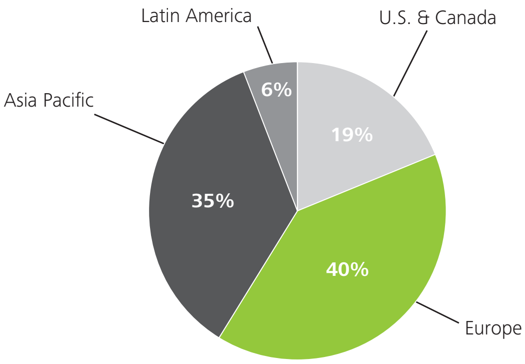
Deloitte Global Risk Management Survey, eighth edition

Setting a higher bar – Australian edition 2013

Professional Services firm Deloitte's eighth biennial Global Risk Management survey, covering 86 financial services institutions including a cross section of Australia's leading banking and insurance entities, identifies an increased focus on liquidity, counterparty, and systemic risk.



As regulators continue to demand higher quality and levels of capital and liquidity, along with new consumer protection measures, the frequency and intensity of regulatory examinations and enforcement activities have increased.

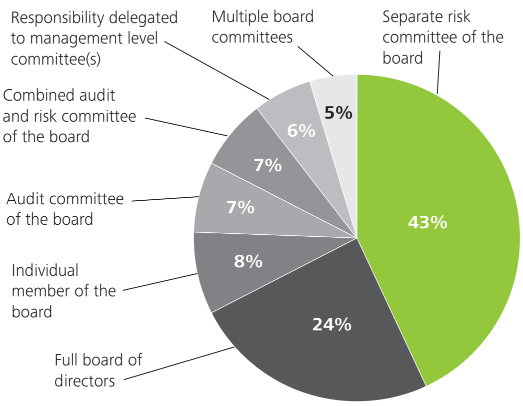
The Board

The Deloitte survey shows the industry and boards are increasing their focus on risk governance and capital management. Eighty per cent of boards are now actively approving and providing direction on risk policy and risk appetite. As they demand more information and clarity on the risks associated with executive decision making, operational processes, and reporting, 94% of company boards devote more time to risk management oversight than they did five years ago.

The survey shows that almost all company boards or board-level risk committees (98%) now regularly review risk management reports. This has increased from 85% in 2010.

In Australia the regulator APRA has proposed that financial institutions have a Board Risk Committee to provide the Board with objective non-executive oversight of the implementation and on-going operation of the institution's risk management framework.

APRA also proposes this Committee operate under a different charter to that of the Board Audit Committee, although APRA's composition requirements will not prohibit the same people sitting on both committees. This requirement is outlined in the amended draft Prudential Standard CPS 510 Governance due to come into force on 1 January 2014 and is also reflected in the proposed revised draft wording to Principle 7[1] of the Australian Securities Exchange's (ASX) third edition of its draft Corporate Governance Principles and Recommendations.



APRA standards

APRA intends to release the final forms of CPS 510 (on governance) and CPS 220 (on Risk Management) in the second half of 2013 after reviewing industry submissions. Both these new requirements are due to come into effect on 1 January 2014. APRA has said it will provide industry-wide transition opportunities to 1 January 2015 with an expectation, that institutions transition as soon as practicable to ensure compliance by the effective date.

Along with CPS 510, APRA's discussion paper on Level 3 *framework and harmonised cross-industry risk management requirements* (CPS 220 Risk Management) is aimed at improving consistency and enhanced risk management across authorised deposit-taking institutions (ADIs), general and life insurers, as well as Level [2] and Level [3] groups.

[1] Draft Principle 7 recommends setting up a risk committee or equivalent and seeks an annual review of the risk management framework and an assessment of an entity's risk appetite. It requires a function similar to an internal audit function, to be able to satisfy the requirements of a prudent risk management framework and internal control practices.
[2] A consolidated group within a single APRA-regulated industry, headed by an ADI, general insurer or authorised non-operating holding company.
[3] A conglomerate group containing an APRA-regulated institution with operations across more than one APRA-regulated industry and/or including material non-APRA-regulated activities.

Chief Risk Officer

As part of this proposal APRA requires that institutions designate a Chief Risk Officer (CRO) who is involved in, and can effectively challenge, activities and decisions that may materially affect the risk profile of the institution.

The CRO must be independent and have no responsibilities that may conflict with his or her risk management role (i.e. no 'dual-hatting'). APRA has stated that the CRO cannot be the CEO, Chief Financial Officer, the Appointed Actuary, or the Head of Internal Audit.

Deloitte's global Risk Management survey of financial institutions found that the role of the CRO is well entrenched at the senior level for the banking industry globally, usually with direct reporting lines to the CEO.

Given that 80% of Chief Risk Officers report directly to either the Board or the Chief Executive Officer, the banking sector is relatively robust - 89% of survey participants globally had a CRO in 2012, compared with 65% in 2002.

However the reporting line direct to the CEO is not so prevalent in insurance companies. The CRO usually holds a less senior position and reports to the CFO. But it is starting to change with a number of major insurers and wealth managers recently announcing senior CRO appointments.

Costs

As the world's largest and the most systemically important firms have had several years of regulatory scrutiny and continue their focus on distinct areas like risk governance, risk reporting, capital adequacy and liquidity, it is hardly surprising that some 65% of banks, insurance and funds management companies report an increase in spending on risk management and compliance in the Deloitte survey. Spending was up from 55% in 2010.

The impact of increased regulation has had a significant effect on business strategy and the bottom line, with 48% of firms confirming that they have had to adjust product lines and/or business activities – double the percentage in 2010.

However there is a divergence when it comes to the spending patterns of different-sized firms. Those firms with assets of less than $10 billion are only now concentrating on building capabilities to address a number of the new regulatory requirements which were first applied to the largest institutions.

The majority of institutions participating in the Deloitte survey (58%) plan to increase their risk management budgets over the next three years, with 17% anticipating annual increases of 25% or more. This is not a trivial matter as 39% of large institutions – particularly those based in North America – report having more than 250 full-time employees in their risk management function.

Enterprise risk management (ERM)

Most Australian organisations have an ERM program in place, with the focus now shifting to improving the robustness of their operational risk processes and enabling their frameworks. There has been an increase in ERM budgets, but not to the levels noted in the survey. Australian increases are more aligned to tactical increases to meet our regulatory change requirements.

In the global survey 62% of financial institutions had an ERM strategy in place, up from 52% in 2010, and a further 21% reported currently building their programs. So the total of 83% of firms either with or building their ERM program, is significantly up from 59% in 2008.

Basel III and II

When it comes to regulation, Australian institutions are currently entrenched in implementing the Basel III requirements, particularly when it comes to liquidity risk.

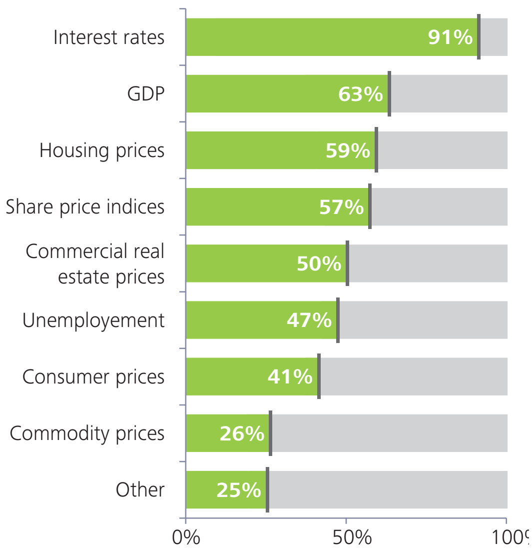
To this end the Reserve Bank of Australia established the Committed Liquidity Facility to enable participating ADIs access to a pre-specified amount of liquidity for a fee.

These repurchase agreements for eligible securities fall outside the Reserve Bank's normal market operations and are contingent on the ADI having positive net worth in the opinion of the RBA and APRA. Australia's smaller entities are also concentrating on building their Basel III capabilities.

The Deloitte survey showed that in general the majority of global institutions are increasingly confident about their effectiveness in managing liquidity risk. Eighty five per cent rate themselves as 'extremely' or 'very effective' vs. 77% in 2010. When it comes to credit risk it is 83% vs. 71% in 2010, and the ratio for country or sovereign risk is 78% vs. 54% in 2010.

In regards to Basel II, Australian 2nd tier banks are heading towards regulatory accreditation, while the big four majors are heading towards their second generation accreditation. Banks are now moving from ICAAP summary statements to ICAAP reporting. Deloitte found that operational risk, which is a key component of Basel II, continues to be a challenge for institutions. The lack of ability to measure operational risk and the complexity of many operational processes are key causes of this. Only 45% of firms rated themselves as extremely or very effective in this area, down slightly from 2010.

Which economic inputs are included in your organization's stress testing models?



Stress testing

Like the rest of the world, stress testing has become a central plank in many Australian institutions' risk management efforts. Eighty per cent of global institutions surveyed stated that stress-testing helps with a forward-looking assessment of risk, and 70% said it informs the setting of their risk tolerances and 66% use the testing for capital and liquidity planning procedures. However, the most common uses of stress tests were for regulatory compliance - assessing the adequacy of regulatory capital (86%) and responding to inquiries from regulators (84%).

In Australia the regulator requires evidence of historical stress testing as well as reverse stress testing. To meet these requirements and embed them into the strategic planning process, financial institutions may need to improve their governance structures and controls over data integrity. This includes using better validation models to capture and provide more granular data across various exposures.

The differences between regulatory and accounting definitions can contribute to numbers appearing unaligned. Institutions that align these definitions initially should be able streamline their stress testing process.

Forecasting models should also consider macroeconomic variables in particular the need for appropriate loan-level models capable of forecasting losses. Institutions may also need to develop broad, well-documented internal capital adequacy assessment processes.

Technology

Technology used to monitor and manage risk was called out in the survey as a particular concern with significant improvements in risk technology needed. Less than 25% of institutions rate their technology systems as 'extremely' or 'very effective' while 40% of institutions are concerned about their capabilities in the management of risk data.

Australian organisations are looking to update their risk systems, not just from a standalone perspective, but more importantly to integrate them with their finance and other management systems. As Australian institutions upgrade their core systems, the time is opportune to consider integrating risk modules and systems into the new operating platforms.

Compensation

Progress in linking risk management with compensation has changed only incrementally since 2010's survey results. Currently, 55% of institutions incorporate risk management into performance goals. The use of 'clawback' provisions in executive compensation, has increased (41% vs. 26% of institutions in 2010).

There is alignment with incentive compensation observations in Australia, given the regulatory changes and standards introduced in 2010 regarding Board remuneration, and the requirements to have adopted a remuneration policy. Clawback provisions in compensation are also becoming common in Australia.

Solvency II/LAGIC

For insurance institutions subject to Solvency II, 92% plan to focus on 'Own Risk and Solvency Assessment' (ORSA) over the next 12 months, while many institutions also said they are intending to work on issues related to review of data quality (77%) and documentation/reporting (69%).

The Australian equivalent to Solvency II is LAGIC and we are more advanced than Solvency II, with LAGIC now 'effective'. This means that insurers in Australia are investing considerable effort into their Capital Adequacy Assessment Processes (ICAAP), and operationalising their Risk Appetite Statements (RAS), as well as building explicit linkages to strategy and internal reporting.

There are a number of regulatory requirements remaining in the queue. But this is not the only driver for change. Financial institutions are continuing to plan for the future success of their organisations and are enhancing their risk governance processes and analytical capabilities. This will not only ensure regulatory compliance but also drive risk management deeper into our financial institutions, improving their agility and building a solid foundation for future growth.

Download the *8th edition of the Deloitte Global Risk Management Survey* here

About the survey

Deloitte's Global Risk Management survey assesses the risk management programs, planned improvements, and continuing risk management challenges of global financial institutions. The eighth edition surveyed chief risk officers – or their equivalent – at 86 financial institutions, and represents a range of financial services sectors, including banks, insurers, and asset managers, with aggregate assets of more than $18 trillion.
The survey was conducted from September to December 2012.

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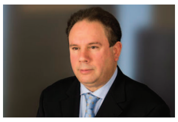

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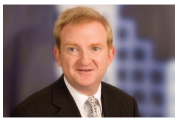

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