RETURN ON RISK MANAGEMENT
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The global financial crisis revealed major risk management deficiencies across the banking industry. Governments and regulators have responded by imposing much tighter controls on banks. For their part, banks have voluntarily taken many steps to reduce risk and to better manage it, recognizing the damaging effects of poor risk management that were underlined by the crisis. One of the regulatory changes with the most impact has been a very substantial increase in the safety margins of capital and liquidity and the way minimum capital and liquidity requirements are calculated; which came with a significant cost through reduced returns on “balance sheet” activities, and made risk management central to any business strategy discussion respectively.

The new rules have also imposed operational costs on banks. Some are one-off project costs incurred in building the processes required to comply with new regulations. At least $50 billion\footnote{‘Streamlining Risk, Compliance and Internal Audit’ 2015, Oliver Wyman Celent} will be spent on such initiatives this year alone. Others are on-going expenses associated with enlarged Risk functions, which now account for about 4% of the operating costs\footnote{‘Managing Complexity, State of the Financial Services Industry’ 2015, Oliver Wyman} of an average US or European bank.

As investment in risk management increases, so the value of this spending becomes an issue of greater importance. A bank is legally required to comply with new risk regulations, of course, but the way it achieves this operationally and what further uses it makes of “compliance processes” are at its own discretion. This is not just a regulatory issue but a matter of commercial logic. Perhaps it should spend the bare minimum to comply with some regulations, and it should go well beyond what regulators demand in other areas, investing heavily in risk management to gain a competitive advantage. The regulations themselves do not answer these questions.

The senior executives of banks need to think about their risk management investments strategically, as they would about any important activity. Many aspects of risk management activity may not be optional in the way that a derivatives trading business or private banking division are, but the logic of return-on-investment still applies to each and all risk management investments.

Both inseparability of the risk function from bank strategy and the growing importance of investments in the risk function elevate the Chief Risk Officer’s (CRO) role and require broader competencies.

This Oliver Wyman Perspective gives the authors’ view of what it means to think strategically about your approach to risk management, both in theory and in practice.
1. A FRAMEWORK FOR INVESTMENT DECISIONS IN RISK MANAGEMENT

From assessing capital requirements at the bank level to approving decisions on loans or other transactions, both stochastic and stress scenario based risk assessment play a central role in decision making processes. A way to think about return-on-investment in the Risk function depends crucially therefore on the value of the risk assessments it delivers. Economics and management science long ago established the core principles of discretionary investment in information. In essence, the value of information is equal to the probability-weighted increase in net worth as a result of making better decisions using the additional information.

In risk management for banks using stochastic approaches, this value depends on five primary variables: the size of the exposure, measurability, the potential for improved accuracy, the extent to which the assessment can be used to improve actual decisions, and the cost of obtaining and using the information.

The most obvious driver of return-on-risk investment is the materiality of the risk exposure or, put another way, the cost of getting risk assessment wrong. Complex banks face many different types of risk from thousands of different risk sources, so some sense of prioritization is essential if a Risk function is to avoid boiling the ocean and giving insufficient attention to the key areas of vulnerability.

However, the size of exposure is just the starting point and the complete probability distribution of potential losses matters for risk assessment. Put simply, both expected losses and unexpected losses at various confidence levels warrant robust risk analysis.

For risk assessment to have a large value, it must also be possible to significantly improve the bank’s understanding of the potential for losses. Money spent to gather additional information that does not help in enhancing the assessment of risks and probabilities cannot be justified unless required for compliance. Some risks, such as consumer portfolio default
risks in mortgages or auto loans, are much more amenable to risk analysis than others, such as low default portfolios of sovereign bonds. A large homogenous portfolio of loans might merit a simple actuarial analysis to assess the portfolio risks under various conditions. A more heterogeneous portfolio might warrant the creation of more detailed models that can finely discriminate along a spectrum of risks and which react as the portfolio composition changes. Some portfolios might benefit from a combination of models and expert overlay, but the key point is to ensure that each layer of the process is adding to the power and accuracy and not just to the cost base.

The fourth criterion determining the value of information is how an improved assessment will change decisions. Information is only valuable if it generates better decisions. The magnitude of the potential for better decisions is driven by the first three criteria, but the actual value also depends on the bank itself. For example, a bank that cannot feasibly change its customer base or lines of business, perhaps because it is restricted by regulation or branding or organizational inflexibility or lack of commitment or leadership or poor delivery, can gain some advantage from risk assessment on a case-by-case basis but has less strategic use for such models. It will thus get less return from investments in risk assessment than a strategically flexible bank with a strong management team.

Finally, the cost of gathering the additional information must be lower than the benefits. It is worth emphasizing that this balancing act affects where the money should be spent, in addition to how much is worth spending. For instance, the approach of “three lines of defense” is now becoming popular within banks but too often they do not conduct a real analysis of the return-on-investment when considering strengthening one line versus another.

A Risk strategy is inseparable from the broader strategy of the bank. The size of risks, how accurately they can be measured and the uses to which risk assessment can be put vary with lines of business, customers and regions. How much should be invested in which parts of risk management thus depends on a bank’s broad strategy. At the same time, the merits of any broad strategy depend in part on the risks it involves and how well they can be managed: that is, on how variable, material and measurable they are.

Deciding on a bank’s overall strategy and making the right risk-return decisions within the risk appetite of the bank must be thought of as solving simultaneous equations. Luckily, a good Risk department is endowed with the right type of analytical resources to tackle such difficult problems in a disciplined fashion and to lead the other functions involved in risk management. In addition, strategy and risk functions have been working much more closely since the global financial crisis.

Regardless of the overall strategy, however, the return-on-risk management can only be optimized through a sound and detailed analysis of the major types of risks, their probability distributions, the possibilities for improving a bank’s understanding of the probabilities, and an overall approach that maximizes the flexibility of better execution based on better information. These steps require structuring of a robust framework, excellent databases and information technology, analysis and comparison of multiple scenarios, the incorporation of
expert judgment from within and outside the bank, efficient organization of the bank, a focus on results and flexible responses to a changing world, and a sound and well understood overall strategy for the bank.

Optimizing the strategy and the allocation of risk management resources also requires excellent coordination between the Risk and Strategy functions, and indeed between them and other key areas such as the Finance function.

2. WHAT DOES THIS MEAN IN PRACTICE?

A. THE ROLE OF THE CRO

The inseparability of Risk strategy from bank strategy means that the CRO must have a seat at the top table. This does not just mean that the CRO should be a member of the executive board, which is largely the case already post-crisis. It means that he or she should be a principal contributor to formulating, challenging and refining the bank’s strategy.

Many banks are now working on a new vision. The CRO should be part of the core team since he or she is able to explain what a strategy will mean in terms of regulatory and economic capital costs, liquidity requirements, earnings volatility and reputational danger. No one is better positioned, in short, to make sure that the strategy is consistent with the desired risk profile of the bank.

The US is a step ahead of Europe and the Asia Pacific region in this regard. The demands of the Federal Reserve’s stress test process, known as CCAR, have forced US bank boards to be much more engaged with risk management, including the articulation of a bank’s risk appetite. The Risk function is crucial for helping Boards to make such choices as well as in evaluating bigger strategic issues around organic and inorganic growth and dealing with financial resource constraints arising from the expanding regulatory requirements for capital, liquidity, leverage and collateral.

Besides understanding the risk implications of any strategy, the CRO will understand its implications for risk management. The CRO is best placed to understand if the bank is equipped to manage the risks presented by any strategy. He or she can explain what the strategy will mean not only in terms of earnings volatility but in terms of the need for increased (or decreased) spending on Risk management, including the risk-related burdens on front office staff. The CRO might also take the view that no amount of spending will bring the risk under a sufficient level of control and thereby recommend that a proposed strategy be rejected.

B. GETTING OFF THE HAMSTER WHEEL

Alas, the upheaval of the post-crisis years means that not all CROs are in a position to fully play this role or have time to think strategically about spending in their own division. Many Risk staff, including the CRO, are still overloaded with tasks assigned to them from
outside the bank. Spending has sometimes been guided by the imperative to comply with new regulations rather than by a strategic vision, either for the bank or for the Risk function.

Understandable as this is, it will prove wasteful over the long run as short-term fixes usually prove to be under- or over-investments. Worse, a strategically inattentive CRO may allow the bank to take poor strategic decisions and may fail to invest in those parts of the Risk function that will be most important given market developments and the bank’s strategic direction.

CROs and their senior team need to get off the compliance hamster wheel and give a material portion of their time to strategic matters. This might require increasing the number of senior staff in Risk functions. Given the current low bank returns and the squeeze on costs, this may seem difficult. But the commercial case in some banks is likely to be strong. The cost of poor risk strategizing far exceeds the modest increase in staff costs required.

C. A LEADERSHIP MINDSET

CROs must not think of themselves as the most senior “analytical type” in the bank but as a leader with as much influence on the bottom line as C-suite peers. The CRO must step up to provide the strategic thinking as it relates to the bank’s risk profile and broader business activities, if they are not already doing so.

To do this effectively, we believe CROs need four broad competencies:

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<tr>
<th>BASIC RISK SKILLS</th>
<th>The CRO might not perform day-to-day risk tasks, such as risk measurement and monitoring. But they must have a good understanding of them and of any methodological innovations adopted within the Risk function. In short, the CRO needs to understand the detail</th>
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<td>BIG PICTURE</td>
<td>The CRO must understand the risks incurred in the banks’ various lines of business and their interactions. This requires an understanding of the key economic drivers of profit and loss in all the major business lines. This will allow them to advise the CEO and business heads on risk-return optimization and strategy</td>
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<td>COMMUNICATOR AND MOTIVATOR</td>
<td>CROs and senior risk officers cannot play their strategic role unless they are effective communicators, something that has not traditionally been considered an important skill for Risk staff. They also need a motivational management style that encourages collaboration. This is crucial for shaping the risk culture of the bank</td>
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<td>TECHNOLOGY WIZ</td>
<td>Technology in risk management (and the rest of banking) is progressing rapidly. An effective CRO will take a keen interest in these developments, looking for opportunities to improve risk assessment and process efficiency. They will exemplify the enthusiasm for technological advance that is expected in his staff and peers</td>
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3. START WITH A REVIEW

Too often, risk management is seen as not contributing as much to the bank as it could. Investments are being driven at least partly by a desire to comply with new regulations as quickly as possible, with not enough consideration being given to the returns on those investments. In the rush to comply, money can be misallocated due to a focus on the short term with insufficient attention to the longer run.

The first step towards gaining strategic control of risk management is to conduct a review of strategic initiatives and operational enhancements as well as spending on risk management across the bank (and not just in the Risk function itself). Does the allocation of spending conform to the framework laid out in Section 2 above? Is the bank spending on risk exposures where it will get the greatest return? Is there an opportunity to rationalize the array of different change programs that are often underway in the bank? How can the bank leverage compliance processes for better risk/return management? Such reviews are very likely to reveal areas where less should be spent and others where more should be.

Regulatory and industry developments following the crisis clearly have been promoting risk management; however, effectively managing Risk functions is tough these days. If they are not already, CROs need to become strategic leaders of both the Risk function and the bank.
Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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