Stand out for the right reasons
Facing the future of Risk

How financial services firms can get risk-ready

July 2015
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Financial Services businesses rise, fall or run on the spot by their ability to price and manage risk. Unlike almost any other sector, their business is risk. Manage that risk well, and they take their opportunities and grow, confidently and responsibly. Do it badly and they boom and bust, stagnate, or cause more pronounced shocks to the real economy.

But now, just as firms need risk management to deliver, they find it battered, bruised and defensive. Risk management needs to change. But for that to happen, the risk managers need to come out from their silos and reinvent themselves as partners of the rest of the business. Only then will risk management become a discipline that everyone builds into their work.

Firms are starting to realise this. They’re asking us for our view on what the future of risk looks like. Here, we’ve set out what we think. If you agree or don’t, why not tell us what the future of risk looks like from where you’re standing.
Risk management has to change. For the good of business, and for the good of the economy.

Risk itself is always changing, and for risk management to protect the business it must anticipate that. So if trouble strikes, then wherever it comes from, the business is in good shape to fend it off and bounce back.

Strong risk management starts with a progressive strategy – where risk and commercial performance go hand-in-hand. But change can only be driven from the top and must filter through the entire firm. Too often, though, we see risk management still in crisis mode, focusing on compliance and the past, not looking into the future. A recovering economy needs resilient, competitive businesses which know which risks to take, how to manage them efficiently and how to cope if they materialise.

For a financial services firm, risk is a fundamental part of business. Their core role is to charge clients to take on risk and pay less to transfer it to investors while managing anything that's left over. So it should be fundamental to decision making, alongside the reward on offer. And it shouldn’t just be left to people with ‘Risk’ in their job titles. It’s a discipline, a way of thinking, which everyone across the business must bring to what they do.

For that to happen, firms need an approach to risk management that truly understands the threats and opportunities faced by the business. And to bring this vision to life, we believe it needs to embrace five new ways of working:

- **A fully switched on risk strategy**
  Broadening the scope of risk management to adapt to fundamental changes in markets, business models and transaction economics as well as recognising new types of risk.

- **Moving the risk function from gatekeeper to partner**
  Taking a more significant role both in business strategy and day-to-day decision making.

- **A fit-for-purpose risk and control operating model**
  Removing inefficiency by bringing risk back to the basics:
  - Who owns the risks?
  - Who owns the controls?

- **A more connected view of risk across the business**
  Working across teams and disciplines throughout the bank to get an overall view of risks facing the business and put these in the context of both the broader corporate strategy and those working on individual transactions.

- **Being faster on its feet**
  Using technology and people to see risk coming, contain it early and adapt quickly. Skills are required to handle not just credit market, operational and liquidity risk, but other kinds, like cyber, reputational and geopolitical risk.
Coming out of crisis mode

Risk management as a business discipline has been through the wringer since 2008. The financial crisis shook many of the fundamental assumptions about the materiality of risks. It exposed firms who were taking too much risk and underlined the fact that the true level of risk wasn’t transparently communicated at the top. The financial crisis itself was only the catalyst for this – since then rogue trading, technology failures and reactions to global politics have continued to shake these principles to the core.

The years since have been about steadying and restoring businesses rattled to their foundations. In the process, risk functions have focused on regulatory compliance. Nothing wrong with compliance, of course. But that focus has come at the expense of the far-sightedness that really creates value for the business.

Firms have learnt two big lessons from the last financial crisis: new risks which banks either hadn’t spotted or couldn’t manage have turned out to be important; and the essence of good risk management is challenging returns which seem ‘too good to be true’.

Delivering risk management more effectively needs firms to have more clarity about the complexity, interlinkage and breadth of risks they face. Importantly they need to put their head above the parapet and understand the risks that are coming but also look at themselves and understand those which are created by their business. This means embedding risk at the heart of their strategy, driving the right risk culture and fixing weaknesses in their operating models.

External entities introduce risk

Risk is a combination of internal and external factors

Internal entities introduce risk

**External entities** introduce risk

<table>
<thead>
<tr>
<th>Clients</th>
<th>Competitors</th>
<th>Market infrastructure</th>
<th>Regulators</th>
<th>Geopolitics</th>
<th>Criminals</th>
<th>Innovation/disruption</th>
</tr>
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**Risk is a combination of internal and external factors**

<table>
<thead>
<tr>
<th>Strategic risk</th>
<th>Model risk</th>
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<tbody>
<tr>
<td>Market risk</td>
<td>Credit risk</td>
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<tr>
<td>Conduct risk</td>
<td>Booking risk</td>
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<tr>
<td>Reputational risk</td>
<td>Rogue trading</td>
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<tr>
<td>Concentration risk</td>
<td></td>
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<tr>
<td>Funding/liquidity risk</td>
<td>Geopolitical risk</td>
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<tr>
<td>Pro-cyclical risk</td>
<td>Staffing risk</td>
</tr>
<tr>
<td>Capital risk</td>
<td>Technology risk</td>
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<tr>
<td>Compliance risk</td>
<td>Cyber risk</td>
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</tbody>
</table>

**Internal entities** introduce risk

<table>
<thead>
<tr>
<th>Business strategy</th>
<th>Policy</th>
<th>Governance</th>
<th>Organisation</th>
<th>People</th>
<th>Processes</th>
<th>Analytics</th>
<th>Systems</th>
</tr>
</thead>
</table>

There are more external and internal sources of risk than before

The impact of internal failures has become more material

The second and third order impacts are both greater and harder to predict
To compete, firms need their risk and control functions to join the dots between risks faster by looking beyond the usual credit, market, operational and liquidity risk silos and harnessing technology for more rapid insight. As the economy recovers, it’s this ability to spot emerging risk early and deal with it while it’s still manageable that will create a firm base to grow from. The firm that knows the right risk to take is the one that stands the best chance of thriving. A reinvigorated approach to risk management is at the heart of that.

The core role of risk management is to:

- **Alert** the business to emerging issues
- **Protect** it from downside
- **Repair** it after problems
- **Adapt** controls and processes to do a better job of alerting and protecting in future

To make sure it can continue to do this, the business needs to:

- Have a fully switched on risk strategy
- Be moving the Risk function from gatekeeper to partner
- Have a fit for purpose risk and control operating model
- Be more connected across the business
- Be faster on its feet
What better risk management looks like

A fully switched on risk strategy

The world of risk is changing. As well as traditional financial risks, the spectrum of material risk now has cyber, reputational and geopolitical risk to deal with. These risks have existed for some time but have evolved in recent years as megatrends such as globalisation and digitisation have made them harder to manage and hit firms harder. Examples include the current Eurozone crisis, the loss of the Swiss Franc peg against the Euro and high-profile reputational impact of IT failures in retail banks. And business itself is changing too. Market dynamics are evolving, transaction economics are changing and business models are adapting.

So the firm’s risk management framework must respond to change around it. That means broadening its recent focus on regulatory compliance. The new engines of business – electronic sales channels, automated transactions, big data – provide opportunities to innovate products and services, price better and execute cheaper. But only if risk management is fully switched-on.

A practical example has been a bank’s strategic investment in low margin, high volume products where, given the limited value of each contract, risk appears minimal. However, incentive structures drive concentration in high-performing industry sectors and reliance on technology for client access. Subsequent system outages, coupled with a lack of client diversification amplify the financial impact of operational and reputational risk eroding any margins.
Change here means evolving from a largely reactive gatekeeper function to being at the heart of the business’ strategic direction and day-to-day commercial decisions. It means keeping eyes open for chances to be innovative with tools like analytics, which give insight into emerging risk. In other words, both the business and control functions can become more adept at spotting the downside as well as the upside.

Effective risk management is about recognising that risk evolves throughout the business lifecycle. That means giving firm, positive guidance on transactions, whether it’s a mortgage application, a multi-million pound derivative trade or a life product. It means influencing the strategy that shapes the business’ portfolio and defines its position on new products and new markets. It means helping to form an overall view of what customers mean to the business – the risk and the reward taken together. And it means making sure the business and its systems are ready for the expected and the unexpected.

Still risk professionals mustn’t abandon the good sense behind their wise counsel. In their eagerness to win customers, firms can go too far and offer too much. Going out on a limb to win business is partly what created the crisis in the first place. So risk management has to keep the ship steady but also help keep it on a clear, decisive course. This all points to a more strategic role at the heart of the business, where it can be more influential.

As an example, risk and finance should be more proactive about articulating the economic benefit of business activity, particularly with respect to components such as regulatory capital. Current limit frameworks, short-term incentives and allocation mechanisms drive behaviour which has poor long-term economic benefit. This can be seen in banks’ approaches to deleveraging where Non Core portfolios are designed to provide short-term capital relief but, in many areas we’ve seen, can fail to recognise sufficiently the long-term benefits to the rest of the business.

Moving the risk function from gatekeeper to partner

The traditional three lines of defence model describes the key responsibilities in relation risk management. This approach was adopted by the FSA about ten years ago, but since then there has been a lot of change in Financial Services. Risk management in financial services firms, while hanging off this model, has often grown organically and needs to be reassessed.

In addition to this, globalisation and alternative sourcing has helped drive down cost but increased levels of operational risk. In banking, the regulatory agenda around too-big-to-fail is also undermining these programmes, leaving firms stuck in the middle of conflicting geographic and legal entity booking model strategies.

The model itself introduces inefficiencies, for example shadow control functions, as organisations struggle to effectively respond to change. It also blurs responsibility leading to challenges with accountability and escalation of costs. Financial services firms need to re-think their end-to-end approach to risk management and get back to basics: who owns the risk and who owns the control?

At its heart this means challenging the validity of the three lines of defence and challenging the firm’s operating model with respect to risk management. Current organisational constructs which, despite similarities, have evolved differently across the industry are becoming old and inefficient. Duplication of responsibility and multiple control functions have led to risk falling through the cracks. Inefficient processes create less transparency and make the business hard to control. Taking the first steps to overhaul the operating model can drive large efficiencies for minimal investment.
Having more influence means seeing beyond the silos of market, credit, operational and liquidity risk. That will give the firm a better view of tomorrow’s risk and how it affects not just compliance but the business’s strategy and vision. The key to this role is making sure risk strategy, processes and infrastructure are better connected across the business.

If the business does take a financial hit, effective risk policies, processes and teams can help contain the damage and shorten the pain by ensuring there is a concerted approach to business restructuring, external response and strategy. Focusing on event risk and managing fall-out might be new to risk teams, but in a business driven by risk there’s no hiding from them.

Financial services firms can learn significant lessons here from other industries where ‘wargames’ or crisis simulations are required training for senior executives. The industry has started to adopt these principles through reverse stress-tests and default fire-drills but there’s much further they can go. This has helped FMCG firms understand how to react more competitively to price wars and reduce the fallout from reputational shocks.

This has created more resilient IT infrastructures in software companies through the use of whitehat hackers and penetration testing. The same concepts will support financial services firms both with respect to the reputation and cyber risks they face, but also managing crises involving rogue traders, market infrastructure failures and economic shocks.

As well as this, a connected business and control function can help internal audit make sure repair is thorough by checking that ‘fixes’ do all they promise.

Financial Services firms do business in real time. So risk management needs to become more automated to mitigate any losses quickly and stop them becoming serious. The risk and control functions need to be part of crisis management to limit any damage along with the business. And they need to help the business anticipate downsides to future, not just current, risk. That’s all part of making firms more resilient, so they can cope with more and recover faster.

Risk must stay ahead of the curve, anticipating not only the range of potential risk and how to deal with crises when they happen, but also the second and third order impacts. These secondary events could be the catalyst for disaster.

The technology exists to monitor and manage risk in near-real time with significantly more automation. Few firms have made significant headway towards embracing it, but those that have will dominate markets.

It’s started happening in some firms. One leading global bank is using analytics and pattern recognition to link data from different sources to help spot the next rogue trader before they do damage. This involves monitoring large quantities of data from across the business in near-real time. But others still work with simple rules and siloed investigative teams, and could catch risks too late as a result.

We see risk and control functions in the future as having a small number of people, placing greater reliance on straight-through processing and leveraging automated checks and balances. The role of risk professionals will revolve around maintaining a largely systematic control model – managing exceptions to policy and standard process – and providing insight and advice to client facing staff.
Making change happen

The first step to a new kind of risk management is a top-to-bottom look at the fundamentals of how you’re operating. Key to this is taking a capability view of risk management across the business. This allows a firm to organise itself in a way that avoids cottage industries and maintains a holistic view of risk across the firm.

We think that the core capabilities of the future include:

- **Understanding Emerging Risk** or recently recognised risk; challenging the firm to proactively look at what the risks of the near future are and build the understanding required to measure and manage these.
- **Risk Agility** and adapting quickly to events or crises. This means thinking through the second or third order impacts of both internal and external events and being able to mobilise the right cross-functional team to reduce fall-out quickly.
- **Connecting-the-dots** to view risk holistically, understand the linkage between risk types and manage them together.
- **Risk as a Business Partner** driving control functions to take a key role in directing business strategy and supporting transactions through providing the insight which reinforces the right decisions as well as challenging the wrong ones.
- **Efficient Risk Management** allowing the firm to manage risk better but also cost effectively driving up revenue (by making the right decisions), reducing operating loss and reducing the fixed cost of control functions – all of which drive up margins and make the business more competitive and sustainable.

These core capabilities allow the business to define a new, comprehensive vision for risk management. This vision then drives the target operating model for control functions and helps build the right culture and behaviours necessary to deliver effective risk management across front, middle and back office.

Finally change is delivered by focusing on enablers. What fundamental changes to infrastructure are required to make the vision a reality? Too often firms have focused on specific enablers without a strategic vision for what these set out to achieve and how they will work in concert to establish a sustainable operating model. These enablers then form the building blocks of a new front-to-back approach to risk management.

- **Efficient Risk Processes**
- **Risk Technology**
- **Risk Analytics**
- **Organisational Design and Alignment (both Front-to-Back and cross-functional)**
- **The Risk Professional of the Future**
- **Risk Culture and Behaviour**
- **Regulation as an Opportunity**
As we continue to explore the future of risk we will focus both on the challenges and opportunities but also on the practicalities of implementing change and the enablers firms need to get in place to really make this happen.

**Give us your take**

What's your view on the future of risk? Join the debate. We’ll be adding blogs and papers on the opportunities for risk, the dangers of being complacent and the steps to trigger change.
Seven big questions – do you have more?

Here are some of the big questions businesses are asking:

• How do we cut the cost of risk management and how do we do this while we continue to spend significantly on regulatory change?

• How do we ensure Risk continues to be relevant at the top table and work better with the rest of the business to challenge and advise on all key commercial decisions?

• How do we reorganise our risk function to recognise the changing nature of the risks we face – can we work better across the traditional financial risk silos; how do we work together with the business, operations and compliance to deliver the heightened focus on operational risks and conduct issues; and how do we respond to cope with the new and emerging risks such as cyber?

• How can we share MI and data across the business so we make better risk management decisions?

• What technology do we invest in and how do we update what we’ve already got?

• What are the right skills, outlook and experience for a Risk professional – and how do I make sure my team has them?

Do you have your own questions?

Do you have answers?

Either way, share them with us. Tell us what you think.

Join the conversation: #futureofRisk
Stand out for the right reasons

Financial services risk and regulation – many see it as a problem, we see it as an opportunity. An opportunity to shine. An opportunity to grow. An opportunity to build trust.

The company that overcomes risk and adversity is the company that people remember. The organisation that understands how to protect itself is the one that customers will turn to.

At PwC, we work with you to redefine the way risk and regulation is seen. Actively embracing change is a powerful way to enhance your reputation, secure long-term growth, sustainable profits and to deliver value to customers. With our help, you won’t just navigate around potential problems, you’ll also be positioned to get ahead.

To achieve this, we support you in four key areas.

• By alerting you to the financial and regulatory risks you are exposed to we help you understand the position your business is in and how to comply with the regulations. You can then turn risk and regulation to your advantage.

• Preparing for issues such as technical difficulties, operational failure or cyber attacks is an important way to protect your business. We advise and support you to design and implement the systems and processes that can make your business resilient, reliable and effective.

• Adapting your business to achieve cultural change can pay dividends. Doing the right thing for your customers and your people will continue to transform your business. By equipping you with the insights and tools you need, we will help you be better prepared to turn uncertainty into opportunity.

• Even the best thought-through processes or products can sometimes fail. We help you to act swiftly to repair any damage so you can ensure that you build even greater levels of trust and confidence in your business.

Working with PwC will help you to get a clearer understanding of where you are and where you want to be. Together, we can develop and help you to implement transparent and compelling business strategies that customers, regulators, employees and stakeholders will buy into. By adding our skills, experience and expertise to yours, your business can stand out for the right reasons.
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George leads the UK financial services, risk and regulatory practice in the UK and financial services risk network in the Central Cluster. He has over 25 years of experience working with financial institutions in Europe and Asia, primarily helping clients to understand and manage the risks inherent in delivering their business strategy. George has worked with global financial institutions to help build and implement the tools, models and working practices necessary to provide the insight to support strategic and operational decision making, whilst embedding the consideration of risk and regulation into daily business activities.

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James is a senior manager in PwC’s risk consulting team working predominately with front office in investment banks on end-to-end projects from strategy to execution. Key areas of expertise include managing the economic impact of changing prudential regulation, wind-down of legacy or non-core businesses and using advanced analytics to detect rogue traders. James’ core strength is combining cross-asset class product knowledge with business strategy and changes to regulation and market dynamics to drive coherent commercial outcomes. Prior to financial services James worked with a number of corporates designing brand analytics to manage reputational risk and increase profitability.

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