Sophisticated data models can help assess the likely impact of interrelated risks across an unlimited number of possible future strategy and market scenarios.

By focusing on the past, present and future, institutions can gain critical insight into the likely impact of strategic decisions, from new product development to planned acquisitions or mergers. It then becomes possible to risk-adjust strategies

and maximize value for stakeholders, while also complying with extended regulatory requirements for strategy stress testing.

Final Word

The financial crisis of 2008 exposed serious flaws in legacy, point-based approaches to risk and financial performance management. This resulted in increased pressure from regulators and stakeholders to take an enterprise-wide view of financial accounting and risk that takes past, current and future factors into account. Increasingly, regulators also require institutions to provide in-depth assessments of specific strategy risks, from planned acquisitions to new product launches, before approval is granted, requiring even greater risk analysis and forecasting capabilities.

To achieve sustainable growth and maximize performance in today's complex operating environment, many institutions are adopting strategic risk management solutions, which shed new light on the risk/return trade off across all strategies and products. Strategic risk management enables institutions to design and deliver strategies and financial plans that are properly risk-adjusted in order to protect assets, increase performance and competitive advantage, and maximize value for stakeholders and customers long term.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.

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