ROLAND BERGER STRATEGY CONSULTANTS

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Fresh thinking for decision makers

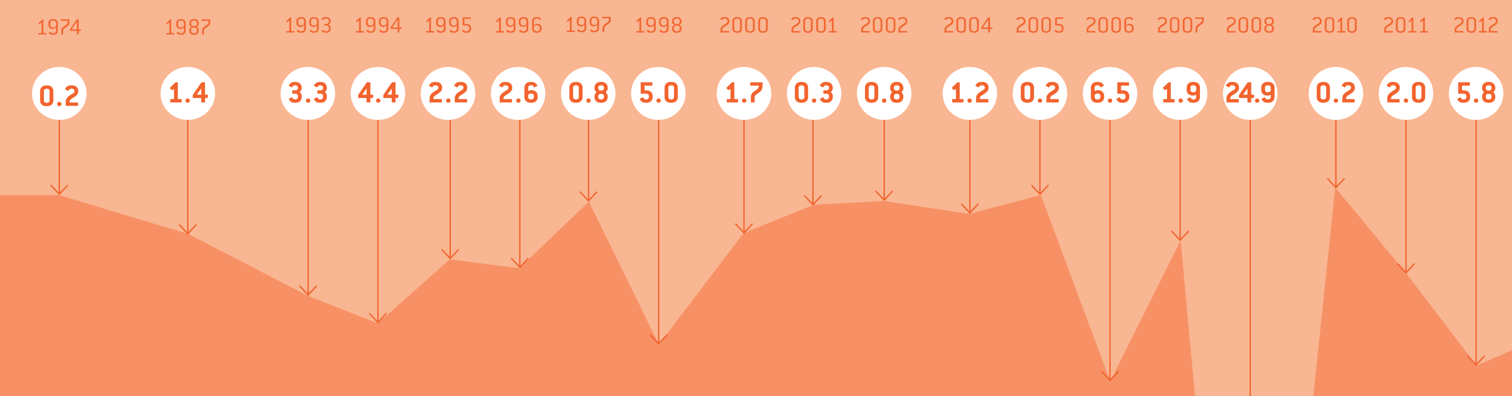
Navigating risk | Banks operate in an increasingly complex world | Risk management will become the key enabler for sustainable earnings | And future success

February 2014

For banks, the state of constant caution is the new reality.
The ability to see around dangerous corners is the new requirement
as the increasing frequency and severity of trading losses illustrates.

GLOBAL TRADING LOSSES OVER TIME

numbers in USD bn.



Accumulated trading losses of the equivalent of USD100 million or higher, 1974 to 2012. Due to the secretive nature of market participants, e.g. hedge funds and fund managers, some notable losses may never be reported to the public.

Source: RBSC Research

In the financial world today, risk management should not be an afterthought. Banks are facing growing compliance requirements that make a holistic risk identification and assessment increasingly complex. At the same time, in a world of growing competition and declining margins, risk management becomes a key instrument to protect relatively low returns and risk bearing capacities and assure sustainable profitability. Against that backdrop, banks cannot afford to continue relegating risk management to being a back office function. Instead, banks today must bring risk management to the front and center of their decision-making process, integrating it with overall bank strategy in terms of how to move ahead. That will require them to transform how they handle risk across their organization, evolving toward a more sophisticated understanding of the risks that they face. Banks that do have a more evolved risk management strategy and operating model have seen the benefits with market value increasing by up to 24% as shareholders become more confident in the institution's future direction.

Though there is no one-size-fits-all methodology. Roland Berger's comprehensive experience in transforming risk management across various types of financial institutions worldwide has given us deep insight into what it takes to bring risk to the front and center of an institution.

1. **Big picture:** Focus on decisive aspects or high risk areas top-down
2. **Integral perspective:** Understand complexity drivers and key interdependencies
3. **Foresighted protection:** Forward-looking judgement on effectiveness of controls and other measures

In order to gain all effects from a new value proposition, the strategic repositioning of risk functions in banks is required.

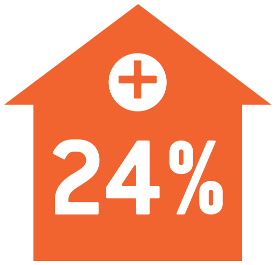
THE EVOLVING IMPORTANCE OF RISK MANAGEMENT IN NEW REALITIES

Clearly, the finance world is littered with recent cases of bank missteps, failures and, in some cases, total collapse. The 2008 crisis at Lehman Brothers and other difficulties that rippled across banks around the world bring one need into sharper focus at banks and financial institutions: sound, long-term risk management in line with strategic targets. A recent paper by the US Treasury Department's Office of Financial Research* reviewed notes that quantitative risk measurement cannot be effective without a sound corporate risk culture. The collapse of massive insurers such as AIG and the short-term liquidity crisis within GE Capital showed clearly that high credit ratings don't mean what they used to. Due diligence and careful monitoring of counterparties now must take place no matter what kind of credit rating a firm has. Brand names such as Bear Stearns and Lehman Brothers are no longer too big to fail as counterparty risks in prime brokerages and over-the-counter derivatives caused unthinkable capital destruction.

Old methods of managing risk proved not to work either in theory or in practice. Some of the smartest quantitative minds working inside Wall Street banks didn't get the formulas quite right. And some of the top management talents in finance didn't predict how risk could be amplified from one firm to others in the global economy. So the new reality of

*Flannery, M. J. et al. (2012), "Forging Best Practices in Risk Management", Office of Financial Research, Working Paper #0002.

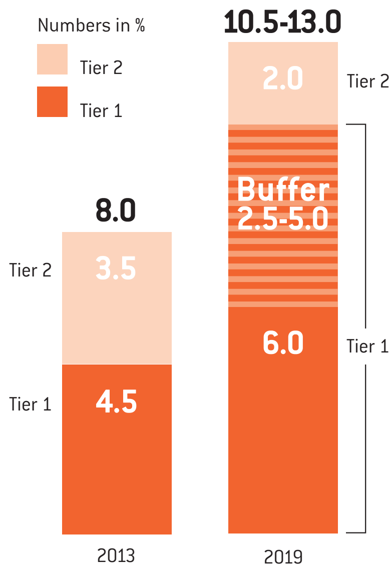
VALUE-ADD OF EVOLVED BANK RISK MANAGEMENT



Banks with a more evolved risk management strategy have market value increasing by up to 24%

Source: RBSC Research

DEVELOPMENT OF CAPITAL REQUIREMENTS FROM BASEL II TO BASEL III



Minimum capital requirements according to Basel III

Source: BIS, "Basel III: A global regulatory framework for more resilient banks and banking systems" global risk leaves leaders at banks and other financial institutions considering new operating models to manage those risks. They are looking, actually, for a risk transformation within their company.

At the same time, decreasing margins in many business areas adds pressure to generate product and service innovations. This increases new product and new business risk exposure. Meanwhile, Basel III rules, which set new liquidity and leverage ratios, and the general economic environments leads to revised business models and, in most cases, decreasing profitability.

In this kind of new regulatory and risk culture, risk management has more potential to create synergy with other assurance functions. But designing and implementing these integrated frameworks is not easy to achieve.

Banking clients we have worked with are finding the need to shift risk functions from a "regulatory and compliance element" to an "active design element of sustainable growth and value creation." Banks use simulation models to test their risk appetite and risk plan with a varying array of imagined and unimagined risk scenarios. They can then adjust their risk plan and risk appetite based on the results of these simulations and stress tests. Such simulation models offer a strong instrument of significant value that provides high quality, forward-looking data to analyze the potential impact of management decisions on the bank's future developments.

INTEGRATING RISK AND CAPITAL MANAGEMENT WITHIN OVERALL STRATEGY

Our work with leading financial services companies in Anglosaxon, European and Asian countries has given us an evolved view of how risk and capital management should be integrated in a bank's overall strategy and management process.

A key starting point for risk planning within a bank is for the executive board to define its risk appetite for the organization. Once the board has written such a statement, the company can develop a risk strategy that coincides with the financial institution's overall strategy and capital limitations. The risk strategy then involves integrating risk implications of the bank's business plan against its risk appetite statement.

The risk plan is then tested by relevant situations to create stress tests and other analysis to show how the institution will perform if bad case and worst-case scenarios emerge. Such scenarios might include catastrophic events such as a hurricane in the US, a major default by a counter party, capital market events such as shifting interest rates, or a macro event such as a major global recession combined with a regional economic slump. Effective scenario management should include reliable data from peer banks with a similar model and in a comparable market environment so executives can see their risk profile in the context of a broader, competitive environment. Today's leading financial institutions must operationalize risk scenarios into their finance and risk control offices and come up with detailed effects on

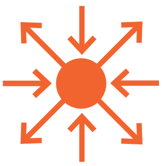
IT'S A VUCA WORLD FOR BANKS

Less "linear" and acquiring the characteristics of a "complex adaptive system"

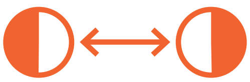
VOLATILITY ...

UNCERTAINTY ...

COMPLEXITY...



AMBIGUITY...



... demand for new tools to strategically manage risk performance. They also must factor in economic conditions and regulatory capital implications as well as concerns about liquidity. Bank leaders then must figure out how to most effectively summarize and communicate these huge streams of data to the executive board in a way that allows for clear insights and simple decision making.

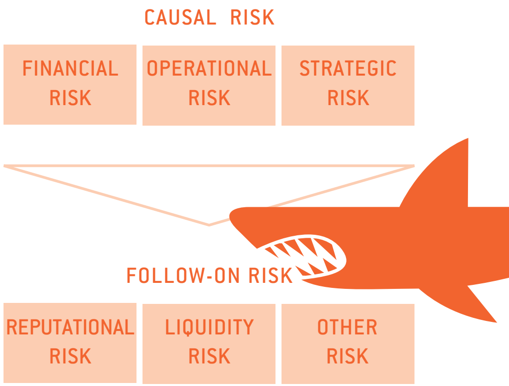
THE RISE OF LIQUIDITY RISK

A new fear factor is bank liquidity risk – the scenario when a bank cannot meet its payment obligations on time. Bank liquidity risk has three main components:

→ **Cash flow risks** that emerge when actual cash flows deviate from expected cash flows.
→ **Funding risks** when external funding is limited in volume or only accessible at a high cost.
→ **Market illiquidity risk** that occurs when assets (i.e. government bonds, securitized loans or unsecuritized loans) can only be liquidated at fire sale prices instead of fundamental prices.

Bank management must analyze liquidity reserves to create a risk buffer from these potential liquidity risks. Similarly, they must have enough capital reserved to prevent solvency risk. Such planning safeguards the bank against the threat of liquidity risk and, of course, reputational risk.

FROM CAUSAL TO FOLLOW-ON RISKS



With this data tracking, information analysis and operationalization of risk complete, banks have the tools in place to help executive officers and board members to evaluate actions and finalize strategic decisions. The data, for example, might tell board members that they should sell private equity activities or to limit a certain kind of trading activity that exposes the sales and trading department to losses that affect the firm's liquidity risk.

Once the risk plan has been tested and analyzed thoroughly, a board can make a final assessment of the bank's target risk profile and can sign off on risk limits that are aligned to the institution's risk appetite.

One European bank group we worked with learned to control and monitor such strategic decisions. The group is involved in retail, SME and mid-cap customers in central and Eastern Europe. They hired us to help them improve treasury and ALM functions. We developed the conceptual blueprint (including mission, philosophy, roles and guiding principles) with them and improved day-to-day operations, including operating models, tools and processes. We did so by identifying the proper benchmarks and best practices for their risk and finance functions. On this project, we learned that the institution must clearly align risk appetite at the management level and ensure that the business lines accept the new group functions.

Once a framework is implemented in daily business, people tend to lose the sense of its importance. Our work is focused on that challenge of keeping risk awareness and culture within a bank or financial firm at a high-alert level.

FOCUS ON RELEVANT FUNCTIONS

In our typical approach to transforming a company's risk management, we take a three-step approach. That involves several steps of gaining transparency with a quick scan of risks, developing target-reporting frameworks, implementing these blueprints and roadmaps, creating a more detailed design and then delivering these models to the right executives. The goal is to improve risk transparency from the bank executive's perspective as well as for stakeholders such as investors and counterparties. The transformation process highlights strengths and weaknesses and areas for improvements, focusing on places for "quick wins". One of the world's largest financial services groups, with 60,000 employees in more than 170 countries, approached us about helping to design a more innovative and centralized risk control framework. This large European banking group wanted help identifying potential for synergy between risk-control functions such as financial reporting controls, operational risk management and compliance functions. In the project, we gathered key stakeholders such as the group CFO, local CFOs, the CRO, the head of legal, the head of IT, the head compliance officers and the head of internal audit to talk about the risk and control framework. The group benchmarked data covering all important parts of the internal risk and control framework in 25 comparative, leading global financial institutions. Then, we outlined the specifications, requirements and prototype for a new major business process system. We developed a business case for implementing such an integrated risk and control framework (IRCF) and selected a new IT solution for that framework.

THE PRESSURE ON BANKS IS GROWING FROM NUMEROUS SIDES

The resulting IRCF included a blueprint of the future framework that involved strategy, management process, organizational set up, and key methodologies such as top down risk scoping and ideal IT support.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Fresh thinking for decision makers

IT budgets in times of stricter financial market regulation | IT can prepare for dealing with external guidelines | Adjusted software strategy makes good sense | As does modernizing structures

DEFINITION OF FUNCTION-SPECIFIC IDEALS

Certain functions within a bank such as operational risk management (ORM) should be centralized. These are the instruments that drive change throughout the organization. They help to create effective and efficient ORM processes. They also shift the painstaking manual data validation and consolidation work of various operational risk management functions to one central service unit.

As bank margins erode, ORM becomes a key for international banks to assure sustainable growth and earnings. But these ORM practices, in general, need stronger integration with management to unleash their full value within the firm and to achieve buy-in from top C-level leaders. Only then will a risk management transformation take place within the firm. This means paying attention to the instruments of communication and information management within a financial firm. In large banks, ORM information needs to reach the right addresses at the right time. There also needs to be a shift to more forward-looking information in order to trigger the right strategic decisions in a cost-efficient manner. Large, international banks can differentiate themselves on this front.

Our surveys indicate that 60% of banks already have or plan to implement an integrated ORM report that includes controls management. But the problem is that many of these reports are not sufficiently demand-oriented. They are over-burdened with information but weak when it comes to interpretation of that data. The majority of the information in the report does not provide for proactive, forward-looking management behavior.

ORM instruments should not be rolled out in a one-size-fits-all manner. Design elements should be adjusted based on top-down, risk-based prioritizing of the business unit or business process. Creating "tiers" of information is key to focusing attention on highly relevant areas and intensifying information density where a global organization can most quickly see and understand major risks from a top-down view.

In many leading global financial institutions, board members and executives desire a stronger alignment or even integration of risk and controls management. Their desire is impaired by limited standardization and documentation of the business process landscape. Meanwhile, financial institutions that are able to integrate such risk controls are able to profit from a more centralized and forward-looking approach to information rather than the silo approach, which for example keeps trading risk factors separate from retail banking or investment banking risk factors. Banks that use a more integrated approach typically gain cost efficiencies and synergies within their operations.

POTENTIAL BENEFITS RELATED TO A RISK TRANSFORMATION PROGRAM

A risk transformation program brings a clear set of benefits to firms that make such a needed overhaul of their risk practices. From our experience, firms that involve themselves in such a transformation receive an efficient overview of the strengths and weaknesses in their risk management approach. It allows them to take effective actions in the short run and to realize a set of quick wins in the context of risk management.

For one Europe-based global bank, we saw the institution reduce risk-reporting costs by 30% after a top-down optimization. We helped the bank redesign its entire risk function with the aim of increasing effectiveness and improving cost efficiency in selected areas. In addition to taking the steps outlined above, we helped the bank design a new risk reporting framework that included templates for key stakeholders, reporting governance and processes. That involved strength-weakness analysis and functional analysis of risk reporting. We then helped the bank transform and test its bank-wide reporting. Our work suggests that banks can find higher efficiency and effectiveness through process standardization and automation.

In summary, when firms successfully make risk management an integral part of strategic management, they will add more intelligence and sustainability to their strategic decisions. In our top-down approach toward risk management, banks develop a common understanding of the future set up of their risk functions and risk management. Based on their definition of a structured transformation roadmap, the bank gains knowledge of industry best practices and the input of risk professionals.

As the bank operates on this risk management framework and communicates data effectively within the firm, the institution is able to make clearer decisions, transform its risk management approach, minimize costs and gains efficiencies. By doing so it improves the value proposition for its entire business model and its clients, shareholders, employees and other stakeholders.

REDUCING RISK-REPORTING COSTS

Global bank: Reduction in risk-reporting cost after a top-down optimization

IF YOU HAVE ANY QUESTIONS, PLEASE FEEL FREE TO CONTACT US:

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