

P E R S P E C T I V E

Make Risks Work to your Benefit
An Integrated Banking Platform-led Approach



YOUR INNOVATION PARTNER

Value of Active Risk Management

In the wake of the black swan events of the past year that left the world economy reeling, the spotlights were firmly trained on risk management or the lack thereof, in global financial institutions. Although risk management has been a key focus area for banks in recent years following the introduction of regulations like the Basel II Accord or the Sarbanes-Oxley Act, it has assumed great urgency in the aftermath of the current crisis. That said, banks have come to realize that risk mitigation and control cannot be driven purely by regulatory imperatives. With the appointment of a Chief Risk Officer at many banks in recent years, risk management is poised to move out of the compliance shadow to assume a much larger strategic role. Indeed, banks must begin to recognize that de-risked opportunities have the potential to create greater business value.

For instance, some forward thinking Wall Street firms that adopted a strong risk focus several years ago have found themselves relatively unaffected by the financial crisis. They have been smart enough to recognize risk management as a strategic principle, and are now projecting that as their competitive advantage.

In his recent book titled 'Financial Darwinism', Leo Tilman says that economic value creation in the financial industry has undergone a noticeable shift. With their margins under pressure, financial firms are taking active risks to, (hopefully), enhance shareholder value. He predicts that the financial renaissance will see greater interplay between risk-taking and business decision making as banks and other institutions look to optimize risk-based economic performance.

Thus, going forward, banking organizations must find a way to spot the opportunities presented by active risk-taking, and integrate that knowledge into their larger business strategy. Clearly, risk management will then find itself at the epicentre of strategic decision making.

Weaknesses in Risk Management Systems

Before this ideal can be realized across board, banks will have to subject their risk management policies and systems to honest scrutiny. Banking risk and its management has been the subject of much attention in recent years. Surveys conducted

by consulting majors across different regions have uncovered the following lacunae in risk management systems:

Lack of risk-orientation: Unfortunately, risk management does not play a central role in organizational strategy and decision making. The absence of risk-expertise at the highest levels and consequent lack of "top-down" communication has ensured that risk management remains in the background, like most other support functions.

Lapses in governance: Inadequate representation of risk professionals on the banks' governing boards could lead to lapses in governance. So could the emphasis on short term profit and immediate growth, without due consideration of the associated risks. The recent meltdown in the United States had brought to the fore, several examples of institutions engaged in the single-minded pursuit of retail deposits at the expense of adequate risk management. Clearly, even best-in-class risk-applications have no defence against human oversight or deliberate negligence.

Lack of organizational perspective: Risk management is usually found to work in silos – enterprise-wide risk communication is unlikely when even risk professionals across business units act independent of each other. The problem is exacerbated in large banking organizations, where, by virtue of sheer size, lines of business become individual power centres. It is likely that these banks have deployed multiple risk management applications, which serve the needs of different units, but do not combine to provide bank-wide numbers.

Absence of metrics: More clarity is needed on how risk must be measured, and the risk-capabilities of business units must be assessed on the basis of Key Performance Indicators. Banks' systems must be designed in such a way that risk measurement can be integrated into regular business processes.

Inadequacies in data: Banks' risk mitigation efforts are hampered by the unavailability of real-time, enterprise-wide data. Because of the strong linkages between lines of business, risks arising in one area can impact several others. Therefore, decision makers must have an enterprise-wide risk perspective in order to correctly assess the overall risk exposure and the organizations' preparedness against it.

Clearly, risk management strategy must address each of these critical issues from a holistic perspective in order to be effective. As banks set forth to foster risk culture, improve organization-wide risk awareness and acquire risk management applications, they must ensure that establishing the right banking platform is part of the agenda. Only an integrated banking platform, based on open architecture has the vital capability to consolidate risk-data across channels, units or lines of business.

Integrated Banking Solutions for Risk Management

The right banking platform can not only help banks manage their risks better, but also be leveraged to exploit new opportunities that present themselves when risks are properly recognized and managed. In this context, banks looking to enhance IT infrastructure as part of their risk strategy could be faced with any of the following scenarios:

- They have not instituted any risk management systems so far
- They have multiple risk management applications at business unit level, which are not integrated and work independently
- They have a risk application at enterprise level, but multiple core banking applications working in silos

When a bank is run on a single or many legacy core systems, it is not in a position to provide comprehensive, unified data collected over several years, which is a pre-requisite of effective risk management. Risk managers resort to extrapolation or using data originating from multiple sources which are not checked for consistency - this could easily lead to sub-optimal decisions. Alternatively, they could err on the side of caution assuming worst-case-scenarios, and thereby cut off business opportunities.

Banks that want to stay competitive in the long run must inevitably undertake core banking renewal, sooner rather than later. The following considerations will guide them in making an informed selection of platform and vendor, specifically from a risk viewpoint:

- Has the core banking application been developed considering risk mitigation as one of the key objectives? Does it support risk management at

transaction and operational level? A risk-capable platform will have embedded functionalities to this effect – for instance, user access must be limited based on function or profile, and be subject to multiple layers of authentication. All transactions must be uniquely identified and recorded. Operational risk is reduced when transactions conforming to principles such as Four-Eye and Maker-Checker and a robust error management system is in place

- A platform that enables a high level of automation and Straight-Through- Processing helps reduce the manual content in operations and consequently, the incidence of error
- Does it have an integrated Service Oriented Architecture that supports consolidation of historical data across customers, channels, products, transactions, geographies and applications?
- Does the platform strengthen the banks' capability to comply with the mandatory requirements stipulated by regulations such as Basel II, USA Patriot Act and others? Primarily, banks are faced with three types of risk – Credit, Market and Operational – and the core banking system must support the capturing, organization, recording and reporting of data as per the banks' needs for mitigation of each of these risks. For example, the system must be able to identify defaulting borrowers or classify Non Performing Assets once past due. Similarly, in order to manage market risk, the system must record in detail current information regarding cash flow and interest as well as project future flows. Banks must ensure that data pertaining to loss, risk exposure and other metrics can be collected from each line of business or regional unit and centralised into a single knowledge repository. They must also verify that a mechanism exists to filter, categorise and validate this information. Finally, the system must be open and powerful enough to enable the combination of risk data from different applications to enable analysis and generation of real-time reports
- Does it meet security control guidelines? Is it robust enough to prevent data loss or destruction? Studies have indicated that banks perceive data theft to be among their foremost risks

Mining Business Opportunity through Risk Management

The institution of tight risk-control practices, coupled with an integrated core banking system can help banks manage business uncertainty and comply with legal requirements. Of greater significance is the potential to derive additional business value from risk-managed opportunities. For example, under the Equal Credit Opportunity Act, banks may extend favorable terms to those above the age of 62. An integrated banking platform that captures detailed customer data for credit scoring could throw up a segment of highly credit-worthy, older customers that banks may have previously neglected.

Similarly, the Truth in Lending Act requires that banks make adequate disclosures to customers regarding the key terms of the lending arrangement as well as all costs. Since generally this law does not regulate rates, banks that charge favorably versus their peers could hope to attract new customers.

Thus enterprise risk management can actually enlarge the customer base or widen the scope of operation for banking entities.

Summary

Risk management is emerging as a critical business priority across the banking enterprise, and is no longer the exclusive preserve of compliance teams. The earliest banks to recognize this have launched initiatives for the short, medium and long term in order to attain a position of strength in the future.

That said, there is some way to go before risk management features prominently in top-level strategic decision making. Banks must launch a strong drive to create a risk-oriented culture, in which there is shared awareness across the enterprise about risk exposure and suitable defence measures.

Core banking systems built on open standards can add teeth to banks' risk management capability but providing enterprise-wide, comprehensive, 'single version of the truth' data, essential for arriving at the right decisions while assessing and managing risk. By enabling automation and Straight-Through-Processing, they can also mitigate operational risk.

Going forward, it is predicted that risk management will assume greater dimensions as banks seek to maximise risk-based economic value.

References:

- 'Never again? Risk management in banking beyond the credit crisis', KPMG International, 2009
- 'Risk, regulation and return. Delivering value through enterprise risk management', IBM

Author

Basudev Banerjee

Principal Consultant - Finacle Product Strategy
Infosys Technologies Limited



YOUR INNOVATION PARTNER

PERSPECTIVE

Universal Banking Solution | System Integration | Consulting | Business Process Outsourcing

Infosys Technologies Limited

Plot No. 44, Electronics City, Hosur Road, Bangalore - 560100. India
Tel.: + 91 80 28520261, Fax: + 91 80 28521747, e-mail: finacleweb@infosys.com
www.infosys.com/finacle

Join us on Twitter, LinkedIn and Finacle Whiteboard at www.infosys.com/finacle/networking.asp

"COPYRIGHT NOTICE: Copyright ©2009 Infosys Technologies Limited, Bangalore, India. ALL RIGHTS RESERVED."
Finacle logo is a registered trademark of Infosys and Infosys acknowledges the proprietary rights of the trademarks and product names of other companies mentioned in this document. Infosys believes the information in this publication is accurate as of its publication date; such information is subject to change without notice.