Aligning risk and the pursuit of shareholder value
Risk transformation in financial institutions

Scott Baret
Global Financial Services Leader
Enterprise Risk Services
Deloitte

Financial institutions of every type face continuing pressure from regulators on one side and shareholders on the other. Working to balance the former's expectations for higher levels of capital and the latter's for superior returns, senior executives and boards are deploying ad hoc, piecemeal responses to financial regulation that—in the long run—only increase costs and perpetuate risk.

These challenges impact senior executives and boards at banks, insurers, broker dealers and other financial institutions across multiple lines of business. While global systemically important financial institutions (G-SIFIs) and SIFIs may be most affected, virtually all national and regional institutions also face similar challenges, if on a different scale. Most financial institutions, however, are overlooking opportunities to holistically address capital efficiency demands by integrating financial, risk and regulatory data streams.

To bring light to these opportunities and begin answering some of the most common issues faced by financial institutions, Deloitte recently published "*Aligning Risk and the Pursuit of Shareholder Value*". The paper presents an analysis of forces impacting shareholder value and the 'transformational moves' that executives and boards should consider when aligning their risk management strategies and operations.

To aid financial institutions in identifying the need for transformation, the paper provides a business case for aligning risk to the pursuit of shareholder value, as well as an overview of the four cornerstones of risk transformation.

The business case for risk transformation: four key drivers

1. Scarce capital, liquidity and funding

Financial institutions must remain competitive while maintaining increasingly high levels of capital as regulatory agencies introduce increasingly stringent supervisory requirements. These needs are compelling the industry to rethink and reconfigure business models, governance processes and risk management capabilities.

2. Extensive industry and regulatory requirements

Global financial institutions with multiple lines of business must respond to a myriad of jurisdictional regulatory requirements. Too often these requirements involve redundancy, overlap, and increased compliance costs and risks. Addressing these requirements calls for global coordination of regulatory compliance and risk management resources.

3. Rising costs and performance pressures

With significantly higher capital requirements due to Basel III and other regulations, the cost of existing business models may continue to rise, eating into margins. To sustain strong earnings, institutions have begun to de-emphasise certain businesses, while emphasising others, reducing costs, and in some cases pursuing new strategies. Such responses can, however, introduce new and potentially dangerous concentrations and combinations of risk, as well as add new costs.

4.Legacy infrastructures

Legacy systems and hardware platforms are likely to present high barriers to effective compliance, risk management and business management. A well-conceived enterprise risk data architecture can help overcome these barriers by making it possible to build the right data repositories and to avoid bolted-on regulatory solutions. An integrated enterprise solution specific to the institution can improve data quality, accessibility and analysis, setting the scene for improved risk management and business management.

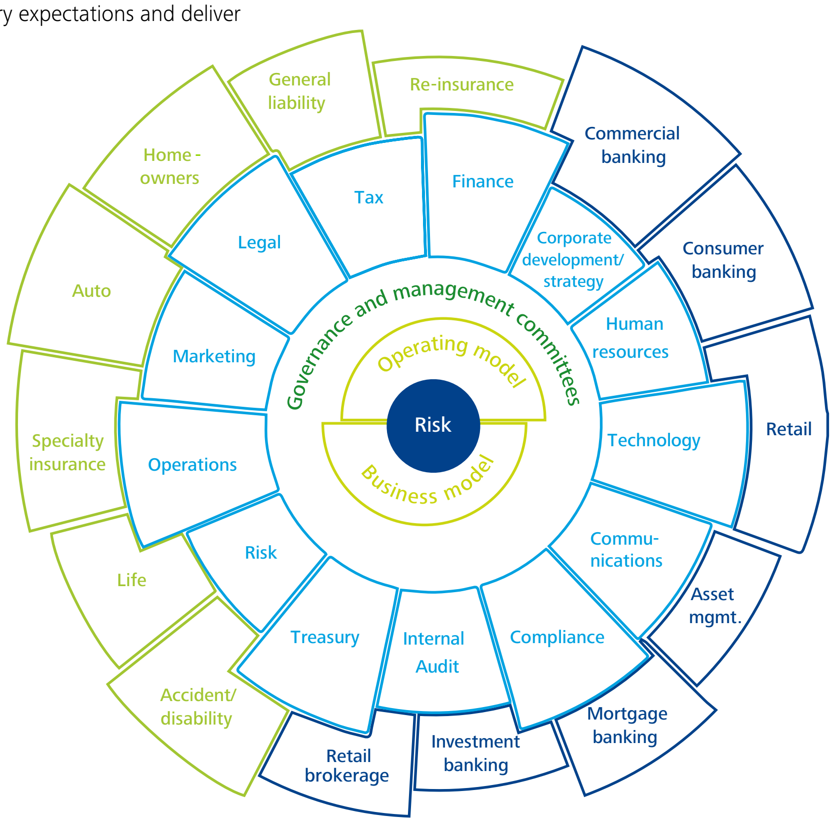
Impact on drivers of shareholder value

Shareholder value is driven principally by achieving a positive spread between the risk-adjusted return on capital and the cost of capital, and factors such as operating costs and taxes. These drivers are impacted by specific forces and market conditions affecting the business. A focus on shareholder value highlights the need to meet regulatory expectations while simultaneously improving operations management and risk management. This approach transforms the need to meet regulatory expectations in areas such as capital planning and management, stress testing, business conduct, organisational culture, risk data management and risk management into opportunities to improve these capabilities from an operational standpoint and further integrate risk management practices into business unit processes and activities. Similarly, regulatory demands pertaining to risk-based capital requirements could present opportunities for management to relate risk to capital more strategically. Doing so is likely to enable management not only to justify capital allocation and obtain business unit buy-in, but also to deploy capital more effectively for higher investor returns.

Needs vary by organisation, and specific responses will be particular to the institution. In general, however, certain approaches will be more likely than others to generate effective responses to regulatory expectations and deliver improvements in business results. These approaches embed risk management into business units and functions at the level of people's daily responsibilities. When that occurs, risk management is no longer considered just the responsibility of the risk management function but an integral part of the job of the trader, loan officer, underwriter, portfolio manager, claims manager, HR professional, IT specialist or other personnel.

This said, maintaining historical returns under today's uncertain conditions is challenging. Thus, management should take a holistic approach to these challenges, which may represent a break with the past. In most institutions, siloed responses to regulatory changes, economic indicators, shareholder demands and risk have generated a lack of alignment, with results that can resemble aspects of the structure depicted in Figure 1. In such organisations, although they are centred on risk, business models and operating models are not aligned, nor are the business units and functional areas. Risk management lacks coordination, and business units and functions may see risk as the responsibility of the risk management function rather than intrinsic to their jobs.

Figure 1: Lack of alignment in a financial institution

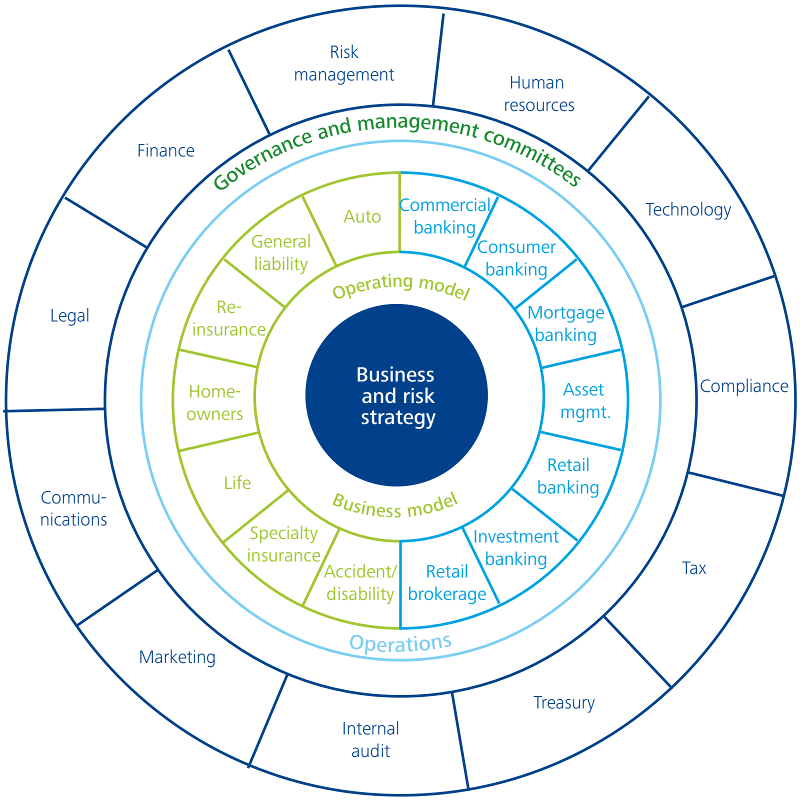


Misalignment and gaps develop over time, sometimes over decades, as an organisation diversifies its businesses, introduces new products and services, and responds to new laws and regulations. Some business units come to see the risk management function as being responsible for managing risk, whereas the risks actually reside in the businesses. The resulting lack of alignment may leave institutions unintentionally exposed to risk and unable to efficiently coordinate responses to regulatory change. Lack of alignment also results in fragmented technology systems and data repositories, inhibiting the organisation's ability to manage enterprise risk cost effectively and respond to regulatory demands.

An aligned organisation (as illustrated in Figure 2) should integrate business and risk strategies and explicitly task risk owners with both organisational objectives and risk management responsibility. Risk owners should manage the full range of risks they face and be supported by a suitable risk management infrastructure. The businesses and functions—and executives and the board—should fulfil their risk-related responsibilities in ways that align regulatory and other stakeholder expectations. This aligned organisation should minimise silos and fragmentation among business and risk strategies, business and operational models, and businesses and functions. It should be supported by a common operational and risk data architecture. This should enable the institution to access specific data when needed and to drive down costs by embedding risk management and regulatory IT support into the broader strategic technology architecture.

> An aligned organisation should integrate business and risk strategies and explicitly task risk owners with both organisational objectives and risk management responsibility

Figure 2: Alignment in a financial institution



This illustration of alignment is **not** presented as a model or framework, but is simply meant to portray the integrated state of an organisation aligned around business and risk strategy. The result is greater synchronisation between strategy and execution in operations and risk management.

How is such an integrated state achieved?

Risk transformation: a path to alignment

The desired state is most likely to be achieved through a process of risk transformation. Risk transformation integrates risk management into the conduct of business, taking risk management to higher levels of excellence by driving practices throughout the organisation. This means embedding risk management in the daily activities of employees so as to align the conduct of business and of risk management with the businesses strategies.

Risk transformation takes the need to respond to regulatory change as an opportunity to strengthen not only the management and governance of risk, but also the management of capital and operations and the supporting IT infrastructure. For instance, regulations impact business models, pushing management to choose which businesses to pursue, what scale to achieve, and how to manage risks and capital in the businesses. Those choices are best made from a holistic point of view with due consideration given to the enabling data and analytical resources.

In an aligned organisation, risk management and governance acknowledge business unit and overall ROI objectives and the risk profile required to achieve those objectives. This aligns operational and risk management and risk governance policies, practices, roles and responsibilities. The risk management function then supports each business in operating within the risk profile each requires in order to meet return objectives.

In the desired state, risk is identified at its source and managed within business activities. To the appropriate extent, accountability for risk management shifts to the businesses and functions, while responsibility for risk is shared among the businesses, functions and risk management. This enhances the visibility on risk of the businesses and functions and the visibility of aggregate risk positions, with the potential to improve decision making in the businesses and functions and at the organisational level.

Four cornerstones of risk transformation

To translate the overall goal of achieving alignment as described here into actionable focus areas, four organisational components—or cornerstones—of risk transformation have been identified. These cornerstones highlight cross-functional, risk-related elements and activities that help determine an institution's approach to risk.

If management firmly establishes these cornerstones, risk management and regulatory compliance efforts have the potential to be implemented in an efficient, coordinated manner within each business and across the organisation.

The four cornerstones of risk transformation	
Strategy	Strategy puts the organisational vision and mission into action. The executive team should consider the risks of the strategy and to the strategy, as well as the regulatory implications of a strategy. Transaction and portfolio risks and individual and aggregate risk exposures should be well understood. Enterprise risk management and governance infrastructures should support execution of the business model and capital allocation. Capital is allocated based on strategically selected risk-reward trade-offs, risk capacity and appetite, and the desired risk profile.
Governance and culture	Governance is intended to ensure that strategies are executed properly and in alignment with risk and business strategy. Culture embodies the shared values, principles and beliefs that guide the organisation. Governance and culture set expectations regarding risk taking and risk management, enabling people to discern acceptable and unacceptable risks even when they are not explicitly covered by policies and procedures. In considering governance and culture, the executive team might assess the organisation's level of risk intelligence, its risk management and governance frameworks, and its risk governance operating model.
Business and operating model	The business model defines economic relationships between the organisation and its customers, suppliers, investors and other stakeholders. The operating model structures the ways in which the business conducts its activities with its stakeholders. Within both models, risk should be managed with clear accountability, authority and decision rules at all levels, and well-defined handoffs between business risk and control functions. Both models require standardised structures, processes and controls for shared and outsourced services, as well as for business units and support functions.
Data, analytics, and technology	Management should determine the key data required to address risk management needs and oversee development of a data management and sourcing strategy to address those needs. Management should also facilitate integration of finance and risk data to enable common and reconciled risk and regulatory reporting. The business units need near real-time processing and reporting of aggregated risk data to monitor volatile liquidity, market and credit risks. An enterprise risk data and architecture strategy can deliver the right risk-related data to the right points and enable the institution to respond to new business opportunities and to risk and regulatory demands consistently and efficiently rather than through ad hoc or bolted-on solutions. A streamlined set of business intelligence solutions can support risk and regulatory needs, while analytics enable scenario analyses of stresses on global positions.

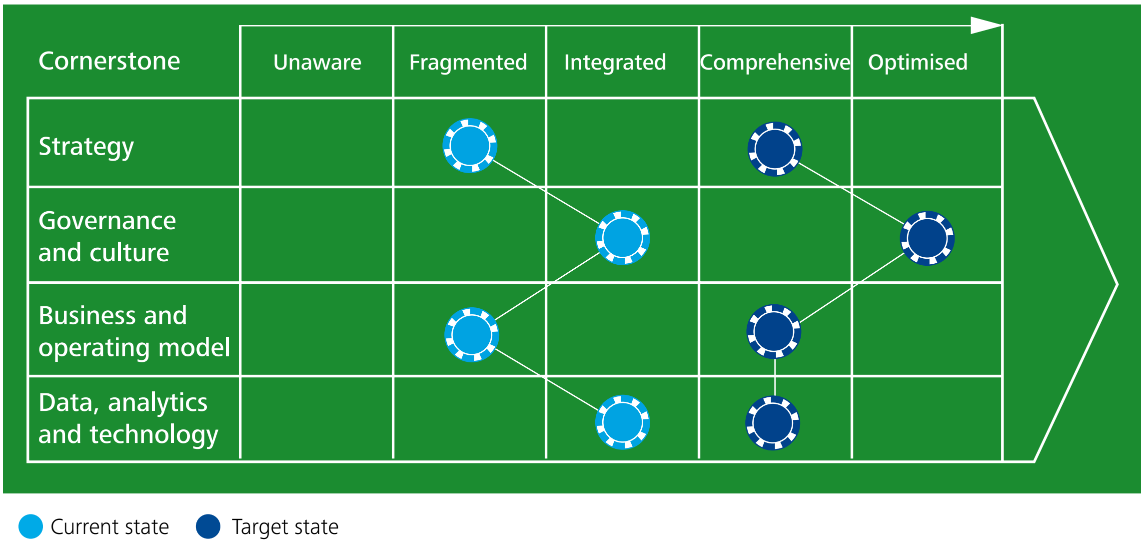
The risk management function then supports each business in operating within the risk profile each requires in order to meet return objectives

Assessing needs

As noted, the risk transformation journey differs for each organisation. In defining the future state of the organisation, executives might assess the current state in terms of these cornerstones (see Figure 3). They can then decide which capabilities related to strategy, governance and culture, business and operating models, and data, analytics and technology require what degree of enhancement. As shown in the chart below, risk transformation helps leaders define subjects for analysis across the organisation against a maturity continuum. Five distinct maturity states are defined for each cornerstone, with the 'optimised state' corresponding to the practices of a 'risk intelligent enterprise'.

Risk transformation recognises that risk management can be organisationally aligned even if parts of the whole stand at various maturity levels. The maturity continuum is only one tool by which risk transformation assists management in identifying, categorising and prioritising activities for enhancement. Primarily, the cornerstones—and the concept of risk transformation—aim to elevate senior-level discussions regarding risk management, risk governance and regulatory compliance.

Figure 3: Example of a maturity continuum



Five distinct maturity states are defined for each cornerstone, with the 'optimised state' corresponding to the practices of a 'risk intelligent enterprise'

Given the nature of the changes, here are some key points to consider, framed as questions to be answered in senior-level discussions of risk management and regulatory compliance:

- Strategy
  How clear are our business and risk strategies to internal and external stakeholders? How can we improve that clarity? How can we bring our risk strategy more in line with our business strategy so they support one another? How can we allocate capital more efficiently while managing the risks to which it is exposed? How much capital should we allocate to new business initiatives?

- Governance and culture
  Do our governance systems and culture support implementation of our strategy? How can we best align our governance goals and our organisational culture with our values and mission? To the extent that we see misalignment, what is the cause? What values are, and are not, expressed in our culture? How can we drive positive values throughout our culture? Are we truly practising good governance?

- Business and operating models
  How can we best drive awareness of and accountability for risk throughout the organisation? To what extent have we rationalised, synchronised and optimised risk management and regulatory compliance mechanisms? How could we enhance these attributes? How can we achieve regulatory compliance without disruption to our operations? Is it possible for a unit to engage in risky activity without the knowledge of the board and the management?

- Data, analytics and technology
  How can we leverage our investments in risk management, internal control, and data management and analysis? How can we better align these across our organisation? How well do our data management and analytical capabilities support our risk management and regulatory reporting efforts? How can we develop an integrated data storage and aggregation infrastructure to support financial, operational, regulatory and risk reporting?

There are many other questions, but the above selection makes a good start. And the time to start is now.