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Risk Governance 2020

From satisfactory to effective and sustainable

Executive summary

After years of regulatory reform, the financial services industry is experiencing a palpable shift in focus by regulators away from improving the financial strength to governance, structure and operations concerns. These issues are central to maximizing risk-adjusted performance and enabling resiliency and resolvability. A core concern in this context has been what can be described as “nonfinancial” risks, such as conduct, compliance and operational risk more broadly. The change in emphasis can be easily explained.

First, regulators are demanding significant enhancements to risk governance in the industry because they will no longer tolerate major control or conduct failures. A firm could lose its license in one or more

jurisdictions for repeated or egregious offenses. In addition, supervisors are holding executives and directors personally accountable, unless the firm can demonstrate that it took all reasonable steps to prevent the breach. In some countries, executives can be jailed for major transgressions, and the potential impact on the businesses of further transgressions in terms of reduced opportunities and more costly funding makes conduct a prudential concern for regulators as well.

Furthermore, investors anticipate real change to continue. They are expecting firms to reset their business models and cost bases in light of new regulatory expectations and market pressures. Current low returns on equity are unsustainable.



Moreover, firm-level fines and settlements have escalated to the point where they can threaten the institution's credit standing, and firms that cannot meet supervisory expectations run a higher risk of failure.

So what's the answer? It cannot be ever-greater numbers of compliance or risk officers. That will certainly increase cost but likely not improve control.

The answer lies in not more but better risk governance – what EY calls *Risk Governance 2020*. Firms have to build on valuable changes made in recent years but go further to embrace fully embedded risk appetite frameworks across all dimensions of risk, strengthened risk accountability frameworks, increased control effectiveness, enhanced risk transparency, and an integrated approach to talent and incentives matters. Board oversight has to be further enhanced, and firms have to fully align their culture with their risk appetite.

This is no trivial task, and the core work in building a more integrated risk governance approach may take three to five years, though the journey will remain ongoing. It is critical that work starts today.

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Whereas firms once addressed risk governance issues in isolation, they now need to work on issues collectively. Ongoing control failures highlight the interdependent elements of risk governance and show that effectiveness lies not in the size of the risk and compliance apparatus, but in its quality.

Regulators and investors recognize major changes are required and will not wait forever. They expect change to start immediately. Approaches need to be practical, conceptually sound and operationalized to realize tangible results.

If done well, firms can be better governed at a low cost and in a way that allows risk governance to enable the firm to compete successfully, and risk governance can move from being satisfactory to effective and sustainable.

A need for change

Many companies are realizing that winning in today's complex and interconnected market means marrying global regulatory expectations with long-term strategic objectives. The financial crisis provided a rude awakening to boards, senior management teams and regulators alike, resulting in significant challenges for firms trying to adapt their business models to meet heightened financial stability expectations of regulators and other stakeholders. Risk governance, culture and control are now priorities for regulators; they are also the industry's central concerns in light of unprecedented regulatory fines. Meanwhile, stakeholder expectations of robust governance balanced with improved profitability are increasing.

Financial institutions began focusing on governance, risks and controls as soon as the fog of the crisis began to lift, and many have taken significant strides in the right direction. Firms are stronger. However, for most, regulators have concluded that current approaches do not go far enough. Significant work remains to create a holistic approach that reaches day-to-day behavior at all levels of the firm and creates meaningful and sustainable change in the way business is conducted and overseen. Going forward, companies will have to take a more strategic approach to risk governance.

Why does it matter?

After several years of building significant risk, compliance and control structures, firms now face three major challenges:

1. **Regulatory pressure to improve governance and behavior:**

Regulatory attention has progressed beyond financial condition and resiliency – that is, improved capital and liquidity, decreased leverage, and strengthened recovery and resolution plans.

Improving governance and conduct at large financial service firms is now atop the regulatory agenda. Major control failures and conduct violations across the industry drove this change, leading regulators to conclude that stronger risk governance is critical to financial reform. Regulators in certain jurisdictions are leading the way by addressing this cycle of misconduct through increased accountability and consequences for firms and individual employees.

The focus on improved risk governance is unlikely to diminish. So it is imperative for organizations to clearly demonstrate that they are well-controlled and effective at managing all of their financial and nonfinancial risks. Greatly elevated risk governance expectations are a common theme across current regulations and can be found in broad-based rules in specific jurisdictions (e.g., the US Office of the Comptroller of the Currency's Heightened Standards¹ and the UK Prudential Regulatory Authority's Individual Accountability Regime)² as well as targeted global guidelines (e.g., incentive compensation, Financial Stability Board's Principles for Effective Risk Appetite,³ Basel Committee on Banking Supervision's revised Corporate Governance principles,⁴ and standards on risk data aggregation and risk reporting). This focus is also embedded in other requirements (e.g., the Federal Reserve's Comprehensive Capital Analysis and Review and global structural reform initiatives). Some of these regulations are sector-specific, while others are more generally applicable.

However, it is clear that, whatever their sector, large financial service firms are facing increasingly similar regulatory expectations on risk governance. Regulators are reinforcing these expectations through findings in regulatory examinations and enforcement actions.

Taken together, these requirements are challenging, especially for global firms operating across multiple jurisdictions.

2. **Inappropriate behavior:** A recent spate of complex market failures, including market manipulation, anti-money-laundering and sanctions program failures, rogue trading, and mis-selling, highlighted significant issues of misconduct and operational failures in certain banks, which in turn revealed significant weaknesses in governance, controls and culture. While the majority of these problems have been in banking, firms in other financial service sectors have experienced similar breakdowns. Current risk approaches may therefore be inadequate in addressing root causes, known weaknesses or emerging risks (e.g., digital risks) and raise broader questions around firms' general inability to manage and control their nonfinancial risks. The onus is now on firms to demonstrate they are taking swift and meaningful action. The resulting conduct costs and related provisions have been substantial, surpassing US\$270b from 2009 to 2013 globally.⁵

1 "OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations (Final Rule)," Office for the Comptroller of the Currency, September 2014.

2 "Strengthening individual accountability in banking and insurance – responses to CP14/14 and CP26/14," Prudential Regulatory Authority, March 2014.

3 "Principles for an Effective Risk Appetite Framework," Financial Stability Board, November 2013.

4 "Corporate governance principles for banks – Consultative document," Basel Committee on Banking Supervision, October 2014.

5 CCP Research Foundation (formerly the LSE Conduct Costs Project).

3. **Cost control:** Operating with returns below the cost of capital is not sustainable or acceptable to investors. In grappling with increasing regulatory expectations and fines, shortened implementation timelines, and major reputational events, firms have often resorted to firefighting immediate issues, leading to disjointed or piecemeal implementation efforts. The outcomes have been significant risk and control expenses, increased headcount with the potential for duplication of efforts in managing risks and controls, lack of clarity in roles and responsibilities, and fractured and uncoordinated infrastructure. All this is the significant cost of compliance with limited return in terms of running the businesses. Shareholder and investor demands for higher returns require firms to manage risks and controls in a more consistent and cost-effective manner. One way firms can begin addressing cost-of-control issues is to use a common risk taxonomy, integrated risk assessments, standardized control frameworks and improved management information systems. The ability to deliver organizational change balanced with improved returns on equity (RoE) will be a true distinguisher for firms in the industry.

Firms that proactively take ownership of their own agenda, instead of reacting to regulatory expectations as “compliance” matters, will find themselves at a significant advantage to their competitors. Strong governance and conduct will be integral to rebuilding trust in the industry, providing a foundation to meet increased expectations for consumer protection, investor protection and market conduct. Further, increased transparency around a broad array of risk considerations will enhance competitive agility by better informing decision-making. Beyond that, an effective governance model will align the firm’s strategy, purpose and mission; will reinforce the core values for employees; and will assist in attracting and retaining the talent required to rebuild trust. A holistic approach to risk governance will force firms’ attention to matters of operational efficiency and effectiveness, thereby helping create a sustainable operating model that delivers value to shareholders and other stakeholders alike. Finally, firms will manage risks more effectively by focusing on both short- and long-term, and financial and nonfinancial, risks equally.

What scope of change is required?

The required scope of the change to meet regulator and other stakeholder expectations for a well-controlled environment, managed growth and an improved bottom line will likely significantly exceed the scope and pace of change in these areas since the crisis. Firms will have to shift their thinking and approach to risk governance – minor refinements to existing approaches will likely not be sufficient. Instead, firms will need to embark on a transformative risk governance journey. The required paradigm shift must surpass short-term regulatory expectations to be more future-proof and sufficiently holistic, practical and flexible, as well as help directors and executive manage the business more effectively.

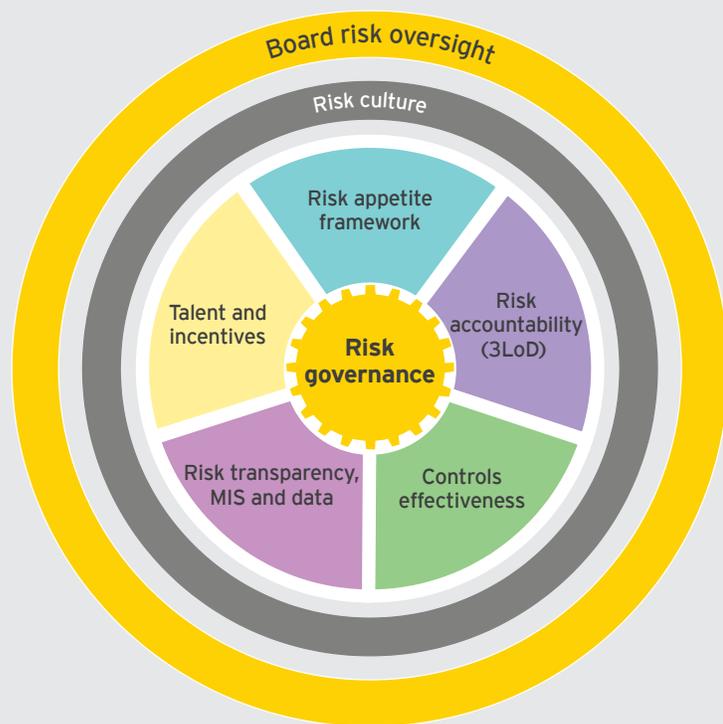
The time for transformative change has arrived, and the effort will depend on a shift in mindset and an innovative approach to risk governance. To enable the firm to successfully navigate their future risk governance journey, the new approach needs to be:

1. **Integrated:** After the crisis, firms were forced to address complex, onerous and multifaceted regulatory requirements coupled with aggressive deadlines for compliance, which in turn resulted in separate or siloed responses to those requirements. In some cases, the resulting changes to governance, risk and control structures did not identify the significant issues of misconduct and control failures that followed. Firms need to address a broader risk governance agenda, not in a compartmentalized manner, but with due consideration for the underlying components that are highly connected and interdependent.
2. **Strategic:** In the past, firms have been somewhat reactive to risk governance issues, often being forced into dealing with near-term compliance needs, which diverted necessary attention from linking governance reforms strongly to strategic decision-making. Firms and regulators now realize that the full benefits of holistic risk governance warrant the required investment. The new paradigm encapsulates strategic decision-making aligned to the firm's mission and organizational vision; a strong governance and effective-challenge model; a comprehensive and embedded risk appetite framework; enhanced risk and control structures; and strong data, analytical and reporting capabilities. The new paradigm will create an environment of higher returns and strong growth.
3. **Forward-looking:** To date, most firms have grappled with the challenges of meeting immediate domestic requirements, leaving them with little, if any, time to fully consider global regulatory trends. This tactical approach has resulted in operating models that may not support further changes in the global regulatory landscape. *Risk Governance 2020* will shift the current mindset by recognizing the holistic nature of the journey ahead, during which both near-term and long-term risks must be addressed. This approach to risk governance has to also be flexible enough to withstand changing regulatory expectations.
4. **Effective and efficient:** Approaching risk implementation or remediation efforts in a compartmentalized manner has often resulted in decentralized or overlapping governance, risk and control processes; unclear roles and responsibilities; and fragmented systems and infrastructure, contributing to high risk and control costs without necessarily addressing the gaps in risk identification and management. By contrast, an efficiency and effectiveness view of risk governance – centralized risk and control approaches, clearly defined roles and responsibilities, integrated systems and infrastructure – leads to a sustainable business model that balances regulator and stakeholder expectations.
5. **Practical:** In several areas, firms have embarked on overly complex approaches to risk governance that are neither fit for purpose nor sufficiently flexible to suit group and subsidiary structures. As an example, risk appetite frameworks (RAFTs) to date have not adequately assessed nonfinancial risks – understandable, given the ambiguity around identifying and measuring conduct, legal, people and IT risks – and thereby failed to address desired risk exposure levels for these risk types. A practical, systematic and dynamic approach to risk governance, as a whole and with recognition of each of its underlying components, is required to realize tangible results.

What is *Risk Governance 2020*?

Risk Governance 2020 will help firms along the necessary transformative journey that realizes the full benefits of effective risk governance within a well-controlled environment, reinforcing the firm's culture and desired risk behaviors. This is not a reprise of a traditional enterprise risk management (ERM) framework – instead, the process helps each element of risk governance to operate efficiently and effectively, alone and in coordination with other elements. This means adapting new approaches and processes to enduring components of ERM – notably risk accountabilities, risk appetite and control effectiveness – which have not universally been implemented across all facets of quantitative and qualitative risk. New elements, notably processes for establishing an appropriate culture and risk-based talent and incentives management framework, have to be integrated into the new risk governance approach.

To add to the complexity, risk governance change will have to take place at both the group and main subsidiary levels. Host country regulators globally are increasingly advocating for local subsidiaries and branches to demonstrate all the elements of effective risk governance, including local boards influencing matters of strategy, capital, business operations and regulatory compliance.



Each of the core components of *Risk Governance 2020* should anticipate change:

- ▶ **Fully embedded risk appetite frameworks:** Firms have invested heavily in establishing and embedding RAFs, with some notable successes. They are much better placed today to manage risks. However, too few firms have embedded risk appetite for financial and nonfinancial risk down throughout the organization and developed robust approaches for identifying and managing nonfinancial risks. Given that the root causes of recent control failures are largely linked to nonfinancial risks, this is no longer acceptable to regulators. Firms will need to address conduct, compliance, legal and other nonfinancial risks in an analytical and forward-looking manner, regardless of historical measurement or quantification issues. Similarly, firms will need to push the risk appetite down into individual geographies; legal entities and products; and “run the firm” limits, policies and escalation mechanisms.
- ▶ **Strengthened risk accountability/three lines of defense:** Although firms have often said the front line is accountable for risks, in practice the second line has taken on responsibility for significant aspects of financial and some elements of nonfinancial risk. Furthermore, as some firms have focused almost solely on financial risks, roles and responsibilities across the three lines can often be ambiguous. The perceived dissonance between firm rhetoric and reality regarding front-line ownership of risk has prompted regulators to send a clear message that this situation is no longer acceptable. They have made front-line risk accountability a priority, expanded the definition of “first line of defense” beyond traditional revenue-generating units, and explicitly called for a strong three-lines-of-defense model, with clear roles, responsibilities and resources.

- ▶ **Increased control effectiveness:** Firms have assumed that the enormous growth in the scope and number of controls after the crisis left them better protected. Yet recent failures in the industry have highlighted problems with control effectiveness. Firms are often grappling with duplicative and overlapping risk assessment frameworks, limited focus on front-to-back controls in the businesses and a somewhat static view of risk. Significant effort will be required to institute firm-wide risk and control frameworks that are properly integrated and standardized, provide forward-looking views of risks, and avoid redundancies and gaps. These changes are critical to supporting a reinvigorated three-lines-of-defense model – with an emphasis on front- and second-line validation and verification processes while avoiding traditional reliance on internal audit alone to comment on effectiveness of controls.
- ▶ **Enhanced risk transparency:** Firms have grappled with risk information since the crisis – risk reports have expanded considerably, in volume and frequency, which has helped raised the quality of dialogue on risks. But today, boards and senior management can still miss important risk intelligence in masses of risk information. Risk data systems remain strained, unable to aggregate and disaggregate data as quickly as regulators consider necessary; manual fixes are commonplace in too many firms. It will be important for firms to develop dynamic IT-enabled risk data reporting that goes beyond dashboards to deliver true risk intelligence, supported by advanced analytics, strong internal controls, and integrated risk and finance data.
- ▶ **Integrated talent and incentives approach:** Recent control failures and conduct matters indicate that, however beneficial in its own right, the strong focus on *financial* incentives alone, such as risk-adjusted compensation, deferrals and claw-backs, is inadequate to generate the level of change required in individual employee behaviors and mindsets. Human resources (HR) has often been viewed only as a front-line enabler. Going forward, firms will require a more sophisticated approach to the HR dimension of culture and control, with a much stronger focus on all stages of the employee life cycle, utilizing both financial and nonfinancial incentives, as well as covering competencies, recruitment, onboarding and promotion processes, and succession planning to achieve desired behaviors. Only a life-cycle view of talent sourcing and development will enable the desired culture, accountability and control environment.
- ▶ **Stronger board oversight:** After the crisis, board oversight has improved considerably via stand-alone risk committees and the addition of new directors with industry and risk experience. However, board members often admit privately that they are now too focused on compliance and deluged with detailed reports and regulator-mandated approvals of complex capital, liquidity and resolution plans as well as related policies and procedures. The burden falls on boards in turn to be more integrated in their oversight role, actively governing their firms while making more informed decisions, identifying new opportunities and enabling the firm to better price risks and allocate capital.
- ▶ **Robust risk culture:** Firms have typically relied on tone-at-the-top messaging, risk-adjusted or deferred incentive pay, and second-line oversight to define and reinforce a strong risk culture and address conduct matters. Regulators have concluded that is not enough. Firms will need a more proactive, explicit and systematic approach to diagnosing cultural problems in the various businesses and functions and implementing comprehensive action plans – across functions and front lines – to address excessive risk taking and unacceptable behaviors.

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What is the way forward?

Significant effort lies ahead. It will be critical to define a road map for success that is tailored to the organization; this starts with an assessment of current state followed by a structured, measurable and integrated plan that includes the following considerations to arrive at the desired end state:

- ▶ **Managing risk governance holistically** – Firms will need to embark on this journey with the understanding that risk governance matters are more effectively addressed as a whole – across all dimensions of risk and considering all relevant inputs and outputs, rather than in a siloed and more limited manner using only more traditional inputs. Formulating a road map that addresses each component in unison will recognize the strong connections and interdependencies that exist.
- ▶ **Balancing regulator and other stakeholder expectations** – Regulators expect an organization to be well-controlled, while other stakeholders expect increased returns as well. Balancing these expectations will require a more efficient and effective mechanism to managing risks.
- ▶ **Applying practical approaches** – Identifying solutions and approaches to risk governance as a whole, and for each underlying component, will be a significant departure from legacy solutions. The new approach should be practical, dynamic and operationalized to realize tangible results.
- ▶ **Designing a fit-for-purpose model** – The new risk governance approaches being implemented should be comprehensive yet flexible. They should be customizable to the organization, its strategy and risk profile and applied equally at the group, parent or subsidiary level, as well as quickly adaptable to changes on any of those fronts.
- ▶ **Managing the scale and pace of change** – As they embark on this transformational initiative, firms need to be prepared to manage the change ahead of them. Significant effort and expertise are required to manage the broad-scale implementation and complex coordination necessary to achieve desired results. However, initial implementation efforts do not have to be all-encompassing; firms can take a modular approach.

The call for action by regulators and investors requires a prompt response by boards and senior management, who should expect a complex journey that will take time. Therefore, it is critical that work starts today. While the task ahead is formidable, firms will rise to meet this challenge if they are to promote growth, long-term profitability and their overall competitiveness. Addressing risk governance in an innovative and holistic manner will provide tangible results when executed in an integrated and structured manner.