RISK FUNCTIONS AT BANKS AND INSURERS MUST BECOME MORE AGILE

FINANCIAL FIRMS' RISK MANAGERS NEED TO MAKE AGILITY A KEY PART OF THEIR AGENDA

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Large, long-established firms find it hard to change. That's okay in a stable business environment when you've got time on your side, but when things start to change quickly in the external market, it puts your organization at risk. Hence, the current fixation with "agility."

Rapid advances in digital technology, changing customer behavior, competitive forces, and new regulations threaten today's established business models and require companies to change at speed. Large-scale businesses need to find a way to change their processes, organizations, and people at pace on an ongoing basis. Nowhere is this need more pressing than in the financial-services industry, which must contend not only with the "digital revolution," but also with an unending stream of innovation and new regulations.

Financial-services firms are responding as one might expect: Many have started ambitious programs to become more agile. One critical area, however, remains a notable exception: the risk functions of banks and insurers. Most have changed over the past 10 years, driven primarily by regulatory demands. But a rise in regulation-based rules and controls has inadvertently reduced the agility of organizations. In some, the risk function has even become a "choke point" to agility.

SCENARIOS FOR THE FUTURE OF RISK

For decades, the risk profile of a financial-services firm was relatively predictable. An economic downturn might push credit defaults to unusually high levels. Market prices might move against an insurer's investment position. A rogue trader might defraud a bank of hundreds of millions of dollars. These are the kinds of risks that risk functions have been working on, guided in part by regulation and in part by experience. In banks, for example, if you wanted to get ahead in risk you worked in the credit division because that was the main risk the organization faced. It was just the way it was.

No longer.

For today's risk functions, their previously perceived "second-order risks" have become the primary concern; cyber risk, conduct risk, operational risks, and strategic and business model risks are occupying the agenda. Risk functions need to reassess which risks they will need to measure, how to manage them over the coming years, and the implications, both analytically and organizationally.

Consider the following two scenarios. In the first, life is made easy for incumbent financial firms: Economic growth is revived; technological progress is slower than expected; regulation continues to limit cross-border competition and becomes more onerous for new fintech entrants; customer attrition remains low; and substantial new risks do not materialize.

In the second scenario, established firms face fundamental challenges: Economic malaise persists; technology advances faster outside financial firms than inside them; a shift to regulatory harmonization reinvigorates globalization and new entrants; customers embrace digital far beyond projections; and the relative importance of various risks changes rapidly.

The risk functions suited to these two scenarios look completely different. In scenario one, risk functions largely retain their current structure and adopt new technologies where suitable. Risk management capabilities remain in-house, and there is only a limited reduction of resources over time. In scenario two, risk functions will undergo a radical re-build. Risk management systems and analytics will be outsourced. Risk leaders will focus on governance tasks, methodology control, and third-party management. In this scenario, the headcount in the risk function may be reduced by as much as 60 percent to 75 percent, with a much heavier reliance on specialist third-party providers.

These are just two scenarios. Actual events are likely to unfold differently in various ways. But the simple fact that change as significant as this second scenario is in the cards means that risk functions must be able to cope with change that is rapid and meaningful in scale. This means that the risk function at financial-services firms needs to change how it performs its role and the framework by which risks are managed.

Risk managers know this. Our recent surveys of chief risk officers of leading European banks and insurance companies showed that most are concerned about their organization's ability to adapt quickly enough. They understand that good risk management can no longer rely on rigid methodologies and processes. They accept the notion that risk functions must be agile. But where should they start?

"AGILITY" FOR THE RISK FUNCTION

The concept of being "agile" in business first emerged in IT, where people began to realize they needed an alternative development approach to a "waterfall" that allowed maximum flexibility and the ability to adjust quickly to customer feedback. This echoed other leadership concepts, for example, the "commander's intent" approach in the military is based on high levels of delegated authority and flexibility to what happens on the ground rather than traditional decision making. The details differ in each area of application, but its essence remains the ability to create or react to change quickly and efficiently.

The risks faced by financial firms and their relative importance are not constant. Over recent years, for example, non-financial risks – cyber, conduct, and legal – have increased considerably. Yet relative to traditional credit, market, and insurance risk management, the resources devoted to such non-financial risks have changed little.

Risk functions should take a more forward-looking approach to risk identification and measurement. (See Exhibit 1.) Rather than relying largely on historic data, agile risk functions place a greater emphasis on what is coming, prompting the need to change both their own risk models and the way they work as a function. Advanced scenario analysis is currently the best way to incorporate variable and changing risk factors into loss forecasting. As part of our research into what we call "scaled agility," we observe that most institutions now use stress testing in their internal planning processes, but few apply it to the full range of tasks where it has real value, such as risk identification and credit decisions.

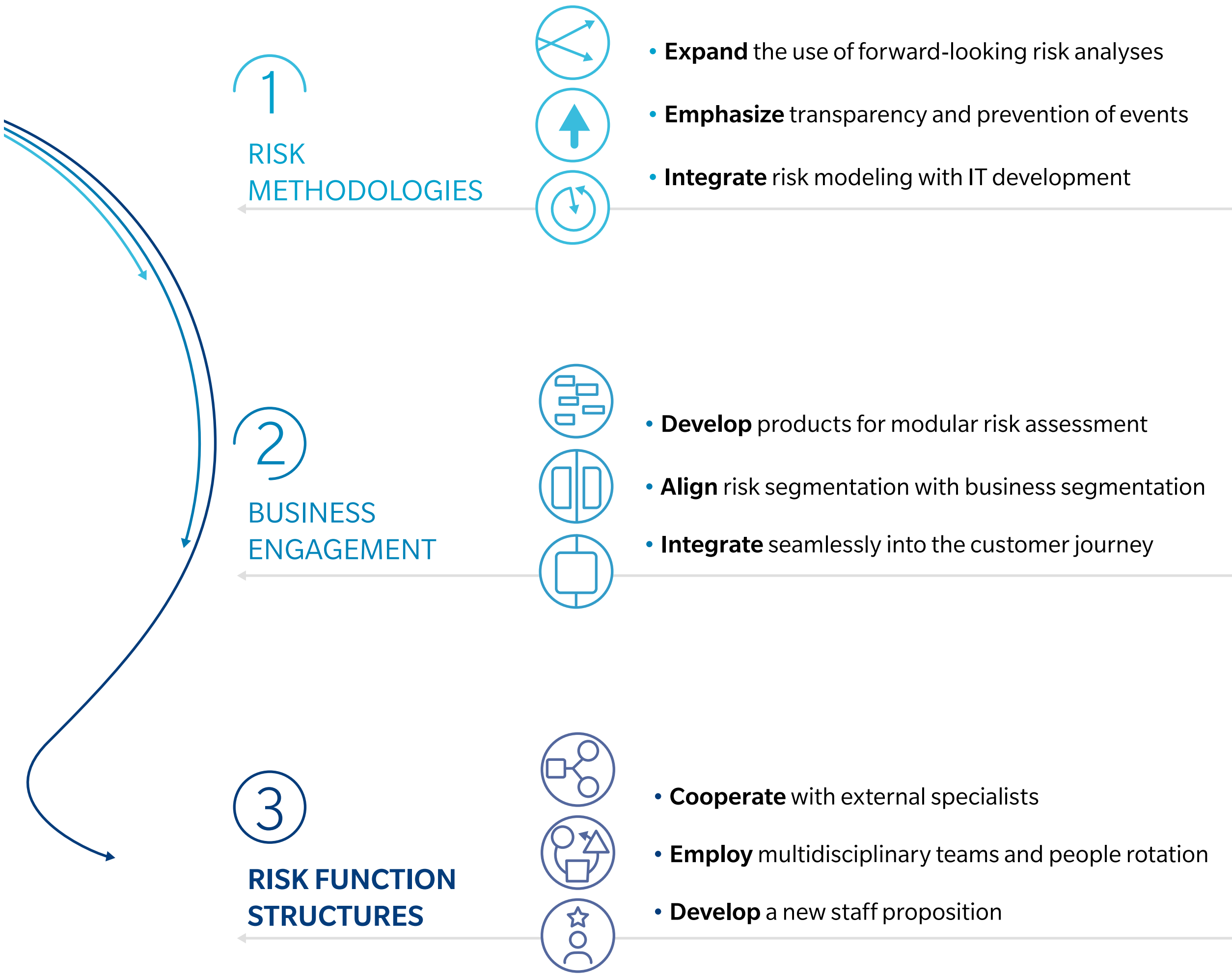
Agile risk functions also help the organization act quickly to prevent or mitigate losses. They work with senior managers to set the firm's risk appetite, and create early-warning triggers and escalation mechanisms to increase local decision-making authority while retaining transparency.

This requires the risk function to have timely access to as much relevant data as possible, from both internal and external sources. To this end, leading institutions are working to improve the interface between risk functions and their firms' wider data systems. For example, they are more closely integrating risk model builders with IT developers and ensuring that they use the same coding language.

Risk functions must respond not only to a changing risk environment, but also to changing commercial imperatives. Customers' expectations for the speed and ease of transactions keep rising, in

EXHIBIT 1: RETHINKING WHAT IT MEANS TO BE "AGILE" AT FINANCIAL FIRMS

Risk functions need to shift their operating models across three fronts to increase flexibility



Source: Oliver Wyman analysis

financial services and elsewhere. Risk functions need to help reduce friction in the customer journey. Right now, this means minimizing the data demands on customers (for example, by using publicly available data wherever possible) and making risk assessments as quick, transparent, and transferrable as possible. In the future, new demands are likely to arise. Meeting them quickly and efficiently will require agile working practices.

RETHINKING OPERATING MODELS

In risk functions, as elsewhere, this means re-thinking the operating model in several ways:

First, agile risk functions will have a best-of-breed network of specialist third-party providers who supply focused expert reviews or analyses. Traditional risk functions typically undertake all key elements of the risk management in-house.

In an agile environment, this is both expensive and sub-optimal. In many areas, third-party providers are quicker, cheaper, and more effective providers.

Agile risk managers are trained in more than one thing. Especially at a senior level, risk professionals have consciously developed a broader skill set and avoid silo-thinking. Staff members are rotated through a wider range of roles and work closely with staff from other functions, such as IT, finance, and compliance. A leading European bank is experimenting with this concept by differentiating staff between "base camp" teams, who perform day-to-day credit assessments, and "mission" teams, who develop new models.

Agile risk functions need people who are adaptable. They must be able to think through the business implications of risk management and provide content based on challenges to the wider business. That means they must have a hunger to learn continuously and recognize the value of cognitive and skill diversity within the team. The days when 70 percent of a risk function's work came from a single risk type are fast disappearing. Agile risk functions will be changing their recruitment, development, and leadership models accordingly.

One key aspect of these changes that needs to be considered in parallel is the wider governance model of an organization and how decisions get made. The agile practice of making decisions fast, even with limited supporting evidence, and releasing new products as "beta versions" is hard to replicate in a risk function, given the requirements of regulators and shareholders. But that doesn't mean improvements are impossible. Risk functions need to get ahead of the agility imperative: Which decisions need the "full" governance process and which ones can be fast-tracked? Most organizations are still applying a one-size-fits-all approach to decision making. Local empowerment and more flexible escalation mechanisms are critical. If speed is of the essence in the new reality, then speed of decision making within a formal governance model needs to be reviewed and challenged.

THE UPSIDE OF AGILITY

The scale of benefits from developing agile practices in risk functions is hard to predict with certainty. What we can say is that research in other areas reveals improvements of 50 percent to 75 percent across a range of performance drivers, such as the time required to respond to new operational requirements, the speed of strategic decisions, and the success in change management. There is no reason why such gains shouldn't be achieved in risk management as well. For example, we believe that an agile risk function could cut credit decision-making time by half or more, and that the agile organization of staff, external providers, and new technologies could result in a reduction of the size of risk teams by more than 50 percent.

Risk functions are rightly cautious in their estimates of risk and in the advice they provide business lines. That's their job: They're paid to be cautious. But rigid ways of working are not required to produce cautious output. On the contrary, an inability to adapt quickly will increase the chance of nasty surprises and of slipping behind competitors in customer targeting, product design, and risk pricing.

Rapid change in the business environment puts risk functions in the same position as other parts of financial firms. The agility imperative is upon us. Risk functions need to get agile.

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