Comment

Avoiding the pitfalls of enterprise risk management

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Leigh Bates
is Head of Financial Services, SAS UK, where he is responsible for both the wholesale and retail banking markets. His areas of responsibility include enterprise risk management, customer experience management, financial management, and fraud and debt management for collections/recovery. Since 1999 he has held a variety of positions at SAS including pre-sales, product management and operational management. Formerly the Head of the Enterprise Intelligence Practice there, Leigh led a number of strategic business intelligence projects working with retail banks to deliver value to their operations. Prior to joining SAS he worked for a large data warehousing software vendor after graduating with a BSc in business and information management from Coventry University, England.

SAS UK Headquarters, Wittington House, Henley Road, Medmenham, Marlow, Bucks, SL7 2EB, UK
Tel: +44 (0)1628 490 551; E-mail: leigh.bates@suk.sas.com

Abstract  Based on the findings of the recent Economist Intelligence Unit report into how financial institutions are reinforcing the risk management capabilities in response to the global financial crisis, the author identifies three of the gaps and weaknesses that the report highlights: complacency in institutions’ internal culture, lack of joined-up risk management across business units and inadequate methods and levels of data management and assessment. The paper considers each of these issues in turn, as well as how they can best be addressed.

Keywords: risk, enterprise, data, management, regulation

INTRODUCTION
The global financial crisis had many causes, but failures in risk management were widely marked as the primary contributing factor. Although there were technical shortcomings, especially related to the use of risk models and metrics, the Economist Intelligence Unit report highlighted a more widespread problem, that of a failure of governance, which meant that the legitimate warnings of risk managers went either unheeded or unnoticed. In the euphoria of the credit bubble preceding the crash, a culture in banking and insurance that prioritised short-term gains over prudence all too often rode roughshod over the concerns of risk managers. Many senior executives were more concerned with outperforming revenue and profit targets than paying heed to growing risk concentrations. The last two years have more than proved that such an approach does not benefit an institution and it is in the best interests of all organisations to turn this strategy on its head.
As a result of this hard-learnt lesson, a lot has changed. In 2009 the Economist Intelligence Unit conducted a report, ‘After the storm: A new era for risk management in the financial services industry’ and this has been followed up in 2010 with ‘Rebuilding trust: Next steps for risk management in financial services’. The 2009 survey found that the majority of financial institutions were already conducting wholesale reforms to the way in which risk was managed and, since then, change has continued apace. Institutions have reappraised their corporate governance structures, risk functions, data, information systems, and business processes and procedures and risk management now occupies a far more central position within financial services organisations across the industry. Discussions about risk have become a key part of the boardroom agenda, chief risk officers have a prominent seat at the top table and there is a renewed zeal for instilling a greater awareness of risk principles in the front office — the so-called first line of defence. In short it could be said that risk has moved from support function to strategic partner.

Despite this progress, however, weaknesses remain. Conducted on behalf of SAS, the Economist Intelligence Unit’s 2010 report shows the results of a survey of 346 executives with risk management responsibilities at banks and insurance companies across the world. The aim of the research was to examine how the world’s financial institutions are reinforcing their risk management capabilities in response to the global financial crisis. The key findings from the research at a glance are:

- Confidence levels are high, but there is a risk of complacency.
- A focus on regulatory compliance may distract attention from emerging risks.
- A clearly defined risk strategy is in place at most institutions, but significant areas of weakness remain.
- Financial institutions are filling gaps in risk expertise with investment in training and recruitment.
- The traditional silo-based approach to risk management continues to pose problems.
- Financial institutions continue to struggle with data quality and availability.

More detail on the specific nature of these findings can be found by viewing the full report, but broadly speaking the findings highlight three areas of weakness in risk management: complacency in institutions’ internal culture, lack of joined-up risk management across business units and inadequate methods and levels of data management and assessment. It is these three areas that will be addressed here, in terms of what exactly the problems are and how financial institutions can avoid the associated pitfalls and achieve best practice.

COMPLACENCY

The financial services industry entered 2010 on a much more stable footing than the previous year. Since the darkest days of the financial crisis, the share prices of major banks have rebounded, economic conditions have improved and the industry has benefited from a surge in liquidity facilitated by the actions of policy makers around the world. These short-term improvements in the economic landscape fostered a mood of surprising optimism among the respondents of the survey.
75 per cent of respondents confident about revenue growth and 68 per cent positive on prospects for revenue growth, confidence levels have almost doubled since last year’s report.

The concern is, however, that such confidence could lead to complacency. There is still a long way to go in terms of recovery; sluggish economic growth in developed countries, combined with stubbornly high unemployment, are likely to lead to further difficulties in mature markets. New regulations and the imposition of more conservative capital and liquidity buffers will drive down corporate profitability, while new macroeconomic risks, such as the sovereign debt crisis in Greece, could derail any nascent recovery.

Also, in terms of complacency, the report warned of the consequences of viewing risk management merely as a box-ticking exercise — ie that a focus on compliance may distract attention from emerging risks. In response to the crisis, regulators stepped up their scrutiny of financial institutions with significant pressure to comply with directives such as Solvency II and Liquidity Risk. While it is true that regulation is necessary, focusing on it too much and approaching risk management as a ‘race to the finish’ may mean that day-to-day risk management gets overshadowed and emerging risks get missed.

The key to not falling into this trap is to work towards ensuring that all areas of the business, from the board of directors to the customer service executives, understand the premise of risk management and the benefits it can bring to the business. If all parties buy in to why risk management is now more important than ever, and also understand the benefits it can bring to the business, then risk management activities are likely to be far more effective in the long term. To achieve this best-practice company mindset, the emerging consensus is that good risk management starts at the top of the organisation. Board members need to have sufficient knowledge and information to be able to challenge and question executive management, and they need to devote an appropriate amount of time to understanding the business. Many organisations are putting in place risk committees and, although a positive step, this is arguably not as important as ensuring high levels of interaction between the board, executive management and the risk function. To achieve this, however, the historically siloed nature of risk management, which still exists in many institutions, needs to be addressed.

JOINED-UP RISK MANAGEMENT

This year’s research revealed that 60 per cent of organisations have a clearly defined risk strategy in place.1 While this is of course a positive statistic, the flip side is that 40 per cent of risk managers feel that they have yet to establish this strategy. This leaves the market in a vulnerable position, particularly given that recent events have showed, in an environment where no company is fully independent of another, one event in one company has the potential to create something of a domino effect across the entire industry.

Part of the reason for the lack of consistency in risk management has been the traditionally siloed infrastructure within banks and insurance firms. The risk management function traditionally sat as an independent department rather...
than being embedded within business units and this meant that risk concentrations and correlations were underestimated in the build-up to the crisis.

This silo-based approach to risk management continues to pose problems. At a recent Risk Breakfast Briefing sponsored by SAS, a poll found that 70 per cent of the C-Level audience agreed that they were now taking an enterprise-wide approach to risk management, however, 43 per cent went on to concede that communication between different business lines was the main barrier to effective risk management. The SAS Economist Intelligence Unit survey supports this finding with less than half the respondents confident that they understand the interaction of risks across business lines.1

One solution to this would be to take a more enterprise-wide approach to risk management, whereby the different types of risk are no longer separated. Aligning strategy, processes, people, knowledge and IT so that risk is better understood and dealt with throughout every part of the business can enhance the stability, performance and profitability of an organisation and ensure that, where the different risks overlap, there are no gaps and nothing is missed.

Enterprise risk management remains a work in progress in the banking and insurance industries but there is a general recognition that managing market and credit risk through different teams using different systems made it difficult to gain an overall aggregate view of risk exposures. Recognising these shortcomings is leading to change and increasing coordination is now being seen between departments.

DATA MANAGEMENT AND ASSESSMENT

When taking an enterprise-wide approach and bringing together information from across many different business units, another issue that frequently comes to light, and which was highlighted by the 2010 Economist Intelligence Unit survey,1 is that of inadequate data quality and availability.

As previously touched upon, effective risk management should ultimately be beneficial to each business unit by providing senior management with necessary information to make informed decisions and understand the company’s overall risk profile. Nevertheless, the ability to do this successfully depends on the quality of data used, and a common denominator in enterprise risk management surveys over the years has been the dissatisfaction with data quality and availability. This year’s survey is no different, with just 39 per cent of respondents saying they are effective at collecting, standardising and storing data.1

When one considers the historically siloed nature of financial institutions coupled with the consolidation of the industry and sheer volume of data, it becomes understandable as to why ensuring data consistency and quality is considered a major headache. Furthermore, data have traditionally been presented in a variety of different formats using different tools and consequently it becomes very difficult to create an accurate view of what is going on across the business. To highlight this point, over-reliance on risk models and problems with the data that populate those models have been judged as key failures in financial risk management.

The fact that the risk management function is not always overarching and
does not interact or engage with all the various business lines compounds the problem and means that it is not always as close to the data as it needs to be. With this in mind it is perhaps no surprise that financial institutions are being forced to completely reconsider how the risk management function integrates with the business. To illustrate this, some companies have now even created a new role of ‘Chief Data Officer’ specifically to tackle and coordinate the issues around a company’s data.

CONCLUSION

The SAS Economist Intelligence Unit report has thrown up some interesting findings. On a positive note, it is encouraging to see that risk management is rapidly rising to the top of the agenda for the vast majority of financial institutions and that chief risk officers (CROs) are taking a more proactive stance and forthright approach.

Nonetheless, the research also highlighted the gaps and weaknesses that still exist in financial institutions’ approach to risk management, such as the danger of complacency as we move towards economic recovery, a lack of coordination and communication between business lines and also inadequate data quality and availability.

Upon taking an enterprise-wide approach and working towards the best practice outlined here, it is important to arm all involved in this concerted effort with the best tools possible to do the job. After all, in terms of risk management, performance is based on decisions made and, if accurate facts and analysis are not to hand or easily understandable, how can the decisions made be relied upon?

Rather than relying on spreadsheet programs which simply cannot perform consolidations fast enough for larger organisations to meet the new, shorter reporting deadlines, financial institutions are turning to technology such as business analytics. Such systems enable employees across different functions and levels of a business to make more informed, fact-based decisions and allow, for example:

- The board of directors to have clear risk metrics embedded into every performance report, including a short- and long-term view of the market with an economic and risk-adjusted view of current and planned performance. The directors can then set the enterprise-wide risk appetite, balancing risks with reward in executing business strategy.
- Marketing and sales managers to identify their most profitable markets and customers to match customer needs with the right products through appropriate and timely sales campaigns, while ensuring their strategies are appropriate for the bank’s appetite for risk.
- Customer service executives to operate profitably by anticipating customer demand across channels and aligning resources with predicted demand. They can also improve the service experience by identifying process bottlenecks, channel design issues and staff training requirements, and analysing complaints.
- Collections and recovery staff to be able to accurately price debt portfolios and identify the most effective collection mechanism, such as whether to use internal strategies, outsource or sell to minimise risk and maximise return.

Whether we have seen the worst of the financial crisis remains to be seen. Yet,
we now have to contend with a global economic slowdown, which in many countries has become a recession. This series of unprecedented events over the last three years has thrown up numerous challenges for all sectors of the financial industry and the associated threats, combined with the damage to the financial services industry’s reputation, jeopardise many organisations’ survival, let alone prosperity. With all concerned striving to redress the balance between risk and return and between short- and long-term objectives, there has been no shortage of comment from the industry, regulators, standard-setters and governments on the causes of the crisis and the remedies. Regardless of the differing opinions, the overall consensus is that financial services firms must transform themselves to meet the new realities of the market and thereby succeed.

References