

## Risk, regulation and return

*Delivering value through enterprise risk management*



*An IBM Institute for Business Value executive brief*

## **IBM Institute for Business Value**

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# Risk, regulation and return

## *Delivering value through enterprise risk management*

### **Executive summary**

Banks the world over are reevaluating how they address risk. New regulations – from Basel II to the European Union's Capital Markets Directive – are driving banks to take a more comprehensive approach to risk management. While compliance will remain the focus of risk management efforts in the near term, leading firms are transforming risk management into a full-fledged partner that provides value to the business. To better understand the perspectives and concerns of today's CROs, the IBM Institute for Business Value interviewed banking risk management executives in depth and cosponsored a wider, cross-industry survey conducted by the Economist Intelligence Unit. Our findings suggest that banks must address the need for change on several fronts:

- *Strategy.* Too often, risk management is not an integral part of business decisions. Banks need to instill a risk management culture throughout the enterprise.
  - *Metrics.* By and large, banks lack the appropriate risk key performance indicators (KPIs) for assessing individual or business performance. Sound risk metrics are critical for building an enterprise risk management (ERM) culture.
  - *Organization.* Banks have largely settled on a model of centralized control and policy-making and decentralized execution. The challenge now is to drive acceptance of ERM across all business units.
  - *Information.* Realtime risk information is lacking, unconsolidated or too aggregated for business units to rely on in making decisions. The ability to generate reports on a realtime basis would make ERM a much more flexible, powerful and valued capability for business managers.
  - *Infrastructure.* While new regulations are driving IT costs upward, banks are not extracting sufficient benefit from risk management systems. Compatible IT architectures are a key enabler of realtime business risk information.
- *Data.* Risk managers frequently cite a lack of clean, quality data as an inhibitor. Driving consistent data definitions across the business and improving processes for capturing quality data at the source are important enablers.

Three strategies can help banks address these problem areas and transform their risk management activities into a full-fledged ERM capability.

### **1. Measure risk performance to drive a risk management culture**

To improve knowledge and commitment and measure performance, banks need to develop appropriate risk KPIs, as well as the systems and processes to monitor and integrate them into planning and budgeting processes. Banks can use these metrics to drive buy-in from the business units by communicating the benefits of ERM and leveraging risk management as a value add.

### **2. Improve data quality and availability**

Most banks recognize the need for improved data. Effective architectures and infrastructures allow integration of risk data from different business areas and provide consolidated reports, query functions and validation of KPIs. The risk data architecture should be driven by the demands of the business and should enable realtime report generation in the business context.

### **3. Manage risk across the enterprise**

Successful banks will implement a framework of activities and enablers – including infrastructure – for ERM. IBM has developed a framework banks can use as a basis for designing fully integrated risk management systems and capabilities. The framework can serve both to assess the organization's current risk management efforts and to guide future development.

## Reevaluating risk management

Today, banks the world over are reevaluating how they address risk. Following a series of high-profile financial failures over the past decade, a wave of new and pending regulations – such as Basel II, International Financial Reporting Standards, Sarbanes-Oxley and the European Union's Capital Markets Directive– is requiring banks to cover the risks they assume and to disclose enterprisewide risk information.

By and large, these new rules are designed to address the threat of financial instability resulting from inadequate risk management. Insufficient frameworks have left banks struggling to cope with increased credit, market and operational risk. Incorrect or misleading financial statements and inadequate accounting processes have exposed institutions to financial losses and even bankruptcy, while insufficient operational risk management can lead to unauthorized deals, fraud and breach of client confidentiality.

*Some 39 percent of organizations worldwide reported an increase in risk in the first quarter of 2005.<sup>1</sup> Top risks include reputational risk to brand or products, regulatory risk and IT risk (including security breaches and system failures).<sup>2</sup>*

For the most part, banks recognize the need to improve risk management capabilities and are moving to address the situation. Indeed, nearly 70 percent of organizations worldwide have appointed a Chief Risk Officer (CRO) or plan to in the next two years.<sup>3</sup> Banks have also made significant strides toward integrating risk across the enterprise, with nearly all firms planning to achieve full integration of all risk types into their ERM strategies within four years.<sup>4</sup> In the near term, the focus of these efforts will largely be on operational risk, which currently suffers the most significant gap.

*The top skills required for CROs include the ability to understand business issues, the ability to measure and compare and the ability to communicate.<sup>5</sup> The most important benefit of appointing a single CRO for the enterprise: expanded risk management that encompasses a wider range of enterprise risks.<sup>6</sup>*

But risk management is still not an integral part of business decisions at most banks. Risk management systems are often fragmented across organizational silos, and elements do not operate cohesively. Moreover, methods and processes lack consistency across the firm, risk reporting is not consolidated, data suffers availability and consistency problems and risk systems fail to produce required information. As a result, risk is inadequately factored into decision-making in critical areas such as business strategy and capital allocation.

Another issue is cost. While risk managers welcome increasing standardization in many areas – including processes, organization and IT – they expect cost improvements to accompany standardization. As risk management evolves into a centralized function that supports business-unit decision makers, sustaining cost transparency is becoming a high priority for CROs.

## Beyond compliance

To better understand the perspectives and concerns of today's CROs, the IBM Institute for Business Value interviewed more than 20 banking risk management executives from across the globe, prompting them to share their views on current performance, emerging trends and critical risk management issues. IBM also co-sponsored – along with Deutsche Bank, ACE Insurance and Cisco Systems – a wider, cross-industry survey of senior risk managers that was conducted by the Economist Intelligence Unit (EIU).

In the April 2005 EIU survey, over 75 percent of respondents expected regulatory compliance to remain a high or very high priority in three years' time.<sup>7</sup> While compliance will continue to drive risk management investments in the near term, the evolving risk environment is prompting banks to take a wider view of the discipline. Basel II, for example, already drives more transparent risk assessment across the organization.

Leading banks will parlay their compliance investments into a wider effort to embed ERM throughout the organization, drive a risk management culture and make risk a part of the everyday language of business management. For these organizations, effective risk management encompasses many facets, including the ability to mitigate surprises and losses, reduce risk expenditures by eliminating duplication across lines of business, align risk level with business strategy, optimize capital allocation, protect and enhance the firm's reputation, boost the efficiency of risk transfer and create value by rationalizing the interaction of risks across the enterprise and exploiting natural hedges.

*CROs say their most important tasks include the development of policies and procedures, the monitoring of risk and – critically – the development of an ERM culture.*<sup>8</sup>

In other words, leading firms are moving beyond compliance and transforming the risk management function into a full-fledged partner that provides value to the business. The goal is to achieve an integrated, comprehensive and strategic risk management program that embodies the following attributes:

- Covers all risks
- Is based on a portfolio view (especially for credit risk)
- Employs consistent processes, methods, reporting and systems across the firm
- Integrates internal and external reporting
- Implements centralized, consistent risk information.

*The top reasons risk managers pursue ERM are to align risk with business strategy, comply with regulations and optimize capital allocation.*<sup>9</sup>

To achieve this goal, banks must address the need for change on several fronts:

*Strategy.* For most banks, risk management is still not an integral part of business decisions. As a result, risk is inadequately reflected in business strategy and capital utilization. Aligning risk management with these critical areas – and moving beyond mere compliance to enhanced business value – will require an ERM culture that is based on relevant metrics and encompasses the entire organization.

*Metrics.* The vast majority of banks struggle to quantify the benefits of their risk management efforts.<sup>10</sup> By and large, banks lack the appropriate KPIs for assessing individual or business performance. CROs are rarely measured on performance and thus are not often held accountable. Developing the right metrics can enable banks to assess CRO performance quantitatively, based, for example, on how effectively they avoid losses or optimize the trade-off between risks and rewards.

*Organization.* Banks have largely settled on a model that centralizes control and policy-making and decentralizes execution and management. But many business managers do not fully understand or are not fully committed to risk management disciplines. In addition, many banks spend too much time gathering, cleansing and consolidating data, but not enough time analyzing and adding value to the data. While risk managers and line-of-business managers agree on the desired strategic role of ERM, the latter are more inclined to see risk management as an "as and when needed" function.<sup>11</sup> The challenge for banks, then, is to drive acceptance of ERM throughout the business units.

*Information.* Realtime risk information is lacking, unconsolidated or too aggregated. While there is great demand among business unit risk managers for automated, consolidated reports and "risk snapshots" as needed, few banks are able to satisfy it today. The ability to generate reports much more frequently, every day or even in realtime, would make risk management a much more flexible, powerful and valued tool for business managers. This desire crosses many risk management areas. For example, while banks typically provide market and counterparty risk reports on a monthly or weekly cycle, risk managers indicate they would like to receive them daily or even in realtime.

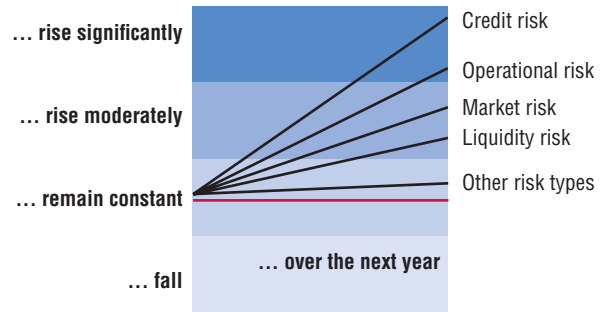
*Worldwide, over 66 percent of senior risk managers agree strongly or very strongly that the IT challenge of consolidating risk systems and processes is the main obstacle they face today.*<sup>12</sup>

There is also room for improvement in the area of process costs in credit risk management reporting. Not only is risk information very important, it is often very expensive to collect and manage due to inadequate organization and infrastructure.

*Infrastructure.* As shown in Figure 1, the demands of regulatory compliance are driving IT costs upward. As a whole, however, banks have failed to realize the full benefits of their IT spend and have dedicated insufficient resources to developing and improving risk management. As a result, processes, systems and capabilities remain fragmented or – worse – incompatible. An integrated risk management IT architecture with centralized data warehousing can deliver more efficient and effective reporting.

**Figure 1. Risk managers expect significant increases in IT costs over the next year – particularly for credit risk.**

IT costs are expected to:



Source: IBM Institute for Business Value analysis.

*Data.* Many banks operate using poor-quality data, so reconciliation costs remain high, as noted above. While regulatory changes have highlighted the need to improve data quality and to develop audit and control trails for risk management reporting, data management remains a significant barrier for implementing ERM strategies.

## The way forward

The challenges of driving risk management across the enterprise can seem daunting. But with the right strategic approach, banks can transform their ERM function, control costs and move toward making risk management a full-fledged, valued partner to the business units.

### 1. Measure risk performance to drive a risk management culture

For today's banks, moving beyond compliance to enhanced business value requires a firmwide ERM culture grounded in relevant metrics. This challenge is widely recognized among banking industry CROs. While 90 percent of respondents to the survey conducted by IBM felt that a strong risk management culture is important, only one-third characterized the current culture as strong.<sup>13</sup>

Improving knowledge and inspiring commitment across the enterprise requires tools for measuring business and individual performance. To drive the necessary changes, banks not only need to develop key risk performance

indicators, they must also implement processes and systems to monitor and communicate risk measures and integrate them into planning and budgeting activities.

Commitment, communication and prioritization are critical drivers of cultural change. With the right metrics in place, top management can show benefits as part of a communication program to improve the perception of risk management. Risk managers can also use measurements to reward and hold employees accountable for their results.

*“Risk is the mirror of the organization. Risk management provides the transparency that allows business managers to understand what they are doing and what they have done.”*

– J.A. Yanes, Managing Director, Grupo Santander

Fostering buy-in from the business units is critical, both in terms of driving ERM throughout the enterprise and collecting data from customer-facing parts of the business. One way to drive adoption of the risk management culture is to clearly communicate how ERM adds value for the lines of business. Representatives from the risk management group can advise the business units directly, helping them stay within their risk profile while realizing the benefits of ERM. The key is to engage in an ongoing dialogue, proactively assisting the business units with the decisions they face while continuously communicating how ERM leads to better decision-making, which, in turn, benefits the business units and the bank alike.

#### **ERM adds value to the business at Dexia**

**Benefits to the business:** Business managers at European bank Dexia benefit from the portfolio aggregation of risk capital inherent in ERM. Economic equity – which is the result of the benefits of diversification at the group level – is passed on to the business units by means of reduced capital charge. Managers see the benefit of being part of the group.

**Buy-in from the business:** Communication is an integral part of the objective of the ERM team, stressing the importance of explaining the benefits of ERM to the business lines. Dexia’s approach to economic added value is used to assess the performance of business lines across the group. The result is an ongoing dialogue. Risk management advises line of business managers by making proposals for best practices in risk management and advising which business classes will help improve their measurements.

#### **2. Improve data quality and availability**

ERM can only be as good as the data that underpins it. Thus, a major challenge for banks is to improve data quality by integrating data capture at its source. Like the need for a risk management culture, this issue is widely recognized among banking CROs: survey respondents cited data management as the biggest impediment to implementing an ERM strategy.<sup>14</sup> Not surprisingly, most firms are already investing in this area.

Effective architectures and infrastructures allow banks to integrate risk data from different business areas and provide consolidated reports, query functions and validation of KPIs. In addition, as banks adopt a portfolio view of the business (see *Manage risk across the enterprise*), a comprehensive data architecture can help top management balance risks across the enterprise while visibly funneling benefits back to the business units.

The risk data architecture should be driven by the demands of the business and should enable realtime report generation in the business context. Banks should integrate data capture and data definition standards into normal business systems and processes with adequate audit and control trails.

### 3. Manage risk across the enterprise

To be effective, ERM must satisfy three requirements. It must be integrated (spanning all lines of business), comprehensive (covering all types of risk) and strategic (aligned with the overall business strategy).

Thus, the key to building an effective ERM capability is to consolidate like risk management activities from across the firm, with a focus on efficiencies and benefits. Considering risk from an enterprisewide or portfolio perspective helps banks recognize the diversity of risks and mitigating measures and their effects on the enterprise risk tolerances. Portfolio management also provides a direct link between risk management and shareholder value.

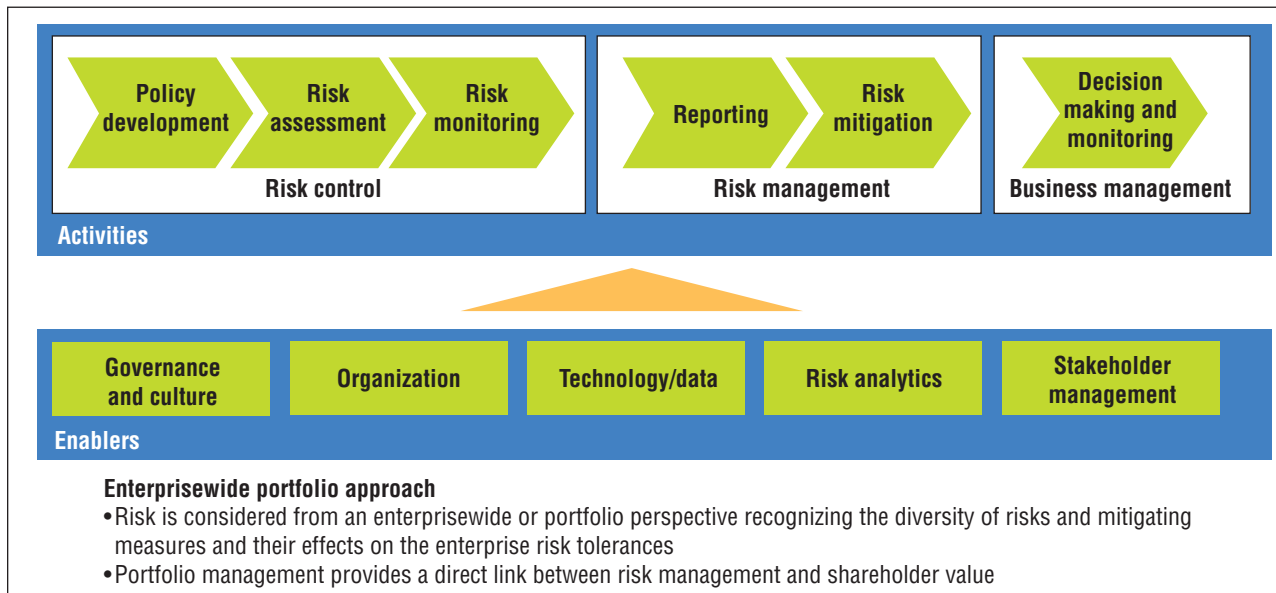
Driving fundamental change in the risk management function requires a comprehensive approach. Successful banks will implement a framework of activities and enablers – including infrastructure – for ERM. As shown in Figure 2, IBM has developed a framework banks can use

as a basis for designing fully integrated risk management systems and capabilities. The framework can serve both to assess the organization's current risk management efforts and to guide future development.

ERM begins with the development of a risk management strategy that is aligned with overall business goals. Policy development, risk assessment and risk monitoring should be based on the bank's overall strategy, the risks and potential risks it faces and the key risk indicators across the bank's units.

ERM helps lower the cost of risk transfer through a portfolio approach and through transparent management of overall risk. Reporting should be driven by a clear understanding of organizational policies and industry regulations, while risk mitigation should be guided by criteria for evaluating, responding to and transferring risk. Business management should focus on decision-making and monitoring, with an emphasis on risk reduction and avoidance, business controls and compliance.

**Figure 2. A framework can help banks assess the status of current ERM initiatives and guide future development.**



Sources: "Enterprise Risk Management Framework," Exposure Draft, Committee of Sponsoring Organizations of the Treadway Commission, July 2003; "Enterprise Risk Management, From Incentives to Controls," James Lam, Wiley Finance, 2003; IBM Business Consulting Services, Risk and Compliance Practice, 2004; IBM Institute for Business Value Analysis, 2004.

In addition to developing and implementing an ERM framework, banks should also consider partnerships with specialized third parties for some elements of risk management, such as data management. In the area of operational risk, banks can sometimes turn to third-party providers to gain valuable insights into the risk profiles (incidence data) of their peers.

Finally, banks can drive their ERM capability to full maturity by developing risk management as a partner with the rest of the organization in mergers and acquisitions, active portfolio management, pricing of complex products and other activities.

#### **Shifting priorities: The next three years**

According to the EIU survey, senior risk managers expect the top priorities of the job to change as ERM matures over the next three years.<sup>15</sup> While regulatory compliance will remain the chief preoccupation, other big concerns will likely shift away from the CRO's purview. Keeping the board of directors apprised of significant risk issues, for example, currently ranks as the second-highest priority, but CROs expect this aspect of the job to fall off precipitously as boards become more sophisticated in making risk decisions. Assuring business continuity is also expected to decline in importance – from the third-highest priority today – as system and process improvements enable business units to take on more of these responsibilities for themselves.

Other issues are expected to increase in importance over the same three-year period. According to survey respondents, monitoring and identifying emergent risks, extending risk principles to the wider business strategy and delivering an integrated picture of risk across the enterprise will all grow in significance as banks develop their risk management capabilities beyond today's relatively narrow focus on compliance.

As we have seen, ERM relies on a strong risk culture with senior executive support and a standard, enterprisewide technology and data platform. Banks can grow a robust risk culture through appropriate governance, communication and management of expectations, both within the organization and externally. An effective platform requires processes, technology and organization for capturing the data, analyzing the risks and delivering the required management information.

## **How will your firm deliver value through ERM?**

The three strategies outlined in this paper can provide your ERM organization with insights for delivering value in a changing risk environment. The following questions are designed to stimulate your thinking about issues that will likely arise as you consider these recommendations:

*1) Measure risk performance to drive a risk management culture.* To what degree is your firm's risk culture grounded in accurate metrics? How much "buy-in" does the ERM function enjoy from your firm's business unit managers? What steps can you take to more effectively communicate the benefits of ERM?

*2) Improve data quality and availability.* How much confidence does your organization have in the risk data it relies upon? How effectively does your bank integrate data from different parts of the business? How much lead time is required to provide risk reports to the business units?

*3) Manage risk across the enterprise.* How thoroughly do you understand your firm's risk exposure? What gaps must be overcome to achieve a full portfolio view?

For banks, developing an effective ERM strategy requires both short-term focus and long-term vision. Successful compliance with new regulatory demands will require enhanced governance and control frameworks. But compliance is only the beginning. In the longer view, developing risk management into a mature ERM capability will require a fundamental commitment to change.

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