

EMEA Banking Practice



Wearing Varifocals – a new perspective on Risk Organization effectiveness and efficiency

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Wearing Varifocals – a new perspective on Risk Organization effectiveness and efficiency

Excessive credit concentrations in high-risk industries due to the bank's inability to take a cross-country view. Overlapping responsibilities for management of operational risk leading to significant trades with unauthorized parties going undetected. Significant mortgage related write-downs as a result of insufficient risk modeling skills. Insufficient contingency plans to support a migration ending in system failure and complete shut-down of the branch network for more than 48 hours. And the collapse of entire institutions whose strategy to rely disproportionately on wholesale markets to fund their international expansion went unnoticed in the absence of a comprehensive view of risks.

The growing list of organization-related risk incidents since the onset of the financial crisis has naturally alarmed bank executives, shareholders and other stakeholders alike. But as senior executives continue to review their reporting structures, incentive systems, risk culture and key processes to identify what went wrong, many are struggling to come up with a robust solution.

In addition to the risk management challenges directly created by the crisis, banks face intensifying pressure from regulators anxious to ensure sufficient risk oversight and control, and from an economic environment that demands tough action on costs. Risk functions must be simultaneously effective (fully resilient to future shocks) and efficient.

Traditional ways of looking at the Risk organization – focused on aspects such as divisional structures or centralized versus distributed decision making – often hinder a complete understanding of the Risk function and leave important gaps in a bank's defences. The complexity of the varied set of risk activities and responsibilities may obscure what needs to be improved to drive effectiveness and efficiency.

In this article we will propose a new way to look at the Risk organization that will help financial institutions assess and then improve their organization's effectiveness and efficiency. This new 'lens' allows executives to identify those areas that are weakest by analysing the different sub-functions of Risk – sub functions that have different objectives and perform different activities and therefore require different skills and remedies for improvement.

We will also present the results of research into 20 top international banks – highlighting typical deficiencies in some areas of the Risk function and some of the weak interactions between them – and recommend an agenda for action.

Defining the lens

Our new approach groups the responsibilities of the Risk function into four components as set out in Exhibit 1: these cover Enterprise Risk and Strategy; Risk Modeling and Monitoring; Single-name Risk Management; and Risk Operations.

The responsibilities of a Risk organization fall under one of four key components

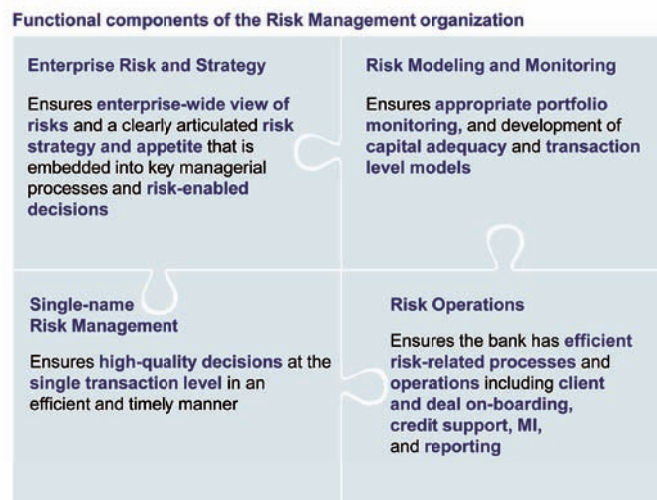


Exhibit 1

Each of the components includes a discrete set of duties, activities and face-offs that require specific skills and talents within the organization. CROs should be able to break down these activities and duties, identifying and eliminating any overlaps or gaps within and between the different components of the Risk function – and between the Risk function and the business – so as to ensure maximum individual and collective responsibility and alignment.

What are the key responsibilities of each component? The following high level description should facilitate a better understanding of each one.

Enterprise Risk and Strategy

This function clearly defines and articulates the bank’s strategic risk appetite across risk types, business lines, geographies and products; it designs enterprise risk management principles and policies for the whole organization and provides the appropriate governance structure for implementing the agreed strategy.

Risk Modeling and Monitoring

The professionals in this function translate the banks’ risk appetite into high-level Enterprise and risk type limits, develop an appropriate management information

framework, build and maintain portfolio/ transaction-level and stress testing models, monitor portfolio exposures and risks and provide guidelines and policies for modeling units embedded throughout the organization.

Single-name Risk Management

This part of the Risk organization strives to ensure the highest quality decisions at the single transaction level for both credit and market risk transactions. It performs risk analysis for individual clients and transactions, approves and dismisses transactions, and proposes and implements mitigation strategies for single name transactions to manage transactions through their life-cycle .

Risk Operations

This component of the Risk organization translates business unit and product risk decisions into keystroke decision procedures, designs and manages effective and efficient risk related administrative processes, ensures appropriate recording (client on-boarding, technology and MI) booking and compliance of all transactions, and produces reports.

The four components comprehensively capture all the risk organization’s responsibilities along the transactions value chain: each responsibility is grouped in one of the four components based on its characteristics as illustrated in Exhibit 2.

A framework covering all risk activities...

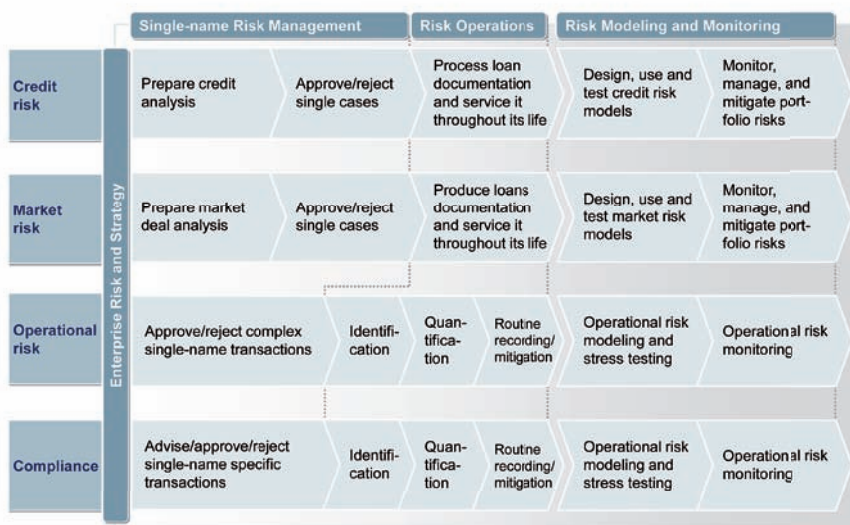


Exhibit 2

Each of the four components in the Risk function has its own clear objectives, priorities and responsibilities that are structurally different from each of the other components; any gaps within them will be with respect to meeting these inherent objectives

and responsibilities, and efforts to improve effectiveness and efficiency by closing the gaps will therefore require a different set of actions or levers (as illustrated in Exhibit 3).

Effectiveness and Efficiency levers are applied differently for each functional component given their distinct success drivers

	Enterprise Risk and Strategy	Risk Modeling and Monitoring	Single-name Risk Management	Risk Operations
1 Org. structure and governance	<ul style="list-style-type: none"> Substantial clout Clear reporting lines Effective collaboration with units outside risk 		<ul style="list-style-type: none"> Streamlined committee structure that enhances decision-making Clear reporting lines 	
2 Roles and responsibilities	<ul style="list-style-type: none"> Clear value creation and value protection mandate No fragmentation of roles 	<ul style="list-style-type: none"> Well-defined responsibilities for monitoring Operational risks 	<ul style="list-style-type: none"> Unambiguous responsibilities vis-à-vis front line 	
3 Talent, capabilities, and culture	<ul style="list-style-type: none"> Strong talent with right balance of required skills "Contrarian" mentality 	<ul style="list-style-type: none"> Appropriate talent with specific expertise Attractive career paths for modeling units 		
4 Activity consolidation and smart sourcing		<ul style="list-style-type: none"> Consolidated modeling units with strong functional excellence 	<ul style="list-style-type: none"> Optimal level of outsourcing/shoring of non-critical activities (eg., collections, basic credit analysis) 	<ul style="list-style-type: none"> Opportunities to centralize and nearshore/offshore are captured
5 Process optimization			<ul style="list-style-type: none"> Extensive process automation Limited number of hand-offs 	<ul style="list-style-type: none"> Lean processes supported by automation
6 Tools and systems		<ul style="list-style-type: none"> Models effectively reflect business reality 	<ul style="list-style-type: none"> Sufficient investment in necessary tools (eg., collection support tools) 	<ul style="list-style-type: none"> Close collaboration with global Ops/IT
7 Internal demand management				<ul style="list-style-type: none"> Active demand management (e.g., reporting)

Exhibit 3

For example, at a bank with a high-quality credit organization - where credit sanctioners were responsible for significant parts of the processing - a dedicated credit back-office was set up with clear responsibilities to process transactions from end-to-end. This not only reduced the burden on credit, but improved customer service through cutting time-to-cash by 30% and significantly reducing re-work from 70% to 20%. Thus, this lens afforded not only higher efficiency, but increased effectiveness by allowing sanctioners to focus more time on assessing credit, rather than checking processes.

It's also important to understand that the four components are interdependent and that the organization will only be effective and efficient if robust linkages are established between them. Any merging of activities, however, will likely result in unclear accountability, and potential lack of alignment between skills and mandates, as illustrated by Exhibit 4.

One key linkage is the mechanism by which the Enterprise Risk and Strategy component disseminates its risk appetite standards and ensures that these are properly and consistently translated into client and business guidelines by Risk Modeling and Monitoring. Risk Modeling and Monitoring, after all, is responsible for detecting early warning signs of stress in the portfolio.

Indeed, the effectiveness of Credit Portfolio Management at a leading bank whose skills in this area were considered very advanced, was being significantly compromised by excessive process complexity (mainly the result of unclear inter linkages

A Risk organization with responsibilities merged across components

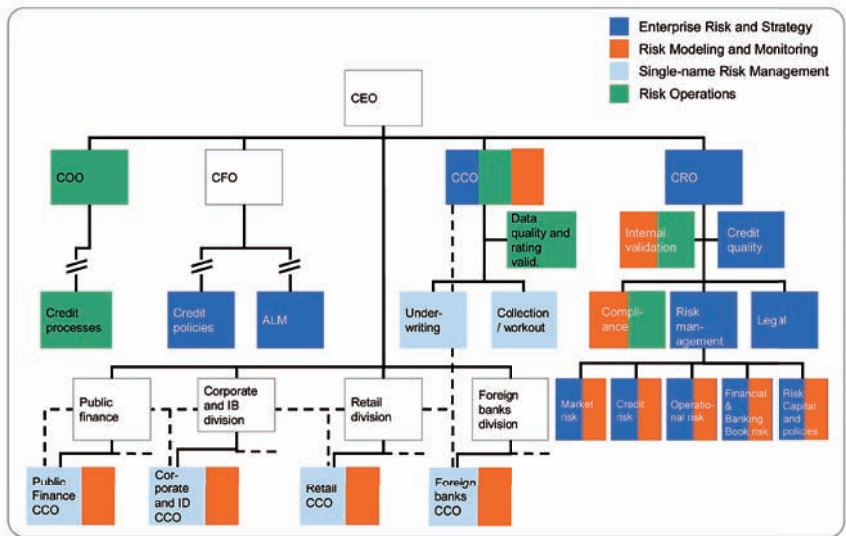


Exhibit 4

between the Single-Name Risk Organization, Risk Modeling and Monitoring and Enterprise Risk and Strategy) and by unclear roles and responsibilities. Using our framework, a detailed mapping of the processes and allocation of responsibilities, including veto rights for the Credit Portfolio Management department in individual lending decisions, removed blockages and cut time-to-cash from over 3 months to

Single-name Risk Management capabilities enhanced through simplifying roles and responsibilities



Exhibit 5

under 30 days for most cases. Doing this also fostered much improved working relationships between front-line, credit, and management because it made process, pricing, pricing shortfalls and ensuing actions significantly clearer.

The dangers of overlap are always inherent in the various approaches to management information. Both the Enterprise Risk and Strategy and the Single-name Risk components of the organization should define what information they require to oversee and manage the portfolio. Another important linkage is Risk Modeling and Monitoring designing the collection process and Risk Operations executing it.

Only by clarifying the roles and common responsibilities within each component can duplication and fragmentation be eliminated and an effective and efficient organization be created as per the case example in Exhibit 5.

As CROs view their organization through this new lens, they will also gain an understanding of the criteria that they should use to assess the effectiveness and efficiency of its different components (Exhibit 6). In our work with banks we often observe that executives wrongly assume that the drivers are similar.

How the criteria differ for each component

Enterprise risk and strategy	<ul style="list-style-type: none"> ▪ Clear, conclusive mandate across organization ▪ CEO/CRO has real 'clout'; requirement should be clear to senior managers ▪ Led by true risk professionals
Risk modeling and monitoring	<ul style="list-style-type: none"> ▪ Typically 'center of excellence' set up to embed best talent and ensure credibility ▪ Clearly defined roles and responsibilities to avoid duplication ▪ Strongly defined formal links to business
Single name risk management	<ul style="list-style-type: none"> ▪ Full independence, but strong link to business (e.g. through mission to reflect bank's risk appetite) ▪ Clear decision thresholds ▪ Measurable decision quality ▪ Blend of decision quality and efficiency at lower end
Risk operations	<ul style="list-style-type: none"> ▪ Systematic, 'factory' approach with clear efficiency and effectiveness measures ▪ Mentality of continuous improvement (towards customer, business)

Exhibit 6

Learning from the lens

By looking at the Risk organization structures of 20 large international banks, we found that the four components are often not individually optimized, and the interdependencies between them do not always work properly together (See Exhibit 7).

Review of Risk function within 20 large global banks highlighted frequent issues across the four components

Risk Component	Organizational issues identified and confirmed	Banks where issue is severe*
Enterprise Risk and Strategy	Fragmentation of responsibilities , lack of overarching accountability on all risks and on enterprise-wide risk	80%
	Weak role of CRO in core management processes (i.e. portfolio management, budgeting, planning, provisioning, etc.)	50%
Risk Modeling and Monitoring	Lack of risk capabilities within units requiring advanced analytical and quantitative skills e.g., modeling	40%
	Absence of attractive career path to attract "internal" talents into the risk organization	40%
Single-name Risk Management	Limited independence of risk functions and unclear mandate	40%
	Ineffective risk committees : slow decision making process, limited control on execution	57%
Risk Operations	Excessive socialization of risk responsibilities due to wide risk committees vs. individual accountability	57%
	Unclear allocation of risk responsibilities e.g., credit risk and internal control in relation to trades with unauthorized parties	30%
Level of Interdependencies across components	Ineffective risk management systems/poor risk data availability and quality	20%
	Weak interaction protocols between risk units internally and other constituencies (BUS, internal controls, CFO) along core processes	00%

* McKinsey analysis

Exhibit 7

Our research showed that:

Among the four individual parts the *Enterprise Risk and Strategy* component is the weakest. In many organizations, this component either does not receive sufficient attention, have the necessary clout or the dedicated organizational focus point. Where it does, the remit of the unit is not clear. In many cases, for example, we found that the strategic unit does not develop a true Enterprise, cross-asset class view (on credit exposures, for example) with the result that those sitting in this sub-function have only a partial (and often misleadingly calm) picture of the truth.

The *Modeling and Monitoring* component often lacks the required analytical talent and fails effectively to leverage that scarce talent it is able to attract and retain. Furthermore, there is often a lack of clear ownership for risk activities (especially for operational risk), leading to a lack of accountability and less effective risk controls.

The *Single-name Risk Management* component is often not sufficiently independent of the business unit and relies too much on committees, with the result that decision processes are ineffective and inefficient. We found that the Single-name Risk Management component struggles to divide responsibilities clearly between itself and the business units: misalignment, and slow and ineffective decision making inevitably follow.

The *Risk Operations* component typically fails to clearly allocate responsibilities, especially for operational risk with the Risk Modeling and Monitoring component. This area of the Risk organization typically offers the largest opportunities to streamline and consolidate activities.

Finally, the importance of the interdependencies between the four components is not well understood, and therefore linkages are often not appropriately defined. A clear illustration of this could be found in the response of banks to the significant increase in rescheduling/restructuring requests received at the dawn of the crisis. Discussions with the Single-name Risk Management component of the organization were not shared with Monitoring and Modeling which therefore failed to revise the assumptions behind its models. Such signals of change from the front line were not in turn translated to Enterprise Risk and Strategy with the result that banks’ risk strategy remained unchanged.

Exhibit 8 catalogues a number of failures that can be laid at the door of the different components of the Risk organization.

Recent history highlights a number of risk incidents that can be clearly linked to organizational failures around these four essential components

Elements	Description
Enterprise Risk and Strategy	<ul style="list-style-type: none"> Wholesale market exposure to fund international expansion resulted in a collapse of 3 major commercial banks Lending businesses were allowed to increase credit concentration in high-risk industry beyond the Risk function’s stated appetite, amplifying loss during the financial crisis
Risk Modeling and Monitoring	<ul style="list-style-type: none"> Identification of suspicious trading patterns were not appropriately escalated, preventing timely intervention and leading to billion dollar loss Significant mortgage-related write-downs – failure to properly model / price mortgage securities risk as a result of insufficient stress testing
Single-name Risk Management	<ul style="list-style-type: none"> Portfolio manager made unauthorized derivatives trades on behalf of clients Failure to properly assess risks associated with offering inappropriate loans to some borrowers
Risk Operations	<ul style="list-style-type: none"> Systems failure leading to loss of tapes containing records for millions of clients Millions transferred through automated currency swap transaction on day of Lehman’s collapse – automated transfer took place before “decision meeting” was supposed to take place

Exhibit 8

Applying the lens

The new framework can help banks understand where to focus their attention as they strive to improve their Risk organizations. It will allow them to enhance their Risk functions so they are both cost efficient and more resilient to future shocks. We recommend that banks take the following steps:

1. Run a detailed diagnostic on the effectiveness of each of the four components and their sub-components. Understand the extent to which each component falls short of what’s required and identify the sources of divergence (organization structure, talent and skills, pro-cess design, for instance).

2. Assess *efficiency* by conducting a mapping of the Risk organization to determine where FTEs sit between and within the four components. Identify where each risk activity take places within the organization and to what extent there are gaps/overlaps or organizational fragmentation. Develop an understanding of the appropriate FTE/activity coverage ratio (the number of credit files per FTE, for instance), and how the size and structure of the Risk organization match up to competitors.
3. *Gauge the effectiveness of the interactions, interdependencies and linkages between the four components.* Are these interdependencies well managed? Identify weak spots where responsibilities within the components are not appropriately articulated or service levels not defined.
4. *Identify specific improvement opportunities for the Risk organization for each of the four components.* Address any talent shortages, any weak interdependencies, any inadequate processes and defects in the organizational structure for each component and identify a targeted set of actions.

Exhibit 9 provides an example of how our approach to the assessment would work in practice: it drills down into the sub functions of the overall Risk Modeling and Monitoring component of the organization and describes a broader set of success criteria which we have developed through our work with banks. The key point here is that the success factors will not just be different for each component but for each sub function.

Each component can be further disaggregated into discrete activities to identify distinct success factors and improvement opportunities

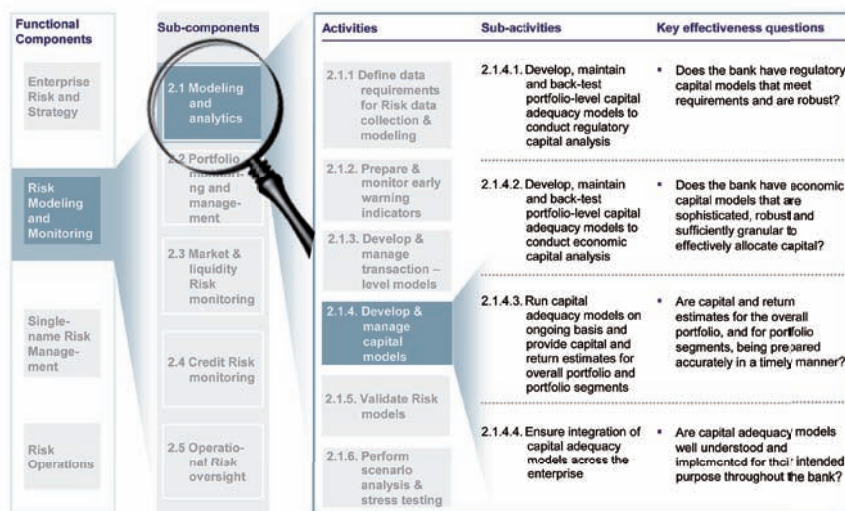


Exhibit 9

Case examples

Here are four brief portraits of how different institutions have scrutinized the four components of our framework:

Example 1 – Single-name risk management

Notwithstanding the bank's high-quality credit organization, it discovered that 70% of credit sanctioners were also responsible for significant parts of the processing. This took up to 50% of their work time and compromised credit delivery as well as the quality of credit decisions.

Determined to become world class, the bank set up a dedicated credit back-office with clear responsibilities to process transactions from end-to-end, including all aspects of credit delivery. The organization had its own dedicated operational KPIs which were measured and published weekly so as to ensure that the team kept focused. As a result of the change sanctioners were able to concentrate on credit decisioning excellence rather than process, not only easing their own burden but improving customer service through credit delivery times that were 50% shorter and re-work that tumbled from 70% of transactions to 20%). Looking through this lens therefore achieved the twin aims of greater efficiency and increased effectiveness.

Example 2 – Risk Operations

Another large bank fared extremely well in the crisis. In particular, its historic strengths in strategic/enterprise risk management paid off. It was quick to identify large portfolios of loans and trading asset classes likely to deteriorate if financial market conditions worsened, and made some bold decisions early on to retrench. A long-standing ERM process considered emerging risks in each major business, encouraged debate and reviewed limits. However, the bank had been less vigilant about risk operations and controls. It lacked strong, clear accountability for a whole range of control and compliance processes throughout the middle and back offices. As a consequence there were a large number of regulatory mishaps which were punished by fines, required expensive new capital buffers and brought extra outside scrutiny. The bank's response has been to upgrade its risk/control operations through instilling the importance of process ownership, tightening up risk tolerance levels and streamlining governance.

Example 3 – Enterprise and Strategic Risk

One highly successful investment bank reviewed its loss experience during the financial crisis to ascertain the strength of its risk function. It found it had done exceptionally well in single-name approvals and in risk operations. Its loan loss experience relative to its portfolio was well below industry average, while it mostly avoided operational risk 'events' during the turbulence.

However, the bank did uncover material weaknesses in its strategic risk management set-up, discovering that it had neither a dedicated function nor strong governance. For example, it had not debated the size of the structured finance warehouse, analyzed concentrations in select sub-asset classes in trading, or monitored the migration into lower-rated underwritings in CRE. In effect it was relying on single-name processes to assess strategic risks.

The bank's response was to make swift and significant changes to its structure, introducing a small but highly insightful ERM unit that reported directly to CRO, strengthening divisional risk committees to unearth strategic risk issues, launching business-level deep dive ERM reviews, and incorporating strategic risk reporting/issue logs into quarterly business MIS.

Example 4 – Single transaction organization and data/modeling

After a detailed review of the reasons behind the failures of its Risk organization during the crisis, a large universal bank acted to improve its central risk oversight, match its risk monitoring responsibilities with risk assessment capabilities, upgrade the quality of its risk talent, and overhaul its risk data. The review confirmed that neither pure business unit nor pure group structures provided the answer.

As a consequence the bank created a Risk function aligned with business units that all report to the center. In cases where it makes sense – for example the Investment Banking Risk Unit and market risks – the Risk function in the business unit monitors risks on behalf of the group. In this way the most appropriate unit with the best talent performs the task. In addition, the bank initiated a determined talent improvement program starting with the most senior ranks of the Risk organization, and embarked on a 12-month campaign to make data about its risk positions more consistent, transparent and timely.

In the middle of the current turbulence, we urge CROs to use our new 'varifocal' lens to reassess the resilience and efficiency of their Risk organizations. We believe such a review – and the lessons learned from the analysis – will better equip Risk organizations to withstand future financial shocks and ensure effective and efficient execution of all critical risk activities.

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