

# FINsights

Technology Insights for the Financial Services Industry

Governance, Risk and Compliance »



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## From the Editors Desk

We are delighted to present the second issue of the Infosys Banking and Capital Markets journal FINsights. The spotlight in this issue is on Governance, Risk and Compliance and the compilation of articles reflect perspectives on risk and its measurement, governance, the compliance conundrum and our take on the priorities in risk and compliance and their technology implications in the coming years.

The increased incidence of failures in the financial services marketplace over the past decade has given visibility to the science (and art) of understanding and measuring risk in running a business, making strategic and tactical decisions and participating in markets and economies that are increasingly linked in a flattening world. A recent such event, covered in one of the articles, has been the sub-prime crisis and the unforeseen ripple effects in markets in distant parts of the world.

As always we have tried to reflect in these articles the unique value that Infosys brings to its clients through a combination of deep domain understanding, technology best practices and global sourcing expertise. The article on sub-prime crisis reflects the current challenges in credit risk measurement and brings a perspective that combines credit risk measurement approaches with a global knowledge process outsourcing (KPO) option.

Risk and compliance is a multi faceted animal and the focus in the past few years has been on giving it a holistic view through a unified Governance, Risk and Compliance (GRC) program. The articles featured on GRC explore integrated controls to implement GRC, use of SaaS in GRC and industry perspectives on GRC and the road ahead. In the area of compliance, the articles look at addressing compliance challenges, an aspect of internal compliance namely employee surveillance and the partial compliance challenge in the wealth management industry. Our articles on risk address credit risk management, the role of master data in risk measurement and risk reporting. Included in this issue is also a case study highlighting the importance of Information Risk Management (IRM).

We would like to thank all the authors from Infosys as well as external contributors - Adam D. Honoré from Aite Group, Tim Leech from Navigant Consulting and Bob Skea of Northstar Systems. As always, we look forward to your queries or comments on Governance, Risk and Compliance or any feedback and suggestions in making FINsights a more relevant and topical journal.

Happy reading and all the best for the new year 2008!

**Balaji Yellavalli and Sudhir Singh**  
*Editors*

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# FINsights

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## Strategic themes in Risk and Compliance

Financial services firms are increasingly viewing Risk and Compliance as two sides of the same coin. As we step into 2008, there seem to be various themes related to Risk and Compliance emerging that in all likelihood will end up as strategic priorities for the banking and capital markets industry.

Ashok Vemuri  
Senior Vice President  
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## Risk- the most creative force in the financial markets today

The future cannot be predicted because of its inherent uncertainties. Yet the financial risk that arises from this uncertainty has to be managed by all firms in the financial industry. Also, whether banks like it or not, regulators carefully watch a bank's risk management process. This is primarily to avoid a systemic "domino effect" whereby one bank's failure leads to the collapse of the rest of financial system. Thus it is not surprising that risk and compliance have always been integral to the operating model of the financial industry

However, interestingly, risk and compliance as disciplines have not always figured in the strategic initiatives of a bank's CEO. Although this could partly be due to the complexity involved in measuring risk or interpreting compliance rules, the biggest reason is the perception that risk and compliance management does not generate revenue.

Over the past decade, this perception has changed. This is mainly due to the evolving landscape of financial markets. In the past decade, for example, there has been a rise in hedge funds that earn their keep by taking on and managing risk. Also there has been the extraordinary development of a large market for credit derivatives, which allow banks to redistribute all or part of their risk to other institutional investors. Alan Greenspan, ex-chairman of US Federal Reserve Board, summed up this new trend best by stating:

"The development of our paradigm for containing risk has emphasized dispersion of risk to those willing and presumably able to bear it. If risk is properly dispersed, shock to the overall economic system will be better absorbed and less likely to create cascading failures that could threaten financial stability"

Source: Address before Council of Foreign Relation, Nov 19, 2002

As we enter into 2008, risk management is being widely acknowledged as the most creative force in the world's financial markets and a key focus for any financial firm.

## Compliance – the other side of the coin

As risk management has improved, it has made it easier for firms to take on more risk. The last decade has witnessed embarrassingly large failures of risk management in its broadest definition. There have been

many examples, starting with the near failure of the hedge fund giant Long term Capital Management (LTCM) in 1998 followed by a string of other financial scandals like Enron, the Russian bank crisis in 2004, collapse of hedge fund giant Amaranth in 2006 to the more recent sub-prime mortgage crisis. This has prompted regulators to increase the watch over financial activities with a series of regulations like SOX to address financial accounting, Basel II to handle banking risk, KYC and AML to better protect against Customer fraud and RegNMS/MiFID to prevent brokers from taking advantage of customers. There is only promise of more in the future.

Whether firms like it or not compliance will be another key agenda for management.

Several themes have already emerged from these two primary disciplines. Let us take a look at some of the key themes, which in all likelihood will end up as strategic priorities for the banking industry in 2008.

## Theme 1: Governance, Risk and Compliance (GRC)

The basic idea behind the Governance, Risk and Compliance (GRC) program is to have a governance process that takes a unified view of risk and compliance. The objective is to use a more effective approach to reduce overall business risk, ensure better compliance and thereby, create competitive advantage for the firm.

The key reason why GRC is getting popular is the consensus in the industry that the current risk and compliance environment in most firms is siloed, tactical and reactive and thus ineffective to address future challenges in this area.

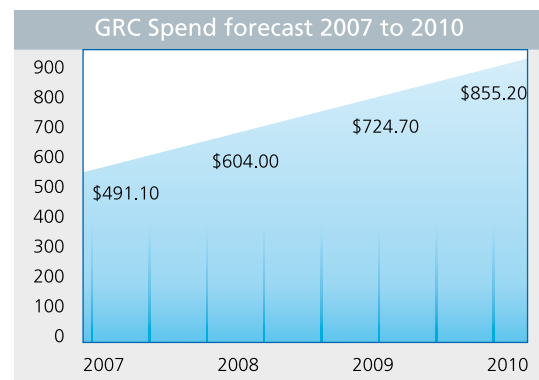


Fig 1: GRC Spend forecast 2007 to 2010 (\$ in millions) (Source: Gartner)

As shown in Fig 1, a study from Gartner, shows that technology spend on GRC will increase by almost 30% in 2008 and continue to increase at around 25% for the next three years. As companies focus on building their GRC programs, technology will play a crucial role.

Technology will help in building the platform necessary to automate many of operational and tactical activities required for effective implementation of GRC program.

## Theme 2: Credit Risk Management

Credit risk is the largest and most elementary risk faced by banks and most financial institutions. It essentially focuses on determining the likelihood of default and its cost and reputation implications. And this is true whether one is referring to the somewhat unglamorous world of consumer lending (retail banking) or the big-ricker market of corporate lending (commercial banking).

There are three key reasons why there will be an increased focus in this in the coming years – continuing regulatory pressures from Basel II, current sub-prime crisis and the extraordinary growth in credit derivatives or risk transfer mechanisms.

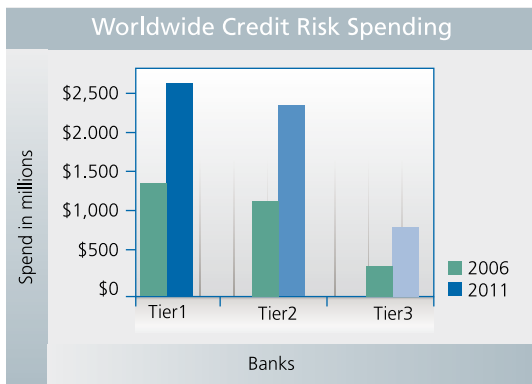


Fig 2: IT spend forecast on credit risk in 2011 from 2006 (Source: Financial Insights)

## Theme 3: Data and master data management - attaining a single version of truth

Data has always been an important input for risk measurement and is the foundation on which risk management and compliance initiatives are built. The two key pain-points with data are:

- multiple data stores across an organization with duplicate data across compliance functions and
- data used in risk management is often inconsistent with the finance data used in business and financial reporting.

An example of the latter is the case wherein accounting adjustments are fed to the finance systems and not to the risk systems resulting in differences in exposures between say Basel II risk exposures and balance sheet exposures for a given product.

Traditionally the approach to resolving data issues has been more bottom-up with focus on the more volatile transactional data. Over the last five years, the approach has become more top-down with focus shifting to master data. Master data management (MDM) relates to creating a single version of truth for the relatively static data of customers, products and assets across dissimilar systems. We expect this trend to continue for the next few years.

As shown in Fig 3, Forrester research anticipates accelerated adoption of MDM across the globe in the next few years.

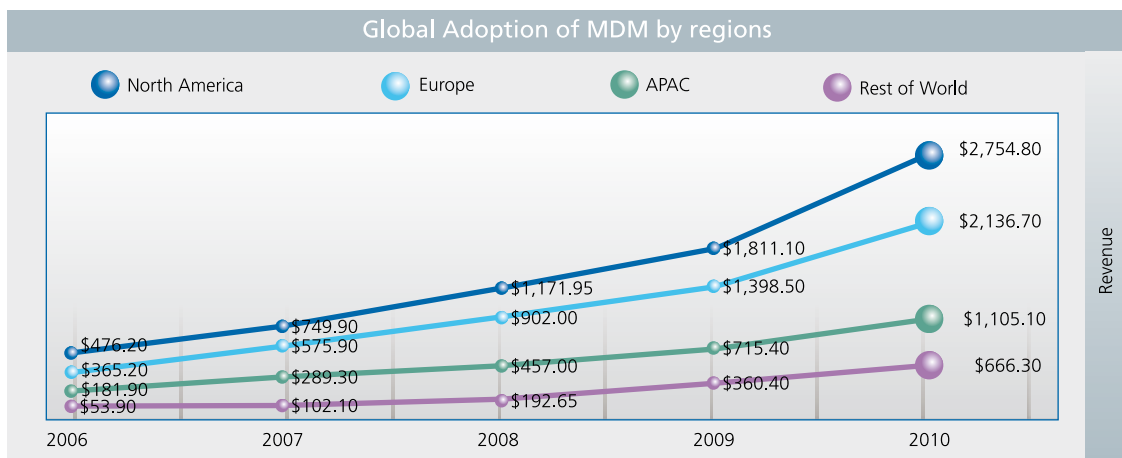


Fig 3: Global adoption of MDM by regions (\$ in millions) (Source; Forrester)

As shown in Fig 2, according to a worldwide forecast by Financial Insights, the estimated spend for banks when compared to 2006 will double by 2011 for all tiers - Tier1 banks (greater than \$100 billion in assets), Tier2 banks (with assets between \$10-100 billion) and Tier 3 banks (assets below the \$10 billion).

## Theme 4: Compliance

The growing demands of the regulatory forces are forcing banks to effectively increase their effort and make

investments in both skilled personnel and technology to reduce any potential risks that may arise because of non-compliance.

challenging in 2008. Bank spending on IT is expected to grow by only about 4% from 2007 to 2008.

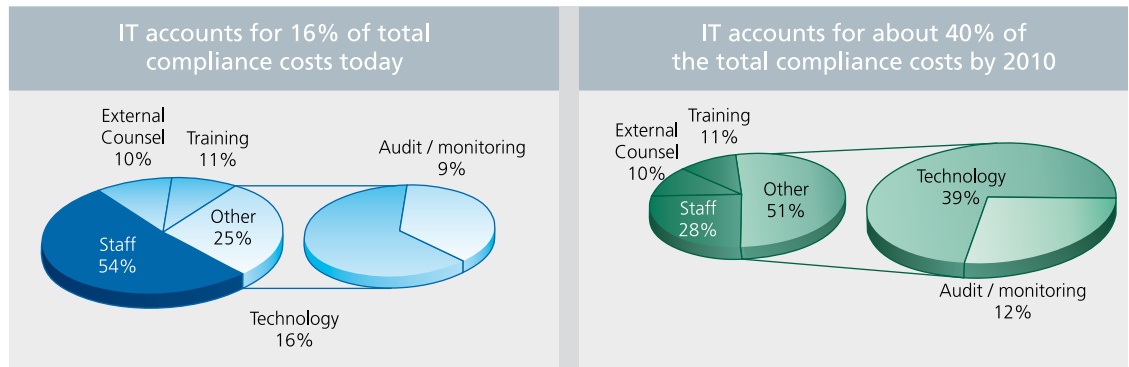


Fig 4: Compliance cost comparative study  
(Source: IDC/Tower Group)

As depicted in Fig 4, a study shows that IT accounts for 16% of compliance costs today and is estimated to account for 40% of compliance costs in 2010.

### Theme 5: Cost-effective ways to leverage technology

Technology budgets are constantly getting slashed in the financial industry and yet technology is the key driving force behind all optimization efforts. As the focus increases on reducing costs and as operating margins get squeezed, there is a need for cost-effective ways to leverage technology. A recent study by Financial Insights shows that as the dollar value keeps falling, the U.S banking technology environment will become more

Lately there has been an increasing interest in on-demand services or the Software as a Service (SaaS) model where the vendor hosts the applications and platforms for the customer and charges on a subscription or per use basis. Several large and medium-sized companies have already started adopting solutions using a SaaS model because of the signification reduction in costs.

### Conclusion


As we enter into 2008, it is clear that risk and compliance will be a key priority and the above themes will keep management busy. As competition continues to increase in the market place, the most successful firms will be those that build processes and technology that demonstrate rapid response times and ability to adapt to an ever changing eco-system.



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