

Strengthening governance, risk and compliance in the banking industry

An Economist Intelligence Unit white paper
Sponsored by SAP





Preface

Strengthening governance, risk and compliance in the banking industry is an Economist Intelligence Unit report sponsored by SAP. The Economist Intelligence Unit bears sole responsibility for this report. The Economist Intelligence Unit's editorial team conducted the interviews and wrote the report. The findings and views expressed in this report do not necessarily reflect the views of the sponsor. Dan Armstrong was the editor of the report and Mike Kenny was responsible for layout and design. Our thanks are due to all of the survey respondents and interviewees for their time and insights.

March 2009



Strengthening governance, risk and compliance in the banking industry

In absolute terms, banks have progressed farther than companies in many other industries in automating financial processes, and yet their gains may be proportionately smaller in terms of the needs of a financial services industry sector. Banks have more to lose from inefficient financial processes and they have faced intensified regulatory compliance demands, both in the case of general regulation such as the Sarbanes-Oxley Act in the United States, the globally mandated industry-specific demands of Basel II, and region- or country-specific directives such as the United Kingdom's Financial Services and Markets Act or the anti-money laundering provisions of the USA PATRIOT Act. Banks have increased their process automation efforts in response to those pressures, but in doing so they have failed to distinguish themselves from the general trend to focus on the negative aims of cost control and avoidance of regulatory sanctions. This conservative approach has ironically increased banks' exposure to risk at the enterprise level even as it contributes to stronger risk management practices within functions and business lines.

Through governance, risk and compliance (GRC) initiatives, some banks have begun to take a more strategic view of financial processes that has both a defensive and an opportunistic aspect. GRC programs seek to embed rules and controls throughout the enterprise to enable greater visibility of financial processes at all levels and a unified picture of risk at the top. Banks with effective GRC multiply the efficiency advantages of more conservative automation efforts while providing accurate and timely insight into the entire financial picture of the enterprise in order to support better decision-making by senior executives.

About the survey

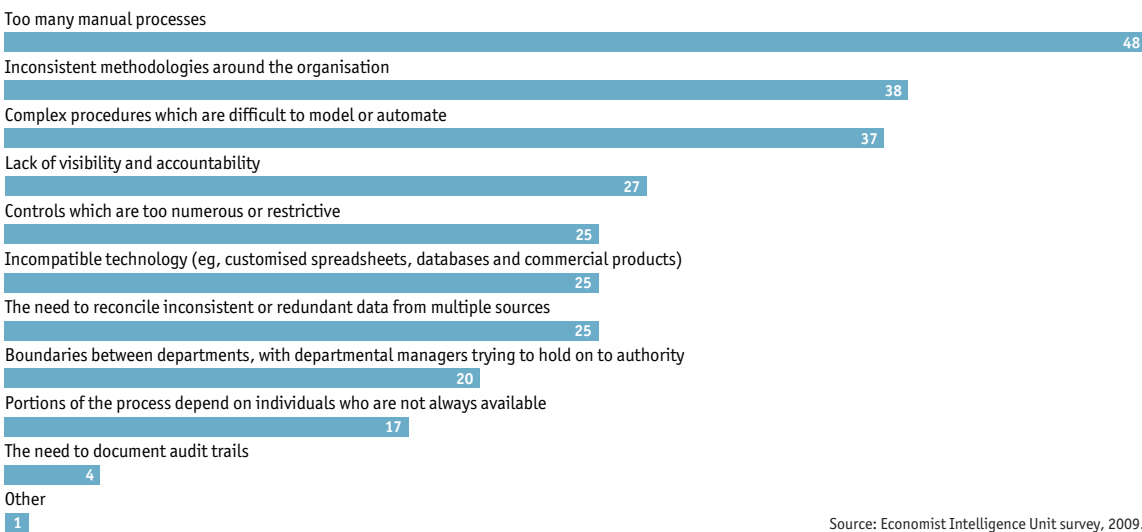
In the fourth quarter of 2008, on behalf of SAP, the Economist Intelligence Unit surveyed 446 senior executives from ten industries about their views on their financial processes and their attempts to improve them. Of this total, 71 came from banks. It

is the responses of these executives upon which this paper is based.

Of the banking respondents, 46% hailed from Europe, 20% from North America and 18% from the Asia/Pacific region. One-quarter had positions in the C-suite and another 41% were vice-presidents, directors or heads of business units. Most respondents served in the general management, finance, risk, IT, or strategy/business development functions.



Figure 1: What are the biggest problems with your current financial processes? Select up to three.
(% respondents)



Source: Economist Intelligence Unit survey, 2009.

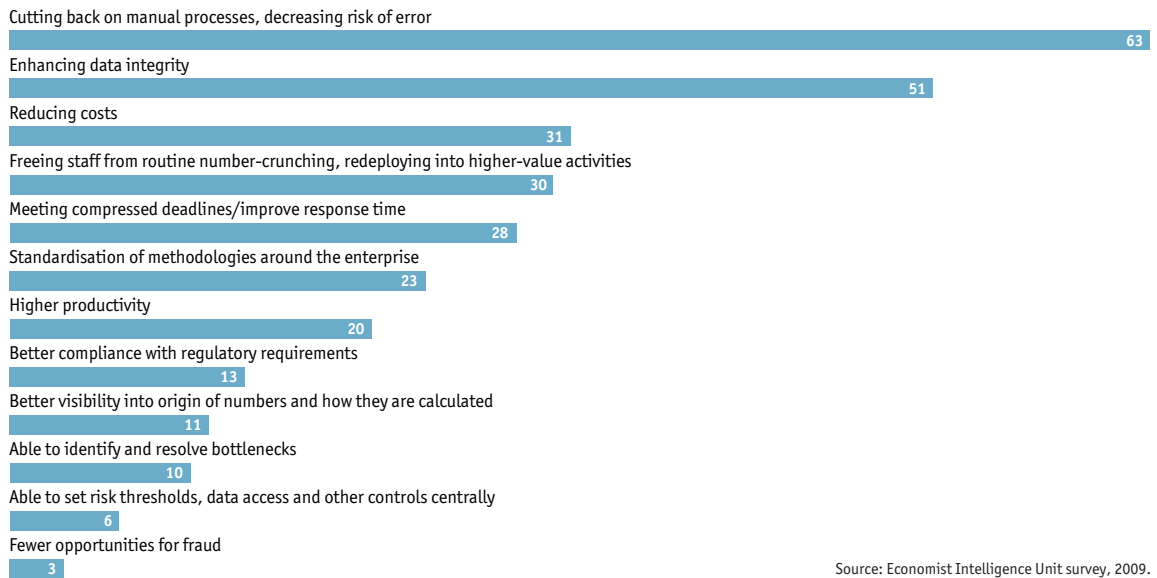
The ability to clearly understand one's company-wide risk exposure is imperative today, in an industry devastated by the credit crisis. Debate continues about which combinations of factors brought down some of the world's largest financial institutions and crippled others. Industry observers offer different theories about what should have been done to avert the recent catastrophe and what ought to be done to avoid a future crisis. There is little debate, however, that banks need to develop a more rigorous approach to GRC. Banks have internal incentives for better risk management, and they will also face retooled capital adequacy requirements from the Bank of International Settlements, greater ongoing scrutiny from the Federal Reserve and new compliance requirements from new regulatory bodies chartered to measure systemic risk to the global financial system.

Banks clearly have a great deal of work to do both to meet new regulatory demands and reassure stakeholders of the soundness of their decision-making. Banks are not strangers to accurate and timely reporting, but their success in this respect has tended to occur sporadically within lines of business or within internal control and auditing functions. As Figure 1 demonstrates, banks rank the proliferation of manual processes as the greatest problem with their current financial processes. Conversely, as shown in Figure 2, banks anticipating the benefits of automation give top marks to the decreased incidence of error caused by manual processes.

However, those benefits are not easily achieved, especially for large banks with multinational

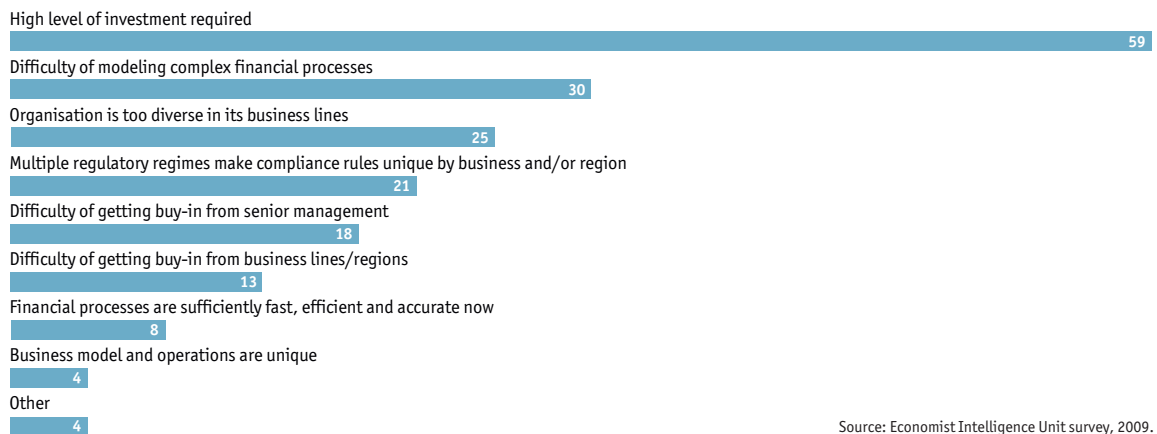


Figure 2: What would be the biggest benefits of an initiative to standardise and automate your financial processes?
Select up to three.
(% respondents)



Source: Economist Intelligence Unit survey, 2009.

Figure 3: What would be the biggest drawbacks of an initiative to standardise and automate financial processes? Select up to two.
(% respondents)



Source: Economist Intelligence Unit survey, 2009.



presence. Banks struggle with the difficulty of managing complex financial processes, such as those required to track a given borrower's obligations and dynamically gauge their impact on enterprise risk. Banks also report the difficulty managing the diversity of lines of business and multiple regulatory regimes. However, As Figure 3 shows, their greatest concern is simply the cost of the systems and process redesign necessary to achieve standardised and automated financial processes.

The integration imperative

If banks have agonised about making such investments in the past, they are likely to be less hesitant now. In order to avoid the kinds of exposures that humbled some of the largest institutions in the world, banks clearly need a more integrated approach than they have traditionally followed.

Traditionally risk management has been undertaken within silos corresponding to lines of business units and control functions dedicated to monitoring credit, market, liquidity, operational, legal and compliance risk. The fruits of these governance, risk and compliance efforts were then factored into decisions at the most senior levels, typically depending on diverse systems feeds and manual interventions in order to reconcile discrepancies and present a more or less unified financial picture.

If this approach seemed "good enough" prior to the financial crisis, that is no longer the case. Banks without standardised controls and the ability to coordinate risk on an enterprise level also lack the ability to enforce uniform risk rules across lines of business. For example, a bank might enforce a conservative policy with regard to subprime risks on the mortgage-lending side of the business, and yet have a more aggressive posture toward collateralised debt obligations (CDOs) within its trading operations. Even in cases where banks exercised due diligence in evaluating the risks of instruments such as CDOs, few were in the position to execute the stress testing necessary to determine the potential impact of CDOs on the entire portfolio in the event that the market froze and the investments' paper value plummeted.

The challenge banks face is to dynamically track risks both in isolation and in terms of their interdependencies. This requires not only learning the specific lessons about credit and liquidity risk precipitated by the financial crisis but also institutionalising a collaborative culture of risk. To a significant extent, this can be achieved by realigning existing responsibilities within an integrated structure.

"Institutions have grown in size and complexity through acquisitions or through just sheer internal growth and they realised that they cannot continue if systems cannot talk to each other or that rely heavily on manual intervention," comments the former compliance chief of a major US money center bank. "They need to attack this and create a more efficient process."

Banks' traditional silos of risk management need to give up the platforms that they have developed within their fiefdoms and work in concert, the source argues. From an organisational point of view, each tier of risk management constitutes a line of defense; the first is the business itself in its control self-assessment capacity; the second comprises the various independent control functions corresponding to



the different categories of risk; and the third is the independent internal audit function.

“Ideally, each line of defense should draw on information captured within a single database, and many banks are already moving toward that state,” the former compliance officer says. “Optimal collaboration between the lines of defense will also require standardised processes.”

Compliance-related controls are by nature costly, and a manually intensive environment multiplies those costs. In the absence of uniform and integrated processes, unnecessary controls and low risk thresholds can result in excessive alerts. According to Luca Pighi, CFO, GE Capital Finance (Italy), too many red flags can introduce confusion rather than clarity. Fragmented, redundant processes result in a glut of data, causing delays in recognising and reacting to risks. Pighi emphasises the need to align risks and controls properly at the outset and refine them continually as the business changes.

It would be a mistake, however, to imagine that banks can entirely eliminate manual processes and the occasion they present for error or fraud. Acknowledging that inevitability, GE Capital Finance introduced a structured system of authorisation in which line staff could only make manual journal entries with the approval of senior managers, according to Mr Pighi.



Conclusion

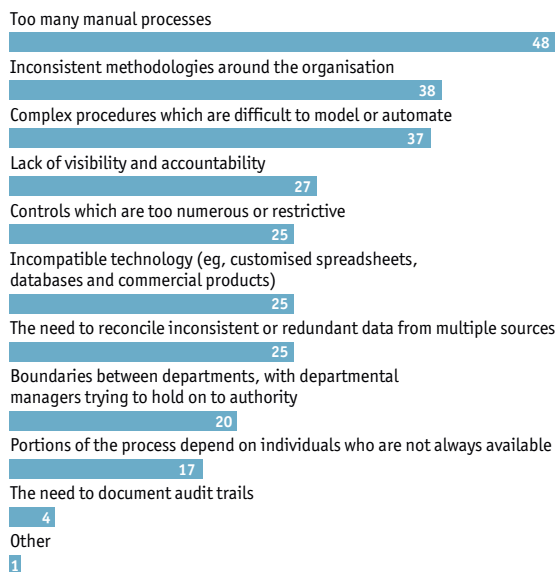
The ravages of the credit crisis have raised serious doubts about banks' ability to effectively manage risk. Bankers now face arduous challenges as they attempt to restore the confidence of regulators, analysts, shareholders and customers. To the extent that senior managers have focused more heavily on governance, risk and compliance over the last five years, they may be tempted to despair about the possibility of anticipating potentially devastating risk exposures. However, a sober appraisal of banks' efforts will reveal that cost considerations have limited the extent to which manual processes have been eliminated and, far more importantly, that sophisticated GRC isolated within lines of business or internal control functions are no substitute for an integrated, enterprise-wide approach to risk management.

The good news for banks is that their efforts to standardise and automate processes within operational silos have prepared the ground for the next stage. In terms of lessons learned, what hasn't killed a given bank will make it stronger. Banks who incorporate that learning into an enterprise GRC culture and continue their evolution to a unified technology platform will be better prepared to avoid catastrophic exposures. Equally importantly, banks that have a more real-time view of their enterprise risk picture will be better prepared to competitively match their risk appetite to the opportunities of the marketplace.

Appendix: Survey results

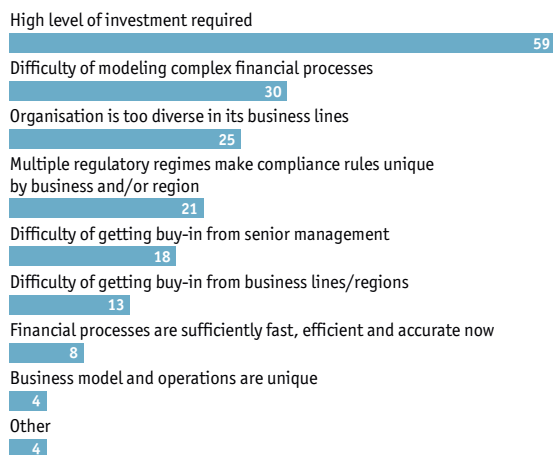
What are the biggest problems with your current financial processes? Select up to three.

(% respondents)



What would be the biggest drawbacks of an initiative to standardise and automate financial processes? Select up to two.

(% respondents)



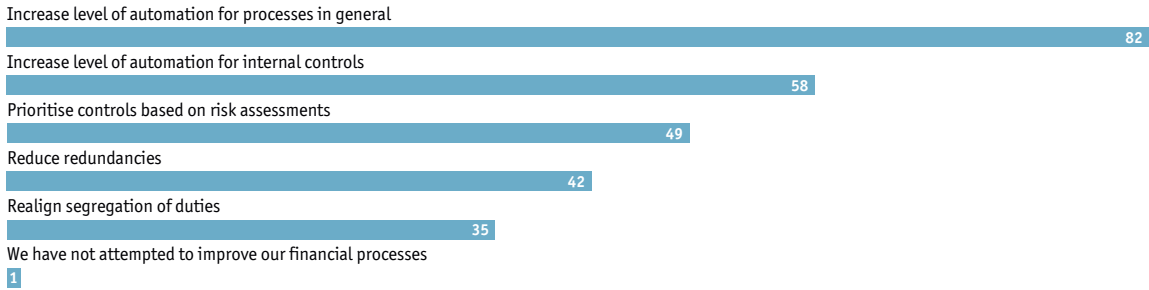
What would be the biggest benefits of an initiative to standardise and automate your financial processes? Select up to three.

(% respondents)



In the past five years, which of the following tasks has your organisation attempted to address by improving its financial processes? Select all that apply.

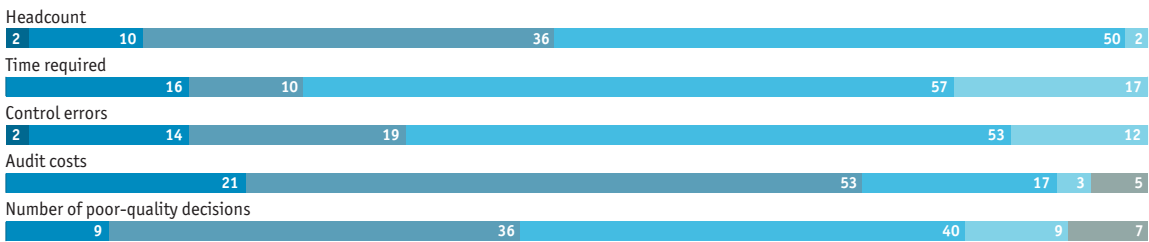
(% respondents)



What improvements, if any, have resulted from these attempts? Increase level of automation for processes in general

(% respondents)

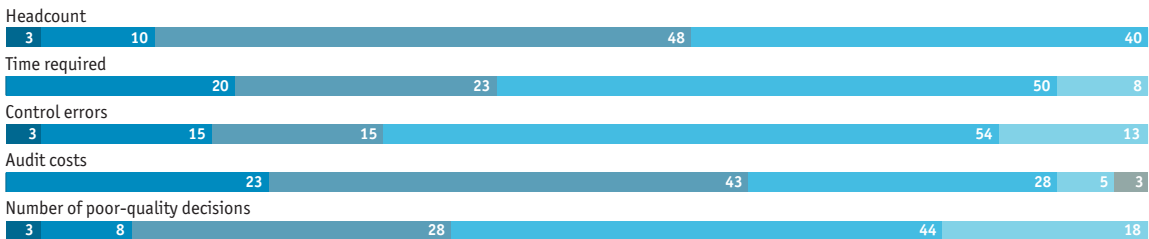
■ Much higher ■ Higher ■ No change ■ Lower ■ Much lower ■ Don't know



What improvements, if any, have resulted from these attempts? Increase level of automation for internal controls

(% respondents)

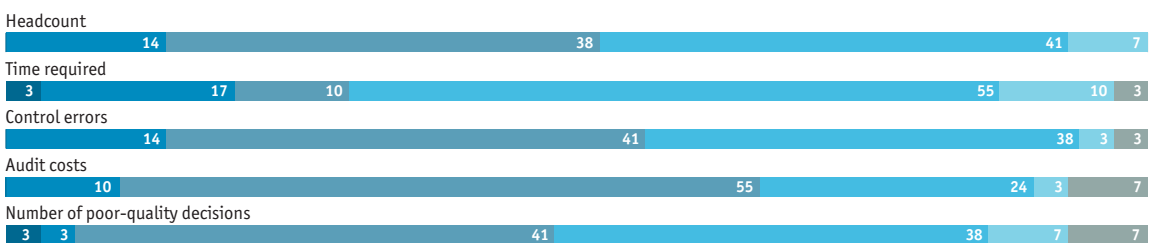
■ Much higher ■ Higher ■ No change ■ Lower ■ Much lower ■ Don't know



What improvements, if any, have resulted from these attempts? Reduce redundancies

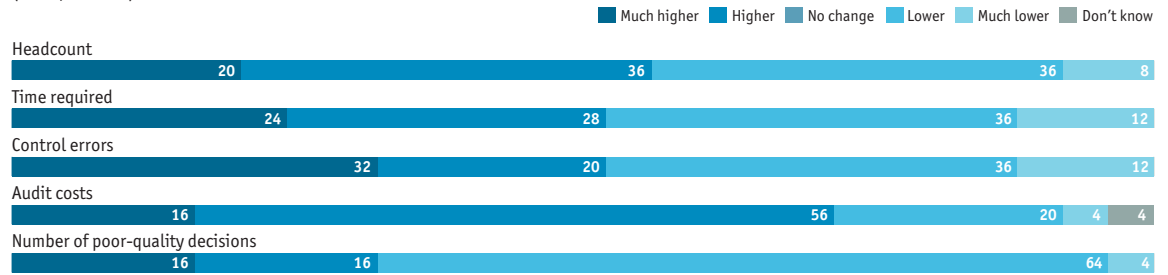
(% respondents)

■ Much higher ■ Higher ■ No change ■ Lower ■ Much lower ■ Don't know



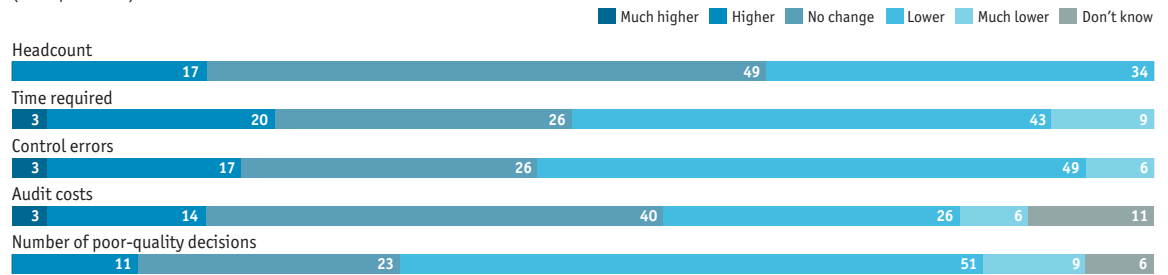
What improvements, if any, have resulted from these attempts? Realign segregation of duties

(% respondents)



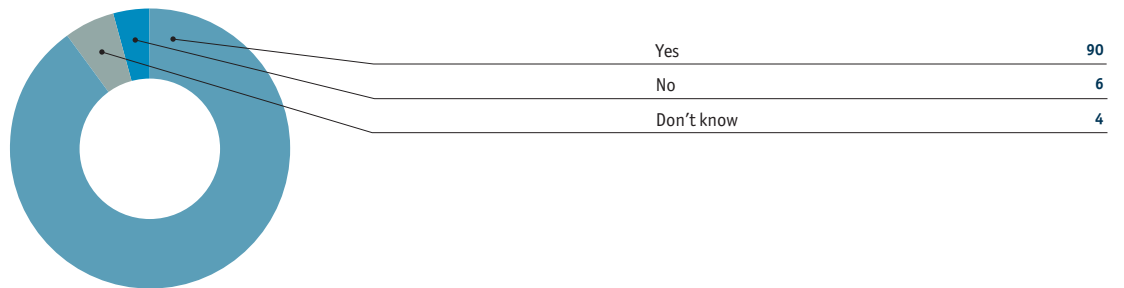
What improvements, if any, have resulted from these attempts? Prioritise controls based on risk assessments

(% respondents)



Does your organisation regularly include risk evaluations as part of its financial processes?

(% respondents)

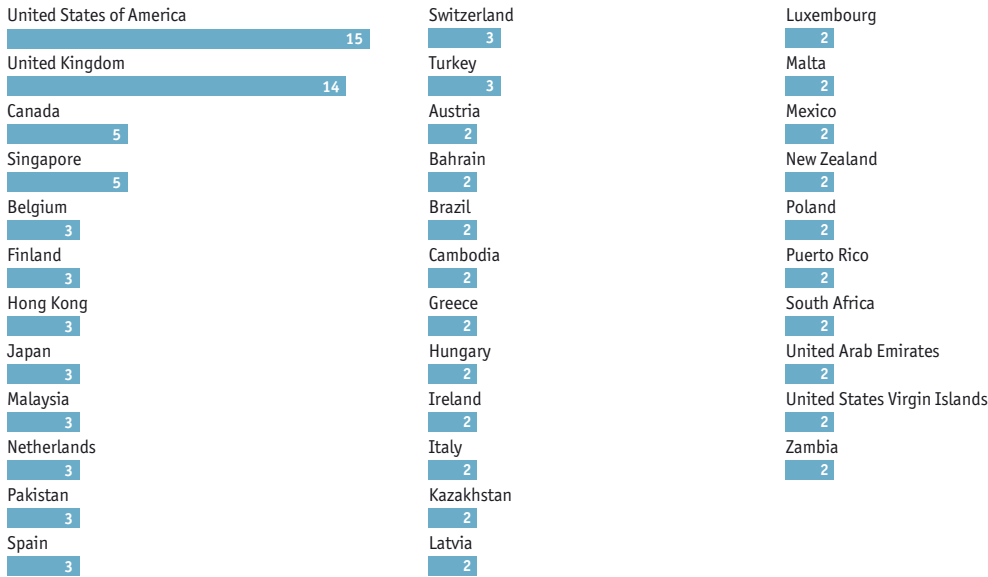


What are the results of these risk evaluations?

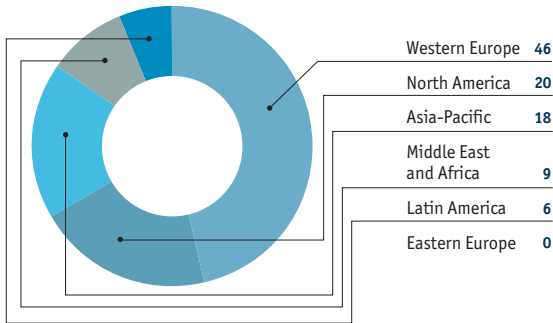
(% respondents)



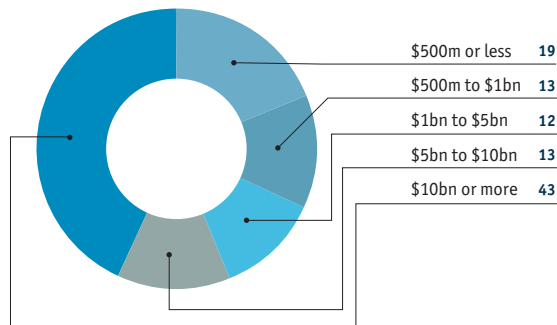
In which country are you personally located?
(% respondents)



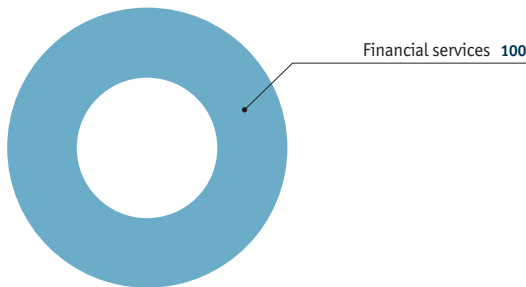
In which region are you personally based?
(% respondents)



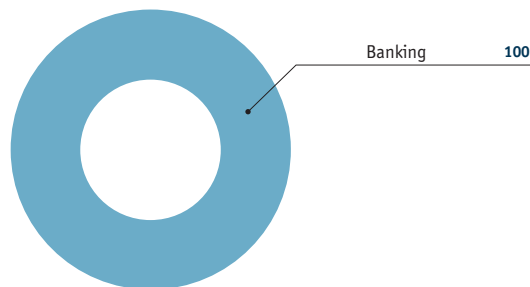
What are your organisation's global annual revenues in US dollars?
(% respondents)



What is your primary industry?
(% respondents)

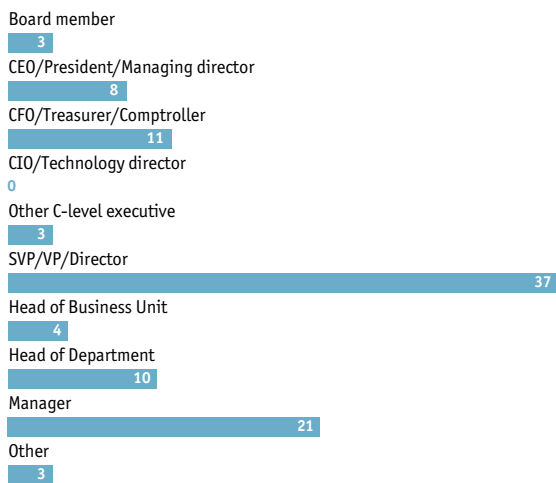


In which sub-sector of financial services does your organisation belong?
(% respondents)



Which of the following best describes your job title?

(% respondents)



What are your main functional roles?

Please choose no more than three functions.

(% respondents)



Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsors of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

LONDON

26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8476
E-mail: london@eiu.com

NEW YORK

111 West 57th Street
New York
NY 10019
United States
Tel: (1.212) 554 0600
Fax: (1.212) 586 1181/2
E-mail: newyork@eiu.com

HONG KONG

6001, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com