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Risk in emerging markets

The way forward for leading banks

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Contents

Risk in emerging markets: The way forward for leading banks

An outstanding decade: Can it be replicated?	1
Sound growth could continue, though at a slower pace	2
Strong profitability in the last decade, but the outlook on margins is challenging	3
Solid capital position so far, though this may no longer be a differentiating factor	4
Current risk-management practices might not be sufficient in the days ahead	5
Four risk priorities for banks in emerging markets in the coming decade	6
Act on risk culture across the organization—not just in risk and credit teams	7
Improve the bottom line through better collections processes	8
Develop—and use—innovative risk models with qualitative and quantitative credit data	9
Start to deploy capital-allocation and optimization approaches	11
Conclusions and implications for banks	13

Risk in emerging markets: The way forward for leading banks

The past decade saw an unprecedented rise in the fortunes of emerging-market banks: their collective revenues grew from \$268 billion in 2002 to \$1.4 trillion in 2012. The financial crisis that had such a major impact on European and US banks seems to have been much less damaging for emerging-market banks. In fact, their growth trajectory has continued, albeit at a slower pace. Most of the banks also have stronger capital and liquidity positions than their peers in developed markets. In particular, emerging-market banks historically have had higher Tier 1 ratios and lower loan-to-deposit ratios. That tide is now shifting. Amid tightening of monetary policy in the United States and stronger growth in developed markets, as well as a changing regulatory landscape and increasing competition, emerging-market banks are facing more pressure, with increased risk costs and declining profitability. Examples in the past two years include a steep increase of about 30 basis points in the cost of risk in Turkey and a 46 percent decline in the profitability of return on risk-adjusted capital in Eastern Europe.

The result is that risk management has now moved to the top of the agenda for CEOs and their boards. The risk function is increasingly being asked to shift away from its traditional focus on measurement, compliance, and control and toward mitigating existing challenges on credit, capital allocation, and liquidity or funding. Risk teams are now considering ways to offer a forward-looking view to support decision making from the boardroom down through all layers of the organization.

Our experience, supported by a survey we conducted with the Risk Management Association on practices in enterprise risk management, shows there are four priority areas for emerging-market banks:

- **Act on the risk culture across the organization.** Traditionally, banks in emerging markets have not properly managed the diffusion of risk culture across the organization—but in the current economic and banking environment,¹ this is becoming one of the most important challenges.
- **Improve the bottom line through enhanced collections processes.** Collections has not been a priority area for emerging-market banks, and there is significant room for performance improvement.
- **Develop innovative risk models on qualitative and quantitative credit data.** There is a scarcity of information on creditworthiness in emerging markets, so banks have strong incentives to invest in developing risk models that incorporate both qualitative and quantitative factors.
- **Start to deploy more advanced capital-allocation and optimization approaches.** A rationalization of bank capital is a great opportunity to support business growth and unlock profitability in an environment of increasingly scarce resources.

Emerging-market banks can address the big-picture challenges they face by acting immediately on these four dimensions: running a risk-culture diagnostic across the organization to identify and mitigate hot spots, redesigning end-to-end collections processes, developing more advanced credit-risk models, and reviewing capital-allocation processes. These all represent clear priorities.

An outstanding decade: Can it be replicated?

Banks in emerging markets have experienced once-in-a-lifetime dynamism and growth over the past decade. They outgrew their developed-market peers, on average, four to six times. They achieved this while having levels of return on equity (ROE) that were, on average, 12 to 13 percentage points above those typical of banks in developed markets.

¹ Hans Helbekkmo et al., *Enterprise risk management—Shaping the risk revolution*, McKinsey & Company and the Risk Management Association, 2013, rmahq.org. The survey covered more than 50 banks globally and revealed insights from emerging markets such as Eastern Europe, the Middle East, and Asia-Pacific.

Can this performance be replicated in the coming decade? Overall, we remain optimistic about the future of the emerging-market banks, yet we also believe that they will need to adapt rapidly to a different environment.

While overall growth rates are likely to slow in many markets, relatively low penetration levels still offer significant opportunities. Loans and deposits, as a percentage of GDP, stand at 215 percent today—less than half of that in developed markets. At the same time, many banks are experiencing contracting margins, while growth is coming from new segments where the risk costs could be higher.

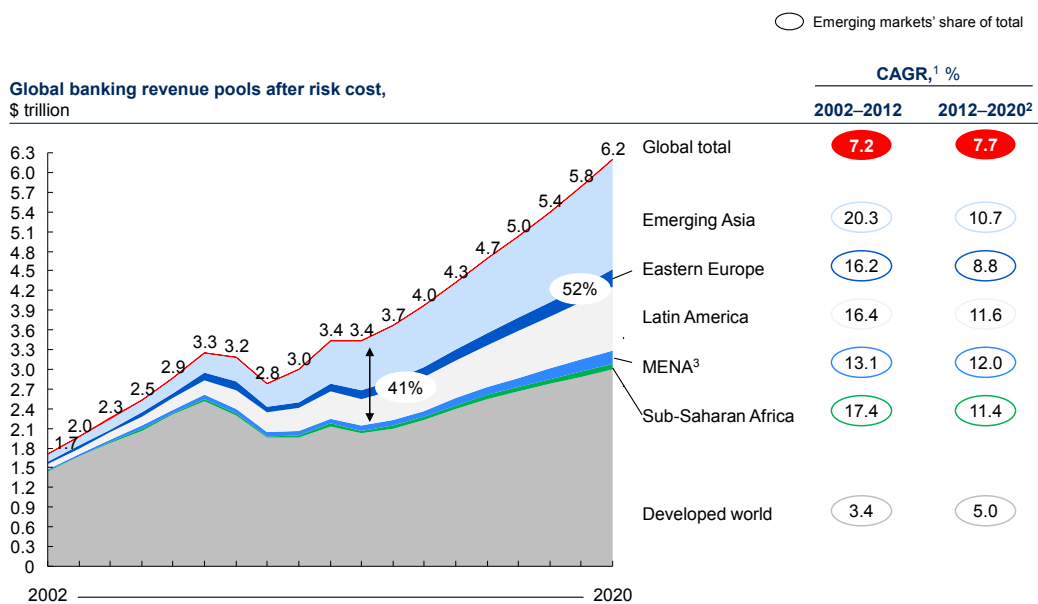
Of course, not all markets are the same, nor do they have the same potential or underlying factors, but we can generalize about the main trends.

Sound growth could continue, though at a slower pace

Emerging-market banks have shown sound growth, even if some countries—including South Africa—grew more slowly than others (Exhibit 1). Similarly, some segments grew more quickly than others. Retail banking, for example, showed much faster growth than wholesale banking in most African countries. There are good reasons to believe that this pattern is likely to continue: consumer demographics are favorable. By 2025, almost 60 percent of households earning more than \$20,000 a year will be in the developing world, and in many emerging markets, the predominant segment will become the mass affluent.

To win customers, banks will need to innovate and tailor their offerings to the changing needs of the population. In particular, banks should focus on segments that are currently underserved—such as micro, small, and midsize enterprises (MSMEs) and infrastructure. In addition, banks can seek out new and potentially lucrative customers by offering multiple new channels and digital solutions. Efforts to stave off slower growth via such initiatives are not straightforward, however. In particular, they bring with them exposure to new categories of risk, on a scale for which many banks are unprepared.

Exhibit 1 Growth in emerging-market banking has been strong in recent years.



1 Compound annual growth rate.
 2 Estimated.
 3 Middle East and North Africa

Strong profitability in the last decade, but the outlook on margins is challenging

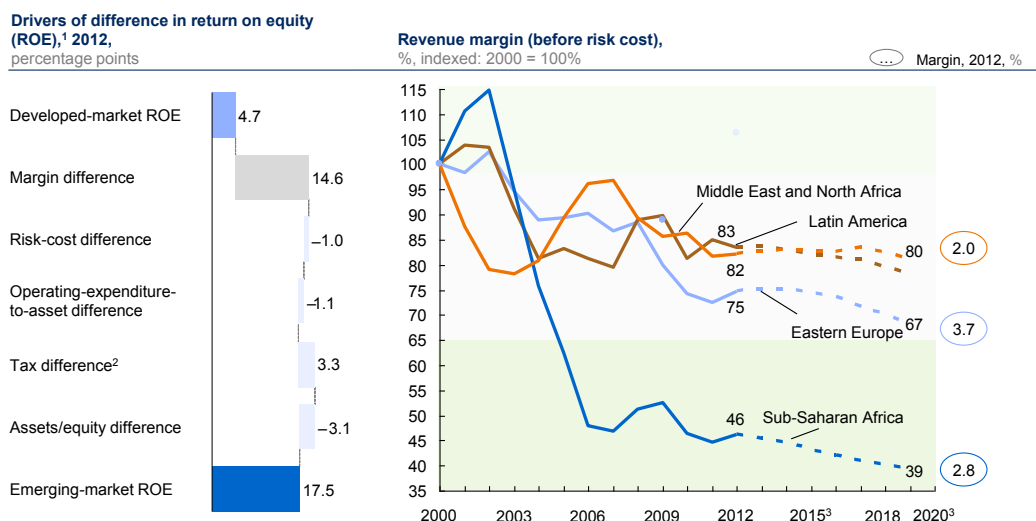
Profitability in emerging markets is still much higher than in developed markets, with countries such as South Africa enjoying very high ROE ratios and strong value creation: its economic-value-added spread is about 5 percent as result of an 18 percent ROE and a 13 to 14 percent cost of capital.

This positive profit performance derives mainly from margins that are double those in developed economies. However, revenue margins have already been hit in some regions and further deterioration seems likely (Exhibit 2).

Historically, margin reductions in emerging markets have happened quite quickly, and current trends suggest that the pressure on margins could increase in the near future. In particular, some elements will be relevant:

- There are tighter regulations on financial stability. Basel III requirements and new consumer-friendly policies, such as caps on income fees and distribution commissions, will limit banks' freedom in setting prices.
- Competitive intensity in emerging markets is increasing from nonfinancial institutions—such as retailers and telecommunications providers—and from foreign banks that are expanding their product and geographic presence.
- Consumer sophistication increasingly matches that of developed markets, with consumers shopping around for the best deals and demanding more service and products for lower prices.
- Cost-to-asset ratios are almost double those in developed markets, posing significant risk to profits if revenue margins drop.

Exhibit 2 Margins are expected to decrease in the consensus scenario.



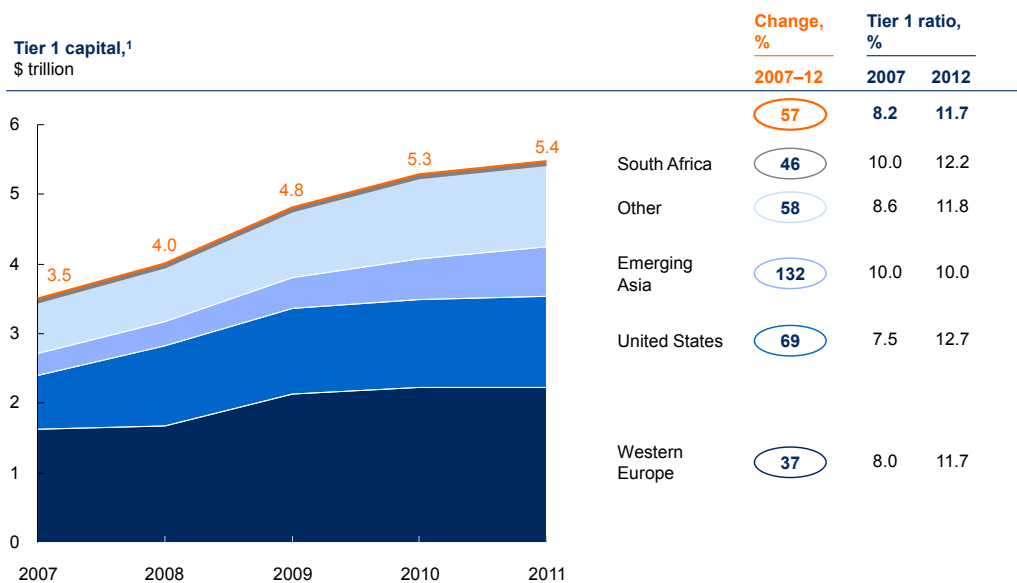
1 Waterfall shows the simulated impact of each profitability driver on the ROE gap between emerging and developed markets.
 2 Including minority interest and discontinued-operations income.
 3 Forecast.
 Source: Thomson Reuters; McKinsey analysis

Solid capital position so far, though this may no longer be a differentiating factor

Tier 1 capital is at much higher levels in emerging markets than in developed economies. This has allowed banks to sustain their growth and to feel little pressure from regulators on capital adequacy. For example, most Eastern European countries had core Tier 1 ratios in line with Basel III requirements as long ago as 2011, and South African banks showed even higher capitalization (Exhibit 3).

Yet the gap to developed-market banks has also been disappearing, as these banks have boosted their capital positions significantly following the financial crisis. Loans in emerging markets have been growing at double-digit rates for most of the past decade, and the economic slowdown has only briefly interrupted this trend. Banks will require additional capital to fuel this growth in the future. Furthermore, emerging markets are quickly adopting regulation on capital requirements from developed economies: major markets have already implemented Basel II, and they are now moving quickly toward Basel III. Until now, the impact of higher capital requirements has been limited, thanks to a historical buffer of extra capital available to emerging-market banks and to their sound profit generation. Now that this buffer is diminishing, banks will either have to improve their capital-usage efficiency or gather new resources to sustain growth, with all the consequences that this will have on profitability.

Exhibit 3 Tier 1 capital is at high levels.

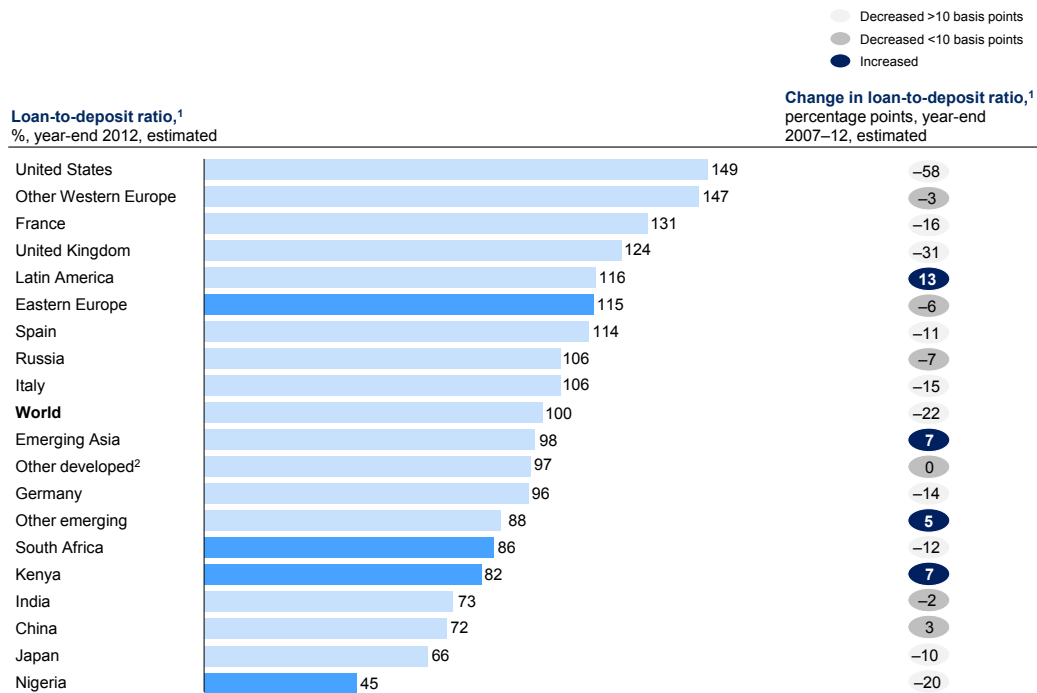


¹ Upscale estimate aggregation of all listed banks with available data in Reuters plus a 10% buffer for nonlisted banks.
Source: South African Reserve Bank supervision annual reports; Thomson Reuters; McKinsey analysis

Funding and liquidity is becoming more of a challenge

In recent years, emerging-market banks have been able to rebalance their liquidity position: the average loan-to-deposit ratio has increased, although it remains low compared with more mature countries. There is considerable variation across markets. Eastern Europe has already breached the 100 percent threshold of loans to deposits, reaching values close to 130 percent, while South Africa and other emerging markets still show ratios below 100 percent (Exhibit 4).

Exhibit 4 Loan-to-deposit ratios are low, especially in Africa.



¹ On-balance-sheet customer loans over customer deposits, except for Nigeria, where it is gross customer loans to customer deposits.
² Includes Australia, Canada, Hong Kong, Korea, New Zealand, Singapore, and Taiwan.

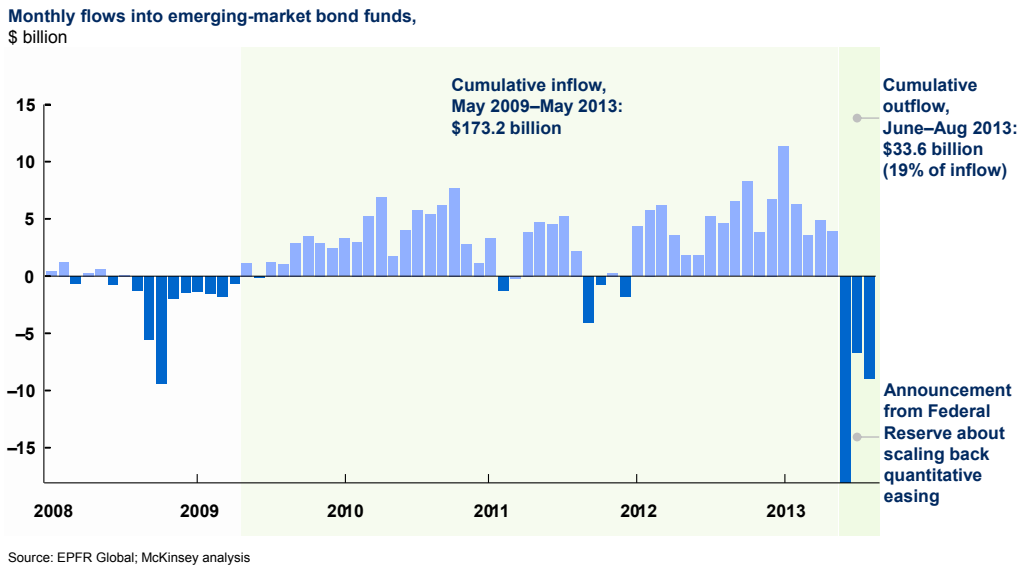
Emerging-market banks were less negatively affected by the financial crisis than their counterparts in developed economies. Central banks in Western Europe and the Federal Reserve in the United States adopted expansive monetary policies, leading to very low interest rates. Investors from developed economies have substantially increased their investments in emerging countries, where returns have been significantly higher than those available at home. This flow of foreign investments has been sustaining and stimulating growth in many emerging countries. However, in June 2013, the Federal Reserve announced it would reduce its quantitative-easing policy—and since then the capital flow has reversed, with investors taking their capital out of emerging markets (Exhibit 5). Emerging-market banks could face significant challenges in gathering new liquidity, especially in the bond market. Adequate liquidity management could become a key advantage.

Current risk-management practices might not be sufficient in the days ahead

Banks have gone to some length to improve their risk-management practices—to support growth strategies and especially to conform to new regulatory requirements. Most of the efforts, however, are incremental improvements on legacy systems and processes rather than a radical rethinking of risk management. Current practices typically have a number of shortcomings:

- **Most emerging markets pay little attention to risk culture, talent, and capabilities.** In many organizations, risk functions are relegated to a secondary role in the organization, struggling to attract, retain, and manage talent. They also have had little impact on increasing risk awareness, literacy, and accountability in other lines of defense, including the business’s front line. Risk management is seen almost as a hurdle rather than a true partner of the business or a group that could play a steering role in the organization.

Exhibit 5 A significant capital outflow began in mid-2013 after talk of 'tapering' quantitative-easing efforts began.



- **Credit processes typically have changed very little for more than a decade.** Although credit is a major source of risk and revenue for the vast majority of banks in emerging markets, credit processes and underlying support mechanisms have remained largely unchanged in most—even when some banks grew tenfold. For example, many banks still do not effectively use predictive statistical models (such as scoring models or behavioral scoring) in underwriting and monitoring, although they may have made significant investments to acquire these tools.
- **Sufficient and reliable risk data and information, as well as infrastructure and applications, may be missing in many institutions.** Much more stringent regulatory requests have come from the Financial Stability Board, the Senior Supervisors Group, and the Basel Committee on Banking Supervision in recent years. However, these have only partially touched emerging markets. The gap in data and infrastructure (for example, limited or scattered presence of credit bureaus in many emerging geographies) is reflected in the low availability of strong risk models to support credit decisions and steer portfolio growth.
- **Areas where risk can add significant value—such as capital planning, strategic decisions, and managing the regulatory agenda—have been ignored in many cases.** Many financial institutions lack a robust risk-appetite and strategy definition supporting portfolio growth, capital-allocation decisions, and daily processes and decision making. The management approach toward, and efficiency level of, available capital is suboptimal. There are also many examples of a growing need for better regulatory management, including the recent introduction of more stringent rules on credit cards and consumer loans in Turkey and the early adoption of Basel III requirements in South Africa. This regulatory pressure will ultimately require banks to take a more holistic and integrated view of the implications of regulatory change for strategy, business-model design, and risk management overall.

Four risk priorities for banks in emerging markets in the coming decade

Our analysis clearly suggests banks need to make adjustments to risk management in several areas:

- enhance the organization's risk culture and better develop risk talent and capabilities

- strengthen the credit process substantially, in particular, by setting up a collections engine in order to cope with the increasing stock of deteriorated loans
- develop innovative risk models to support credit decisions and healthy growth
- upgrade capital-allocation skills and capabilities, ensuring greater capital efficiency via improved risk-weighted-asset (RWA) management

In the remainder of this paper, we examine each in turn.

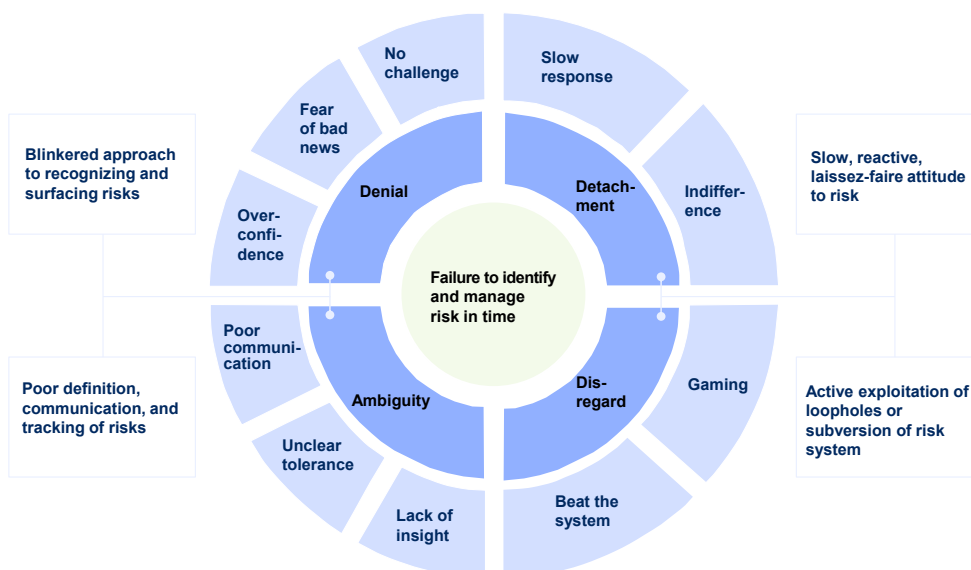
Act on risk culture across the organization— not just in risk and credit teams

Risk culture encompasses the mechanisms and approaches an institution deploys to strengthen mind-sets and behaviors, such as fostering an open and respectful atmosphere in which employees feel encouraged to speak up when observing new risks. In Europe, many initiatives are already in place; in the United Kingdom, for example, an industry-wide diagnostic is under way to address four areas of concern: responsiveness, respect, transparency, and acknowledgment (Exhibit 6).

Banks perceive risk responsiveness as the major risk cultural challenge in emerging markets, where little attention traditionally has been paid to ensuring that risk culture permeates the organization. One explanation is that, in order to organize an effective response, a multitude of stakeholders—such as risk, compliance, and legal—must be involved, and this usually takes a lot of time.

In the current economic and banking environment, in which banks are acting more decisively to respond to existing and emerging risks, it is increasingly important to act on risk culture. Many banks have recently begun initiatives to enhance risk culture—for example, by setting up dedicated sessions with business, risk, and control functions to think through a set of potential risk-response scenarios ahead of time; by explicitly defining the expected actions for all stakeholders; and by engaging in and publishing test runs that will strengthen and reinforce a strong risk culture in the risk function and the overall business.

Exhibit 6 Mind-sets and behaviors play an important role in risk management.

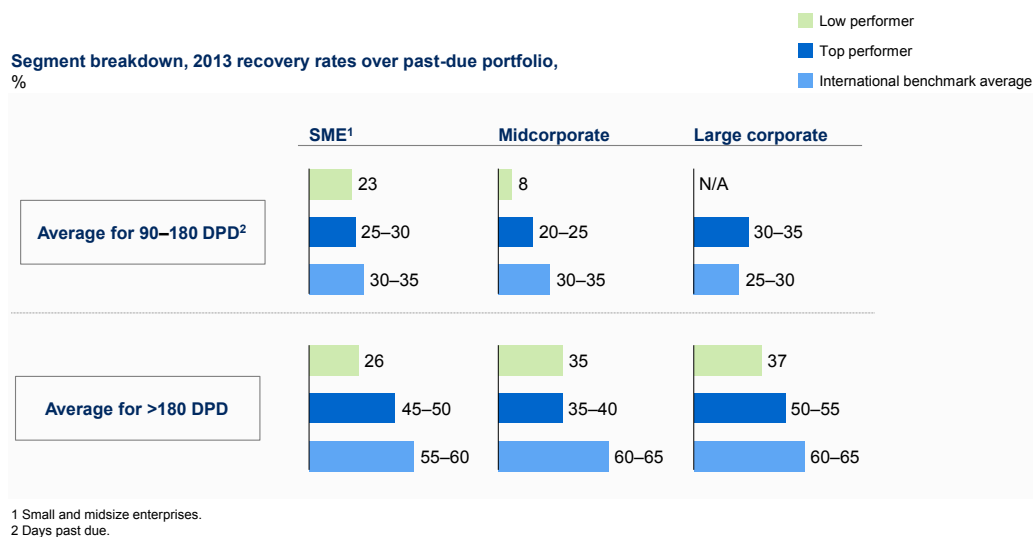


Additionally, many emerging-market banks intend to introduce or upgrade a risk-appetite framework to support common language about risk decisions within the organization and promote risk-conscious decision making. This has been strongly encouraged by regulators, who are concerned about banks strengthening risk management and governance.

Improve the bottom line through better collections processes

There are early signals that can show potential deterioration of credit risk, particularly in retail segments. A good example is credit cards, personal loans, and small-business lending in Turkey, areas where rating agencies recently noted their concern after a period of strong growth. In particular, the sharp increase in loan-loss impairments, which nearly tripled from €12 billion to €34 billion between 2007 and 2012, is putting pressure on profitability for many emerging-market banks. Given this context, many banks are acting promptly on multiple fronts and focusing on credit collections, which has been an area of weakness historically. There is clear variability among players that are low and top performers and a gap between emerging-market banks and international players (Exhibit 7).

Exhibit 7 Recovery rates vary widely.



Specifically, banks address credit collections using an approach that entails both a “crash” program and a transformation journey for the “credit machine,” as Exhibit 8 shows:

- First, they identify actions on the nonperforming-loan (NPL) stock in order to make an immediate positive impact on bank performance. Such actions typically include running a granular credit-portfolio analysis and identifying and launching specific campaigns for each portfolio cluster of NPL stock.
- Next, they support structural improvements to credit management related to a defined recovery strategy, organizational structures and processes (for example, processes and work flows), and systems (for example, incentives). Broader change can emerge once banks carry out a detailed diagnostic on all elements that affect the credit machine.

Programs of this sort have resulted in huge short-term impact with respect to NPL stock reduction: in Eastern Europe, for instance, banks have seen up to 20 percent stock reduction, including positive returns on P&L and decreased NPL flows in the medium term.

Exhibit 8 A systematic approach can improve collection performance.

Overall objectives	Crash program on non-performing loans	
Identify quick-win solutions (“crash” campaigns) and approaches to effectively tackle current stock	1 Granular credit-portfolio analysis	<ul style="list-style-type: none"> ▪ Detailed assessment of current credit performance vs peers ▪ Granular analysis of problem and deteriorated loans, including all relevant dimensions, to identify key hot spots and areas of attention
	2 Identification and launch of crash campaigns	<ul style="list-style-type: none"> ▪ Identification and launch of specific campaigns for each portfolio cluster, based on a set of standardized best practices ▪ Estimate of P&L and balance-sheet end-of-year impact for each campaign
	3 Setup and launch of implementation machine	<ul style="list-style-type: none"> ▪ For each campaign, detailed identification and syndication of a set of activities to achieve estimated impact, with owners and deadlines ▪ Setup of a rigorous monitoring machine involving bank top management
Support structural changes, leveraging internal and market best practices, by pulling a set of transformational levers	Transformation of “credit machine”	
	1 Granular credit-machine diagnostic	<ul style="list-style-type: none"> ▪ Diagnostic of health and performance of the credit machine across all segments and elements, including strategy, tools, infrastructure, skills, and capabilities
	2 Identification of transformational levers	<ul style="list-style-type: none"> ▪ Identification and detailed description of a set of transformational levers to improve credit management with respect to strategy, structure (eg, processes), and systems (eg, incentive system)
	3 Development of a transformation journey	<ul style="list-style-type: none"> ▪ Prioritization of levers and development of a comprehensive work plan to achieve excellence in credit management

Develop—and use—innovative risk models with qualitative and quantitative credit data

Banks need to make better-informed credit decisions. There are peculiarities in emerging markets, including limited availability of reliable financial information about customers (especially for small and midsize enterprises), missing credit-bureau information, limited reliable historical data about customer performance, unbanked clients, and so on.

An opportunity exists to improve the availability of sound information about client creditworthiness from credit bureaus. Organizations such as Equifax, Experian, and TransUnion, which are widespread in the developed world, have only begun to penetrate emerging markets. Wider use of credit bureaus in credit-decision and risk models can have a significant positive impact. For example, after a credit-bureau system was implemented in one emerging country, the MSME loan books of small banks showed a 79 percent decline in default rates, while large banks’ default rates fell by 41 percent. At the same time, the probability of a loan being granted to an MSME increased by 43 percent.

In order to cope with the poor data environment, many banks have started to develop risk models incorporating qualitative factors as the main valuation drivers. The qualitative credit assessment (QCA) is an important part of many credit-rating models, as Exhibit 9 shows, and complements quantitative measures such as statistical scoring models, improving overall predictive power (Exhibit 10). In Middle Eastern countries where this model has been implemented in recent years, QCA has fulfilled the Basel II requirement for human judgment to inform the assignment of ratings to corporate obligors and has allowed banks to significantly improve the overall predictive power of their models.

Exhibit 9 A qualitative credit assessment complements quantitative methods.

Sample structure of qualitative credit assessment (QCA)

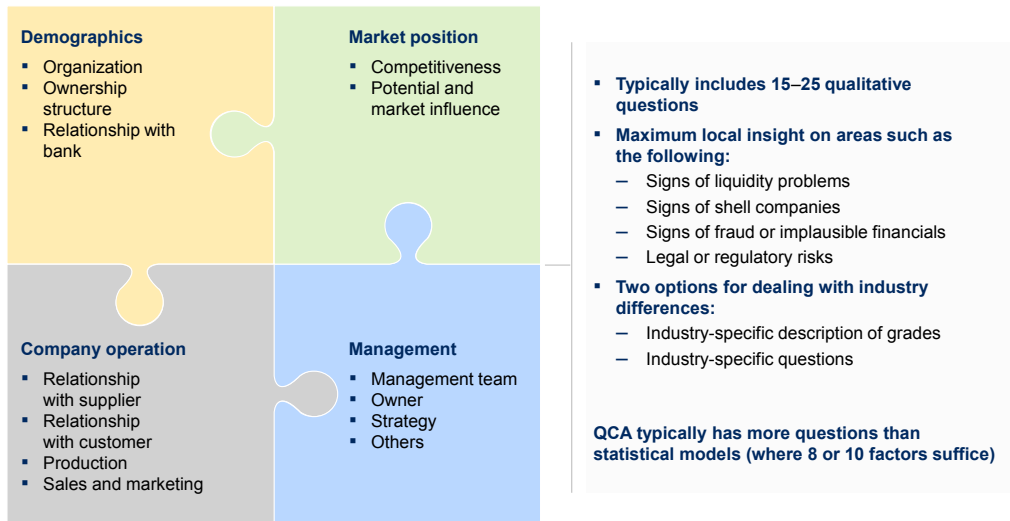
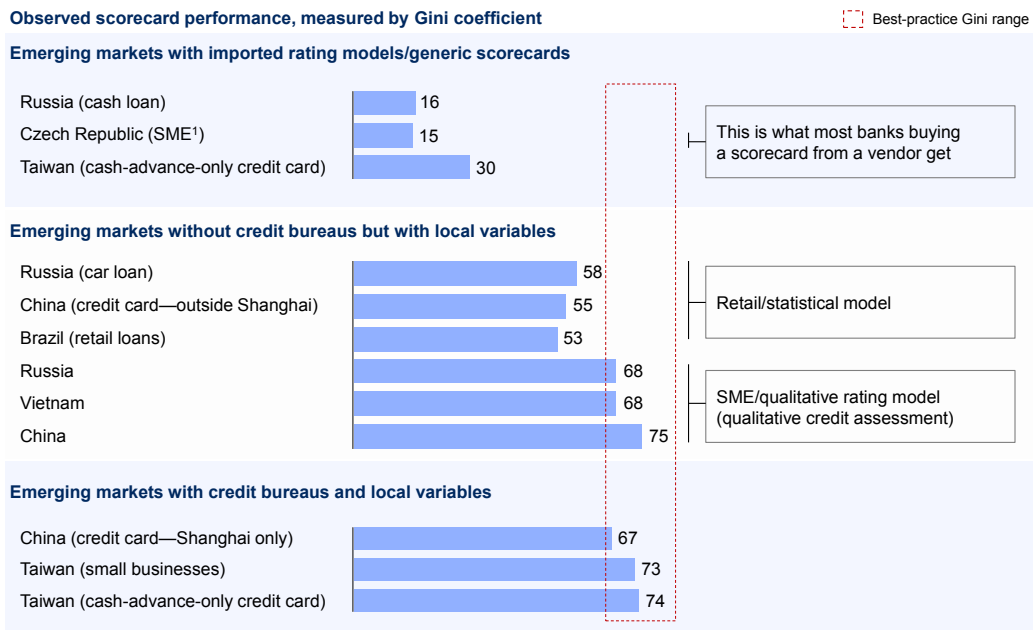


Exhibit 10 Qualitative risk factors can significantly improve risk assessment.



¹ Small and midsize enterprises.

Bank leaders should understand that having access to better information in an environment where information is not readily available offers a significant competitive edge. It is time that informed bank leaders move to take advantage of this, seeking not just to acquire these capabilities but also to use them.

Start to deploy capital-allocation and optimization approaches

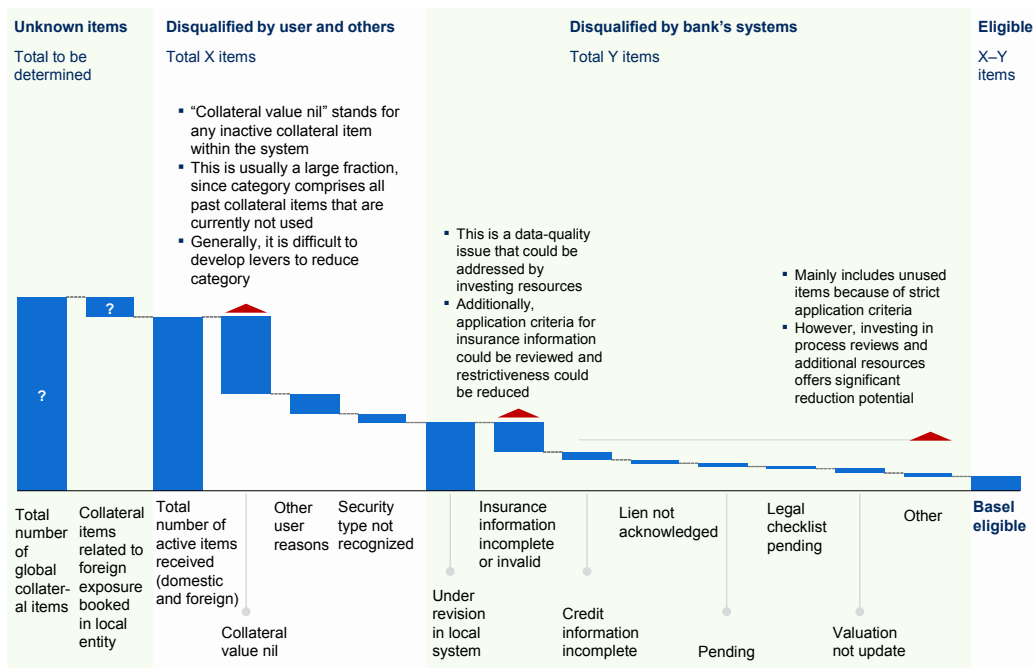
Bank capital will be an increasingly scarce resource for most markets. Rather than simply raising new capital, understanding where current capital is consumed and optimizing capital absorption are great opportunities for banks to support business growth and unlock profit potential.

To achieve this, some banks take the following actions²:

- **Establishing a capital-based threshold at which banks retain a client’s business.** Analysis can show which clients are unprofitable after the cost of capital.
- **Improving collateralization.** This has been done, for example, by seeking more collateral, pushing for more favorable collateral from an RWA standpoint, recognizing collateral such as Krugerrand in South Africa and real estate in Turkey, and adding covenants to loans that help the bank react to “rating drift” (Exhibit 11).
- **Optimizing the product portfolio for capital consumption.** To this end, banks can, for example, steer customers toward receivables-based financing rather than working-capital financing. In many emerging countries, regulation gives banks an incentive to simplify products. Pushed by stricter regulatory requirements, some Turkish banks have actively started initiatives to review undrawn retail-credit lines (especially on credit cards and overdrafts) to optimize their capital position.

Exhibit 11 Improving collateralization can help banks unlock potential.

Example breakdown of collateral items by status



² Bernhard Babel et al., “Capital management: Banking’s new imperative,” McKinsey & Company, McKinsey Working Papers on Risk, Number 38, November 2012, mckinsey.com.

- **Repricing certain products according to capital absorption.** Banks' ability to reprice will, of course, be severely limited by tighter regulation. However, for certain combinations of markets, products, and the bank's own circumstances, repricing may be possible (in particular, for MSMEs).
- **Creating new outplacement models.** Institutional investors such as insurance companies see certain banking assets with long tenor, high ratings, fixed-income flows, and low levels of complexity as ideal investments. That said, no one transfer mechanism will fit all assets and buyers; a detailed assessment of the various parties' interests is necessary to identify asset classes that are optimal for divestment.

Recent experience in markets such as South Africa has shown that a structured approach to capital optimization can free up to 20 percent of a bank's capital (Exhibit 12).

Exhibit 12 A South African banking example shows how a structured approach can help free up capital.

Objectives	Types of levers	Description	Impact on RWA reduction
<ul style="list-style-type: none"> ▪ Reduce capital absorption while maintaining market share and revenue level (without reducing business volume) ▪ Increase returns on capital absorbed 	Risk	<ul style="list-style-type: none"> ▪ Improve methodology, data quality, and processes related to calculation of risk elements (probability of default, loss given default, exposure at default) and risk-weighted assets (RWA) ▪ Ensure all regulatory opportunities from Basel II and Basel III are captured ▪ Few investments needed; no change in underlying business models 	<p>10–20%</p> <p>▼</p> <p>Equivalent to return-on-equity increase from 14% to 16% for a leading local player</p>
	Business	<ul style="list-style-type: none"> ▪ Develop new capital-light business model (clients, products, commercial strategy) focused on maximizing returns on RWAs, acting on reduction of capital usage and increase of return (ie, revenues) ▪ Change commercial approach/business model and build capabilities of frontline staff 	5–10%
	Financial	<ul style="list-style-type: none"> ▪ Reduce capital absorption through financial levers (such as securitizations, dividend policy, and divestitures of noncore assets) 	N/A

Finally, capital allocation has emerged as a weak spot among emerging-market banks. Typically, capital is allocated through the yearly budgeting process; in consequence, the capital-allocation process is influenced by issues that are intrinsic to budgeting itself. In particular, budgeting processes are not designed to take a through-the-cycle perspective and do not take into account differences in cost of capital across the business.

The typical approach to managing capital allocation at the portfolio level relies on three fundamental metrics: risk-adjusted returns on capital, revenue growth, and size of businesses. Risk-adjusted returns on capital are fundamental to understanding whether businesses earn their cost of capital, which differs greatly. For example, in the case of a leading South African bank, stand-alone domestic retail operations require a different cost of capital (and have different profit expectations, or hurdle rates) from that for other stand-alone operations spread across more than 15 African countries. Businesses that achieve a level of profitability through the business cycle—above their cost of capital but below their hurdle rate—contribute to capital generation for the bank and might finance other business lines with higher profitability and stronger growth. Such businesses would typically be good candidates to keep in the portfolio but not to invest in further, unless they are also growing quickly. Likewise, businesses that do not earn their cost of capital should either be sold or, if possible, turned around, depending on revenue growth and size. Of course, businesses with profits above their hurdle rates are cases for further investment, especially if they can produce large revenues or grow substantially.

Conclusions and implications for banks

In the early years of the 21st century, banks in emerging markets went through a period of tremendous growth, showing solid fundamentals in capital requirements, liquidity, and asset quality compared with banks in developed markets.

Over the last few years, though, the business environment has shifted: an increasingly demanding regulatory and policy environment, growing risk costs, and declining profitability levels are combining to present banks with significant new challenges. Risk management has a major role to play. As we have argued, many banks will need to take immediate action, focusing on four priorities:

- **Run an extensive risk-culture diagnostic.** Such a diagnostic should be applied across the organization to spot critical areas in need of attention and to define concrete mitigating actions, including training, professional development, and a review of incentive schemes; this will substantially improve banks' ability to cope with the new environment.
- **Redesign the end-to-end collections process.** This effort usually includes upgrading collections strategies and approaches from early delinquency to workout, strengthening the organizational setup with properly skilled resources, and developing customized tools and solutions to support decisions.
- **Develop a strong decision-making platform.** The revamped platform should be based on more advanced credit-risk models that include qualitative factors along with scoring-based components to overcome challenges related to the availability of reliable customer data, and it should leverage nontraditional data sources across industries. This will support more effective decision making and ensure healthy credit-portfolio growth.
- **Systematically and dynamically review capital allocation and efficiency.** Banks need to rebalance their portfolio allocations toward the most profitable segments and asset classes and should free up resources—reducing capital waste—thereby supporting business growth.

Tackling these strategic and operational imperatives successfully will require focus and effort, but the banks that succeed will have important competitive benefits. They'll see stronger financial performance, as enhanced risk-management capabilities lead to better prevention, detection, and response to material risks. They'll use the educated, insightful risk-return dialogue to inform the strategy process and thus improve the strategic management of the bank. And, in some cases, they'll realize true competitive advantage, as stronger capabilities result in superior risk selection, risk pricing, and active risk management.



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