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The Economist

Transforming the CFO role in financial institutions

Towards better alignment of risk, finance and performance management

A report from the Economist Intelligence Unit
in collaboration with CFO Research Services
Sponsored by Oracle

CFO research services

Preface

Transforming the CFO role in financial institutions: Towards better alignment of risk, finance and performance management is an Economist Intelligence Unit report, produced in collaboration with CFO Research Services and sponsored by Oracle. The Economist Intelligence Unit conducted the survey and analysis, and wrote the report. The findings and views expressed in the report do not necessarily reflect the views of the sponsor.

The report's quantitative findings come from a survey of 199 senior banking executives in finance and risk, conducted in January 2011. The Economist Intelligence Unit's editorial team designed the survey. Paul Kielstra is the author of the report, and Gerard Walsh is the editor. Mike Kenny is responsible for the design.

To supplement the quantitative survey results, we conducted in-depth interviews with finance and risk executives, corporate leaders and other experts around the world. We would like to thank all the interviewees for their time and insight.

April 2011

About the survey

A total of 199 senior executives from financial institutions participated in the survey, with roughly half each coming from the risk (52%) and finance (48%) functions. Of these, 28% are C-level or above. Twenty-eight percent are based in Asia and Australasia, 23% in North America, 23% in Western Europe, 13% in the Middle East and Africa, and the rest in Latin America and Eastern Europe. Forty-eight percent of participants represent financial institutions with assets of more than US$200bn.

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Interviewees

Andrew Burns
Chief Strategy Officer
Bank of East Asia

Stephen Cecchetti
Head of the Monetary and Economic Department
Bank for International Settlements

David Craig
Chief Financial Officer
Commonwealth Bank of Australia

Enrico Dallavecchia
Chief Risk Officer
PNC Bank

Professor Jean Dermine
Director of Risk Management in Banking Programme
INSEAD

Morten Friis
Chief Risk Officer
Royal Bank of Canada

Professor Charles Goodhart
Director of the Financial Regulation Research Programme
London School of Economics

N S Kannan
Executive Director and Chief Financial Officer
ICICI Bank

Sir David Kwok-po Li
Chief Executive Officer
Bank of East Asia

Chuck Kim
Chief Financial Officer
Commerce Bank

Denise Letcher
Director of Risk Information
PNC Bank

Johnny Mao
Chief Risk Officer
Bank of East Asia

Mark Midkiff
Chief Risk Officer
Union Bank

Thomas Mueller
Chief Financial Officer
Sarasin Bank

Tim Tookey
Group Finance Director
Lloyds Banking Group

Michael Venter
Deputy Chief Financial Officer
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Executive summary

The combination of a global financial crisis, increased uncertainty and greater regulation has expanded dramatically the role of the chief financial officer (CFO) at financial institutions around the world. In such a challenging environment, financial institutions must now devise a sustainable growth strategy and be better protected against new or emerging risks. To do so, many finance departments are recasting their business processes in an effort to provide better access to information for internal decision-making, risk management, financial reporting and regulatory compliance.

One of the essential tasks for financial institutions is to improve how their finance functions understand and use risk considerations and information. Financial institutions have certainly been active: in the survey conducted by the Economist Intelligence Unit for this study, in collaboration with CFO Research Services, over 99% of respondents report that their companies have significantly increased the use of risk considerations or metrics in at least one area of operation or decision-making in the last two years.

This study, sponsored by Oracle, draws on a global survey of nearly 200 senior banking executives in finance and risk, as well as in-depth interviews with 16 finance and risk executives, corporate leaders and other experts to examine the current state of finance processes and how these processes could be modified to address the new competitive and regulatory dynamics faced by financial institutions. Its key findings include:

- **Alignment between the risk and finance functions is now essential to banking**. As David Craig, CFO at Commonwealth Bank of Australia, puts it, "risk and finance are inextricably linked." Outside stakeholders now expect risk and finance to work together and certain activities, from capital planning to the conduct of stress tests, cannot take place efficiently without close co-operation between the two functions. Survey respondents most often cite improving risk processes in general as the leading risk-related priority for finance functions (54%), followed by integration of data across the organisation (46%) and improving the management of data relevant to risk (40%).
- **Financial institutions can boost profitability by a better alignment of risk and finance**. Financial institutions that benchmark themselves well on aligning their risk and finance functions also say they are doing better financially. Among survey respondents, of those who rank themselves much better than their peers at alignment between risk and finance, 60% are also much better at financial performance and 92% are above average. The equivalent figures for those who are average or worse at

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alignment are 8% and 32% respectively. The benefits are both specific, such as identifying potentially profitable clients, and general, such as providing a greater understanding of the global context in which major strategic decisions are made.

- **Alignment between risk and finance begins with good data, but the bigger problems are different perspectives and cultures between the two functions**. The leading risk-related priorities for finance departments are improving processes (cited by 54%), data integration (46%) and data management (40%). Alignment involves the creation of a common view of risk, and common data relating to it, across the company and especially between the risk and finance departments. This is essential for alignment, but not sufficient. The survey reveals that the biggest barriers to the two functions working closely together are that the primary focus of each is not the same (52%) and that there are more general cultural differences (43%). Overcoming these impediments to alignment requires the creation of structures for executive and employee interaction so that the two departments understand each other.
- **Attention to risk lowered downside risk for US banks during the 2008-09 global financial crisis**. Research shows that at the 15% of US banks where the chief risk officer (CRO) was among the five highest-paid executives in 2006, the proportion of total assets made up by mortgage-backed securities at the time of the crisis was one-fortieth that of banks where the CRO was less well paid. There is even a correlation between higher CRO pay and lower stock volatility.
- **Financial institutions are now better prepared for another crisis like the last one, but may not be as well prepared to deal with new or emerging risks**. Forty-five percent of survey respondents say that their company's risk management prepared them well or very well for the 2008-09 global financial crisis, and 63% now have this level of readiness for a similar shock. Although positive news, 46% admit that they need to do more to identify emerging risks.
- **Financial institutions are investing more in technology to improve their ability to integrate risk information into financial and performance management**. The main barriers to incorporating risk-based data into financial and performance management are poorly integrated systems (cited by 41% of survey respondents) and inconsistent metrics within their companies (37%). Moreover, 28% of respondents believe that information silos within their companies erode the capacity to share relevant risk information. Financial institutions have responded with significant investment in this area.
- **A majority of finance functions are not applying risk data beyond compliance and product allocation to areas like analysis and budgeting**. Fifty-six percent of surveyed financial institutions have increased their use of risk data in compliance efforts, and 54% in product allocation–both areas where its application was already well established. Fewer are applying the data more broadly, to significant responsibilities of the finance function such as financial analysis (41%), front office lending (39%) and budgeting (36%). Only 19% are making greater use of risk data in assessing employee remuneration despite stakeholder and regulatory demands in this area. CFOs need to make sure they go beyond gathering risk data to using risk data more broadly.

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Key points

- **No financial institution had an easy time during the 2008-09 financial crisis, but those with a strong risk culture did better than others.**
- **A correlation exists among US banks between higher CRO pay in the years before the crisis and lower stock volatility during 2007-08.**
- **When asked the leading priority for their function in our survey, only 27% of finance executives mention something directly risk-related.**

Introduction: A strong risk culture is imperative

A strong risk culture mitigates the impact of crises

Every banking executive understands that banking as a business revolves around risk. The 2008-09 global financial crisis, however, showed what happens when the sector experiences a widespread failure to understand those risks correctly. No financial institution had an easy time during the financial crisis, but some did better than others. Mark Midkiff, CRO at Union Bank, explains: "If there was a strong risk culture where people really thought about risk in their day-to-day decisions, then those companies generally weathered the storm."

A study by Andrew Ellul and Vijay Yerramilli for the National Bureau of Economic Research[1] supports this observation. The two found a direct link at US banks between attention to risk and performance during the crisis. By creating a broad index of the status of risk management at banks–a useful proxy for the seriousness with which risk was taken–Messrs Ellul and Yerramilli found that those banks scoring higher in the index "had lower exposure to private-label mortgage-backed securities, were less active in trading off-balance sheet derivatives, had a smaller fraction of non-performing loans and had lower downside risk during the crisis years." In just one example from their data, at the 15% of all banks where the CRO was among the five highest-paid executives in 2006, the proportion of total assets made up by mortgage-backed securities at the time of the crisis was one-fortieth that of banks where the CRO was less well paid. The research even found a correlation between higher CRO pay (as a proportion of CEO pay in the years before the crisis) and lower stock volatility (as measured by option prices) during 2007-08.

Our survey also bears out the link between an effective risk culture and successfully weathering the downturn: where respondents benchmark their company as much better than peers at aligning finance and risk, 64% are very well prepared for the crisis and 84% are at least well prepared. Among other financial institutions, these figures are just 9% and 48% respectively.

The need to link risk better into decisions across the company has not been lost on finance executives. Chuck Kim, CFO at Commerce Bank, recalls that "in this credit crisis things happened that no one anticipated could ever happen." Accordingly, he says financial institutions are much more careful about issues such as over-concentration of investment portfolios and the spread of risk between different parts

1. National Bureau of Economic Research, *Stronger risk controls, lower risk: Evidence from US bank holding companies*, July 2010.

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of the economy. Similarly, Professor Charles Goodhart, director of the Financial Regulation Research Programme at the London School of Economics, sees “a sort of new humility about how the unexpected can happen and the need to be aware of it.” In particular, he believes that a better understanding exists of the difference between emerging risk, or even uncertainty—which is not measurable because of lack of data—and simple risk. “Prior to 2007,” he notes, “banks thought that they had risk under control and ignored uncertainty. Now they are much more aware that it is impossible to measure all potential outcomes and give a quantitative probability.”

This new awareness has brought some action. In early 2009 an Economist Intelligence Unit survey of senior executives in financial institutions found that 53% of companies had completed or were undertaking a thorough overhaul of their risk management, with only 5% planning no changes.[2] More recently, in the survey conducted for this study, over 99% of banks had significantly increased the use of risk considerations or metrics in at least one of the 11 areas examined, and 97% had seen an improvement in at least one aspect of risk management. This activity, however, may indicate less thoroughgoing change in how the finance function uses risk data than the numbers suggest. Only about four in ten financial institutions are making significantly greater use of these data in areas such as financial analysis, budgeting and reporting.

Moreover, risk is only one issue currently on the very crowded plate of CFOs. In the wake of the downturn, finance functions are undergoing massive changes as they simultaneously seek to meet new regulatory requirements, satisfy demands of other stakeholders for information, reduce costs, enhance data technology and meet the growing competitive demands of a global marketplace in financial services. When asked the leading priority for their function, only 27% of finance executives mention something directly risk-related, similar to the 25% who mention an IT-related matter. Other issues related to improved reporting, budgeting and forecasting, cost reduction, and seeking out new customers and growth.

As CFOs oversee the transformation of their functions, however, attention to risk need not be just one chore among many. It is as essential to bringing about the other changes successfully as its absence was in bringing about the financial crisis. Morten Friis, CRO at Royal Bank of Canada, calls accurate risk information “a key component in building market confidence in the value of the enterprise.”

2. Economist Intelligence Unit, *After the storm: A new era for risk management in financial services*, 2009.

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Key points

- Since the crisis, best practice in the industry has increasingly been defined to include a strong, independent risk function with a CRO who has direct access to the CEO and the board.
- The benefits of alignment are real: 92% respondents who rank themselves much better at alignment between risk and finance than their peers say their financial performance is above average.
- Despite its benefits, alignment is less of a focus for finance than its data and process improvement efforts.

Aligning risk and finance: The benefits and the barriers

Tighter alignment is part of the emerging competitive landscape

A central element of the integration of risk considerations into the management and operation of financial institutions is the improvement of alignment between the risk and finance functions. The push in this direction predates the 2008-09 global financial crisis. The requirements of the second accord of the Basel Committee on Banking Supervision (Basel II) expressly encouraged it. What the accord offered as a method for reduced capital requirements, however, the crisis made clear was a matter of survival. Leading financial institutions understand this. According to Mr Craig of Commonwealth Bank of Australia, “risk and finance are inextricably linked. Every financial decision should be coloured by risk: it is a yin and a yang.” Tim Tookey, group finance director at Lloyds Banking Group, adds: “Alignment between risk and finance is an absolute expectation of the board of all major banks. It is not an option. It is taken as read.”

Alignment, of course, does not mean merger. Since the crisis, best practice in the industry has increasingly been defined to include a strong, independent risk function with a CRO who has direct access to the CEO and the board. In the UK, for example, the government-commissioned Turner Report (March 2009) and Walker Report (November 2009) both favoured this, as did the influential Counterparty Risk Management Policy Group’s third report (August 2008) in the US. More recently, the US’s Dodd-Frank act requires the boards of large banks to have risk committees that include at least one expert, effectively making the CRO a board-level position. A strong voice for risk is essential to better risk management.

As Professor Goodhart of the London School of Economics explains: “In the past, there was a tendency of top management to support the trading desk and to downplay the advice of the risk officer. It is most important that the risk management function is given a sufficient hearing and support by top management.” This heightened influence, however, makes alignment all the more important as well. If risk and finance are not to engage in endless power struggles, with one side dominating the other, they need to work together.

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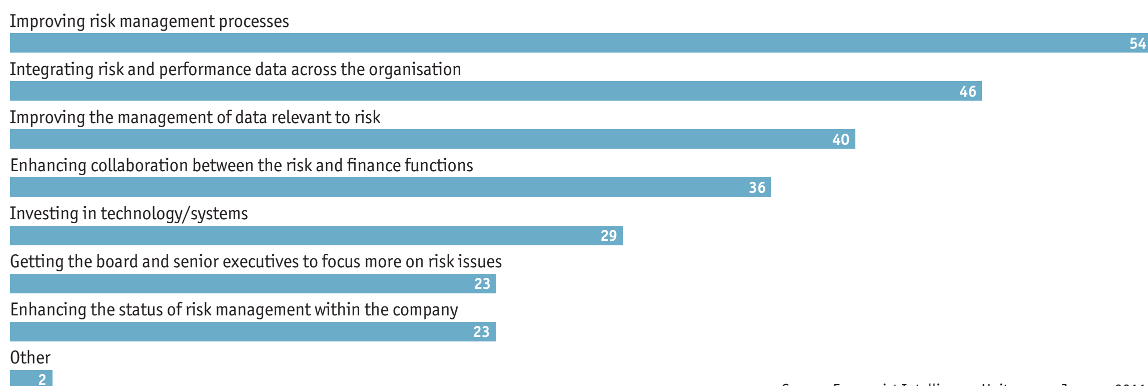
Strong alignment between risk and finance can boost financial performance

The benefits of alignment are real. Among survey respondents, of those who rank themselves much better at alignment between risk and finance, 60% are much better at financial performance and 92% are above average. The equivalent figures for those who are average or worse at alignment are 8% and 32% respectively. This obviously no longer includes those that were very bad at alignment before the crisis and have ceased to exist. Mr Craig reports that his bank was able to buy up BankWest in 2008 at a very good price because that bank had not properly embedded risk into its organisation.

The link between alignment and profit takes diverse forms. Some gains are simple. N S Kannan, executive director and CFO at ICICI Bank, sees "huge synergies", explaining that certain activities, such as running stress tests and Basel II's internal capital adequacy assessment process test, are impossible without the teams working together. Andrew Burns, chief strategy officer at Bank of East Asia, adds that the new requirements arising out of Basel III will only reinforce the need for co-operation. Mr Tookey, meanwhile, believes that having risk and finance work together on planning, rather than each dealing with matters in turn, has not only improved the process but made it quicker and more efficient. According to Mr Kim of Commerce Bank, risk has been able to "identify tranches of customers who are lower risk but willing to pay more. We are using that kind of analysis a lot."

The broader benefits, however, are less tangible ones associated with more informed decision-making. Enrico Dallavecchia, CRO at PNC Bank, and Mr Tookey speak of the enhanced ability that risk gives to efforts to create scenarios which allow for better understanding of emerging risks. Similarly, at Union Bank, Mr Midkiff believes that alignment gives a much more complete understanding of the overall environment in which financial institutions are operating. Unsurprisingly, financial institutions that rank themselves as much better at alignment than peers are more likely to say that the use of risk management to provide competitive advantage has improved significantly in recent years (56%) than those who are average or below (20%).

Which of the following represent the highest risk-related priorities within the finance organisation?
(% respondents)



Source: Economist Intelligence Unit survey, January 2011.

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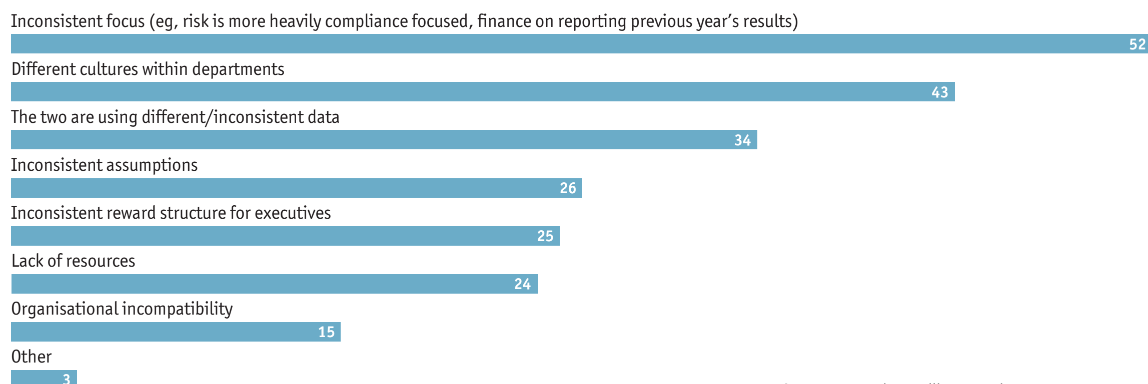

Despite its benefits, alignment is less of a focus for finance than its data and process improvement efforts. Survey respondents most often cite improving risk processes in general as the leading concern (54%), followed by integration of data across the organisation (46%) and improving the management of data relevant to risk (40%). Collaboration between the risk and finance functions comes next, cited by only 36%.

This is a key first step towards better alignment. Mr Tookey notes that risk's new role requires it: "Before planning was done a little bit in series, with risk following finance, so a degree of disjointed information was allowed." This is no longer the case, so the data used by finance and risk departments need to be the same. Furthermore, a common view of reality on its own can go a long way. "For retail banking, if your data are consistent, then day-to-day alignment issues end up being something you don't have to think much about," explains Mr Friis of Royal Bank of Canada.

> "Finance people tend to think about data as a flow. For them, change over time is important. For risk, data is often a point in time view."
>
> *Michael Venter, deputy CFO at Commonwealth Bank of Australia*

As with risk management in general, data management improvements are necessary, but on their own are not sufficient. While inconsistent data are a major barrier to better alignment at 34% of financial institutions surveyed, far more widespread problems are that the primary focus of each function is not the same (52%) and more general cultural differences exist (43%).

Several interviewees describe a "natural" or "innate" tension between risk and finance given their distinct roles. Survey answers reveal that, although the two agree in many areas, they have sometimes clashing viewpoints: for example, 42% of finance executives believe that risk management at their companies is having a neutral or negative impact on overall performance, compared with only 26% of risk executives.

These cultural differences also reveal themselves in how finance and risk approach data. Michael Venter, deputy CFO at Commonwealth Bank of Australia, notes, for example, that people from the two functions approach information "with different mindsets. Finance people tend to think about data as a flow. For them, change over time is important. For risk, data is often a point in time view." He adds that finance executives also feel comfortable only when they can reconcile data to the general ledger, while risk ones are more flexible. In practice, he adds, these are small differences, but they "show why we differ,

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Getting the best of both worlds—Union Bank

The pressing need for alignment between the risk and finance functions can lead executives to forget that the different perspectives and cultures that make this difficult to achieve actually represent more of an asset than a liability. As Mark Midkiff, CRO at Union Bank, explains: "There are different insights that the teams bring. There is a view that finance brings which is fully informing to risk, and a view that risk brings which is fully informing to finance."

Both these perspectives contain great value, and any effort to combine them should not look for a lowest common denominator. Mr Midkiff joined Union Bank about a year and a half ago, around the same time that a new CFO, John Woods, was appointed. The two decided to enhance existing regular discussions and create a capital analysis committee that brings together senior executives from both departments in what Mr Midkiff describes as a "work stream and governance structure that allows us to debate elements where the convergence of views between risk and finance has to take place."

The main benefit is breaking executives out of their silos, notes Mr Midkiff. "I see often with quantitative teams that they can get very aligned around a certain set of information and a particular view. This allows [the committee] a big picture understanding of the environment." The topics for discussion can include things as simple as what each function will do separately and together on joint projects, or more complex issues such as where the company might need to model risk further or analysing the outputs of stress tests.

> "Often...quantitative teams...can get very aligned around a certain set of information and a particular view. This allows a big picture understanding."
>
> *Mark Midkiff, CRO at Union Bank*

More broadly, however, these discussions help the company to achieve the goals that Mr Midkiff thinks apply to any bank: soundness, profitability and growth. To achieve these, he believes that risk and finance have to reach "a natural convergence around risk and return. These are two sides of an equation: there are the needs for capital that are formed by models of risk and management's judgment, and then there is availability of capital. You have to marry up risk and finance to get that balance and to decide where you want to pick your position." This convergence can only be reached when both sides understand each other.

why this needs work. We come at this from quite different angles." Similarly, Denise Letcher, director of risk information at PNC Bank, reports that in monthly financial review meetings which are attended by both the bank's CFO and CRO, the former's questions tend to begin with issues such as historical compared to current positions or likely future trends, while the CRO's questions more typically start by examining policy change issues. "All the information is needed," she adds, "you just have a different first thought from the CRO and CFO."

These sorts of attitudes show that a common data set, on its own, is not enough. Nevertheless, such differences of focus and culture, however likely they are to occur, do not inevitably cause problems. They do, however, need addressing to ensure collaboration.

Those financial institutions that already have good alignment between the two functions might conceivably need to do less work on collaboration, but the survey shows that they pay more attention to it. Respondents who rate their abilities in this area as much better than peers are much less likely to cite a divergence in focus (20% compared with 56% for the rest of the survey) or cultural differences (32% compared with 44%) as major barriers to alignment. However, 40% of them list enhanced collaboration with risk as a priority for their finance departments, compared with just 31% for the other respondents. In other words, those who need to address cultural issues most are doing the least about it.

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Structured co-operation can enhance collaboration between finance and risk

The best way to enhance this collaboration is to use structured co-operation in order to get executives from each function to understand the other's thinking. Mr Craig, for example, believes that because the tensions between the two are a cultural phenomenon, "the best way to overcome them is culturally. Make sure you rotate executives around the functions. Then people will have seen both sides."

Some financial institutions also benefit from having structured exchanges that treat the different perspectives of the departments as an asset in creating an aligned view. Personal meetings are extremely effective. Mr Burns notes that although the Bank of East Asia's data systems are very valuable, "what is really important is the interface between different departments of the bank. The bank has a morning meeting every day where all the senior managers sit down and discuss the issues face to face." At an inter-functional level, meanwhile, Mr Midkiff says that his bank has begun regular meetings between senior risk and finance executives as a formal part of work stream governance (see box: Getting the best of both worlds). Both Mr Midkiff and his finance counterpart at Union Bank, John Woods, lead the capital committee discussion at the bank, where debate and alignment between both organisations occur. Even something as simple as positioning the workplaces of the two functions close together so that employees inevitably interact in doing their daily business, as Sarasin Bank does, can help.

Better alignment between the risk and finance functions, then, is both necessary and profitable. Improved data are an important part of the picture, and financial institutions are working towards this aim. More of them, however, need to go further and look at the differing perspectives and cultures in the functions—the human side—in order to gain full benefit. Mr Dallavecchia of PNC Bank points out that the need for managers to work closely together in the financial crisis and in running stress tests in 2009 and 2010 "has overcome some of the cultural aspect where there were some people in finance who did not understand what risk was doing, and vice versa. That collaboration will increase because companies are seeing the benefits."

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Key points

- **Financial institutions are now better prepared for another crisis like the last one, but may not be as well prepared to deal with new or emerging risks.**
- **Leading financial institutions are developing new tools to improve their ability to identify emerging risk.**
- **An enterprise-wide view of risk is becoming a critical part of management and boards are demanding more risk information in far greater detail.**

Preparing for the next crisis

Financial institutions need to work harder at identifying emerging risks

In a world populated with fallible human beings, a future financial crisis of some sort is always a matter of "if" rather than "when". Creating the attitudes and processes that will make a financial institution ready for the next storm cannot be the job of a single function, but neither can any function ignore the task. CFOs and CROs play a particularly important joint role in this regard: as noted previously, alignment between the two departments and ability to deal with market turbulence are closely correlated.

In our survey, 45% of respondents say that their risk processes and information systems prepared them well or very well for the 2008-09 global financial crisis, and 63% now say that they would have that level of readiness for a similar shock in the future. Although this represents progress, the situation is far from ideal. According to our survey, over one-third (36%) of financial institutions—a disturbing proportion—still do not consider themselves well prepared for such an event. Moreover, the heightened preparedness may be for a broadly similar shock, not for some new, unexpected risk.

Professor Jean Dermine, director of the Risk Management in Banking Programme at INSEAD, sees improvements by financial institutions on liquidity and counterparty risk—issues during the crisis—but acknowledges that "they are still busy fixing the problems of the past. They should be more creative in looking at future risk. They are not prepared at board level to put the brakes on the next expansion."

The survey provides some evidence for this view: only one-half of financial institutions claim to have improved significantly at identifying emerging risks and 46% admit that this area needs more work. The implications are worrying because the very novelty of the risks associated with the securitisation of assets in the run-up to the crisis contributed greatly to the failure of financial institutions to price them adequately. Now, notes Thomas Mueller, CFO at Sarasin Bank, "We are seeing risk emerging which historically we believed them to be only hypothetical and completely improbable. Who has integrated in their models that a country like Ireland might go bankrupt? When the credit spreads explode, it is already too late." He characterises the need to find and take preventative measures for emerging dangers "the big challenge of risk going forward." These risks, however, almost invariably involve uncertainties about

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Horizon scanning—ICICI Bank and Lloyds Banking Group

Forty-six percent of survey participants say that they need to improve their ability to identify emerging risk. This is a critical area in which to be found wanting. Tim Tookey, group finance director at Lloyds Banking Group, recalls that five years ago "nobody in banking or regulation was considering that there could be a liquidity risk. Now that will be on people's radars, but what is the next risk that people will not notice? Inflation in China? The withdrawal in Western economies of imported deflation from the developing world?" N S Kannan, executive director and CFO at ICICI Bank, sees the same need. He says it is "easy to give the information after a risk has materialised," but where risk "can really help is with timely information passed up to higher levels of executive management that identifies emerging risks." He considers it one of the leading contributions of the risk function.

Both ICICI and Lloyds have substantially increased their capacity in this area. It is not simply a matter of gathering information from within the firm and reporting. Mr Tookey explains that this sort of analysis requires extensive horizon scanning and examination of scenarios, married up with hard data, to consider what executives might be facing. Global financial institutions, in particular, need to be able to spot potentially significant developments anywhere in the world and to examine the implications—a tall order. Mr Kannan also emphasises the need for independent thought rather than excessive adherence to process. The unit that monitors such risk at his company has been valuable because it "has been proactive in quickly analysing market events and then going to the appropriate forum in the bank, such as the Board Credit Committee, rather than waiting for the committees to ask."

> "Within 48 hours of the North African unrest beginning, we had reports available setting out in tremendous detail any exposure in those geographies."
>
> *Tim Tookey, group finance director at Lloyds Banking Group*

These efforts can help on several levels. Mr Tookey reports that this sort of analysis showed Lloyds the likelihood of an increased interest in personal savings in Britain and allowed it to react accordingly, while Mr Kannan says that, on a regulatory level, a better understanding of underlying realities has greatly improved the effectiveness of ICICI's stress testing. Perhaps the biggest benefit, however, is the ability this sort of analysis gives in terms of reacting quickly to issues around the world. Mr Kannan confirms that his bank was able to understand immediately the potential impact on its portfolio of economic troubles in the weaker euro member states. More recently, says Mr Tookey, "within 48 hours of the North African unrest beginning, we had reports available setting out in tremendous detail any exposure in those geographies. Fortunately, it was de minimis, but we were very alert to it and understood its potential impact."

which quantifiable data simply do not exist. Leading financial institutions are therefore turning to other strategies to prepare (see box: Horizon scanning).

Readiness is also about the attention paid to risk in general, and here too the survey has apparently positive news: 80% of respondents say that their company's interest in improving risk management will remain even after the economy recovers. Historically, however, boom times are associated with a declining concern about risk. Is there any reason to believe it will be different this time around? Nobody is under any illusions: maintaining an appropriate focus on risk in a booming economy will always be swimming against the tide. Professor Goodhart of the London School of Economics says that the cycle of attention to risk waning with economic growth "is absolutely built in. It is innate in human nature and we can't get rid of it." Part of the solution, he believes, is better regulatory enforcement to curb exuberance.

Even with such oversight, however, theoretical difficulties remain for whoever is doing the enforcing. Stephen Cecchetti, head of the Monetary and Economic Department at the Bank for International Settlements, notes that at points in the economic cycle "there is a sort of cognitive dissonance: it is when estimates of risk are at their lowest that in fact risk is at its highest." Thorny questions include how appropriate it is to downplay data from the distant past in calculating risk and how to prepare for infrequent, large impact events, when such occurrences might not actually appear in the risk data being

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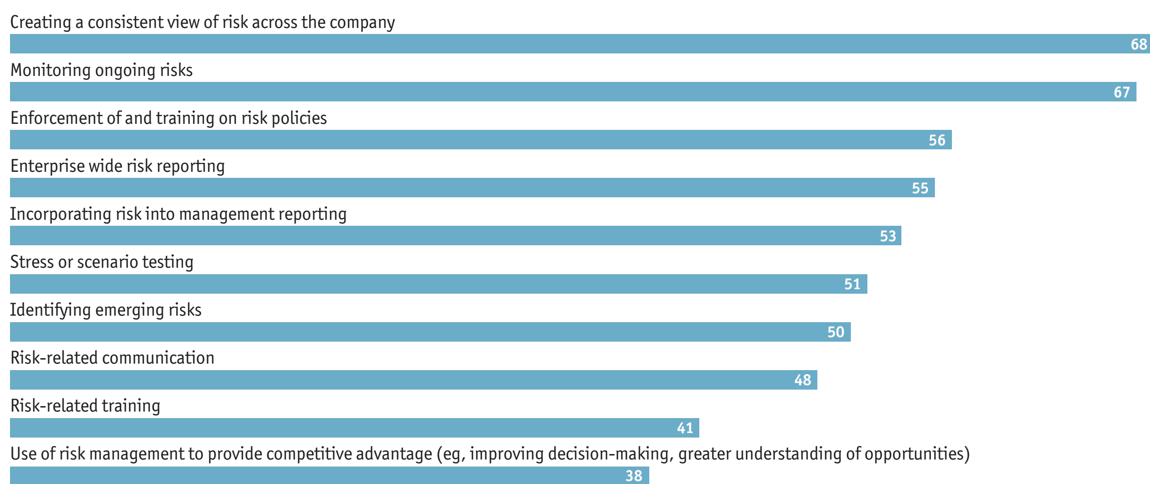

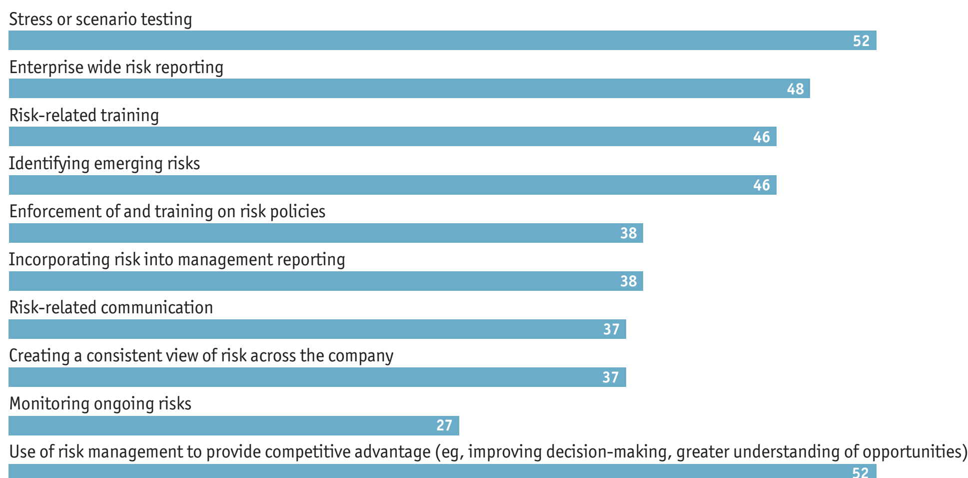

used. A better understanding of risk therefore will continue to require further conceptual work as well as vigilance by financial institutions.

There are grounds for optimism that improvements will be lasting

CFOs and CROs, however, found reasons for optimism that the improvements they are making as a result of recent events will yield some lasting changes. The most widespread risk-related improvements are fundamental but basic: creating a consistent view of risk across the company (68%) and monitoring ongoing risk (67%). As noted earlier, only one-half of financial institutions have become better at

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"Outliers can be extremely costly and therefore cannot be borne easily. Going forward things are going to be treated differently."

Thomas Mueller, CFO at Sarasin Bank

identifying emerging risks, and just 38% say that they have become better at using risk management to provide competitive advantage through, for example, more informed decisions. The latter is also the area where most respondents say further effort is needed (52%).

Mr Tookey of Lloyds Banking Group stresses that the enterprise-wide view of risk is becoming a critical part of management and that boards are demanding more information in far greater detail. "I don't see them giving that up quickly at all," he says. Mr Kim of Commerce Bank acknowledges that the increasing number of processes to capture early risk signals will make business "less likely to hit the wall at 100 miles an hour in the next crisis." Certain regulatory changes will also help. Mr Midkiff of Union Bank believes, for example, that new regulations are making it impossible for originators of risk to sell on all of that risk to other parties and this will lead to greater accountability in deal-making.

The memory of recent events will also have a salutary effect. According to Mr Friis of Royal Bank of Canada, the lessons of the crisis "have been so severe and the consequences so dramatic that the collective memory will be strong. We will remember for quite some time." Similarly, for Mr Kim, "the people who sat in the CFO or CRO chair during this crisis—they won't have a short memory", although he acknowledges that in time, when a new generation of bankers comes along, this may fade. Such memories will not apply only to the specific risks which brought on the crisis. Mr Mueller's view is that there is "a learning curve within the industry. It has learned that the extremes in terms of the outliers can be extremely costly and therefore cannot be borne easily. The events are also not so improbable as we thought. Going forward things are going to be treated differently."

Mr Kannan of ICICI Bank—most of the business of which is focused in India's expanding economy—agrees that "in a high-growth market, it is important to be reminded that there is a need to be watchful. This time around, however, the impact of the crisis has been so phenomenal and the regulatory focus will make sure that the lessons are more embedded than any time in the past." He adds that ongoing sources of uncertainty—such as Europe's sovereign debt issues, political news from the Gulf and equity volatility in Indian markets, to name a few—will also help to "prevent complacency from setting in."

Although good data are absolutely necessary, ultimately, as Sir David Kwok-po Li, CEO at Bank of East Asia, notes, their proper use "is basically an issue of corporate culture." This provides the best protection in a crisis, says Mr Kim. "To the extent an organisation can make a strong risk management culture part of who they are, they will not forget when the next cycle comes around." Moreover, that culture has to involve a strong lead from the top. Mr Craig of Commonwealth Bank of Australia comments: "Computer and measurement systems are all very well, but you need sophisticated commercial acumen laid over the top. The grey hairs of risk officials are incredibly useful in picking the right transactions and knowing how to resolve problems when things go wrong." This is one old lesson that many financial institutions apparently still need to relearn.

Risk management, then, is likely to be better for some time, particularly in the area of liquidity and credit risk, but perfection will never be possible. Nor have financial institutions learned how to avoid all crises, just ones similar to the most recent. As one interviewee put it: "We will mess up in a different fashion the next time."

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Key points

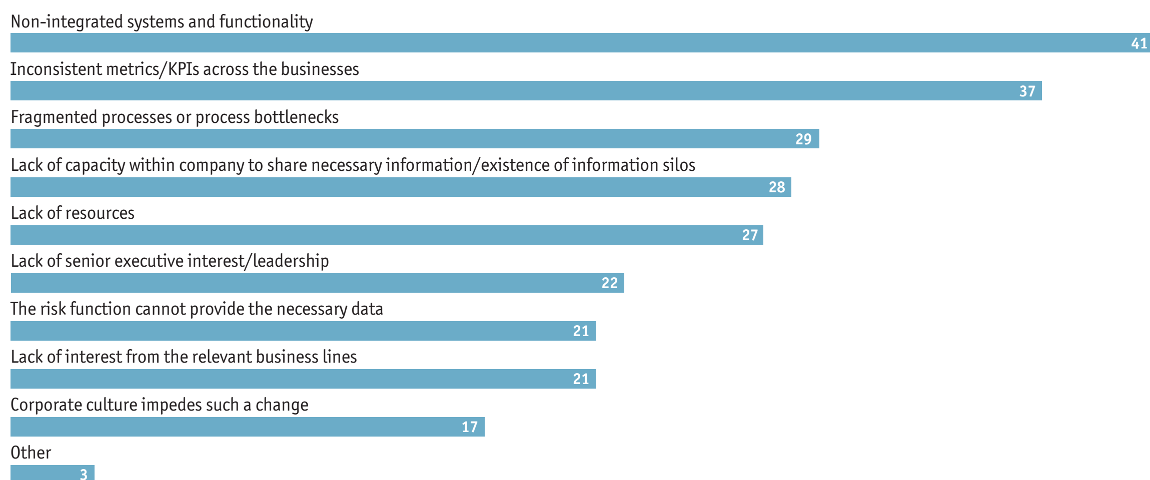
- **CFOs have been moving towards more comprehensive risk management by getting the necessary data to make properly informed choices.**
- **The main obstacles to incorporating risk-based information into finance decisions are technical, such as poorly integrated systems and inconsistent metrics within companies.**
- **Under one-half of survey respondents have seen a significant use of risk considerations and metrics in several key finance responsibilities: financial analysis, front office lending, management and profitability reporting, and budgeting.**

CFOs and risk data: Getting priorities right

Two of the top three risk-related priorities for CFOs are data-related

Just how much better financial institutions will be at dealing with risk will depend on the changes that they have carried out, and are carrying out now. The financial sector has begun a journey to more comprehensive risk management that is still at an early stage. The predominant effort of recent years has gone into getting the necessary data to make properly informed choices. For CFOs in particular, this is a leading element of improving their risk management: integration of data across the organisation (cited by 46%) and improving the management of data relevant to risk (40%) are two of the three leading risk-related priorities for the finance function; the other top priority is improving risk management processes (54%). Mr Dallavecchia of PNC Bank sees "a general recognition in the industry that the complexity of

In your organisation, what are the major obstacles to incorporating risk-adjusted information in finance and performance management processes?
(% respondents)



Source: Economist Intelligence Unit survey, January 2011.

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Risk data initiatives—PNC Bank and Commonwealth Bank of Australia

PNC Bank is currently engaged in a major effort to create a single data warehouse for all risk information, which it will then be able to combine using different analytical tools to get a more complex view of its operating environment. Commonwealth Bank of Australia's data efforts, meanwhile, include replacing the current system of different client identification numbers assigned by each of its service arms with single unique identifiers to make it easier to understand the entirety of a client's relationship with the bank.

Although a comprehensive view of data is beneficial in itself, it is only the beginning at both banks. The much expressed desire for a single view of reality does not mean conformity of approach so much as understanding how others in the organisation use data. Michael Venter, deputy CFO at Commonwealth Bank of Australia, explains that all functions "often draw on the same data—usually from our product systems—but then it follows different paths. You end up with information at the end we struggle to reconcile." He notes, for example, that for finance, a loan is a sale in the period where the approved facility is drawn down, but for risk it is a sale in the period when the liability is approved. Thus even as basic a figure as annual sales might differ. His bank is therefore expending substantial effort in being able to reconcile such data easily.

> "Risk people really need daily data. Monthly reporting puts you in a reactive mode."
>
> *Denise Letcher, director of risk information at PNC Bank*

Denise Letcher, director of risk information at PNC Bank, similarly finds that the way numbers are reported weakens the relationship between risk and finance. Even the amount of time it took to work with risk and finance on common definitions of terms was unexpected. Her company's goal is that "the credit people can talk about their portfolios as well as what financial adjustments were made and everybody can be comfortable with the different numbers as they change and with their own role and responsibility in the process."

A barrier that both projects have met is costs, which are not always easy to fund. "It is a surprise to everybody how many resources it takes to have an enterprise-wide data governance programme. It will always be a struggle to justify resources for data governance because it doesn't have a big black and white return on the bottom line," says Ms Letcher. Similarly, Mr Venter reports that "these projects cost more than you think and take longer than you expect." He adds that resource contention is a big issue, especially as the bank is simultaneously upgrading in other areas.

The benefits of these efforts, however, go beyond those of better risk information discussed elsewhere in this study. The investments are also leading to greater data speed. This is essential to remain competitive. Ms Letcher comments: "Risk people really need daily data. Monthly reporting puts you in a reactive mode; if you want to be proactive you need daily reports."

the products that the financial institutions own or invest in, as well as the rapid changes that can occur, requires very granular risk data."

This very basic necessity for good risk management, however, remains a challenge. The main obstacles to incorporating risk-based information into financial and performance management are technical: poorly integrated systems (cited by 41% of survey respondents) and inconsistent metrics within companies (37%). Meanwhile, 28% of respondents do not believe their companies have the capacity to share relevant risk data because of information silos, and 21% think that the risk function in their organisation cannot provide the necessary data. As noted earlier, for the finance function, data issues on their own are almost as important as risk ones, so the improvement of risk-related data is an obvious focus in the broader transformation of the department.

Financial institutions as a whole have been tackling the challenge actively: in the last two years, at 97% of surveyed companies at least one board committee or C-level executive has requested new or enhanced risk data from the finance function. "The consideration given to data and analytics has increased significantly, and on the investment banking side exponentially, in the last few years," confirms Mr Dallavecchia of PNC Bank (see box: Risk data initiatives).

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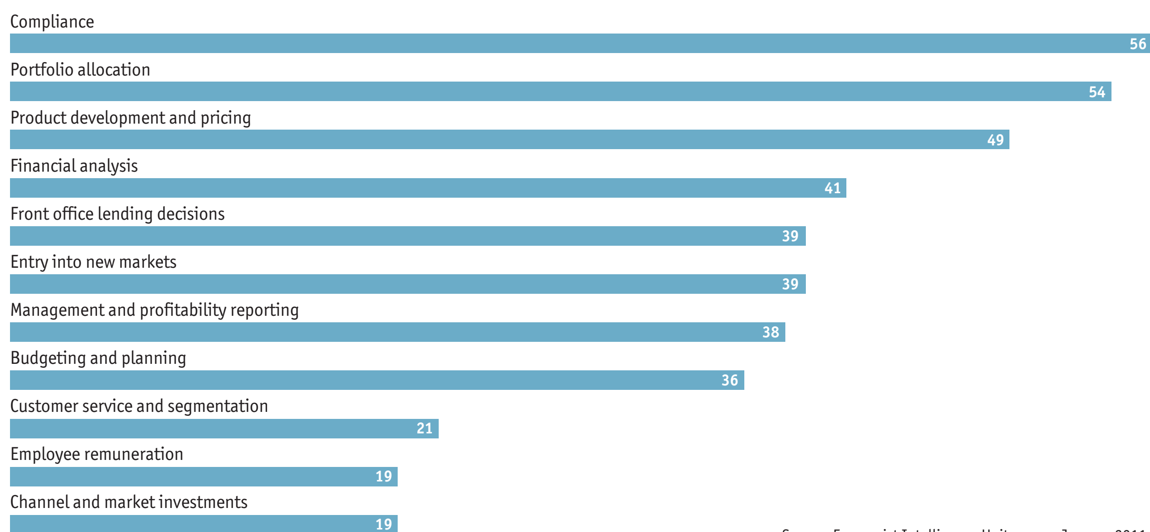
Although the second accord of the Basel Committee on Banking Supervision (Basel II), issued in 2004, promoted this well before the 2008-09 global financial crisis, even institutions that were early adopters of its Internal Rating Based approach are going further. Sir Kwok-po Li comments: “We are definitely looking deeper for more information. We are looking to place limits on each different type of risk and if there are any changes we want to know why.” Data reliability is also getting attention. Mr Midkiff, for example, thinks that the evolution of data oversight and governance is one of the biggest changes he has seen in recent years at Union Bank.

Are board members and CFOs ready to act on new risk data?

Obviously, this effort is essential. “Until you have the facts on the table, you can’t have an intelligent conversation,” stresses Mr Craig of Commonwealth Bank of Australia. Nevertheless, it is only a prerequisite for the changes that the industry faces. “The absence of good current data and the inability to provide quick and accurate risk aggregation make you more vulnerable. It is also a competitive problem. However, to blame the losses [in the crisis] on bad risk data is overstating the fact,” comments Mr Friis of Royal Bank of Canada. Indeed, at INSEAD Professor Dermine finds it “a bit amazing that banks are still busy in 2011 with technical problems and data aggregation. Clearly it must be done, but it is not enough. The question is what the board is going to do with this.”

Use of risk-related considerations and metrics has increased most significantly in the compliance field (cited by 56% of respondents), which is a result of regulatory demand rather than internal consideration. Obviously, tightened regulation has been, and will continue to be, in Mr Midkiff’s words, “a huge driver” of these changes. However, this does not mean that it is only a compliance exercise. “The input of regulators has helped the banks to do what is right—spend a great amount on a higher level of data quality,”

In which of the following areas has the role of risk considerations and metrics increased significantly at your company in the last two years?
(% respondents)



Source: Economist Intelligence Unit survey, January 2011.

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"In the end, everything stands or falls on risk-adjusted considerations. Planning is not possible without considering the associated risk."
Thomas Mueller, CFO at Sarasin Bank

observes Mr Dallavecchia. Mr Kannan of ICICI Bank agrees: "The learnings from the crisis have been so significant that executive management can't afford to ignore them. The focus on risk is driven by these learnings, while the regulatory guidelines give that extra push."

Looking at the broader use of risk data, however, raises questions, especially for finance functions. "If you build it, they will come" may have been excellent advice in the baseball movie *Field of Dreams*, but if you gather risk data, CFOs may not come to use it. Certainly, too few are taking full advantage of it. Fifty-four percent of those surveyed have increased the use of risk considerations in product allocation, but this is an area where risk issues are already intrinsic. Under one-half of respondents, in contrast, have seen a significant use of risk considerations and metrics in several key finance responsibilities: financial analysis (41%), front office lending (39%), management and profitability reporting (38%), and budgeting (36%). One of the most oft-repeated demands by those looking at the roots of the crisis, a larger role for risk metrics in assessing remuneration, has occurred at only 19% of financial institutions.

Not using risk data in some of these areas means operating more or less blindly. As Professor Goodhart notes on remuneration: "You can't tell whether somebody has done really well until you do the risk adjustment." Mr Tookey believes that risk is "now fundamental to evaluating strategic choices in any allocation of scarce resources, even human resources." It goes well beyond broad strategy to the minutiae of banking decisions. Previously "risk data probably have been underused," adds Mr Mueller, but he too thinks that "in the end, everything stands or falls on risk-adjusted considerations. Planning is not possible without considering the associated risk."

According to Mr Kim, Commerce Bank is now gathering data on a broad series of risk factors that might have an impact on specific segments of loans to look for early warnings of trouble. "The way we've changed," he says, "is using the data to get in front of problems and understand them sooner, as opposed to looking at the rear view mirror." Mr Dallavecchia also sees a "heightened need to understand even more, if possible, the interplay between different factors." For example, in areas with many automotive companies, how a downturn in that industry would affect other parts of the economy. Thus financial institutions would now consider the broader regional impact of such a development, such as the home equity loan risk of everyone in the region. "Information on that sort of second- and third-order effect was available before," he adds, "but how you put it together requires information packaged in a different way."

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Key points

- **Leading financial institutions are moving towards a more comprehensive use of risk information, but many others are trailing behind.**
- **Nearly one-half of respondents report that lack of leadership interest, lack of interest from other business lines, or corporate culture are major barriers to greater use of risk data.**
- **Greater alignment between risk and finance, and better use of risk data across the company and especially by the board may require the investment of significant time and resources.**

Impediments to more active use of risk information

Some financial instituions still have a long way to go

Leading financial institutions are moving towards a more comprehensive use of risk information, but why are so many others still trailing behind, especially in areas of particular relevance to the finance function? Partly it is a matter of time, as the technology changes necessary to gather and analyse data are significant and require investment. It is not a trivial change. Mr Craig is leading Commonwealth Bank of Australia's finance and risk architecture project, the goal of which is a single, unified view drawing on all finance and risk data. He cautions against underestimating the work involved: "This is very hard to do, with lots of countries, systems and products involved. It is a major exercise."

Nearly one-half of respondents report that lack of leadership interest, lack of interest from other business lines, or corporate culture are major barriers to greater use of risk data

This provides at least a temporary advantage to larger firms. Mr Dallavecchia of PNC Bank comments: "The largest financial institutions are moving ahead because they have the scale that allows them to invest the significant amount of money necessary to accomplish this significant amount of work." For larger financial institutions in our survey (those with assets of over US$250bn), 78% have seen significant improvement in creating a consistent view of risk across the company in the last two years; this is 61% for smaller institutions. With time, the latter figure is likely to rise.

Many interviewees in the industry indicate that the transformation in the use of risk information in all parts of the company will be "broad and deep", in the words of Mr Kim of Commerce Bank, especially given analyst, investor, media and regulatory pressure in addition to the business advantages. Mr Midkiff of Union Bank agrees. He sees great strategic benefits to increased use of risk information, but also notes a strong regulatory push with implicit "expectations that risk will have a strong seat at the table around pay and rewards as well as financial analysis and strategic planning."

Although some financial institutions, as they seek to improve their use of risk information, need more time in order to sort through the inherent complexities and find the necessary resources for the work involved, the survey also shows up a significant minority with deeper problems. Lack of interest by leadership is a major barrier to greater use of risk data at over one in five (22%) financial institutions, as is lack of interest from the relevant business lines (21%). A corporate culture that impedes change is a problem at 17%. Overall, nearly one-half (48%) of respondents report that at least one of these issues is a major impediment to progress.

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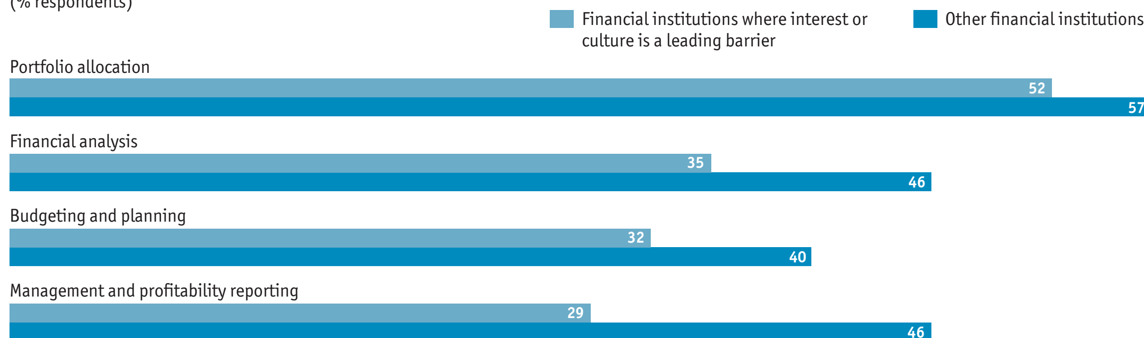

This has worrying implications for the industry. These financial institutions are less likely to have seen improvement in every area of risk management—for example, only 29% say they are gaining more competitive advantage from risk data, against 46% of other respondents, and 49% say they still require greater effort on creating a consistent, cross-company view of risk, against just 25% of other respondents. Moreover, these financial institutions are more likely to think that risk is simply a technical exercise (37% compared with 46% who disagree) than their more risk-conscious peers (17% compared with 65%).

Although it is impossible to determine directly from the survey how far this lack of interest is an issue in finance functions, the data suggest that the problem is having a notable impact. Financial institutions where such barriers exist are much less likely to see a significant increase in the use of risk consideration in areas where finance is largely responsible. Moreover, 32% of finance respondents call lack of resources a leading barrier to greater use of risk information across the business compared with just 21% of risk respondents, suggesting that the spending priorities of some CFOs are elsewhere too.

The need for leadership buy-in and a culture of risk management that encompasses the entire company is widely recognised. The focus on technology and information gathering in current efforts to improve, however, entails the danger of financial institutions losing sight of this cultural requirement. Indeed, without understanding it, the data can be an impediment to running the company. “The trick in reporting on all these things is to make it simple,” explains Mr Craig. “The tendency is to give more data, but the best decisions tend to be made from simple, clear data.”

Major changes at board level are needed to look at long-term value creation

When asked to cite the leading priorities of the finance function, respondents put processes and data issues at the top. Only 23% mention getting greater board and senior executive focus on risk issues, one of the lowest figures. With the survey showing that boards and the C-suite are at least asking for enhanced risk information, this might simply reflect a focus that is already sufficiently high to require no further effort. Among the group with leadership and culture shortcomings described above, however, requests for data are not part of more thoroughgoing change: only 26% of these finance functions are seeking greater

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board and executive attention for risk. Professor Dermine of INSEAD warns: “It is part of human nature to look at short-term profit and not to look at risk. Therefore there needs to be major changes at board level to look at long-term value creation. I don’t see much being done so far.”

This reluctance is difficult to understand. Greater alignment between risk and finance, and better use of risk data across the company and especially by the board may require the investment of significant time and resources. Nevertheless, as this study also shows, they lead to a more compliant, more robust financial institution with a healthier bottom line.

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Conclusion: What next for the CFO's agenda

The banking industry in general, and bank finance functions in particular, need to transform in response to the failings that led to the 2008-09 global financial crisis. A major part of this is the journey it has begun towards the better use of risk information. It needs to go much further down this road, however, both for its own sake and to respond to the demands of clients, investors, regulators and other stakeholders whose confidence was shaken so dramatically. Fortunately, the necessary changes will lead not only to a more stable banking system, but they will also result in better-run financial institutions. As they guide their companies along this path, CFOs and their teams should consider the following:

- **The integration of detailed risk data with information from finance into a coherent whole is becoming an essential part of banking**. Competitive and regulatory pressures have made a thorough knowledge of underlying risk shared across the company best practice. This is not easy or cheap to achieve, but it has become a basic expense of banking. Moreover, financial institutions can no longer afford the luxury of separate world views for finance and risk. The ongoing conversation which the two must have needs to begin from a common starting point.
- **CFOs in particular, and financial institutions in general, need to use risk considerations much more widely, in particular to obtain competitive advantage**. A majority of finance functions have not significantly increased the use of risk considerations in financial analysis and budgeting. Over eight in ten financial institutions have not done so in employee remuneration. This is unlikely to satisfy regulators and will soon become a liability as other competitors press ahead in using risk to improve in these areas. The nearly one-half of financial institutions where leadership and business lines are uninterested in greater use of risk, or where the culture militates against it, will be left behind.
- **Tight alignment of finance and risk is a part of the emerging competitive landscape**. Certain regulatory requirements, such as stress testing, simply cannot be fulfilled without close co-operation between risk and finance sharing a common set of data and assumptions. Meanwhile, the value to CFOs of such links in identifying lucrative new clients groups and in choosing where to focus capital is becoming ever more apparent. The survey data suggest that financial institutions with close alignment here may be strikingly more profitable.

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- **Alignment requires not just common data, but also processes and structures for people to work together**. Although common data are important, the main barriers to alignment between the risk and finance functions are their differing perspectives and cultures. To take full advantage of alignment, CFOs and CROs need structures and processes that allow executives in each function to engage in an ongoing conversation so that they understand each other better and work together more efficiently.

Ultimately, this is a journey without end. No system will be foolproof, and it is impossible to guarantee a future free from crisis. Nevertheless, as financial institutions improve their understanding of risk, and finance becomes more effective at actively using risk information, they should benefit from better performance by a transformed organisation.

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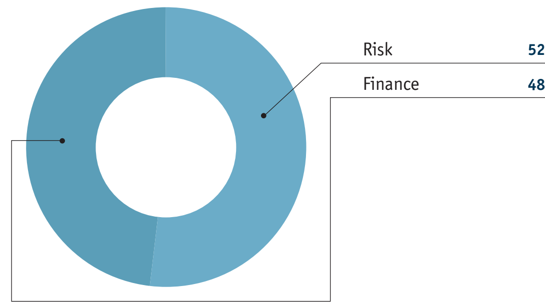
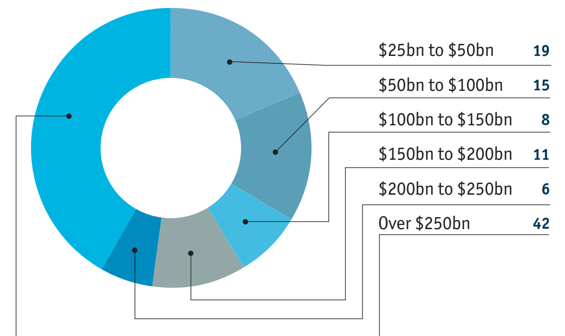
Appendix: Survey results

Percentages may not add to 100% owing to rounding or the ability of respondents to choose multiple responses.

What is your main functional role?
(% respondents)

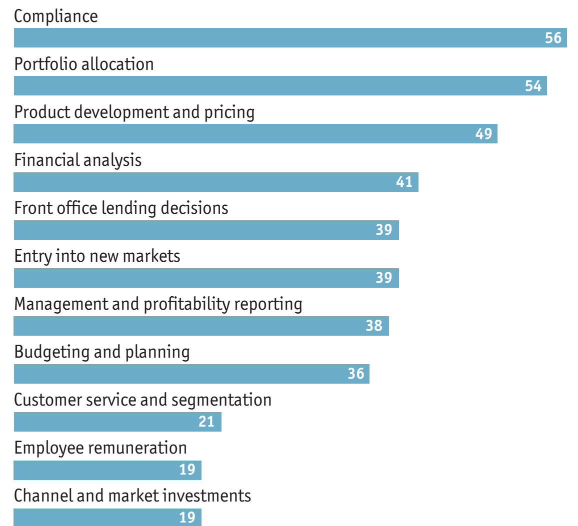


What are your company's annual global revenues in US dollars?
(% respondents)



In which subsector of financial services does your organisation operate?
(% respondents)

In which of the following areas has the role of risk considerations and metrics increased significantly at your company in the last two years? Select all that apply.
(% respondents)



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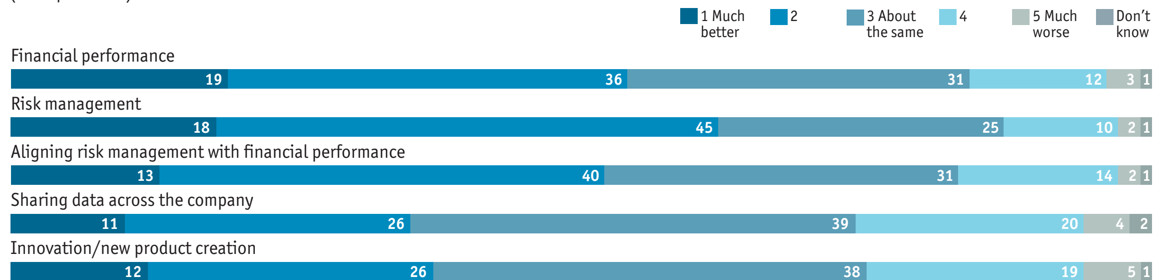
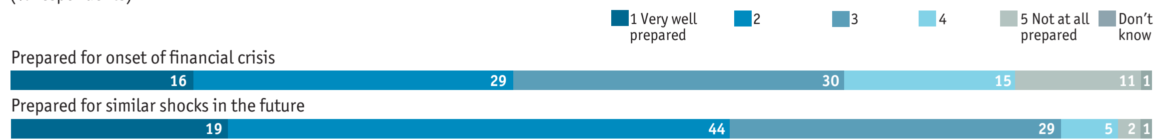
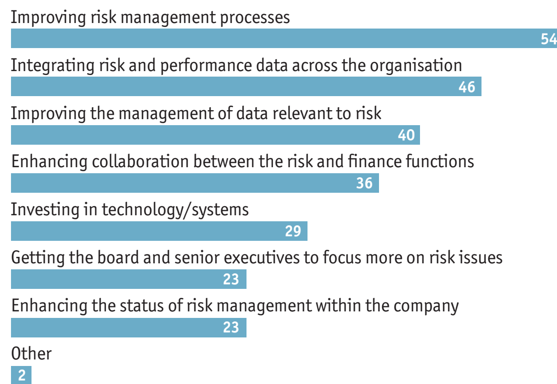
Compared to peer companies, how would you rate your company's performance/effectiveness in the following areas?
Rate on a scale of 1 to 5, where 1=Much better, 3= About the same, and 5=Much worse.
(% respondents)



How well did risk management processes and information systems prepare your company for the onset of the financial crisis and how well prepared do you believe current processes would make you for a similar shock in future?
(% respondents)



Which of the following represent the highest risk-related priorities within the finance organisation? Select up to three.
(% respondents)



Which of the following has your company improved during the last two years? Select all that apply.
(% respondents)

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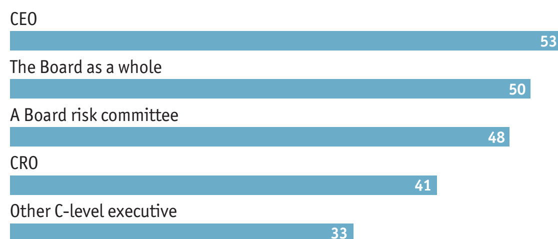
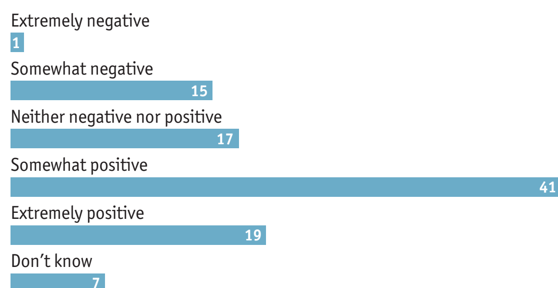
Which of the following still requires further effort, whether or not improvement has occurred? Select all that apply.
(% respondents)

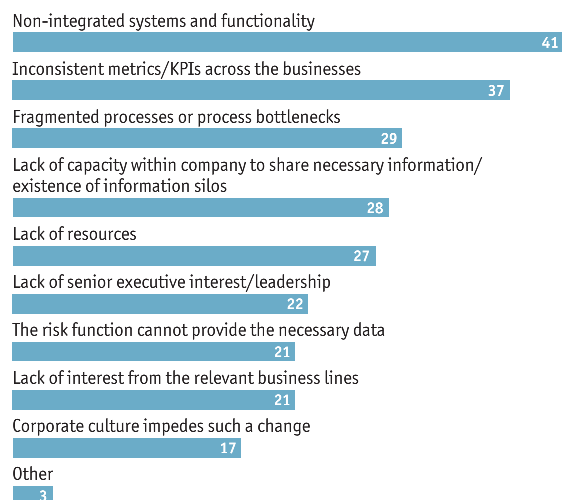
In the last two years, which of the following have asked the finance function for enhanced or different risk data? Select all that apply.
(% respondents)



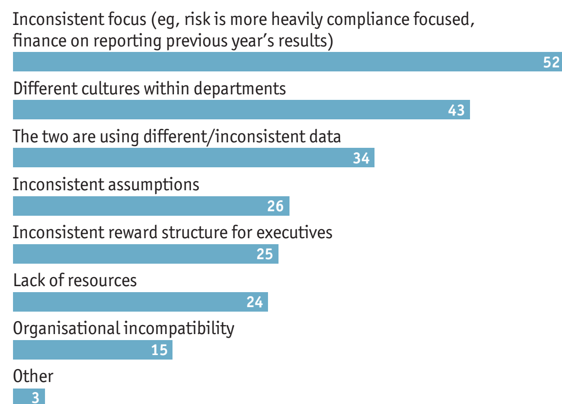
What impact are risk management activities having on your organisation's current performance?
(% respondents)



In your organisation, what are the major obstacles to incorporating risk-adjusted information in finance and performance management processes? Select up to three.
(% respondents)



What are the major barriers to better aligning the finance and risk functions at your company? Select all that apply.
(% respondents)



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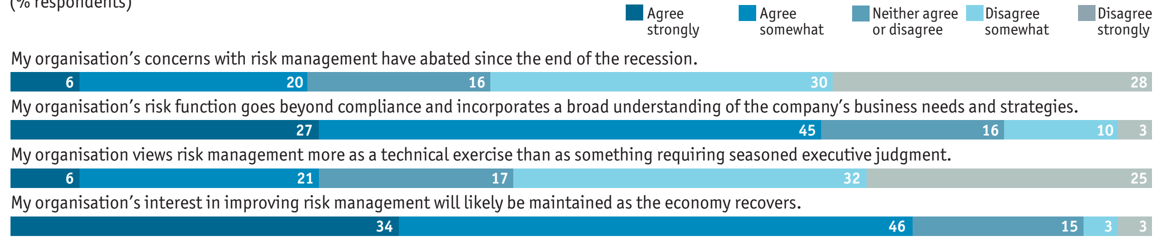
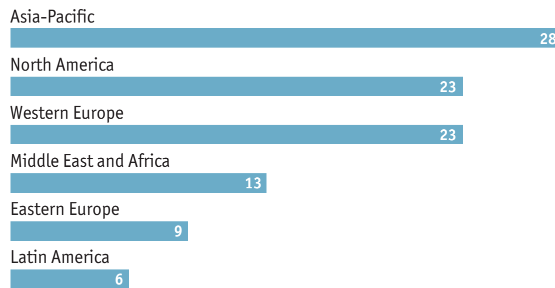
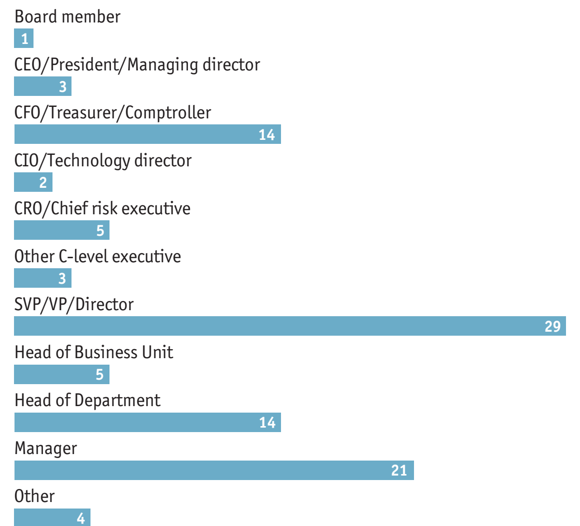
Do you agree or disagree with the following?
(% respondents)



In which region are you personally based?
(% respondents)



Which of the following best describes your job title?
(% respondents)



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