The future of risk in financial services

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The future of risk management will likely look dramatically different than the current risk capabilities many are familiar with. Business units will have clear ownership of the risks that they take. Conduct and culture management will be pervasive throughout the organization. The role of the risk management function will also be clear, consisting of oversight and challenge. The risk function itself will be streamlined and much slimmer with a rationalized risk infrastructure. It will use location and delivery models for cost optimization and leverage the power of digital tools for both efficiency and effectiveness.

The digital tools will include cognitive agents scanning a wide range of signals in the internal and external environment to identify new risks, emerging threats, and potential bad actors. These digital tools could not only strengthen the risk function but also provide the business and strategic execution with additional insight. Big data analytics will be used to provide deeper insight into the interactions of risks and causal factors. Robotics and process optimization will restructure and automate processes; it will dramatically reduce operational risk and improve risk management quality, including the review of conduct and culture risks.

Automated risk triage will continuously take place to elevate the risk analysis for assessment and treatment in the event of more significant risk issues. Insofar as reports are needed to summarize the risk activity, natural language generation techniques will be applied to prepare draft reports, with risk analysts only required to perform reviews and selected input tasks.

Developments in risk management

Over the past two decades, risk management has gone through several distinct phases:

Pre-crisis period

In the years preceding the global financial crisis, there was a broad consensus among the industry and regulators that risk management appeared well-equipped to identify and mitigate risks affecting individual institutions and the financial system as whole. The extent of risk-focused regulatory requirements was more modest than it would become after the financial crisis.

Financial crisis period

Risk management during this period was largely engaged in tactical responses to maintain orderly operations during the capital and liquidity crisis. These tactical responses included responding to urgent requests by management, boards of directors, and regulators, and often required a quick assessment of risk exposures to areas of concern, such as specific markets or counterparties.

Post-crisis period

The financial crisis led to a period of "re-regulation," with governments and regulatory authorities issuing a wide variety of new or stricter requirements. Among the many regulatory developments were those by the Basel Committee, which revised and ratcheted up capital and liquidity requirements; the Dodd-Frank Act in the United States; the US Comprehensive Capital Analysis and Review (CCAR); the Basel Committee on Banking Supervision BCBS 239; and the new requirements and proposals by the Basel Committee for key risk types including credit, market, liquidity, and operational risk that seek to wholly revise risk-based capital calculation methodologies. To comply with new regulatory requirements, institutions have dramatically expanded their risk management function and budgets.

Yet risk management has now reached an inflection point, presenting financial institutions with a fresh set of demands.

Risk management enters a new era

Today's environment presents risk management with a unique set of demands. Slower economic growth and declining margins have placed a premium on increasing the efficiency and reducing the cost of risk management. These developments are all characterized by a heightened level of volatility and uncertainty in the business, geopolitical, and regulatory environment. The responsibilities of the business and risk management are not clearly defined. A legacy risk technology infrastructure and the difficulty in gaining access to timely, accurate, and aggregated risk data create complexity and additional costs. Institutions will need to make sure risk management plays an active part in setting strategy; they need to leverage the new technologies available to substantially reduce costs by automating repetitive manual activities, while simultaneously improving monitoring and response.

To move forward, institutions should ask themselves the following questions:

Is risk management doing the right things?

- Is there a clear definition of the activities and services it should perform according to its core mandate and regulatory requirements vs those performed by the lines of business?
- Is the function able to plan, assess, and manage increased demands from regulators and the business?
- Should other additional activities and services be performed?
- Is there an appetite to provide increased transparency for the function?

How should risk management be organized to deliver effectively?

- What is the optimal organizational structure for risk management?
- Is the resourcing structure optimized between the lines of defense and business units?
- Are there efficiencies that can be achieved through shared services of centers of excellence for some risk capabilities?
- Should lower cost locations or outsourcing be considered for some capabilities?

How can transformation be made through digitization and ecosystems?

- Application of robotics to reduce manual processes, human resource requirements, and improve central environment
- Application of cognitive intelligence to provide better automated decision support and data filtering (e.g., credit underwriting, surveillance)
- Increase use of Big Data, advanced analytics, and visualization for better data management and decision support
- Partner with external ecosystems (collaboration of different firms working together) to transform, innovate, and provide core CRO services

Today, risk management is at a crossroads. Financial institutions need to decide whether they will continue with business as usual or fundamentally rethink their approach to risk management.

The new environment provides strong incentives for financial institutions to transform how they manage risk to become substantially more effective and efficient. This will require institutions to seize opportunities related to strategy, people, technology, and the three lines of defense model in a coordinated way. Institutions will need to embrace emerging technologies—such as robotic process automation, artificial/cognitive intelligence, natural language processing, and machine learning—that can reduce costs, while also offering foresight into emerging risk issues.

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Six imperatives

Increase focus on strategic risk
Strategic risk will demand more attention from senior executives, supported by an improved ability to identify strategic risks and analyze their potential impact on the organization. These improved capabilities can not only help the institution manage strategic risk, but they will also provide insights to help the institution achieve its strategic goals and objectives.

Rethink the three lines of defense and risk alignment
Institutions should consider restructuring and eliminating overlapping responsibilities across the three lines of defense. In particular, they should ensure that business units take full ownership of the risks in their area, while the risk management function focuses on its risk control role through oversight and challenge.

Do more with less
In addition to traditional process reengineering, substantial efficiency improvements can be achieved by leveraging RegTech solutions. Deeper and more sustainable cost efficiency and improved return-on-investment performance can be realized by leveraging new capabilities, such as using business decision modeling to assess the cost of change, cost mutualization, and cloud-based services, such as Platform-as-a-Service.

Establish a formal conduct and culture program
Recent instances of inappropriate behavior by employees at financial institutions have led to an increased focus by senior management and regulatory authorities on the importance of instilling a risk-aware culture and encouraging ethical behavior.

Enhance risk management capabilities
Institutions will need to integrate their siloed responses to the many regulatory requirements that have been introduced in recent years. At the same time, they will need to leverage the power of RegTech solutions to increase their agility in responding quickly to new developments, while providing the analytics that support more effective risk management.

Strategically manage capital and liquidity
Recent regulatory requirements have significantly increased capital and liquidity requirements; institutions will need to carefully consider the impacts of their business strategy on capital and liquidity so they can improve their returns on equity by optimizing the use of these scarce resources.

Institutions should address these six imperatives in a coordinated program so that they do not work at cross-purposes on individual initiatives. An integrated risk and regulatory change portfolio management approach will be required to advance simplification and modernization efforts, while making sure that underlying capabilities are not compromised.

The six imperatives for risk management previously outlined affect almost every part of an institution. The drive to transform and modernize risk management will need to be based on the following four foundational areas.

Levers to drive change

Infuse risk management into strategy
Risk management should play an active part in setting the institution's business objectives and strategic plan, and assessing the impact of new products and markets on the organization's risk profile and on its capital and liquidity position.

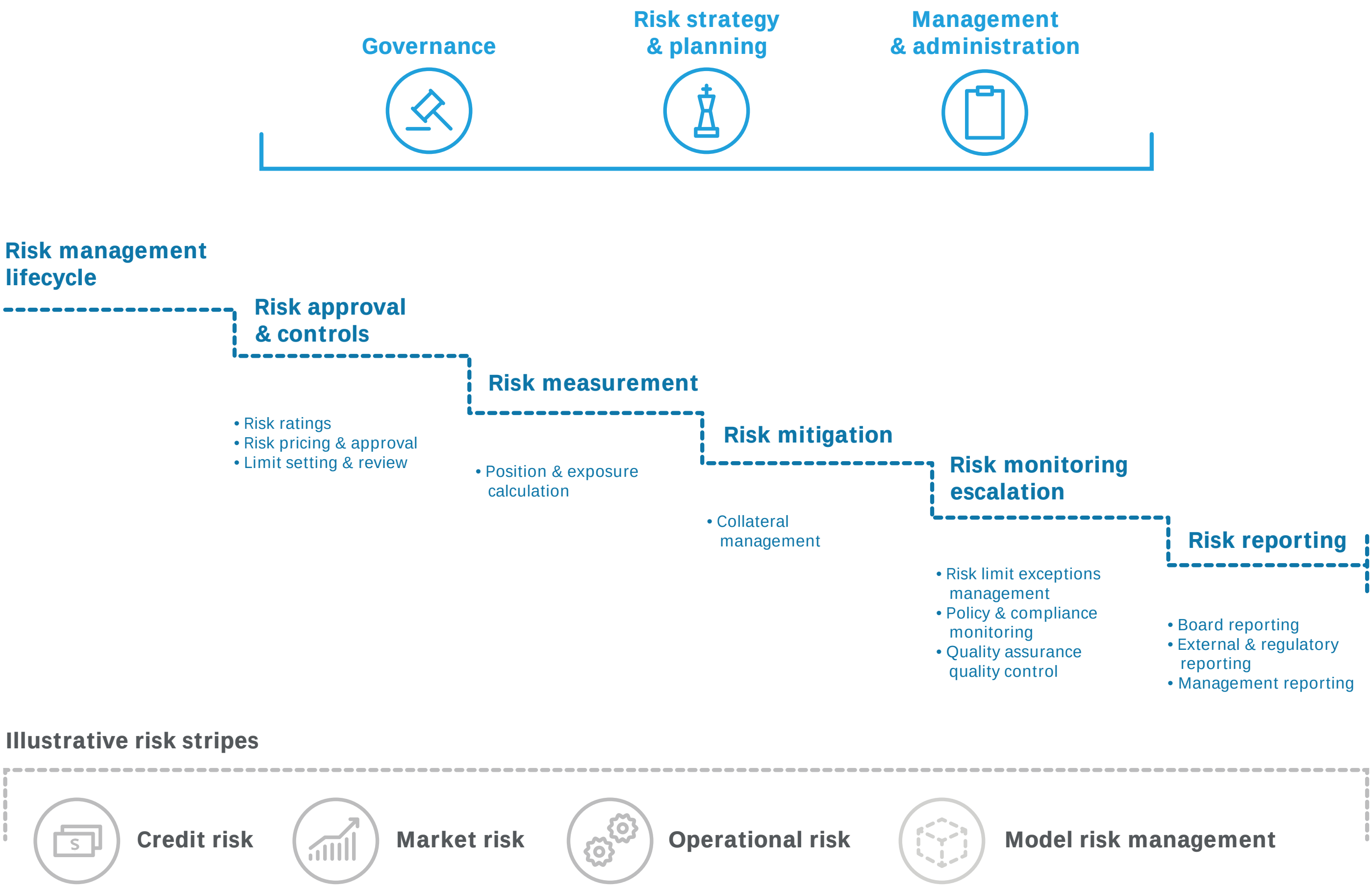
Focus on people
Institutions should work to ensure they have sufficient specialists with subject matter expertise on high-risk and complex activities and provide adequate training to continually upgrade skills. Risk practitioners across all three lines of defense need to work more closely with senior leadership to drive cultural changes across the organization that encourage constructive challenge, ethical decision-making, appropriate incentives, openness, and transparency.

Enhance the three lines of defense
Institutions should clearly define the risk management responsibilities of each line of defense, streamline the governance structure by eliminating overlapping responsibilities, and ensure that business units take full ownership of the risks in their areas.

Leverage emerging technologies
The latest technologies have the potential to fundamentally transform risk management. In addition to substantially reducing operating costs, these and other technologies can provide risk management with new capabilities, including building controls directly into processes, prioritizing areas for testing and monitoring, deploying automated monitoring of limits with defined escalation, addressing issues in real-time to improve the enterprise-wide view of risk, and providing decision support.

These levers should not be addressed in isolation, but instead need to be pulled in a coordinated way. For example, the business strategy established will have significant implications for the potential for conduct risk, while the responsibilities assigned to business units will determine the types of risk management skills they require. An overall risk management approach needs to be developed that harmonizes the steps taken to address each of the four levers and considers their interaction.

Firms can get started by identifying key processes in their risk lifecycle for assessing the impact of the future of risk change levers



Example automation opportunities

1. Risk identification
2. Credit rating/scoring
3. Product pricing
4. Product P&L attribution
5. Limit setting & review
6. Vendor risk management
7. Counterparty/Product/Position risk exposure
8. Limit management
9. Collateral management
10. Automated risk monitoring
11. Compliance testing
12. Loan review
13. Model validation documentation
14. Risk reporting
15. Model governance and reporting

Conclusion

In today's environment of volatility and uncertainty, risk management is at an inflection point. Will financial institutions continue with their traditional methods or instead fundamentally rethink how risk is managed? Institutions content with their existing approach will suffer from inefficient processes, will lack the capability to proactively identify and manage risks, and will struggle to gain a holistic view of the risks facing the organization.

Institutions that instead fundamentally transform how they manage risk can become more dynamic and capable of responding quickly to new developments. In the new era, the risk management function will need to:

- Play a greater role in the organization's strategic decision-making
- Expand risk management capabilities through all three lines of defense
- Secure talent with the right risk management skills and business experience to effectively manage risk
- Be agile to react quickly to the unexpected developments inevitably arising in today's uncertain environment
- Leverage emerging technologies to create a new digital environment able to substantially reduce costs while simultaneously improving the ability to proactively identify and manage risks, and do so at a lower cost

Each institution will need to decide whether to continue with business as usual, thereby running the risk of being unprepared for new risks, trailing their peers, and falling short of regulatory expectations, or to seize the opportunity to take risk management to an entirely new level that truly provides the capabilities to support the organization's strategic plan.