Remaking financial services: risk management five years after the crisis

A survey of major financial institutions

Executive summary

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Executive summary

Remaking financial services: risk management five years after the crisis is the fourth annual study of risk management in banking and insurance conducted by EY in conjunction with the Institute of International Finance since the 2007–08 financial crisis. Seventy-six firms across 36 countries participated in the study, comprising 50 interviews with chief risk officers (CROs) and other senior risk executives and 68 online survey responses. The study paints a picture of continued improvement and focus on risk management, but with some change in priorities to reflect recent developments. It also highlights the extent to which embedding changes and renewing IT and data infrastructure will continue to be an area of significant investment for many banks.

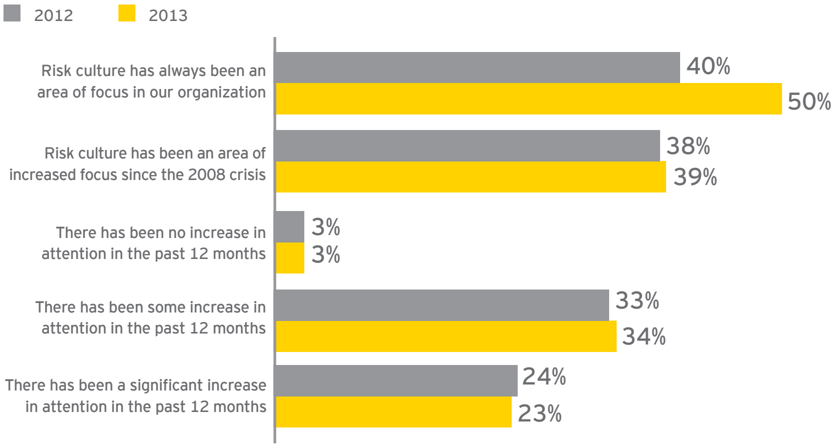
Despite a broad range of responses to changing regulatory requirements, market unease and internal pressures, there is agreement that aligning boards, the leadership team and the business units of a firm around a shared understanding of risk culture is crucial to changing, monitoring and managing behavior.

This brochure contains excerpts from a larger report. With the exception of a short section on insurance, all the data, charts and quotes in this brochure pertain solely to surveyed banks.

Five key themes run throughout the study:

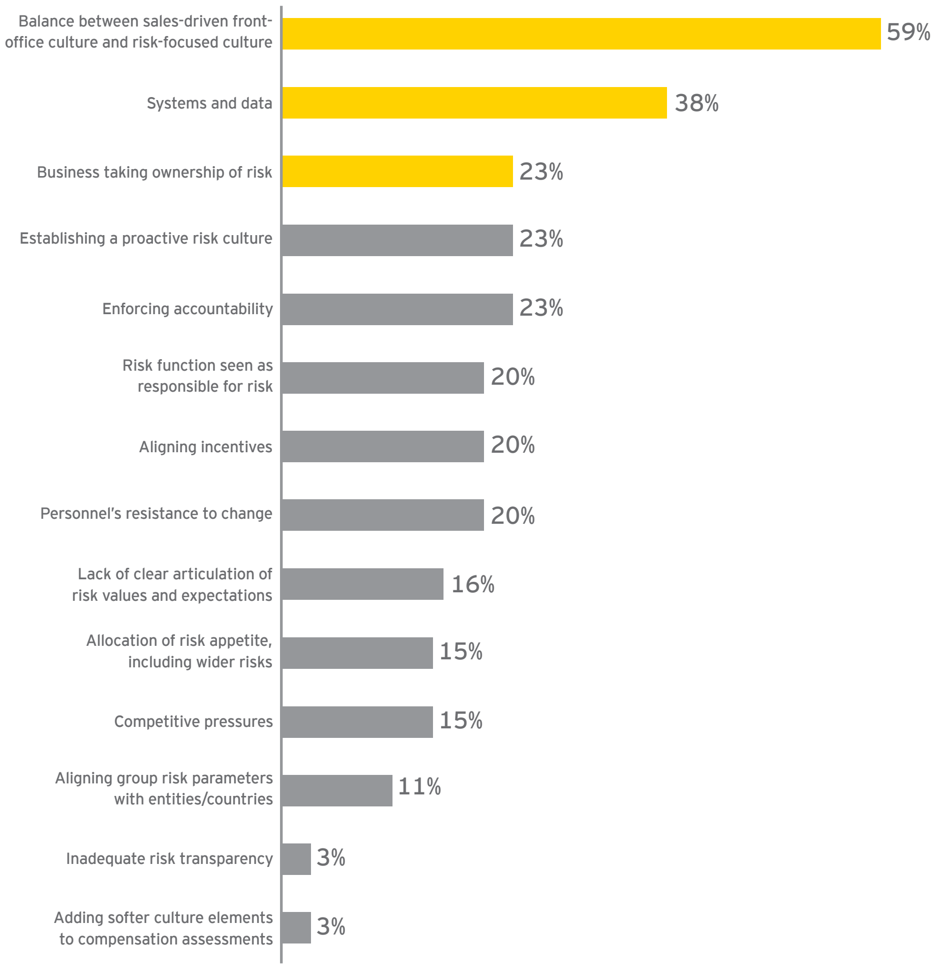
- Banks are reviewing their cultures across legal entities and business units following several high-profile conduct scandals.
- There is a much greater focus this year on operational risk and reputational risk, including the issue of risk appetite.
- Banks, having moved to enhance the structure of risk management post-crisis, are still working to fully operationalize those policies – with most banks still finding it difficult to embed risk appetite.
- Risk transparency is driving further enhancement of stress testing and sizable further investment in IT and data.
- Business models are being rethought in light of the regulatory changes, with banks exiting from activities, businesses, markets and geographies.

Senior management's attention to risk culture



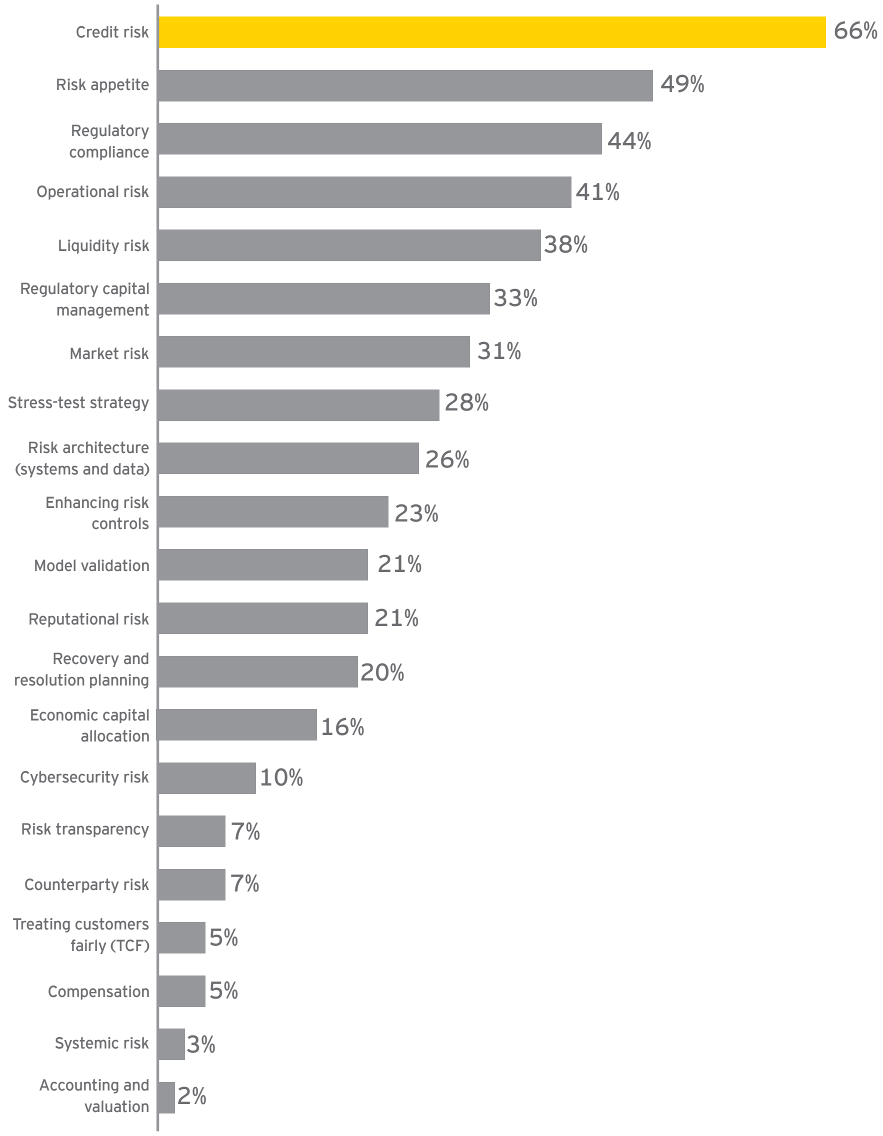
Does not sum to 100% because respondents could select more than one option.

Top challenges of strengthening the risk culture

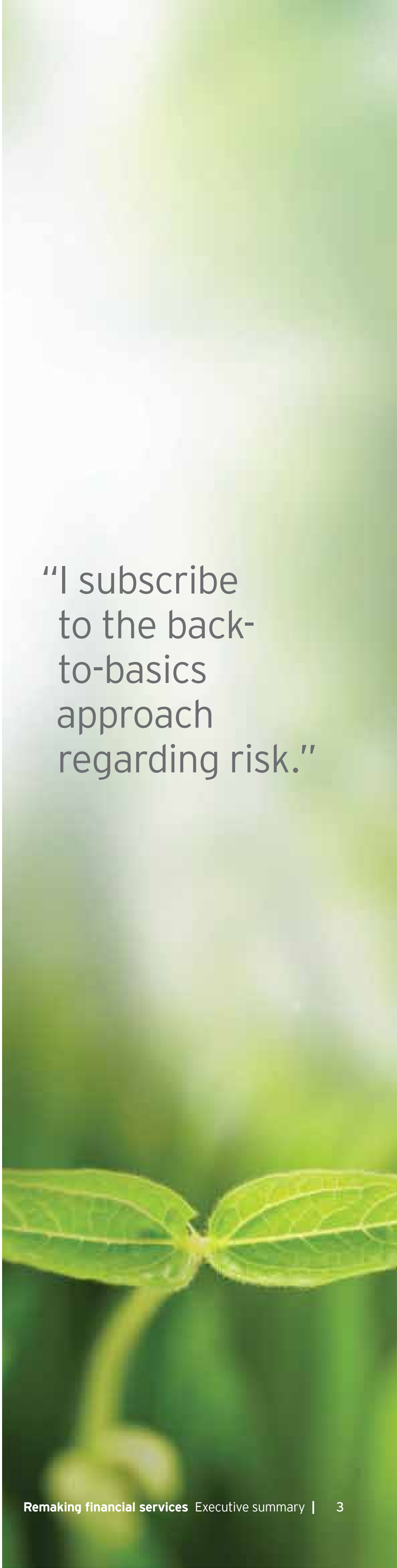


Does not sum to 100% because respondents could select more than one option.

Top issues requiring most CRO attention over the past 12 months

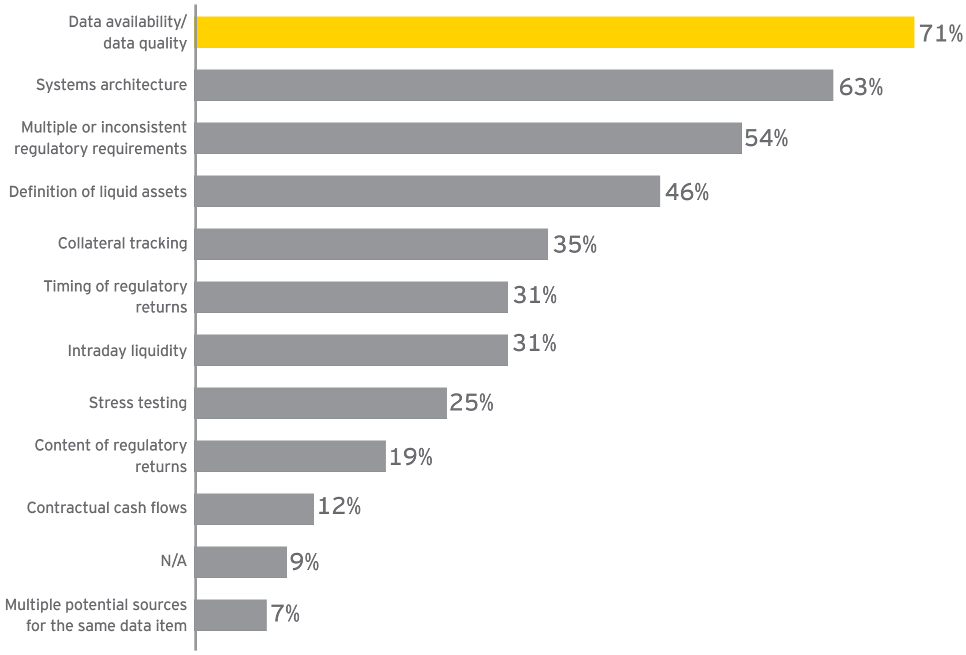


Each respondent could select five areas.



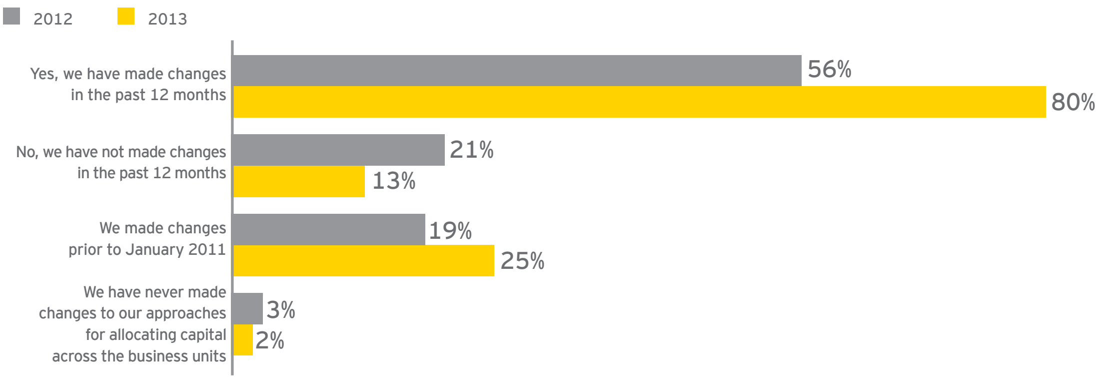
"I subscribe to the back-to-basics approach regarding risk."

Key challenges experienced or expected to be experienced in implementing Basel III



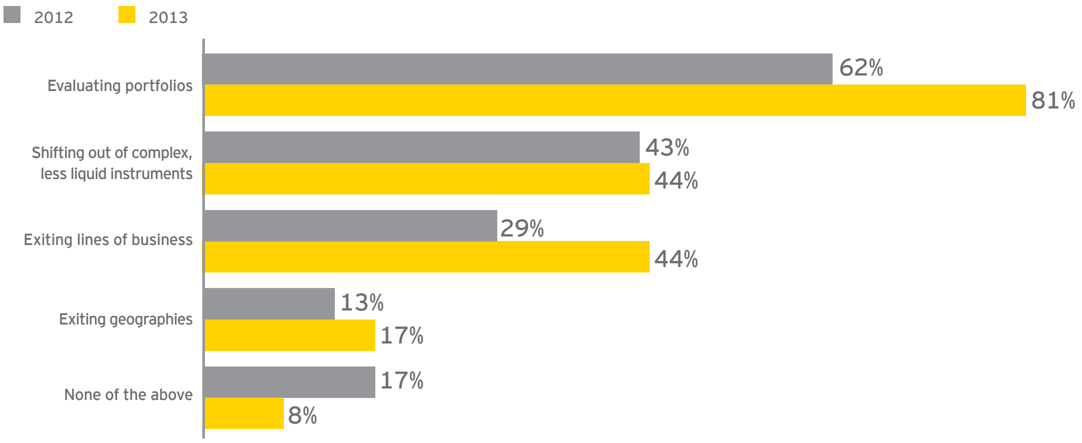
Does not sum to 100% because respondents could select more than one option.

Adjustment of approaches to allocating capital across business units



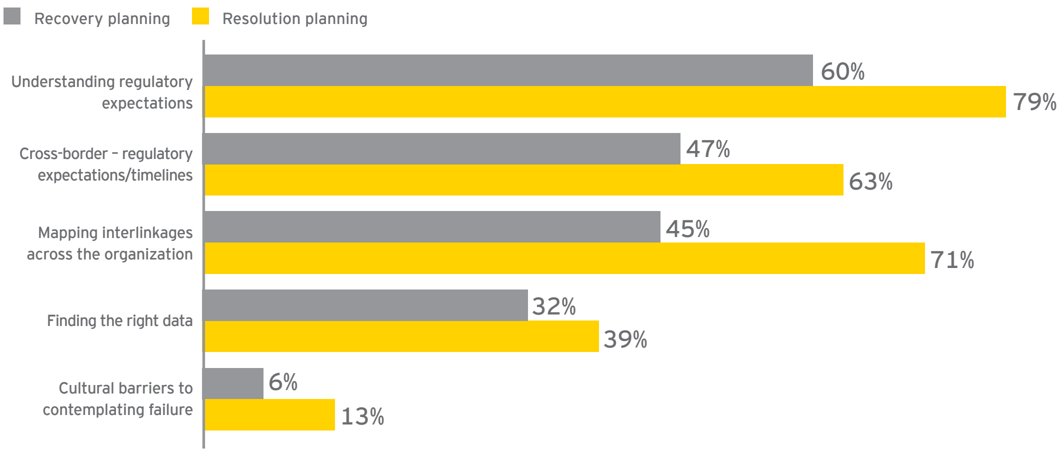
Does not sum to 100% because respondents could select more than one option.

Effect of combined liquidity and capital changes under Basel III on business model



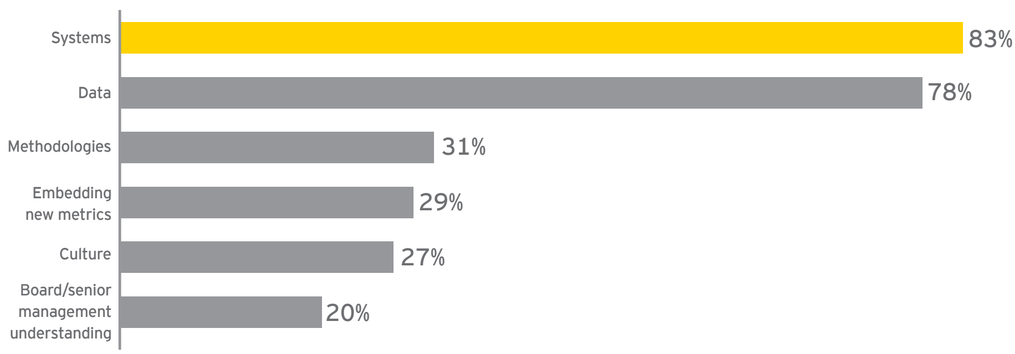
Does not sum to 100% because respondents could select more than one option.

Top challenges to recovery/resolution planning



Does not sum to 100% because respondents could select more than one option.

Top challenges to achieving greater internal risk transparency



Each respondent could select three challenges.

Findings at a glance

Firms have been working post-crisis to remake their risk governance frameworks, and many of the themes seen in previous years remain a feature of this year's study. The largest shift this year is a renewed focus on risk culture. While risk culture has been a high priority since the crisis, senior management and boards have become less certain of the culture prevailing in different business units. In addition, management has shifted its focus to operational and reputational risk following high-profile conduct cases.

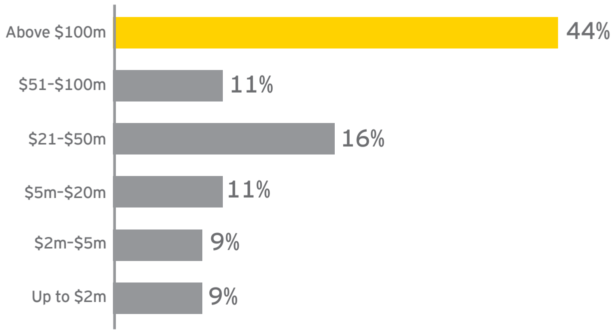
CROs pointed out that the challenge is two-fold, requiring both buy-in throughout the organization and the tools to monitor and assess that buy-in. Fifty-nine percent of survey respondents cited the balance between a sales-driven front-office culture and a risk-focused culture as their top organizational challenge; 38% cited a lack of systems and data, the second most frequent challenge raised. CROs noted that without adequate risk data and systems, accountability for risk is undermined and can damage the culture.

Other key findings include:

- Although 43% of banks said they have achieved a strong culture, up slightly from last year, more than half believe there is further distance to travel, underscoring the need for a sustained effort over a long period to effect significant cultural change.
- Banks are taking different approaches to assessing risk culture, but what stands out is the degree of momentum behind taking action. More than 85% of North American banks have programs to assess internal culture, and the figure is similar for Latin America. In Europe and Asia-Pacific, 60% or more of banks have programs to assess internal risk culture.
- There is continued ratcheting up of board oversight; 51% of respondents reported an increase in focus in the past 12 months, with risk appetite being the area of greatest influence. Board risk expertise is being enhanced through new appointments and training.
- The stature and role of CROs have increased markedly since the crisis: 81% report either to the CEO or jointly to the CEO and risk committee. Partnering effectively with business units continues to be a challenge, as does data and information technology (IT).
- Risk appetite continues to be an essential part of risk governance, but the industry continues to be challenged to embed risk appetite into business decisions. There is also an emphasis on trying to cover different risk types in the framework, particularly operational and reputational risk.
- Banks are still working to improve stress-testing methodologies and frameworks. Sixty-seven percent reported implementing new methodologies and frameworks over the past year — but integrating these into a flexible management tool remains an aspiration for many banks. Extracting and aggregating data is the largest challenge to improving stress testing.
- Liquidity risk remains at the top of agendas, with banks starting a slow move away from governance through asset-liability committees toward balance sheet committees or shared responsibility with risk/executive committees. Data availability and quality are the top challenges to liquidity risk management for most banks.
- Capital management is being rethought across the industry. With regulatory capital now much higher than economic capital, 55% of respondents said they are aligning capital allocation with regulatory capital. Eighty-three percent reported they have placed a greater focus on managing capital by entities or geographies.

- A strong theme this year is the pressure on business models from the Basel III requirements. Eighty-one percent of respondents said they are evaluating portfolios, and 44% said they are exiting lines of business, up from 29% last year. This is being driven by pressure to mitigate falls in return on equity following the capital increases.
- Recovery and resolution planning continues to progress unevenly, with the former more developed. Understanding regulatory expectations is one of the greatest challenges, particularly cross-border regulatory expectations for international firms. Of the firms that have completed recovery plans, half took six months to a year to complete them and almost a quarter took one to two years. For those that have completed resolution plans, 36% took six months to a year and another 36% took one to two years.
- Improving risk transparency remains an ongoing initiative. Partly this requires changing existing tools to reduce under-reading of risk. Almost half of banks are balancing economic capital with other metrics, with 79% reporting an increased focus on stress testing.
- Investment in data and systems continues to be a significant challenge — and an area that will take up considerable investment for years to come.

Expected incremental costs of complying with global Basel III liquidity requirements (in US$)



"We've got all kinds of task forces that have been given the job of picking out what needs to be done. Committees, task forces, working groups, subcommittees — so the biggest challenge is, how do you do this and still keep your day job!"

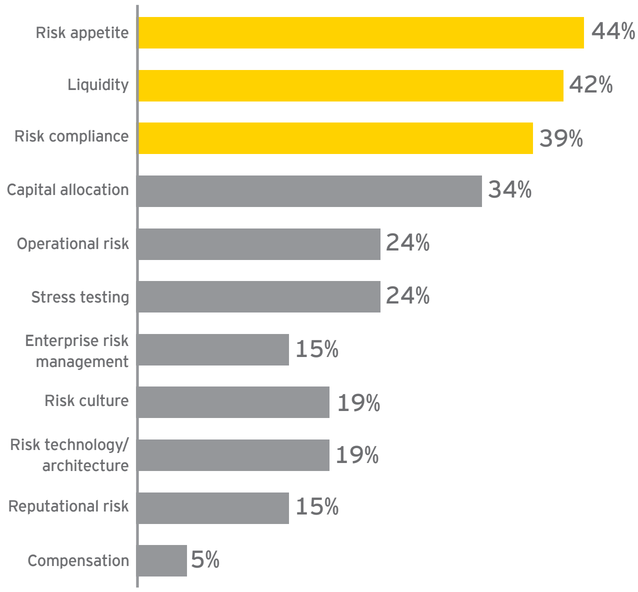
Culture at center stage

Almost universally, risk governance is more central to the management of the banks and has much more senior management and board attention placed on it than was the case pre-crisis. Banks, however, are still on a journey toward embedding new structures and processes, new tools are being developed and difficult areas remain. Despite considerable investment in recent years, data and IT remain challenges, and enhancements continue year in and year out. Against this backdrop, new conduct issues have arisen, leading to a refocused effort. Culture, which was an issue identified at the time of the crisis, is now center stage, with most banks carrying out some kind of review or audit. The change and momentum in risk governance is set against a backdrop of evolving business models and overall strategy made more complex by economic and regulatory uncertainty.

Our first survey, undertaken in 2009, found an industry measuring itself against the industry best-practice recommendations for risk governance and already moving forward in a variety of areas. Most banks had programs in place to fill gaps against the recommendations. Since then, our surveys have shown banks making significant progress toward change in governance frameworks. Board risk committees are now almost universal, the time boards have spent on risk has substantially increased, board skills have been enhanced through training or a change in the mix of board members, and the role and influence of the CRO and risk function have broadened. At the same time, the CRO's seniority and status have been enhanced.

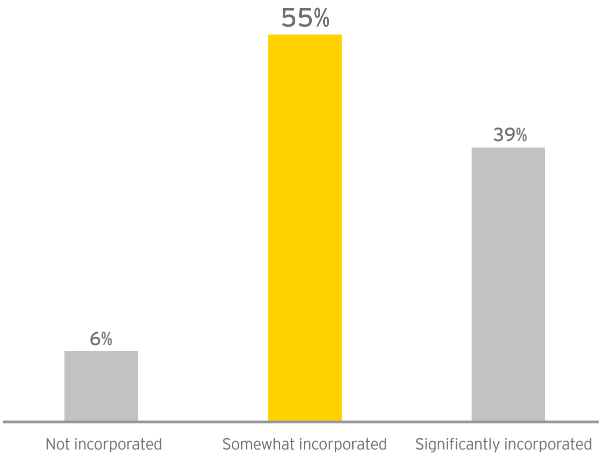
This year's survey shows an industry continuing to wrestle with the process of embedding the risk governance framework in the organization and, in particular, moving risk appetite out of the boardroom and into the business units. The industry continues to focus on how to ensure adequate risk transparency. One of the challenges is how to take a standard tool like stress testing and enable it to sit at the heart of decision-making. Sixty-seven percent of respondents to this year's survey reported that they have created and implemented new stress-testing methodologies in the past 12 months, and 60% said they have created new management reports on stress testing in the past 12 months.

Risk areas where board is placing the most focus



Each respondent could select three areas of focus.

Incorporation of stress-testing results into strategic management decision making



The degree of regulatory change is posing a challenge for bank business models; rethinking strategy in an uncertain environment is difficult and is taking up large amounts of senior management time. The rules around Basel III have been finalized now in many jurisdictions, including Europe and the United States. But more items are being added to the regulatory agenda all the time.

The effects of the changes to date are driving a retreat to core activities and core geographies, and costs have to be reduced and margins increased. Cost reduction at a time of substantial investment in data and IT infrastructure is difficult. "We are all in the same boat in the industry," one executive said. "One of the bigger challenges is the increased cost of regulation, both in terms of increased capital requirements, as well as the internal costs to keep up with regulation. The challenge is to adhere to the regulatory changes, to incur the costs that go with that in operational costs and capital costs, and still turn out a profit in a macroeconomic environment that is a bit cloudy. We're all going to be a less profitable business."

The pendulum has undoubtedly swung toward more conservative risk management and de-risking of businesses over the past five years. As one executive said, "If you look at where we are in terms of the structure of the organization and the staffing of the risk management team, we're fairly well equipped. The priorities are very simple. They are to make sure that we're conservative in our liquidity planning, to make sure that we're conservative in our capital planning, and to make sure that we also enable ourselves to really meet all the requirements of the various stakeholders." The challenge is to ensure that the pendulum does not swing back too far the other way when markets improve. It's a challenge that firms seem to be keenly aware of as they refocus on building risk awareness in the front office, embedding risk appetite throughout the organization and assessing risk culture.

An emphasis on operational risk

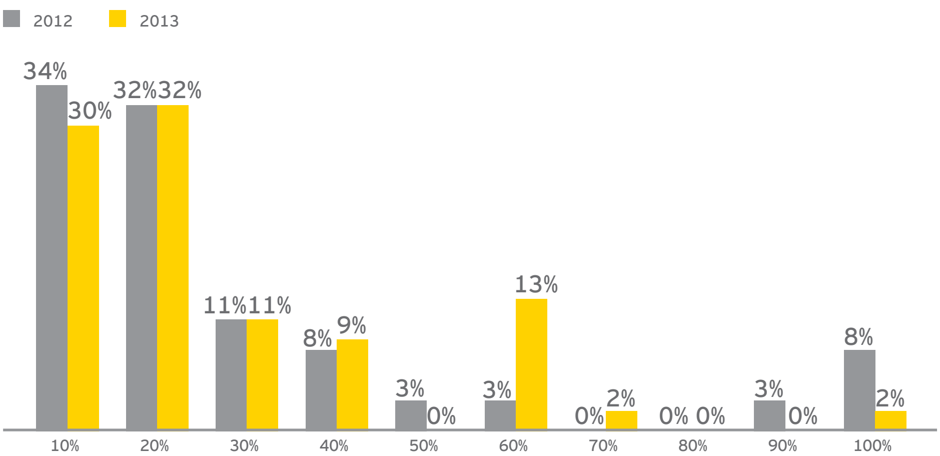
In the years since the crisis, the financial services industry has made real progress toward structural change but is still working to embed policies and procedures down through the organizations. The industry itself recognized that boards needed to change focus from share price and profitability to the risks entailed in their strategies, and this change has happened. The industry also recognized that empowered CROs were needed with a broad remit and a reporting line direct to the board or CEO. They also needed sufficient stature to be able to stand up to business heads. This shift has occurred almost universally across the industry.

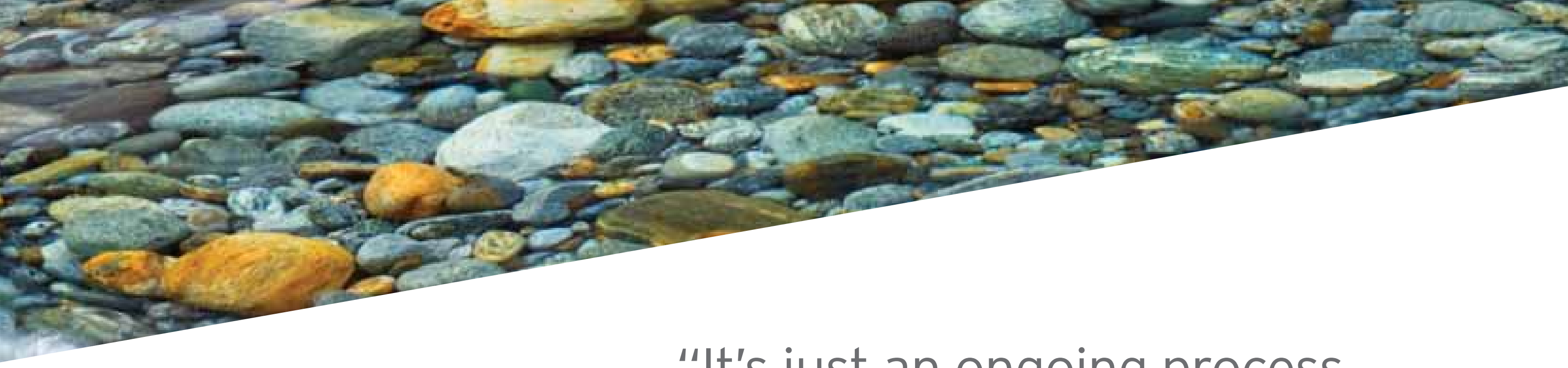
The experience across many banks and markets in the past 12 months shows, however, that more work is needed on culture. A key issue at the time of the crisis was balancing a sales-focused culture with a risk-control culture. This remains an issue, but this year the emphasis has been on assessing overall culture and moving reputation and operational risk higher up the agenda. The belief at board level that they knew what the culture was throughout the organization has been shaken, and the majority of banks surveyed have moved, or are planning to move, to carry out reviews of culture.

In line with this, there is greater focus on embedding operational risk and reputational risk more firmly in risk appetite. Nonetheless, banks are still struggling to ensure that specific business decisions are consistent with risk appetite even for more traditional risk types, such as credit and market. Many banks have put in place programs to achieve this.

One lesson from the crisis was that many banks were not fully aware at the board or senior management level of the concentrated positions in their organizations. This had led to a focus on risk transparency, and work is still continuing with programs to enhance stress testing and make it a more usable management tool, as well as through redevelopment of models and management information. But all of this is putting ever-greater strain on IT and data platforms; enhancements, although continuing apace, will continue for some time to come.

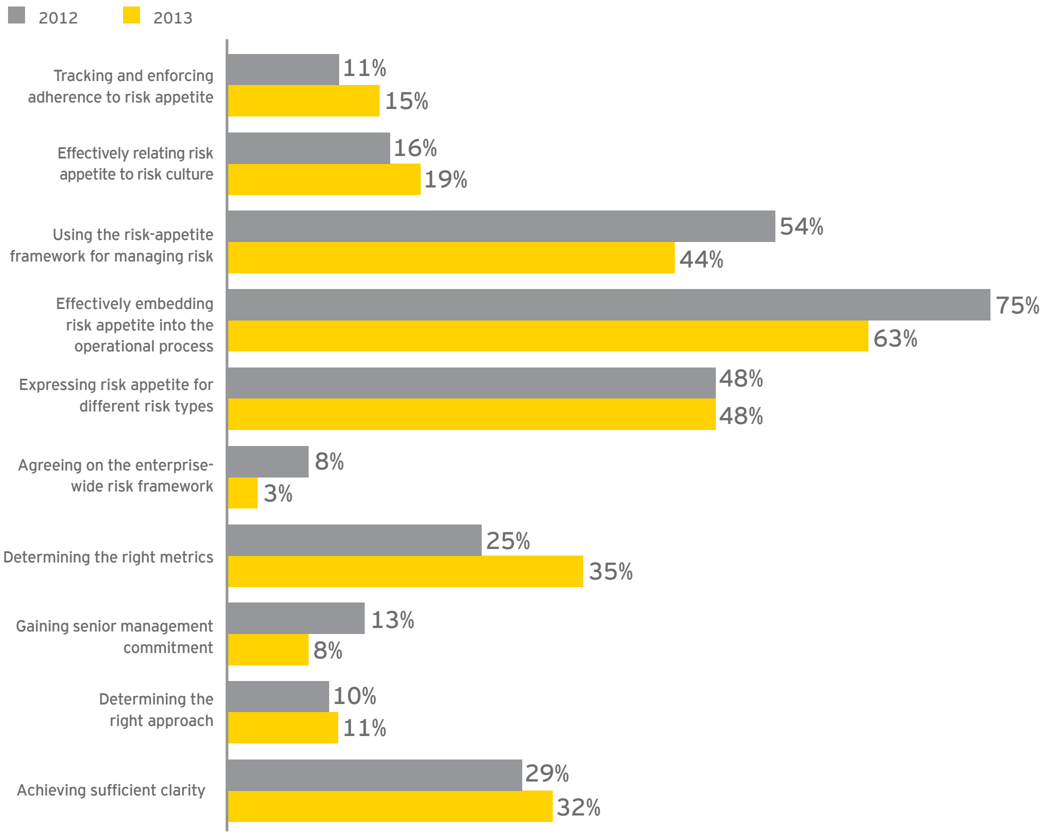
Percentage planned increase in IT spend to support the risk architecture over the next two years





> "It's just an ongoing process. You talk about it, you communicate, you recognize it, you applaud it, you put into practical effect what that culture should suggest."

Top challenges of risk-appetite development and implementation



Each respondent could select three challenges.

Insurance firms

Insurance firms are facing many challenges similar to the banking industry: evolving and more stringent regulatory demands, economic volatility and the continuing complexities of the European sovereign debt crisis. Some challenges are particularly acute for insurers, such as poor equity market performance and the low interest rate environment that has resulted from loose monetary policy. Especially of note this year is discussion of liquidity pressures, an issue that the industry has been largely shielded from until recently.

In the face of these challenges, executives cited risk culture as the compass that keeps their firms on course. "Maintaining the company at the right level of risk culture, so that everybody feels and acts as a risk manager, is one of the biggest challenges I see in my role," one executive said.

Important challenges in improving such a risk culture include having the adequate systems and data in place as well as ensuring that the business is taking ownership of risk. These are themes echoed in our discussions with bankers.

As with banks, a major challenge remains to cascade the risk appetite statement through the operational level and embed it into the decision-making processes. As one executive said, "We have at the moment a framework which is very well embedded with the plan, with strategic decision-making, but we have identified improvement potential in the risk culture awareness of the entire organization, so everybody in the company gets it."

Keys to continued progress:

- A core challenge is embedding risk appetite in business decisions; risk appetite must be broadened to encompass reputation and operational risks.
- Firms cannot assume that culture is consistent across large organizations; reviews are a fundamental tool to assess the state of culture throughout the enterprise.
- Clarity is needed regarding the values of the organization, supported by training and communication.
- Tools like stress testing should be enhanced so they can be used as flexible management tools while appropriately covering the risk profile.
- Continued investment in IT and data is essential to facilitate timely transparency; how firms deploy people, time and money toward improving IT will be a major consideration for years to come.
- Strategy should be rethought in light of the effect of new regulations on the profitability of different businesses.
- The combination of regulation, increased pressure from investors and uncertain economic environments should not be underestimated as banks contract their activities back to core portfolios and core countries.

Research methodology and demographics

From December 2012 through February 2013, EY, on behalf of the IIF, surveyed a sample of IIF member firms using two methods. An online quantitative questionnaire was distributed to the top member firms (by asset size). In addition, the team conducted telephone interviews with CROs and other senior risk executives of many of the largest global firms. A total of 76 firms across 36 countries participated in the study either online, by telephone or both, comprising 50 interviews with CROs and other senior risk executives and 68 online survey responses.

Africa/Middle East

Ahli United Bank
Arab Bank
FirstRand Bank
National Bank of Kuwait
National Commercial Bank
Standard Bank Group

Asia-Pacific

ANZ Banking Group
Agricultural Bank of China
Bank Mandiri
Bank of the Philippine Islands
China International Capital Corporation
China Merchants Bank
Commonwealth Bank of Australia
DBS Bank
Kasikornbank
Kookmin Bank
Macquarie Group
Maybank
Mitsubishi UFJ Financial Group
Mizuho Financial Group
National Australia Bank
Nomura Holdings
Norinchukin Bank
Sumitomo Mitsui Banking Corporation
Suncorp Group
Westpac Banking Group

Europe

Allianz
AXA Group
Barclays
BBVA
BNP Paribas
Banco BPI
CaixaBank
Commerzbank
Credit Suisse
Danske Bank
Deutsche Bank
DNB
Erste Group Bank
Generali Group
Grupo Santander
HSBC
ING
Intesa Sanpaolo
KBC
Lloyds Banking Group
Natixis
Nordea Bank
Piraeus Bank Group
Royal Bank of Scotland
SEB
Société Générale
Standard Chartered Bank
Swiss Reinsurance Company
UBS
Zurich Insurance Group

Latin America

Banco Bradesco
Banco de Chile
Banco de Crédito del Perú
Banco Nacional de Costa Rica
Bancolombia
Itaú Unibanco
Mercantil Servicios Financieros

North America

AIG
BNY Mellon
CIBC
CLS Bank International
Citi
Goldman Sachs
JP MorganChase
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State Street Corporation
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