

The Point

An *Outlook* Financial Services Publication

Crossing to Safety

High performance through risk management in the new financial services landscape

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A post-recession approach to risk

With the financial sector emerging from recession, governing bodies are formulating long-term plans to minimize future disruptions. While the specific requirements of such plans vary by country or region, the common threads include a focus on stronger governance, risk management, capital management and a closer alignment of international standards.

The impact of new regulations will be significant. Increased demands for operational transparency and more detailed information will require institutions to access audit-quality company data quickly to meet greater reporting and analytic demands. At the same time, stricter capital, accounting, liquidity and risk standards will compel many firms to carry substantially more capital. Many of these new standards may jeopardize business viability, forcing institutions to consider changes to product lineups, marketing strategies and operating models. They will need to find new ways of working across the company and determine how to minimize or offset the increased compliance and operational costs brought on by new regulations. And because most institutions lack a true enterprise approach to risk, many will find they need to develop new risk management capabilities to understand the full range of risks within the marketplace.

With these challenges come opportunities. For some, regulations may open up new markets or lines of business. For many, careful compliance planning can generate substantial cost savings. Companies that approach the new regulatory environment with a holistic view of the possibilities will be better positioned to achieve high performance in the post-recession world.

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As global financial markets exit the recession, governments and regulators are implementing plans to avert future crises. In many instances, these policies reflect principles recently formulated by the G20, regulators, government and congressmen to guide the global economy back to health and stability. Initial policy emphases include the following:

1. Stronger governance, risk and capital management
2. Increased transparency and closer alignment between risk and compensation across all levels of the organization
3. Convergence of US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), specifically concerning fair value
4. Increased capital adequacy requirements to ensure financial institutions can survive future market challenges

Not surprisingly, the economies most impacted by the recession—North America's and Europe's—have been the most proactive in addressing these changes.

Key challenges for financial services

The degree to which these new requirements will affect a given institution depends upon its scope and scale. It is likely that large insurers deemed "too big to fail" in the United States will be subject to more stringent financial holding rules, changes specific to the insurance industry and new rules covering derivatives. Likewise, many investment banks will be challenged by the dual imperatives of converting to bank holding companies while addressing new derivatives and hedge fund legislation. Large banks will need to maintain constant "stress-test" readiness while strengthening risk management and capital standards.

Beyond these concerns, there are other impacts that all financial services companies will feel as a result of the new regulations, regardless of size or scope. First, all institutions—including smaller banks, hedge funds and private equity firms—will receive increased demands for risk and financial

information from supervisory bodies and the marketplace. New rules tying compensation to risk will add to the volume of data companies will have to manage, necessitating changes to performance management processes across the organization. And all institutions will be expected to comply with requests for information quickly while being subject to greater oversight and a lesser degree of leniency in regulators' interpretation of the rules.

Financial institutions also face more stringent capital, liquidity and risk management standards. For instance, regulators in the United Kingdom recently implemented revised processes for reporting, governing and managing liquidity, and the United States is likely to follow suit. In many regions, such stringent capital standards will extend beyond the largest organizations to mid-sized firms. As a result, many institutions will need to hold more capital. In fact, nine out of 10 of the largest US bank holding companies were compelled to obtain an aggregate of \$74 billion in additional capital during the past 12 months to meet more stringent capital standards deployed by the government. This trend is likely to continue as new rules on Basel II and additional US regulations take shape, changing the execution of fundamental financial products and core business processes.

The preceding will result in a host of organizational challenges for financial institutions to comply with the new market regulations as well as a need to determine how to counteract higher compliance and operational costs. At the same time, the new regulatory landscape has resulted in a rare chance to be the first to improve key business processes and identify new market opportunities.

Four focal points for transforming risk

As the economy begins to stabilize, financial institutions should consider how they will respond to these challenges and translate new regulations into growth opportunities while offsetting the costs of compliance. Four key focus areas should receive the bulk of their attention in these efforts.

1. Corporate Strategy. Institutions should conduct a targeted, top-down business assessment identifying the affected areas of an organization's business model. The assessment should highlight recommended action steps, including but not limited to changes in business models, capital requirements and individual product execution standards. Given what's known about the regulations to be enacted, and the breadth of changes, many organizations are too compliance-focused in their analysis. To develop a comprehensive vision that glues together the regulatory changes while enabling an organization to seize marketplace opportunities, a focused group of corporate strategists, architects and risk professionals should be organized to define the strategic implications while ensuring regulatory compliance.

2. Corporate Data. Increasingly rapid access to high-quality data is the key separator between underperforming and high-performance businesses. Financial institutions must develop more robust data capture, storage and reporting systems. These will be essential to meet increased demand for more detailed exposure information and disclosures to meet new requirements and enable execution of complex analytics such as stress testing at increased levels of granularity across multiple portfolios and risk types. Solving this data problem with carefully designed enterprise systems can ensure that high-quality data on finances and operations can be quickly accessed to capitalize on emerging marketplace opportunities. The strategic opportunities and compliance activities must be assessed together. This will require more advanced analytical systems to enable fast, accurate reporting to regulators, support effective decision-making and meet more stringent risk management rules. In many cases, institutions will need to integrate and consolidate multiple point solutions, strengthen corporate security standards and redefine IT systems and other key business process controls and policies.

3. Risk Management. Banks must broaden and deepen their risk management practices to increase the scope of risks monitored, measured and managed. For example, modern risk practices where banks manage a robust, systemic process to incorporate risk-reward and risk-control information into business decisions are rarely in the scope of most bank risk management practices today. Based on the 2009 Accenture Risk Management Survey including 250 chief risk officers across the world, 85 percent of CROs confirmed the need to overhaul their approach to risk management if the lessons of the economic crisis are to lead to improved business results. More specifically, financial services firms noted that they must deepen their knowledge and analysis of those risks—traditional and new—that pose the greatest threat. They also need to enhance risk management data and stress test techniques for risks to enable better, faster management decisions. However, this will only work if risk management is positioned as an equally important practice alongside sales and marketing. Without significant cultural change, risk management will remain a compliance exercise, not a competitive differentiator.

4. Financial Management. New rules around accounting treatment, liquidity and capital will force companies to transfer many "higher-risk" instruments back onto the balance sheet, hold greater risk-adjusted capital and increase liquid reserves. Thus, organizations will need to strengthen their financial, capital and liquidity management practices, specifically around asset valuation, capital and liquidity forecasting and the use of risk management data. In doing so, their goals should be adopting a more forward-looking perspective, as well as identifying deeper reserves to support future downturns and provide greater balance sheet strength.

High performance in a changed landscape

A common thread running through all the preceding focus areas is people. To be successful in transforming an organi-

zation to meet the new requirements means companies must ensure all employees understand, comply with and make the most of the new rules. Institutions must enhance employee training activities, management of compliance exercises and focus on retaining and developing the right talent and skills to seize competitive advantage from the impending changes. Such efforts are vital to an institution's ability to transform and have the changes take root.

Importantly, leading institutions will not simply approach the new regulations with a "compliance-only" mindset. Rather, as part of their substantial efforts to meet new regulatory requirements, they are identifying and working to capitalize on myriad opportunities for cost savings—for instance, by streamlining their analytical capabilities and lowering their cost of capital as a result of improved risk profiles. These savings are a major benefit at a time when reducing operating expenses is still a significant concern for financial services companies and many organizations are facing increased liquidity demands.

With most observers agreeing that the worst of the recession is now behind us, companies are cautiously planning ways to reignite growth. They will need to consider how best to grow within the confines of the new business environment shaped by regulatory reform efforts.

There is no doubt that emerging regulation in Europe and North America will generate challenges for financial institutions and may even threaten the viability of some. However, the changing marketplace also presents a compelling opportunity to be first to market in implementing process improvements and identifying opportunities arising from new regulations. That is why forward-thinking institutions are getting a head start. They are defining a vision for how reform will affect all aspects of their business. They are planning proactively for the coming changes to enable smooth, immediate compliance with the new regulations. They intend to grow profitably and achieve high performance in the post-recession world.

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