Setting a higher bar for risk management

Global financial institutions increase risk management focus and resources

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Heightened regulatory requirements and scrutiny of risk management and governance have led financial institutions to increase their risk management budgets and bolster their governance programmes, according to a recent global survey from Deloitte Touche Tohmatsu Limited. Deloitte's eighth biennial survey on risk management practices found that about two-thirds of financial institutions (65%) reported an increase in spending on risk management and compliance (up from 55% in 2010) to address rising risk concerns. The survey gathered data from Chief Risk Officers (CROs)—or their equivalents—at 86 financial institutions, including diversified financial services companies, banks, insurers and asset managers, with combined aggregate assets of more than US$18 trillion.

The majority of institutions that participated in the 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.

The survey's responses also illustrated divergence when it came to the spending patterns of institutions of different sizes. The largest and the most systemically important companies have had several years of regulatory scrutiny and continue to increase their focus on risk governance, risk reporting, capital adequacy and liquidity. In contrast, firms with assets of less than US$10 billion are now more likely to be concentrating on building capabilities to address what for them are a number of new regulatory requirements, which were applied first to the largest institutions and are now cascading downwards in the industry.

"The response to the financial downturn has led to far-reaching changes in financial institutions' risk management practices, with stricter regulatory requirements demanding more attention from management and increasing their overall risk management and compliance efforts", says Edward Hida, partner, Deloitte & Touche LLP and global leader, risk & capital management for DTTL and editor of the survey. *"That said, risk management shouldn't be viewed as only a regulatory burden or as a reporting exercise destined to gather dust on a shelf. Instead, it should be embedded in an institution's business framework, philosophy, and culture for managing risk exposures across the enterprise"*.

The roles of management and the board in risk governance

The existence of a Chief Risk Officer (CRO) position at global financial institutions has grown steadily over the past eight years with the percentage of companies employing a CRO rising to 89% in 2012, up from 65% in 2002 and 86% in 2010. The current survey found that the CRO is a strategic, senior-level role at many financial institutions, reporting directly to the CEO or the board at nearly 80% of participating global financial institutions.

CROs are increasingly senior-level executives responsible for overseeing the risk management activities of their organisations who can advise the CEO and board on the organisation's risk profile and risk appetite. 87% of the institutions surveyed say the CRO assists in developing their organisation's risk appetite statement, while about 80% of CROs participate in executive sessions with the board or board risk committee and provide input into the development of business strategy. Some financial institutions have also created a chief compliance officer position, in some cases hiring former regulators to fill this senior-level opening.

Many financial institutions also report having a variety of management-level risk committees, such as asset liability management (74%), credit risk (59%), enterprise risk management (59%), operational risk management (44%), market risk management (44%) and investment risk (42%).

In addition, large institutions were more likely to have a variety of management risk committees, which is understandable because their activities and risk profiles are likely to be more complex. For example, 72% of large institutions report having a management-level operational risk management committee, compared with 43% of mid-sized institutions and 33% of small institutions.

Risk management has also risen significantly on the agendas of boardrooms. According to the survey, 94% of company boards now devote more time to risk management oversight than was true five years ago. In addition, 98% of company boards or board-level risk committees regularly review risk management reports, up from 85% in 2010.

Aligning incentive compensation and risk management

There has been extensive discussion about how some incentive compensation plans may inadvertently encourage excessive risk taking. Yet, only about half of the institutions, 49%, said that their board of directors reviews the compensation plan to consider the alignment of risks with rewards; this percentage increased in 2012 from 35% in 2010. Other actions related to compensation planning were reported more often: 83% of institutions said they use multiple incentive plan metrics, 73% require that a portion of the annual incentive be tied to overall corporate results, and 58% have deferred payouts linked to future performance. More institutions also reported using clawback provisions—41% in 2012, versus 26% in 2010.

One CRO who participated in the survey commented that a significant step in compensation plan development or change is approval by the risk function before the plan goes to the board. *"We have introduced what we call key risk takers, and when it comes to their annual assessment process, for every key risk taker there's mandatory input from at least one senior member of legal and compliance or risk in assessing that person's performance."*

Operational risk presents continuing challenges

According to the report, operational risk, which is a key component of the Basel II bank capital requirements, is a continuing challenge for institutions. Only 45% of firms rated themselves as extremely or very effective in this area, down slightly from 2010. These findings suggest that operational risk management capabilities are still developing, with many institutions implementing some of the basic steps to creating a programme. These steps include identifying risk types (completed by 81% of institutions) and gathering relevant data, such as key risk indicators and loss data (true for 60%). However, as was true in 2010, only about half of responding institutions had taken other necessary steps, such as standardising the documentation of processes and controls and developing methodologies to quantify risks.

Risk technology systems and data

As with the 2010 survey, the need for significant improvement in risk management technology and infrastructure was reported by many institutions. Less than one-quarter of institutions rated their systems as extremely effective or very effective in data management/maintenance, data process architecture/workflow logic, or data governance. The leading concern regarding risk technology continues to be the quality and management of risk data, where 40% of respondents were extremely or very concerned about capabilities at their own institution, followed by roughly one-third who said the same about the ability of their risk technology to adapt to changing regulatory requirements and the lack of integration among risk systems.

The highest priorities for new investment in risk technology systems were for improvements to risk data quality and management, cited by 63% in the current survey, versus 48% in 2010, and for enterprise-wide risk data-warehouse development, mentioned by 51% now, compared with 35% in 2010.

Other noteworthy findings from Deloitte's risk management survey

- Almost three out of four CROs rated their own institution to be either extremely or very effective in risk management overall, an increase from 66% in 2010's survey results
- The use of institution-wide enterprise risk management (ERM) programmes is continuing to grow. Today, 62% of financial institutions have an ERM strategy in place, up from 52% in 2010, while an additional 21% are currently building a programme. The total of 82% of firms that either have or are building an ERM programme is up significantly from 59% in 2008
- The impact of increased regulation is having a significant effect on business strategy and the bottom line, with 48% of firms confirming that they have adjusted product lines and/or business activities, a percentage that doubled from 24% in 2010

- Institutions are increasingly confident about their effectiveness in managing several specific risk types, including liquidity risk (85% rate themselves as extremely or very effective versus 77% in 2010); credit risk (83% against 71% in 2010); and country/sovereign risk (78% compared with 54% in 2010)

- Stress testing has become a central plank in many institutions' risk management efforts. 80% of the institutions surveyed state that stress-testing enables a forward-looking assessment of risk, and 70% say that it informs the setting of their risk tolerances

Key implications for management

As in past years, Deloitte's risk management survey examined a wide range of issues including governance, management of diverse risk types, methodologies, regulatory requirements and risk data and technology infrastructure. The findings from the current survey suggest a number of important issues that financial institutions should examine.

- **Managing regulatory change**
  The unrelenting pace of regulatory change is having a major impact on financial institutions through new requirements in many jurisdictions in areas such as regulatory capital, liquidity, restrictions on proprietary trading and the use of exchanges for most derivatives trades. There has been a particular focus on those institutions designated as systemically important, with requirements for higher capital levels, living wills and enhanced regulatory reporting, among others. The stricter regulatory requirements are demanding more attention from management, affecting the profitability of different lines of business, and increasing the costs of compliance. Financial institutions should consider how their business models will be affected by current and potential future new requirements, and whether their risk management programmes have the ability to respond flexibly to the ongoing process of regulatory change

Financial institutions may also consider their capabilities in stress testing macroeconomic variables and forecasting potential losses at the loan level

- **Strengthening governance**
  Given the strategic implications of risk management, it has become even more important that the board of directors and senior management provide strong leadership and promote a risk-aware culture throughout the organisation. The board of directors has the final responsibility for approving the organisation's risk policy and risk appetite, and for providing oversight of the risk management programme. Many financial institutions have also recognised the value provided by a CRO position—a senior-level executive responsible for overseeing the risk management activities of the organisation and who can advise the CEO and board of directors on the organisation's risk profile and risk appetite, the effectiveness of the risk management programme and the risk implications of strategic decisions

- **Examining incentive compensation**
  Ultimately, an institution's risk profile is the result of the many decisions made each day as employees seek to accomplish business objectives. Although the risk management function sets standards and provides oversight, employees in the business units are on the front line in terms of taking and managing risk. For this reason, institutions should consider reviewing their performance management and incentive compensation plans to ensure their alignment with the organisation's risk appetite

- **Managing a wider range of risk types**
  Institutions should consider whether they have sufficient capabilities to manage a wide range of risk types, in addition to more common risks such as market and credit risk. Developments in financial markets during the credit crisis raised the priority of managing liquidity risk. The pace of regulatory change has increased the importance of regulatory risk. Institutions are paying more attention to reputational risk given the potential for negative publicity and reputational damage if an institution fails to comply with regulatory requirements or becomes the target of an enforcement action. A varying series of management breakdowns at major financial institutions has also underscored the impact of operational risk events. Finally, many institutions are also giving a higher priority to managing model risk

- **Improving stress testing capabilities**
  The increased emphasis on stress testing for banks and certain systemically important financial institutions, especially among U.S. regulators, will require risk management programmes to have the capabilities to employ this technique on scenarios stipulated by their regulators as well as on their own scenarios. An effective stress testing programme requires governance structures and controls to oversee data integrity, the selection of stress testing models and model validation. Financial institutions may also consider their capabilities in stress testing macroeconomic variables and forecasting potential losses at the loan level. When stress testing is used to assess capital adequacy, institutions should consider whether it is part of a broad, well-documented internal capital adequacy assessment process

- **Upgrading risk data quality and technology infrastructure**
  Managing risk effectively requires institutions to be able to aggregate and analyse risks on a consistent basis across the organisation in order to provide timely reporting to management and regulatory authorities. Institutions should consider whether they may need to improve the quality and consistency of risk data and also upgrade their risk technology systems in order to gain such an enterprise-wide view of risk

The unsettled market and economic conditions of the last several years have created a new and dynamic environment for financial services. Governments and regulatory authorities responded by introducing major regulatory reforms intended to strengthen the financial system, in large part by seeking to increase the likelihood that individual institutions will have sufficient capital and liquidity to survive a future crisis. As they respond to regulatory and other market and competitive challenges, financial institutions will need to continue to enhance their risk management capabilities—setting a higher bar.

Access the complete report of findings from Deloitte's **'Global Risk Management Survey',** eighth edition, at www.deloitte.com/us/globalrisksurvey.

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