Rethinking Risk in Financial Institutions

Making the CFO-CRO Partnership Work

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Research and interviews were conducted by Accenture and Oxford Economics, who collaborated to write this report.

OXFORD ECONOMICS

Risk and Finance Masters

In this report you will see certain survey results tagged with an indicator. These tags identify survey responses that were significantly more likely to be provided by high-performing risk and finance "Masters" than by the average financial services firms. We identified certain firms as "Masters" on the basis of finance and risk management performance metrics provided by the survey respondents, as follows:

Risk "Masters"

- Comprise approximately 10% of the companies participating in the Accenture 2011 Global Risk Management Survey, which have relatively strong risk management capabilities; and
- Consider risk in the decision-making processes of the organization across strategy, capital planning, and performance management, establish risk policies based on their appetite for risk, and delineate processes for managing risks that are communicated across the enterprise.

Finance "Masters"

- Are identified based on a series of comprehensive finance performance metrics reported by companies and governments participating in the Accenture 2011 High Performance Finance Study; and
- Report higher performance than the overall survey group in three key areas of finance: core accounting, cost of finance, and delivering value.

Preface

In today's new risk era, the CFO-CRO partnership can promote a more effective, integrated approach to risk management while driving further operational efficiencies in financial firms, helping to build agility, and retain and attract talent.

Equally important, a strong CFO-CRO partnership can set the foundation for a next-generation risk management initiative that is designed to align global strategy with risk, optimize the use of data and analytics, and draw on sophisticated tools for coping with unknown and non-traditional risks.

This report reviews our research findings on how global financial firms worldwide have been changing the way the risk and finance functions work together, particularly since the global financial crisis. To deepen the richness of our analysis, we undertook a blend of quantitative and qualitative research, including in-depth interview discussions with CFOs and CROs from 17 leading financial institutions worldwide and analysis of the financial sector results from three major global surveys of senior executives—including more than 1,400 respondents in total—regarding risk management, finance, and risk analytics. These surveys are described in more detail below.

CFOs and CROs in the financial sector, particularly in many advanced economies, are facing a "perfect storm" of volatility in the economy and financial markets, escalating regulatory demands, and intensifying pressures on business profitability. Against this backdrop, and in a context in which the risk function increasingly has an independent reporting line, achieving the risk-finance coordination necessary to ride out this storm can place the CFO-CRO partnership under strain. Even as many financial firms have sought to ensure greater authority for the risk function, factors such as a move toward use of risk-adjusted capital adequacy frameworks and regulatory pressure for more integrated reporting are creating pressure for greater operational integration.

Our research reveals that companies are using a number of mechanisms to achieve coordination between risk and finance, while retaining the independence of both the risk and finance functions. These include:

- Sharing and joint development by risk and finance of data warehouses and modeling competencies;
- Mechanisms for coordinating risk and finance input on steering the business, from risk frameworks to formal risk input into corporate strategy; and
- Personnel strategies such as appointing CROs with greater business acumen.

Those financial firms that are succeeding in coordinating risk-finance interactions are better positioned to reap a number of benefits, including higher risk-adjusted returns, increased competency both in finance and risk management, more accurate and timely reporting, and increased staff quality and performance.

We would like to thank the 19 senior executives with global financial firms who took part in our qualitative interview discussions and participated in our survey. We are grateful for the input of senior staff at each of these organizations, including:

- Allianz
- Allstate
- Aviva
- Chubb Insurance Company of Europe
- DBS Group
- ERGO Insurance Group
- Generali Germany
- Nationwide
- Partner Re
- Prudential
- Santander
- SCOR
- Standard Bank
- Standard Chartered's Wholesale Bank
- Swedbank
- Tokio Marine Holdings
- UniCredit Bank AG

We would like to thank the following senior leaders from Accenture who provided expert direction on the research, and insight on the issues covered:

- Paul Boulanger, Managing Director, Accenture Finance and Enterprise Performance
- Steven Culp, Managing Director, Accenture Risk Management
- Richard Lumb, Group Chief Executive, Financial Services at Accenture

Thanks to the following Accenture executives, who also contributed ideas and guidance on this effort:

- Christian Altrock
- Lamyae Belhadri
- Laura Bishop
- Sara Cima
- Eva Dewor
- Gary Fink
- Amit Gupta
- Deborah Hinson
- Eric Jeanne
- Chris Johnston
- Pedro Marcos-Huertas
- Domingo Mirón
- Keith Novek
- Haralds Robeznieks
- Adriana Scozzafava
- Phillip Straley
- Valérie Villafranca

This study draws on the finance-sector-specific results of three broader Accenture surveys: the Risk Analytics Survey (2012), the Risk Management Survey (2011), and the High Performance Finance Survey (2011).

About the Research – Accenture 2012 Risk Analytics Study

The Accenture 2012 Risk Analytics Study is based on a survey of 465 managers and executives from all major geographic regions. Respondents were from the banking, insurance, and chemicals industry, and all held corporate positions in which they were responsible for developing or utilizing industry-specific analytics capabilities. The purpose of the study was to assess the relative maturity of risk analytics methods, tools, technologies, and processes; to determine their current effectiveness in driving business, customer, and market insights to support better decision-making; and to identify current trends. Seventy-five percent of the participating companies have revenues of more than US$1 billion and nearly half have revenues of more than US$5 billion. The analysis in this report focuses on the 377 survey respondents representing the financial sector.

About the Research – Accenture 2011 Global Risk Management Study

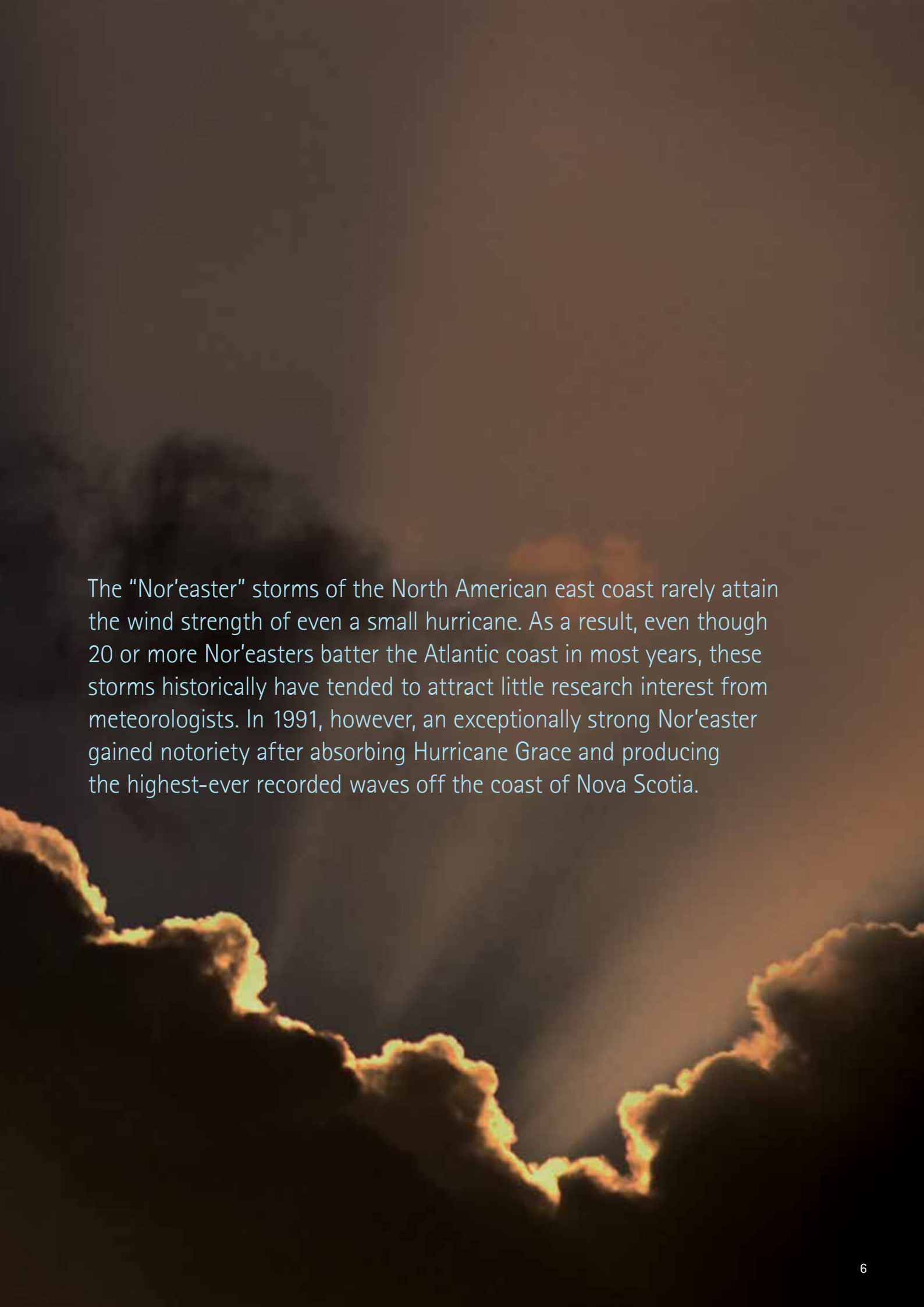
The Accenture 2011 Global Risk Management Study is based on a quantitative survey of executives from 397 companies across 10 industries. All respondents were C-level executives involved in risk management decisions at their companies; organizations were split primarily among Europe, North America, Latin America, and Asia Pacific. Different-sized companies were also represented. About half the companies had annual revenues over US$5 billion; one-fourth had revenues between US$1 billion and US$5 billion; the remaining quarter had revenues between US$500 million and US$1 billion. The analysis in this report focuses on the 47 survey respondents representing the financial sector.

About the Research – Accenture 2011 High Performance Finance Study

The Accenture 2011 High Performance Finance Study is based primarily on a survey Accenture conducted between January and August 2011 among 536 finance executives across 14 industries. The research focused on identifying what constitutes "finance mastery" and the actions and behaviors that masters exhibit. The survey was fielded using a mixed method of phone and online methodologies. More than one-quarter of respondents were CFOs. The balance of respondents were finance directors, vice presidents of finance, and corporate controllers. More than 20 countries were represented in the survey. Eighty-five percent of the participating companies and governments had revenues of more than US$1 billion and greater than half had revenues of more than US$5 billion. The analysis in this report focuses on the 147 survey respondents representing the financial sector.

Introduction

The "Perfect Storm"



The "Nor'easter" storms of the North American east coast rarely attain the wind strength of even a small hurricane. As a result, even though 20 or more Nor'easters batter the Atlantic coast in most years, these storms historically have tended to attract little research interest from meteorologists. In 1991, however, an exceptionally strong Nor'easter gained notoriety after absorbing Hurricane Grace and producing the highest-ever recorded waves off the coast of Nova Scotia.

The exceptional strength of this "perfect storm" resulted from the unusual confluence of three factors: cool and dry air from a high-pressure system coming from the northwest, warm air from a low-pressure system coming from the south, and tropical moisture from Hurricane Grace.[1]

The "perfect storm" can also describe conditions now facing CFOs and CROs in the financial sector, as market and economic volatility combines with regulatory and commercial pressures to produce an exceptionally challenging operational environment. "This is a combination of challenges we've not seen simultaneously before," observes Brian Hardwick, CRO of Chubb Europe. "So people in my position are having as busy a time as we can conceive of, frankly."

Indeed, our recent discussions with CFOs and CROs at some of the world's leading financial institutions indicate that this already exceptional storm could still be building. "Looking at the regulatory landscape," says Håkan Berg, Group CRO of Swedbank, "I think it may even blow harder before it gets calm again."

The first section of this paper looks at how some of the main internal and external shifts and pressures are causing financial services firms to rethink their approach to risk management. The next section looks briefly at the current context, in which the risk function is increasingly gaining in authority and responsibility, and yet regulatory demands are driving closer operational integration between risk and finance. The third section reviews the different techniques firms are using to enhance the CFO-CRO partnership, including integrated data and models, mechanisms for steering the business, and personnel and culture issues. The paper's fourth section presents the potential benefits of achieving a strong CFO-CRO partnership, based on the input of our discussions with leading CFOs and CROs. We then conclude with our view on lessons learned.

Permanent volatility

The most obvious element of the current storm is the volatile global economy. According to 95% of financial sector respondents that we surveyed, "permanent volatility" in the global business environment is having either a "moderate" or "high" impact on their organization. Among banks, the figure is 91%; among insurers, 95%; and among capital markets firms, 100%. Swedbank's Berg reports that as much as 50% of his time reporting to the Board of Directors involves various risk scenarios relating to the Eurozone crisis. "The risk of a Eurozone breakup is high enough that it's a risk I would not insure." says Philippe Trainar, Group CRO of SCOR.

Of course, the specific economic risks of greatest concern and their impacts vary by financial institution and, to some extent, by operating region. "For example," states Paul Boulanger, Managing Director of Accenture Finance and Enterprise Performance, "Potential business disruption in the Eurozone, and financial institution exposure to Eurozone sovereign debt valuations—or worse, default risk—are affecting financial institutions' balance sheets." Of the many elements of volatility, however, macroeconomic and related financial market stresses feature strongly for financial firms (see Figure 1).

"Winding the clock back to 2008-09, none of the South African banks were actually impacted directly by the [onset of the acute phase of the global financial crisis]," explains Paul Hartwell, CRO of Standard Bank. According to Hartwell, the impact was felt more strongly indirectly, notably by regulatory fallout in the crisis aftermath. "If we see a slowdown in Southeast Asia, particularly in China, that will impact commodity prices, and that will affect a lot of countries across Africa," says Hartwell. Likewise, Elbert Pattijn, CRO of DBS Bank, describes that while his Singapore-based bank is not currently directly exposed to the Eurozone crisis, he is concerned that a Eurozone recession could amplify a slowdown in China, with negative economic effects throughout Asia.

And the current, volatile economic environment can have effects that stretch across the business. "If you go back to the credit crunch, we saw a greater impact on the underwriting side than the investment portfolio side," says Chubb's Hardwick. "...since then defense of both the underwriting and the investment portfolio have become a focus." By contrast, Peter Hofbauer, CFO of UniCredit Bank AG, argues that operational risks were underestimated by many financial institutions. "Operational risk is already a significant part of the risk weighted assets and the number is growing," he contends.

[1] From Sebastian Junger, *The Perfect Storm*, W.W. Norton, 1997, and Robert Davis and Robert Dolan, "Nor'easters," *The American Scientist*, September-October 1993.

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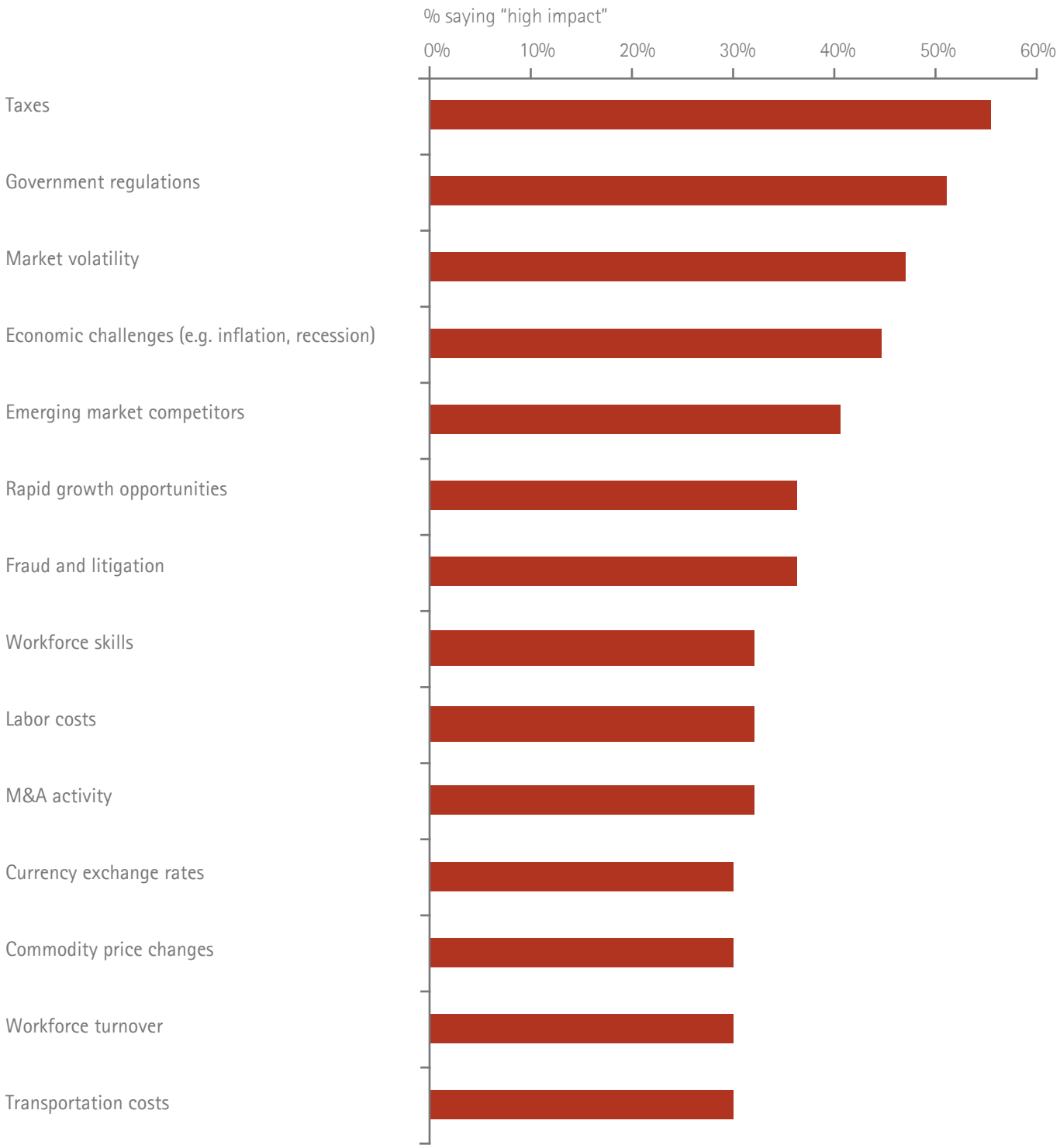
Figure 1. To what extent is your finance organization impacted by increased volatility caused by the following factors?



Source: Accenture High Performance Finance Survey (2011)

Top risks to the global economy

Oxford Economics' Global Scenario Service currently sees three main downside risks to the global economy: the financial contagion and economic turmoil that would be sparked by the departure of countries from the Eurozone; a sharp slowdown in Chinese economic growth triggered by a sharper-than-expected correction in China's property and construction sectors; and uncertainty over the US fiscal stance, which threatens to push the US into another recession.

The most serious of these risks, according to Oxford Economics, is posed by the prospect of the financial contagion and economic turmoil worldwide that would result from the departure of one or more member economies from the Eurozone currency union. Although a sudden Greek exit from the currency union was averted following the outcome of recent elections in that country, the Eurozone debt crisis deepened at midyear as concerns intensified that the €100 billion (US$121 billion) bailout for Spain's banking sector might have to be followed by a larger sovereign bailout. The financial contagion resulting from multiple exits from the Eurozone could also produce a severe global credit crunch, and raise investor and business uncertainty, causing world GDP growth to fall back to 2% on a purchasing power parity basis during 2013 compared with Oxford Economics' baseline forecast of 3.2% if the Eurozone survives intact (see Figure 2).

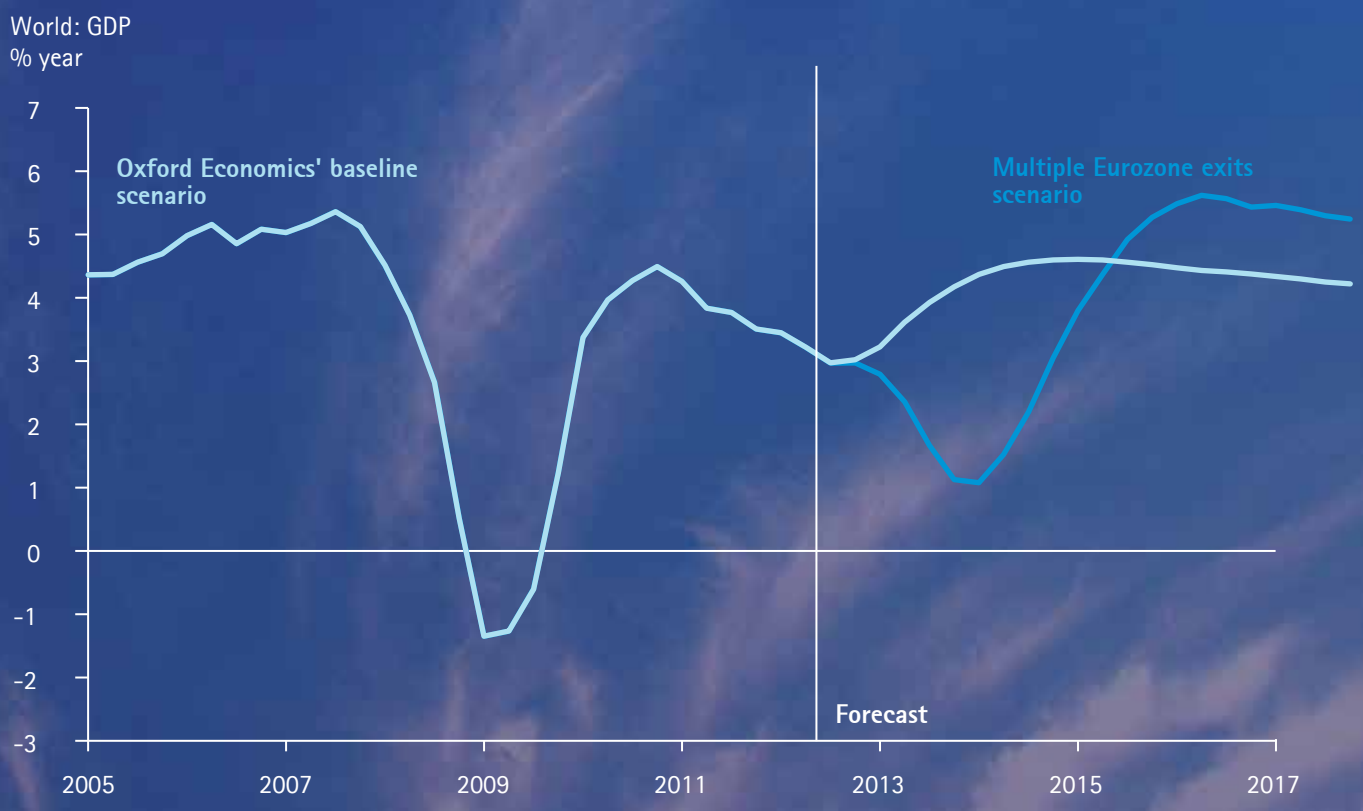
The combined negative impact on trade flows and financial contagion following a disorderly exit of multiple countries from the Eurozone would likely also raise the risk of a "hard landing"—a dramatic slowdown—of China's economy. The risk of a hard landing for the Chinese economy has fallen overall in the past few months, however, as the country's less-overheated property and construction markets have given policymakers more room to respond to signs of slowing growth. Financial and trade linkages would cause world GDP growth to slow to a projected 2.6% in 2013 under this scenario according to Oxford Economics.

The US economy is heading for a tightening of fiscal policy toward the end of 2012—the risk of a so-called "fiscal cliff." A slowdown in US economic growth could hit the world economy negatively. According to Oxford Economics' baseline assumptions, the probability of a fiscal cliff scenario is 10%.

There is also an upside risk scenario for the global economy, according to Oxford Economics. Under this scenario, the significant cash accumulated on balance sheets by corporations across a number of countries worldwide would be spent more quickly than had been envisaged, boosting confidence in industrial economies and stimulating demand.

Source: Oxford Economics, *Global Scenario Service*, June 2012.

Figure 2. Oxford Economics' GDP forecast (2005 PPP)



Source: Oxford Economics/Haver Analytics

A regulatory whirlwind

If the global economy represents the offshore low pressure system of a Nor'easter, the hurricane that may be about to add its strength to the storm could be the whirlwind of global regulatory activity. Financial sector companies simultaneously face a range of new regulatory challenges relating to privacy, anti-money laundering, improper payments, and accounting standards—even as major sector-specific regulatory packages such as Basel III and Solvency II are being adopted in many geographies. "Evolving regulation in the form of Solvency II is, in itself, a massive risk to the insurance industry," says Robin Spencer, 2012 Chairman of the European CRO Forum and CEO of Aviva UK & Ireland (previously Aviva's CRO). Solvency II could pose an even greater threat to the insurance sector than the volatile financial environment, making regulation today's "dominant challenge," agrees Chubb's Hardwick. A nearly unanimous 95% of survey respondents in the financial sector say they expect regulatory risk to increase "significantly" (56%) or "somewhat" (39%) over the next two years (see Figure 3). (This combined share is 92% for banks; 96% for capital markets firms; and 100% for insurers.)

The specific regulatory changes that surveyed executives expect will occupy the greatest amount of time and resources are the Solvency initiatives in insurance, and Basel III initiatives in banking (see Figure 4). The expected impact of the sheer breadth of simultaneous regulatory changes is also apparent in the survey results. Seven separate sets of regulatory reforms feature as top-three concerns for 10 or more surveyed companies, including International Financial Reporting Standards (IFRS), industry specific regulatory changes, and privacy regulations (e.g., data privacy). This broad distribution of responses suggests a sector simultaneously under pressure on many different fronts.

In addition to costing time and resources, regulatory changes can create strategic challenges, which can vary considerably in impact by region and financial market context. From the perspective of a bank operating in Africa, where banking systems tend to be highly capitalized, but with low leverage, "Basel III is actually almost a tax on growth in our region," says Standard Bank's Hartwell. By requiring banks in this region to hold more expensive capital against the same types of risk, this would make already expensive and scarce credit in these lending markets even more expensive and scarce, especially at the medium- to long-term end of the credit spectrum.

The external stakeholders involved in regulatory demands also appear to be changing rapidly—and can impose these demands at regional as well as national and international levels—which can create contradictory pressures. Swedbank's Berg notes that national regulators across the countries where Swedbank operates don't necessarily align to provide a consistent regulatory framework. "I think that is internally the most important challenge we currently face," he adds. In the US, rating agencies can set standards of capital adequacy that are even more demanding than those of regulators if insurers wish to maintain a top rating. While the UK's Financial Services Authority has historically used a risk-based approach to capital adequacy, continental regulators have not—a balance that now appears to be shifting, however, with Solvency II's risk-based framework.

Regulatory shifts can also produce unexpected second-tier impacts. According to Aviva's Spencer, "the [regulatory] environment is causing a new risk to emerge—it is harder to attract and retain the best leadership talent." Increased scrutiny is making highly qualified senior executives reluctant to join boards, for example. The regulatory "tsunami" tends to amplify other risk-management challenges as well: "If we have a 25% debt-to-capital ratio, and the regulator says you need to have a 20% ratio, that reduces the return on capital," says Richard (Rich) Carbone, CFO of Prudential. This could pose a serious challenge for capital-intensive sectors in which average profits are lower than before the financial crisis.

Commercial pressures

Indeed, pressures on profitability could constitute the third element of heavy weather. Combined with regulatory change and economic volatility, this commercial pressure is producing waves that threaten to swamp some financial firms. Banks that once enjoyed exceptionally high returns seem to be undergoing fundamental restructuring of business models as they attempt to adjust to business environments that make profitability difficult to achieve. "Banks are responding strategically to these new regulatory shifts, and asking what businesses they can be in," observes Richard Lumb, Group CEO of Financial Services at Accenture. This may lead to the radical cost restructuring of some lines of business, such as retail banking, to return them to profitability, and the exiting of other lines. "It's a different business today, with different profitability and so on," agrees a senior manager with a top European bank. This is forcing executives to rethink "what is really banking and what is not," he adds.

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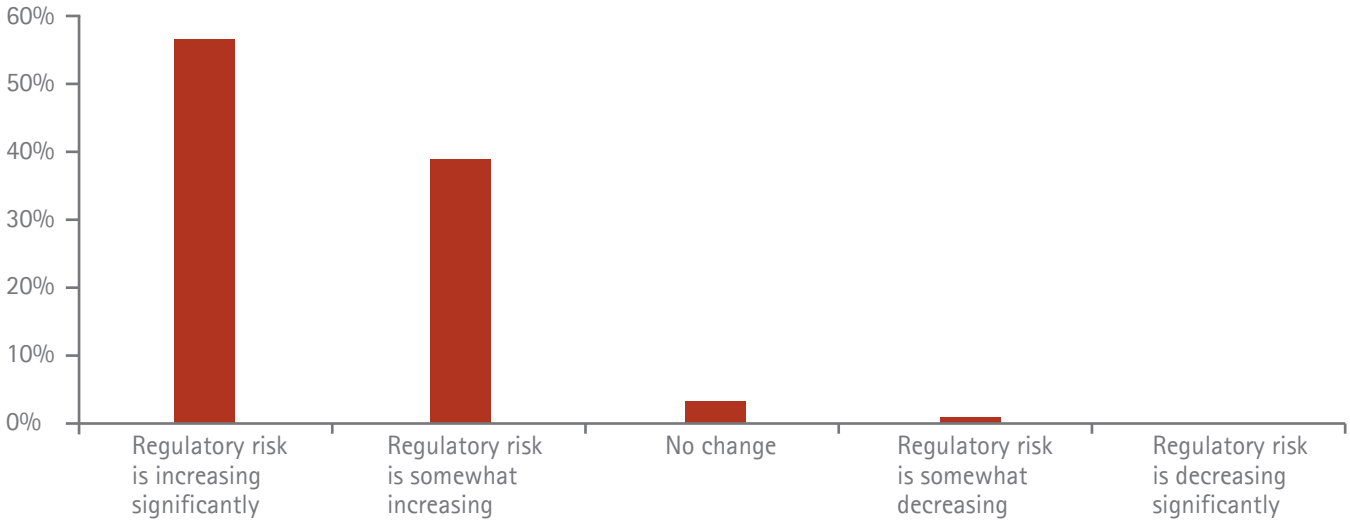
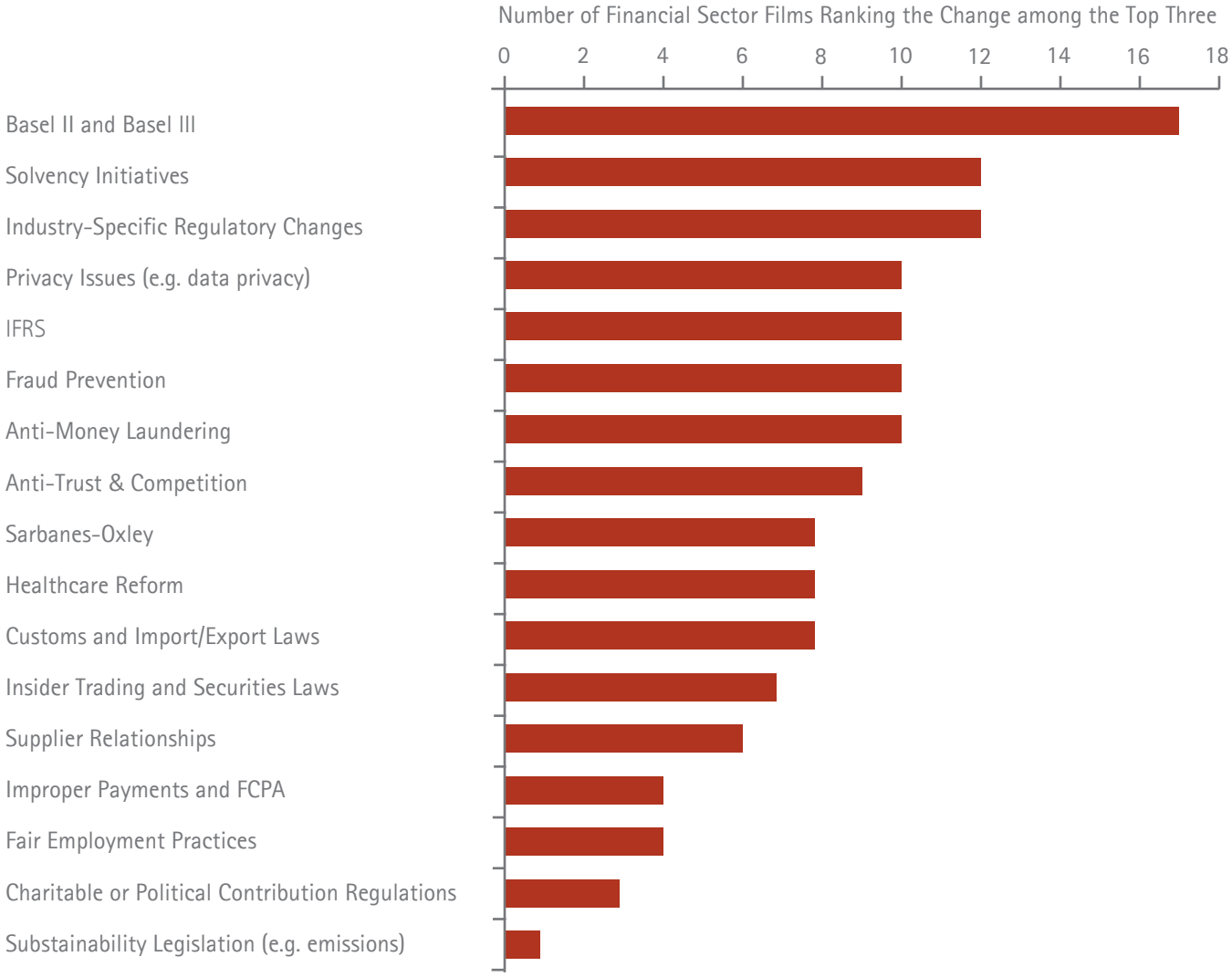
Figure 3. In the next two years, to what extent will regulatory risk change in your industry?



Source: Accenture Risk Management Survey (2011)

Figure 4. To which regulatory changes is your finance organization devoting the most time and resources?



Source: Accenture High Performance Finance Survey (2011)

In the US, the Volcker Rule—the section of the Dodd-Frank Act that places limits on proprietary trading—has amplified such trends, leading to a series of spinoffs and closures of hedge funds and proprietary trading units that were parts of US investment banks. In Germany, our discussions with CROs reveal concerns that a new financial transaction tax could lead to the end of money market instruments, and that higher capital requirements are causing major financial institutions to move out of asset-backed finance entirely.

Although many emerging markets banks face a much more favorable commercial environment, they are not immune to these pressures. "For me the biggest risk I worry about is the potential dislocation of current business models and current paradigms—in terms of how we operate and how we price," says Simon Ridley, CFO of South Africa's Standard Bank. He gives the example of "know your customer" regulations requiring detailed monitoring and analysis of customer information, which could make it economically difficult for the bank to serve corporate as well as retail customers, particularly in countries where national-level personal identification regimes may be less comprehensive and reliable.

In the insurance sector, low interest rates are causing policy lapse ratios to vary sharply from actuarial projections. The prolonged low interest rate environment is "a challenge for US insurance companies," says Prudential's Carbone. Aviva's Spencer describes the combined impact of pressure from multiple storm fronts: "An acute problem for life insurance firms is not only the obvious impacts of mark-to-market accounting and capital requirements on firms, but also low interest rates—and all of this has come at the same time in the past two or three years."

Of course, it is possible that some geographies and subsectors will pass through the storm relatively unscathed. But the scale and breadth of the pressures mean that most financial firms are now grappling with simultaneous challenges. Michael Mahaffey, CRO of Nationwide, describes the financial crisis, harsh weather conditions, and the need to finance acquisitions as "three seemingly distinct capital-related exposures" that have occurred simultaneously. "So we've had the perfect storm in terms of what's affected our balance sheet and risk profile," he concludes.

Riding out the storm: a challenge for the CFO-CRO partnership

This convergence of multiple pressure systems is posing acute challenges for CFOs and CROs. In discussions held with top global financial firms' CROs and CFOs, one challenge frequently mentioned is the need to achieve greater coordination between finance and risk. Following the global financial crisis, this need appears to have become acute at many levels, as data, reporting, and outputs are pulling finance and risk together across operational and strategic decision sets. Progress is being made across many firms, although challenges admittedly persist. For example, as noted by Swedbank's Berg, for many financial firms, there is much closer cooperation between the CFO and CRO today than before 2008. The CRO of a leading global bank agrees: "If you go back even a few years, most organizations hadn't done a huge amount in terms of bringing together the CFO and CRO." But they point out that the finance and risk functions within many financial firms have since begun to forge a closer partnership, impelled by a combination of factors including cost and effectiveness pressures, regulatory demands, a desire to do more stress testing, exposure reports—and "wanting a very fast turnaround on figures."

More than 90% of financial firms we surveyed are either currently implementing or planning better integration of risk and finance processes and information over the next two years. 53% have already begun the implementation process (see Figure 5, blue dashed box). There is a sharp difference in progress between Masters and other companies, however: 75% of Masters are already in the implementation stages of risk-finance integration, versus only 49% of non-masters.

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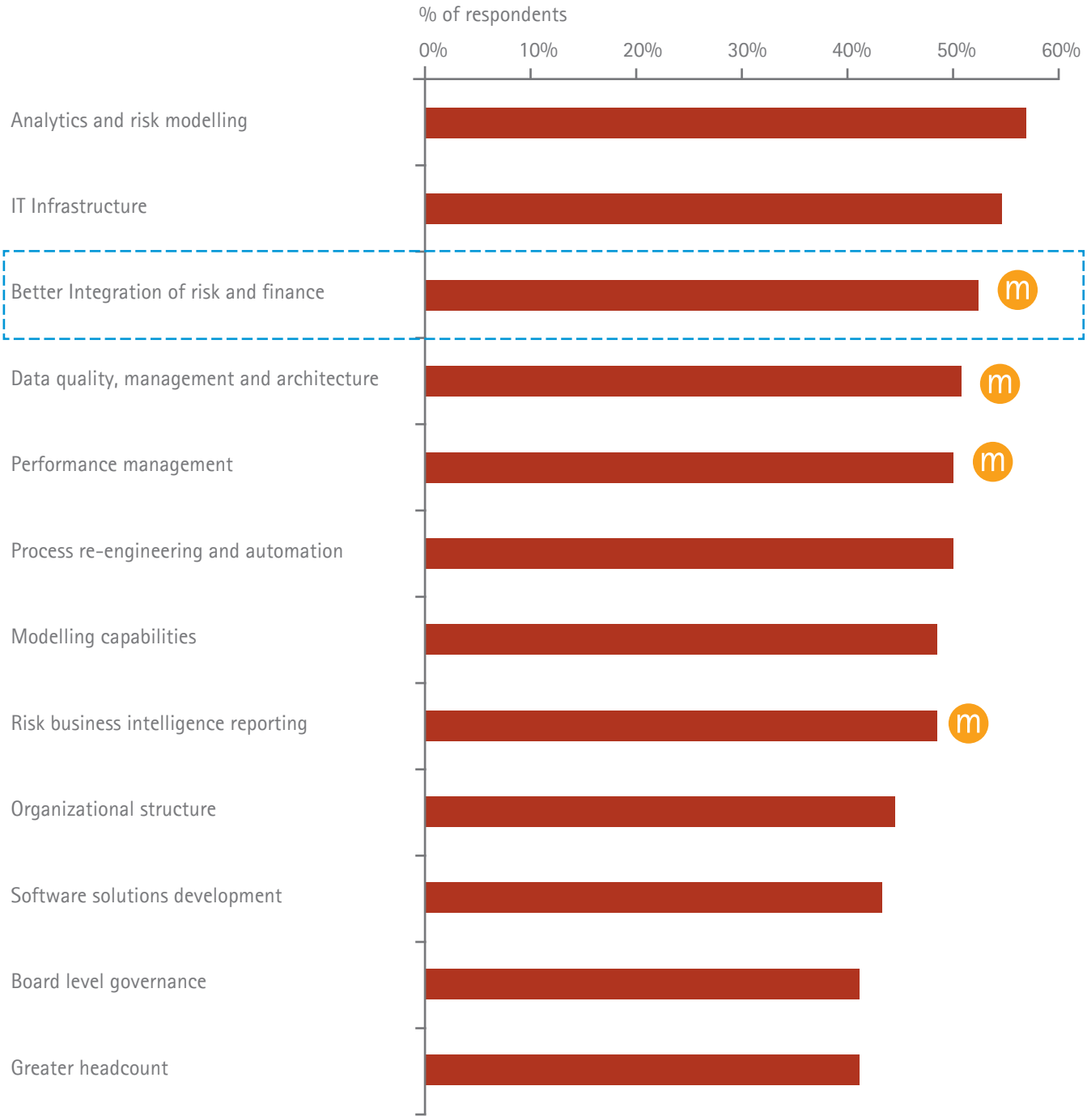
Figure 5. Capability changes currently being implemented



Source: Accenture Risk Management Survey (2011)

The current context

A new role for risk

Increasing the authority and reporting independence of the risk function

Ironically, some of the challenges that CROs and CFOs face in navigating the waves and winds of the "perfect storm" may have been made more acute by recent efforts to improve financial sector governance. Across financial institutions and regions, many financial firms have been endeavoring to increase the authority of the risk function. As Swedbank's Berg puts it: "Normally, a company is run by the CEO and the CFO. What is developing at banks today is that the main management is the CRO, CFO, and CEO."

At many financial firms, this separation has been executed via a shift to independent reporting and the development of new, separate capabilities for the risk team. "We do try to be a good partner, but the actual risk management thought process, where the rubber meets the road—finance really isn't part of that," says Nicholas (Nick) Silitch, Prudential's CRO. "Between financial management and risk management there is a potential conflict of interest," says Stefan Winands, Group CFO at Partner Re. "If risk management is part of the finance function, it is important that risk management preserve its independence."

This growing authority for the risk function can have unintended consequences. Risk and finance can have a tendency to operate in silos, making it harder to achieve coordination in day-to-day business decisions. "With the deluge of third-party demands for companies to get better at risk management—whether that's through the Own Risk and Solvency Assessment (ORSA), Solvency II, Dodd Frank, Fed supervision, or ratings agency Enterprise Risk Management (ERM) evaluations—I think it can become a challenge for a company to continue to make risk management a value-added internal function," says Nationwide's Mahaffey.

The decision-making authority of the risk function tends to be well established in the financial sector in advanced economies, according to the results of the 2011 Accenture Risk Management Survey. For instance, nearly 81% of surveyed companies have a CRO, and Masters are significantly more likely to have a CRO than the average financial company (see Figure 6). More than 85% say that the risk manager at their firm has a direct reporting line to the CEO, and 6% are considering making this change. "Going forward, global regulators will continue to look at the reporting lines of the risk function," says Aviva's Spencer. "They don't think you can get this cultural change [of more authority for risk] without having very clear, independent reporting lines—it is a very similar transition to what has happened for internal audit."

There are clear grounds for ensuring the authority of the risk function, in that certain decisions will almost certainly bring the interests of risk and finance into opposition. For instance, as Tom Wilson, CRO of Allianz, notes, "when holding an asset at fair value, if you no longer like the position of the asset, you are most likely going to have to sell into a soft market with a resultant operating or net income loss." This means that there will be an explicit tradeoff: Improving the company's risk profile may enhance its long-term profitability, but it may tend to reduce its short-term operating profit.

Those few firms participating in our discussions that have not made such a change to independent reporting tend to find risk-finance integration is much easier. "I report to the CFO and always have," says Chubb's Hardwick, "so questions around integration seem slightly alien to me because we've not really had it any different way." Similarly, Nationwide's CRO, Michael Mahaffey, who reports into the company's CFO, notes that, "at Nationwide risk is a part of finance and it's inextricably linked—as a way to create value for the enterprise, to enhance our key objective of risk and capital management."

Of course, for those companies in which risk has an independent reporting line, achieving coordination between risk and finance does not necessarily entail undoing the progress in developing the capabilities and authority of risk. Bringing risk too close to finance is "sloppy and dangerous," argues Prudential's Silitch. Risk increasingly has gained a seat at the table in top-level decisions, and this new authority must be preserved. Risk should be able to push back against finance if commercial and risk objectives come into conflict, and a healthy CFO-CRO partnership can sometimes mean agreeing to disagree. "Since risk has a limiting role, the CFO and CRO have slightly different roles from time to time, and we have concluded that it is important we keep those differing roles," explains Swedbank's Berg. SCOR's Trainar agrees: "The differing views of the CFO and CRO allow the CEO to have access to the best information."

Regulatory pressure for integration

Even as regulators seek to enhance the authority of the risk function, regulatory demands since 2008 are perhaps the single greatest force bringing risk and finance together. Risk-finance integration efforts have historically tended to run aground because of differing objectives and priorities. But recent regulatory pressures have created shared priorities for risk and finance, in areas including reporting, data, and modeling.

Capital provisioning is often a joint risk-finance responsibility, and at the very least requires extensive risk—finance coordination. For instance, "we work together on the internal capital adequacy assessment protocol (ICAAP); on the internal liquidity adequacy assessment protocol (ILAAP); on the allocation of capital and liquidity to maximize/optimize performance across our various corporate and retail books," says Standard Bank's Hartwell. Historically, the CFO was responsible for reporting, and the CRO for compliance,

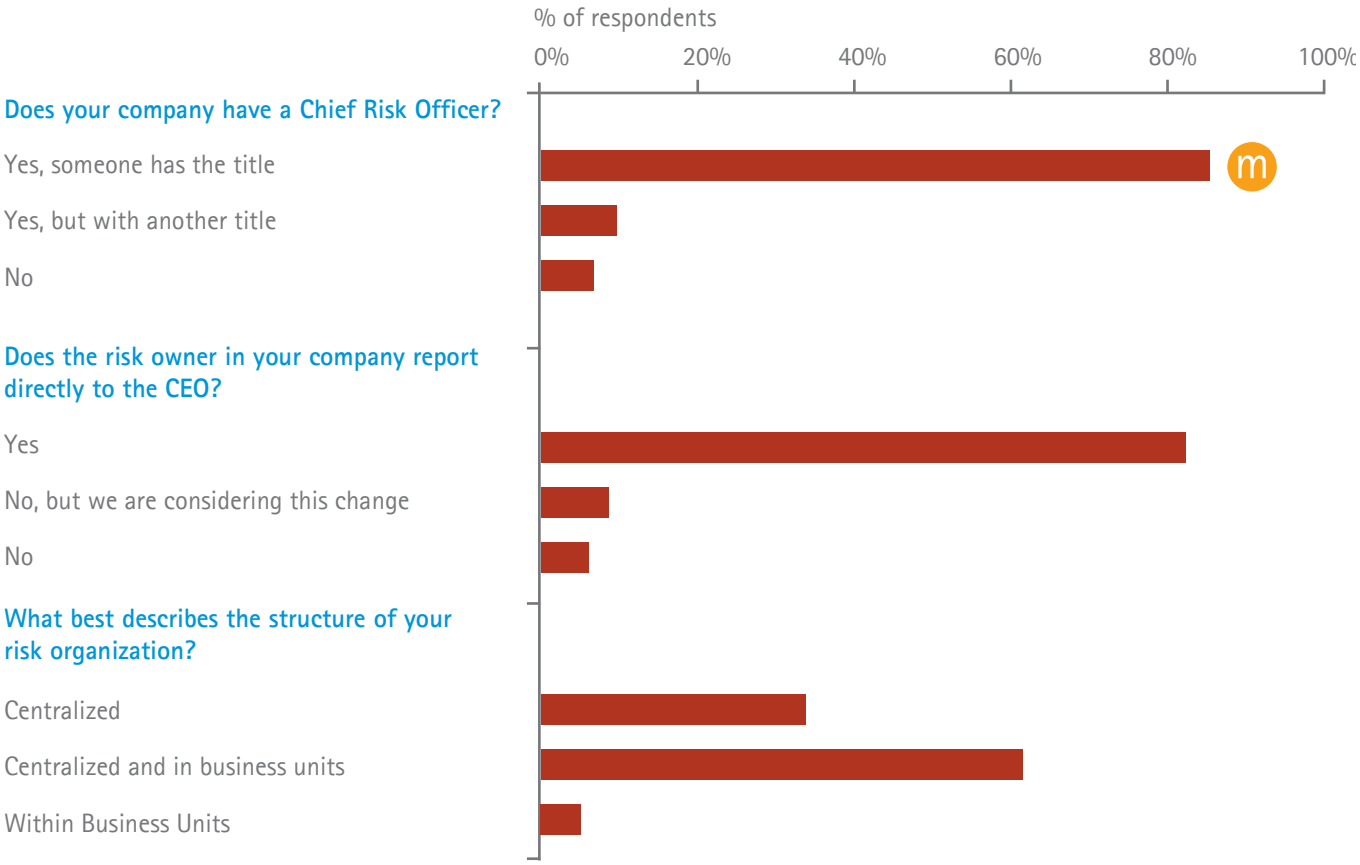
Even as regulators seek to enhance the authority of the risk function, regulatory demands since 2008 are perhaps the single greatest force bringing risk and finance together.

agreed Unicredit Bank AG's Hofbauer. But he explained how new regulatory approaches now make compliance the common responsibility of the CFO and CRO. This shared priority makes it more likely that risk-finance integration efforts will succeed.

Risk-adjusted capital models are at the heart of both the latest Basel regulatory initiatives in banking, and the latest Solvency initiatives in insurance. Implementing such models often involves extensive coordination by risk and finance on inputs, and possibly also on decision-making. While not necessarily contradicting the goal of independence of the risk function, this pressure for operational integration has made the CFO-CRO partnership a delicate balancing act. According to DBS Bank's Pattijn, five to six years ago, there was risk-finance integration because most organizations didn't have an independent CRO—it was all under the CFO. "That created clear agency issues, so there's been a push from various parties to split those roles," he says, adding that moves to integrate them back together are akin to "putting back the clock again."

At a more fundamental level, however, it can be argued that "if you make the CFO and CRO independent, that is actually a strong impetus for operational integration," in the words of SCOR's Trainar. According to this line of reasoning, if risk and finance begin to oppose each other on some business decisions, this increases the need to avoid unproductive disagreements over facts. Separating risk and finance puts the CFO and CRO in opposition. Whether this opposition is constructive or leads to time wasting may be determined by whether or not operational issues become a source of needless disputes. "The risk function should be separate in reporting to the board," agrees Accenture's Lumb, "which is what creates the pressure to integrate around processes, systems, and data."

Figure 6. Structure of the risk organization in financial sector companies



Source: Accenture Risk Management Survey (2011)

"Since risk has a limiting role, the CFO and CRO have slightly different roles from time to time, and we have concluded that it is important we keep those differing roles," explains Swedbank's Berg.

Balancing independent reporting and risk-finance coordination at Prudential

It is immediately clear that Prudential's CFO and CRO believe that different perspectives, healthy disagreements, and vigorous debate are in the best interest of the company and fundamental to their relationship. "The CFO function, in all cases, is a business function," says Nick Silitch, the firm's CRO. "Working for our CFO are all of the VPs of finance within the businesses, and they are charged with making a profit. Meanwhile, their risk counterparts provide an appropriate balance."

Prudential's CFO, Rich Carbone, agrees. "The way this works in practice is that there should be a clear division of authority. I don't want to help the risk officer set limits—that is their job." To maintain the decision-making authority of the risk function, some elements of the function must remain separate from finance, at an operational level, argues Silitch. "In terms of the day-to-day risk management function, the principal tools that we use to manage investment limits and operational risks are not done in any way through the finance organization. We have an independent role to play, but coordination is essential," he says.

Thus, the risk function should not operate as a silo—nor should it be focused solely on compliance. To avoid this potential pitfall, the risk function should focus on providing "value-added" to the rest of the business, according to Silitch. "In terms of capital assessment, we want to get to a risk-adjusted capital number," says Carbone from his perspective as CFO, explaining how the risk function provides value-added by supplying the input into the risk-adjusted return on capital (RAROC) models. "This gives us risk-adjusted pricing," Carbone notes, "and for everything we sell, we need to price the equity we put into the product."

Having this attitude of providing value-added means risk should not produce "ivory tower" models. Above all, models must have real-world applicability. Silitch provides the example of models and stress scenarios to assess the company's government sovereign bond exposures in a country. An "ivory tower" approach might produce unrealistic numbers based on a government bond default scenario and simultaneous appreciation of the country's currency; a more credible approach will use a realistic scenario in which a government bond default is accompanied by currency. Realistic models and stress scenarios that provide value-added "gain the respect of the organization and are implemented," says Silitch. "Coming up with measures that are absolutely transparent to people, and bought into by the group, is the critical part of what we do."

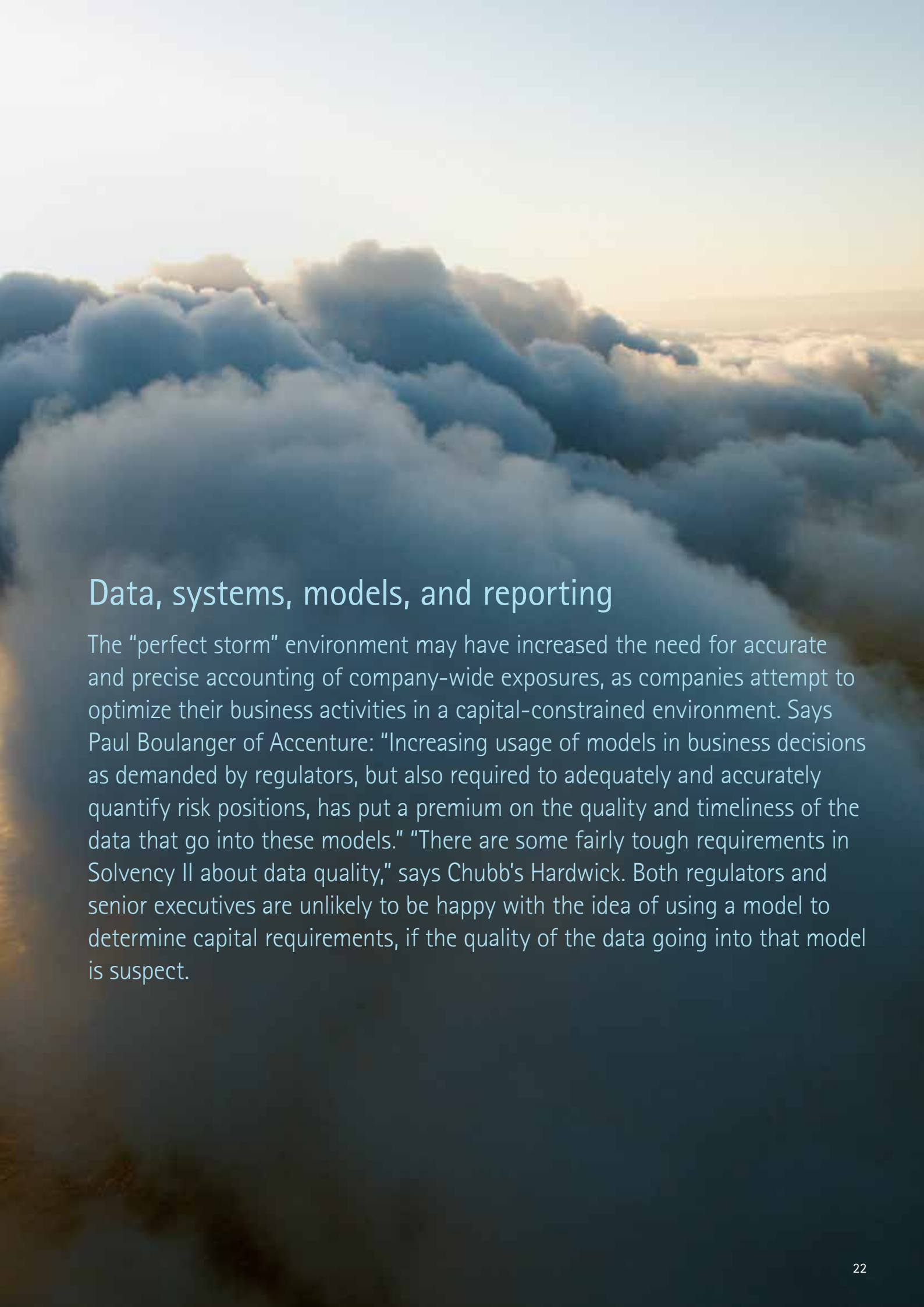
In developing the models that drive capital management, Silitch emphasizes that coordination between risk and finance must be very good. But, even here, there are limits on the CFO-CRO partnership. "There is a fundamental problem with the idea of a 'partnership' and that is that someone has got to be responsible for the final decision," says Carbone. "If the company runs out of capital, the CFO is responsible," he stresses, pointing out that the risk function can measure the risk, but treasury determines the amount of capital the firm holds against the risk.

Silitch agrees: "The job of finance at the end of the day is to make sure that all the subsidiaries and the parent have enough capital to operate, both legal and economic."

Moving up to the level of the CFO and CRO themselves, how does the partnership at Prudential operate smoothly, if the decision-making authority of the risk function is believed by both parties to be crucial to success? Soft skills play a role. "Finance likes to focus on shareholder return—increasing the stock price by any legitimate means—while risk likes to focus on avoiding destruction," said Carbone. "Both can do better with a bit of bipartisanship," he added, noting that success in this bipartisan relationship is highly dependent on the personalities of CFO and CRO, and the leadership shown by those two.

"I think risk needs to earn its seat at the table," says Silitch. "The only way to get a seat at the table is to provide value." Silitch also advises that risk management must be done transparently, and with a spirit of collaboration and openness to debate. This is also assisted by an encouraging corporate culture: "The key is that the businesses folks, the risk folks, the finance folks—everybody you can imagine, even auditors—get a say, and they should."

Enhancing the CFO-CRO partnership



Data, systems, models, and reporting

The "perfect storm" environment may have increased the need for accurate and precise accounting of company-wide exposures, as companies attempt to optimize their business activities in a capital-constrained environment. Says Paul Boulanger of Accenture: "Increasing usage of models in business decisions as demanded by regulators, but also required to adequately and accurately quantify risk positions, has put a premium on the quality and timeliness of the data that go into these models." "There are some fairly tough requirements in Solvency II about data quality," says Chubb's Hardwick. Both regulators and senior executives are unlikely to be happy with the idea of using a model to determine capital requirements, if the quality of the data going into that model is suspect.

Indeed, Christoph Jurecka, CFO of ERGO Insurance Group, argues that "key synergies between risk and finance are data-related. If you have a risk-adjusted or economic capital steering and reporting process in place, you need a certain level of data integration to be able to rely on the results coming out of it."

Because regulators increasingly require the integration of models into day-to-day business decisions, these models must also operate at a pace consistent with business demands. This means the data inputs must also be timely. According to Standard Bank's Hartwell, "it's very important that, when we look at the set of data today, we are comfortable that it is a true and accurate reflection of our portfolios as we speak." Hartwell emphasizes the importance of confidence in data quality if crucial decisions such as constraining the origination of assets, distributing assets, changing risk appetite or pricing, or changing mutualization of capital on the balance sheet are to be made based on model outputs.

Dietmar Meister, CEO of Generali Germany, notes that "risk management methods and approaches are increasingly incorporated into insurers' key process areas." "Risk-specific" enhancements are being made in pricing, product development, portfolio management, and sales-force steering, and will be intrinsic elements of these insurance processes. Here, risk management acts as an incubator and internal consultant to achieve these enhancements. Meister adds that "achievement of such risk-specific process enhancements will require substantial investments—including in data."

The need for faster and more accurate reporting is driving greater integration at the operational level. According to a senior manager with a top European bank, in recent years there have been more points of interaction at an operational level between the areas of risk and finance within his bank. He cites regulatory requirements and the need for more accurate data as two causal factors. "Data needs to be more integrated because you must report this information fast and it must be accurate," agrees the CRO of a leading global bank. "The old days of being able to take a month to report your risks are long gone." Meeting new capital disclosure requirements issued by the Basel committee, for instance, may require extensive CFO-CRO coordination. Global banks that operate across borders will be required to follow common templates in publishing their capital positions under the new Basel rules—a change that should foster more integrated risk and finance reporting.

According to input provided by financial institutions participating in qualitative interview discussions for this study, one result is that CFOs and CROs are increasingly working together on data quality issues. To this end, reports Berg, Swedbank's finance and risk functions have jointly hired a Chief Information Officer for both functions. At a leading global bank, the CFO and CRO meet regularly on a committee that reviews the quality of data, reports their CRO.

In many cases, CFOs and CROs have collaborated on major overhauls of corporate data processes and systems. "Finance and risk ought to operate off a common set of data, which has been a challenge in many organizations," says Standard Bank's Hartwell. "But a number of years ago, we established a data-reengineering program between risk and finance so that we could have greater certainty over the accuracy, completeness, and timeliness of our data." Similarly, Swedbank's Berg says his bank has been working in the past few years to develop a common data warehouse, so finance and risk are actually using the same source of information.

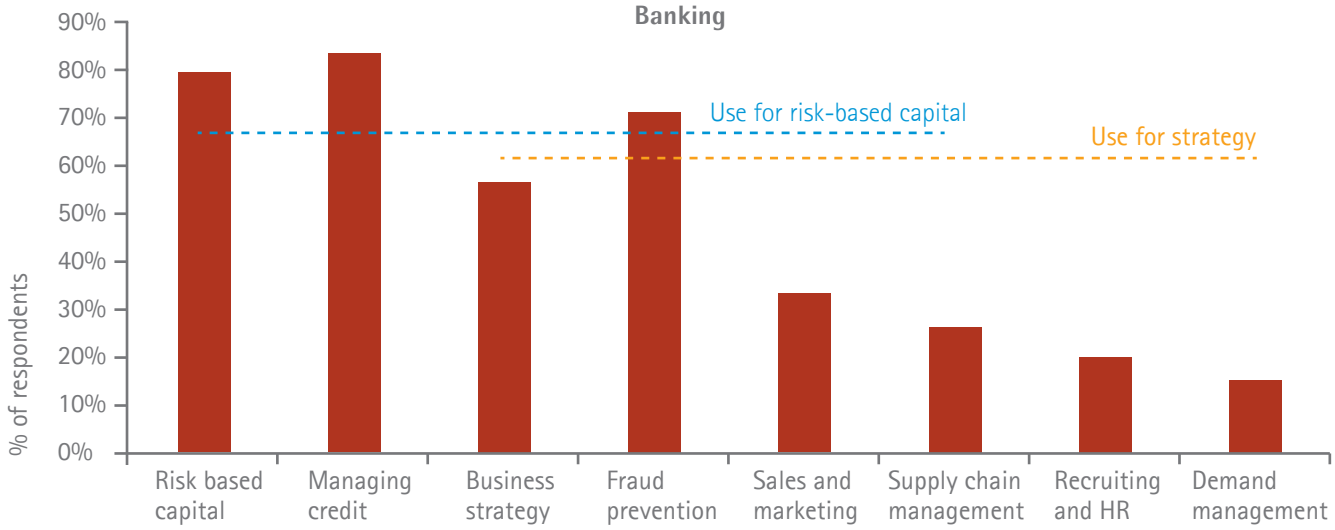
Differing data sources not only cause delays, but may also become a source of unnecessary conflicts and impair the risk-finance working relationship. "When you're looking at a common set of facts, it helps focus the dialogue on differences in interpretation, around possibilities—not around whose facts are right or wrong," notes Allstate's CRO, Steve Verney.

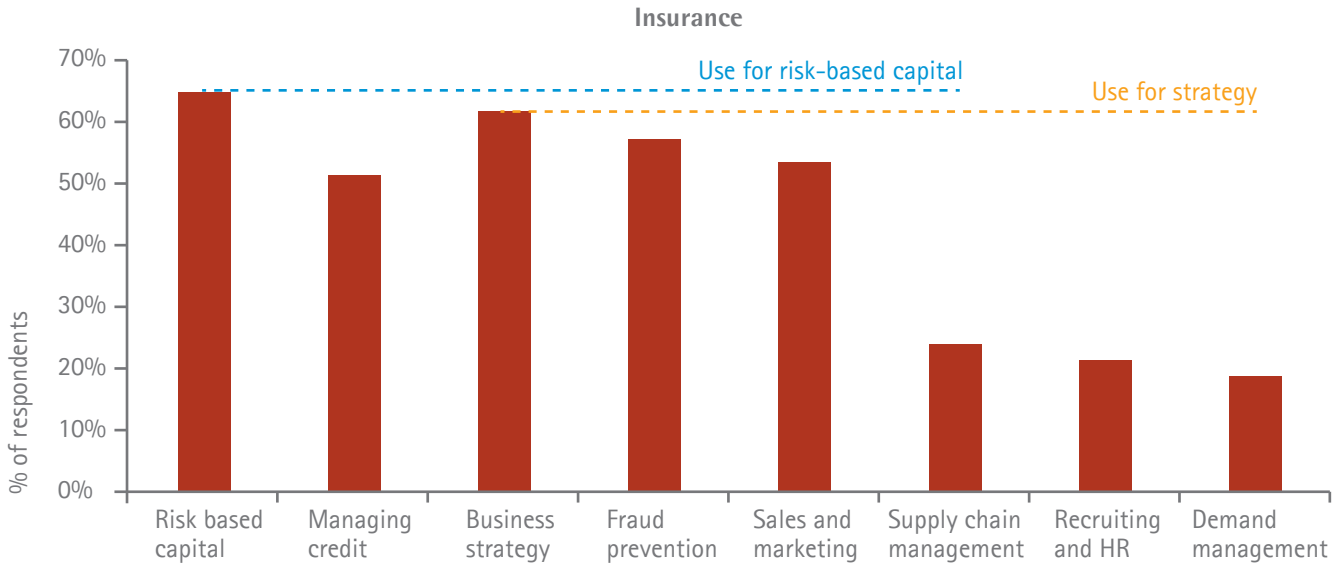
In many of the financial firms participating in our discussions, the development of risk and capital models has also brought risk and finance together at the operational level. "Coordination is improving, and will improve further, due to ICAAP," says UniCredit Bank Germany's Hofbauer. Often the models are developed by the risk function but in close coordination with finance. "A lot of the data we feed into our capital model is essentially coming out of the systems that finance has put together, and many of the outputs from the model influence our financial reporting," explains Chubb's Hardwick.

Our survey results indicate that use of risk analytics has advanced significantly in the financial sector, particularly in banking (see Figure 7). "The ICAAP models, as such, represent a quite dramatic technical development over the past couple of years," notes Swedbank's Berg. Some 80% of surveyed banks and 65% of surveyed insurance companies use risk analytics for risk-based capital. Banks are thus well above the cross-sector average of 66% (blue dashed line).

In many cases, CFOs and CROs have collaborated on major overhauls of corporate data processes and systems.

Figure 7. Current use of risk analytics





Source: Accenture Risk Analytics Survey (2012)

Similarly, banks are far ahead of other finance subsectors in adopting model-based management of credit and fraud risk. Interestingly, however, in the use of risk analytics for corporate strategy, banks lag insurers and even the cross-sector average (orange dashed line).

In many cases, integration of analytics is, in part, a cost-restructuring initiative, given the low-profitability environment. "Risk operates 'service centers' that provide services to all teams in the company, including finance," said SCOR's Trainar. "Wherever possible we are sharing data, sharing services, and running off common platforms, and that's a bit of a shift that's occurred," says Standard Bank's Ridley.

Organizational structures and processes can also be a key element in responding to the strategic challenge of a low-profitability environment. Some business lines may be viable only if radical cost restructuring is undertaken. This restructuring can involve outsourcing and offshoring of shared service areas, including modeling. In contrast to the piecemeal approach to process outsourcing adopted by banks during the past decade of high profitability, this may require "radically simplifying the business to take cost out," says Steven Culp, Managing Director of Accenture Risk Management. Culp predicts that some outsourced service centers will be shared across the industry. A low-profitability environment for the sector makes it likely that financial services in advanced economies will undergo an outsourcing and offshoring transformation on a similar scale to the shifts that have occurred, for instance, in many manufacturing sectors. "Uncertainty over future regulation is making it difficult for banks to respond to these pressures," adds Accenture's Lumb, "but generally, they know which way is North."

These shared services may be provided internally or outsourced to external vendors. "Risk and finance had fiefdoms, but improving efficiency means addressing redundancy around data, process, and technology," says Lumb. For example, DBS's Pattijn noted that his company had elected to outsource capital calculations to an external vendor. Some aspects of model creation and validation that add relatively little unique value are likely to be outsourced across the sector, adds Lumb. Emerging technologies for accounting rule engines and integrated risk and finance platforms will increasingly facilitate the integration of data, calculations, and reporting, as finance companies upgrade legacy IT systems over the next few years.

Still, our discussions revealed the view that it is necessary to avoid, or at least carefully delineate, such risk-finance integration, lest the independence of risk be undermined. At Aviva, the finance teams develop the economic capital models, and the risk teams ensure they are satisfied with the models' assumptions and calibration. "This allows us to review the business' assessments of a deal—or even the overall capital position—and independently assess whether the risk function agrees or disagrees with the business or the finance team," says Spencer. The risk team therefore plays a quality assurance role. SCOR's Trainar says there should be a close risk-finance relationship in reserving, but that "risk control systems should be separated."

The new importance assigned to stress testing is another potent force for risk-finance integration. This is partly, but by no means solely, a response to regulation. "From a regulatory perspective, we only need to do the stress scenarios once per year, but from a capital steering perspective, it would be good to have more continuous updates," says Swedbank's Berg. "Finance and risk are very much joined at the hip when it comes to the stress testing environment we utilize, and what we do around portfolio optimization and macro-hedging," agrees Standard Bank's Hartwell. Allianz's Wilson notes that "risk management, through their oversight of scenario assumptions, helps support the business units in managing their underwriting, reputational, and operational risks." At Allianz, this includes forward-looking scenarios that help address emerging risks and so-called "black swans."

Steering the business

The involvement of risk and finance in strategic decision-making can be a difficult topic, because the demands of regulators sometimes pull in contradictory directions, as noted above. Regulators tend to require independence of the risk function but also deep integration into, and understanding of, the business, so that the risk manager's voice may be heard.

Capital constraints are also arguably making it necessary to coordinate risk and finance input into day-to-day business decisions. When capital is constrained, it is necessary to have the risk-weighted assets number correct on a transaction-by-transaction basis, cautions the CRO of a leading global bank, who also emphasizes the importance of understanding how each transaction will affect the financial, regulatory reporting, and regulatory capital sides. The fact that regulatory situations and economic conditions vary from country to country, means risk considerations must input into financial decisions, such as where to book transactions.

The new importance assigned to stress testing is another potent force for risk-finance integration.

Regulatory pressures that arguably constrain the viability of some lines of business also can create an impetus for risk-finance coordination around strategy. "Financial institutions need to respond to regulatory pressures both strategically (deciding which businesses they can be in) and technically (restructuring businesses to make them profitable)," argues Accenture's Culp. "This needs to be managed enterprise-wide, which brings risk and finance together. Before 2008, responding to regulation was just something the CFO implemented. Now the response to regulation involves the whole executive team."

The "perfect storm" of simultaneous commercial, regulatory, and economic challenges can also put a premium on effective coordination. Given the number of "capital-consuming events," as described by Takashi Kawamura, Senior Risk Manager of Tokio Marine, the finance and risk sections at the firm had to work together monitoring risk, capital, and liquidity closely, and carrying out countermeasures. This was done through the auspices of the ERM committee, which is a forum for management consultation and discussion. "Since 2009, the finance and risk sections held joint ERM executive meetings more than 20 times," he notes, "through which important risk-based decisions were made." Kawamura credits his company's success in maintaining its ratings in part to this risk-finance coordination.

Despite such success stories, the senior risk and finance executives we interviewed have differing views on whether the CFO and CRO ought to collaborate to steer the business. For instance, according to the senior manager of a top European bank, while risk and finance should collaborate around data, they should not attempt to coordinate activity at the managerial level. Allianz's Wilson notes that there is a "tension created if risk is too often called upon to make P&L [profit and loss] decisions." P&L decisions inherently must be finely balanced, while for "core" risk decisions, a clear "yes" or "no" is often called for. Asking risk managers to switch smoothly between these roles in different contexts may be an unreachable standard. Similarly, ERGO Insurance Group's Jurecka contends that "a strong risk management function should play a proactive role within the product development process to optimize the overall portfolio—but the primary decision-making responsibility should remain in the business units and branches."

By contrast, Standard Bank's Hartwell argues that risk needs to play an active role in top-level strategic decisions, such as his bank's decision to focus on African markets. "Risk and finance are getting much more intimately involved in formulating strategy, and the implementation of that across the group," he points out. This is not just a question of setting country limits in 20 to 30 countries, he adds, but also understanding the correlation/diversification effects across those particular markets and then positioning the actual assets within those portfolios accordingly.

There will likely continue to be opportunities even in difficult market environments, notes Accenture's Culp. However, risk-finance integration will be crucial to taking advantage of these opportunities. "The opportunities will be around responding to the complex environment and regulation better than competitors, reducing costs more than competitors, and exploiting digital distribution opportunities effectively," says Culp.

For a number of companies, this elevation of risk and finance to more strategic roles occurred during the transition to ERM approaches. "We believe the most important difference between traditional risk management and enterprise risk management is actually the cooperation between finance and risk," says Tokio Marine's Kawamura. He recounts how Tokio Marine's Corporate Planning and Risk Management departments started working together after 2008 to make business decisions based upon risk information. "Finance and risk have been working together to maintain financial soundness and improve capital efficiency at the same time," he says, "not merely to enhance risk management but to embed risk-based decision-making into business practices." Allstate's Verney describes a similar approach taken by his firm that he referred to as "Enterprise Risk-Return Management." According to Verney, the aim here is to think about risk as a portfolio from which one makes money—rather than trying to build a control-focused static process.

For a number of companies, this elevation of risk and finance to more strategic roles occurred during the transition to ERM approaches.

The mechanisms of risk-finance integration at Standard Bank

Executives at South-African headquartered Standard Bank face a somewhat different set of challenges than other CFOs and CROs participating in our interview discussions. These include challenges that many other banks might love to have, such as "near-exponential" growth in key focus markets. But the bank's decision to focus on Africa may have also created testing conditions for the risk and finance functions.

One is that large firms in many African economies tend to be relatively undiversified, particularly in the region's resource-rich economies. Any bank focusing on Africa typically soon finds itself with all the exposure to the fast-growing mining and energy sectors that it wants, and more, which can create concentration risks. Another area of exceptionally rapid growth in Africa is unsecured lending. This can be profitable if managed well, but the associated risks tend to be correlated with a country's level of inflation—and inflation is running high in Nigeria, Ghana, and some countries in East Africa. Finally, the bank's decision to focus on Africa, and the continent's growing trade with Southeast Asia, Latin America, and to some extent Europe, has resulted in a growing demand for cross-border country risk limits.

The focus on a business environment characterized by obvious risks has meant that Standard Bank, held to international regulatory standards by the South African Reserve Bank, has adopted a relatively orthodox approach to risk. This is most apparent in two areas. First, the bank has integrated risk, finance, strategy, and compliance around a single risk framework. Second, the bank has enhanced operational integration of the risk and finance functions to ensure smooth risk management and risk reporting.

"We were already working closely with our finance partners prior to the global financial crisis, in setting our risk appetite, understanding the consumption of capital and liquidity, and managing earnings volatility across the various risk portfolios," says Paul Hartwell, the bank's CRO. "Since 2008, we have been working hand in glove with finance on model development and model validation." Hartwell explains how within the bank there used to be separate quant teams for the two functions that were involved in developing risk and finance models. "I now have a team within risk that is solely responsible for the development of risk and finance models," he says, "as well as a separate validation team."

"The tension between risk and finance has been resolved by a common currency between us and that's capital," says Simon Ridley, the bank's CFO. "Value at risk, and potential stress value at risk, are independent models—independent of the trading business—run by Paul's team and we would accept those outputs into our capital projections and our earnings projections."

Standard Bank has also created a common data warehouse through a data re-engineering program. Credit, payments, or market risk information, or capital information now come from the same data warehouse. "The simple trick to getting this right is that we must decide to use only one source of data and let one group control it, rather than someone else inventing a parallel world," says Ridley. "And once that accountability's clear, there are multiple uses of that data but there's one owner." This has been strengthened by the ICAAP process, which incorporates stress scenarios. "I used to run the whole stress testing

kind of process, before Paul came," says Ridley. "Once Paul became chief risk officer, we agreed that Paul would independently determine scenarios, and then we, in finance, would run forward-looking projections against that." Hartwell concurs that finance and risk work in partnership when it comes to understanding the stress testing environment.

This coordination is supported by risk and finance teams that work closely together. At the day-to-day operational level, a treasury and capital management function within finance is responsible for managing and optimizing capital and liquidity allocation, as well as supporting funding optimization. And Hartwell describes how they work closely with the risk team to understand what's happening in the portfolios, the stress testing, and the forward looking risk tendency outlook. "At the senior level, there are one or two key individuals who have bridged finance and risk," adds Ridley. "Paul has a coordinator who spends probably half his time with finance people, but if ever there's a disagreement or lack of clarity, we all go to him and he makes sure there's no misunderstanding between the divisions."

The other major area of risk-finance integration is around reporting. This integration helps the bank deal with the growing need of stakeholders to have an accurate understanding of the bank's risk exposures, in the present volatile environment. "Since 2008, there's been a complete shift in how shareholders look at a bank," says Ridley. "They used to look through the rear-view mirror to see if the results were there or not, but, today, 60% to 70% of the discussion is about what might happen, rather than explaining your last result."

To improve risk-finance coordination in reporting, the two functions at Standard Bank have established a "consistent financial language," Ridley says. While a credit loss a few years ago, for example, could have had as many as three different meanings—a loss given a default, an accounting credit non-payment, or a write-off—the bank has brought together a consistent lexicon of these terms between risk and finance.

The common data sources, models, and lexicon create consistency in reporting that seeks to ensure different stakeholders receive the same message. This is important given that banks today tend to be increasingly questioned on these issues, by regulators and other stakeholders. "The ones that are coming through my office are shareholder queries and rating agencies, and the typical questions that come through Paul's office would be regulators," says Ridley.

In addition, strong risk-finance integration means that the stakeholders, including the bank's board, have grown accustomed to seeing alternate scenarios, and can make better decisions. Ridley says board directors have been deeply involved in understanding the results of stress scenarios. "For example, we would not take a budget to our board for approval without an attached stress budget," he says.

Our survey results suggest that Masters tend to do much better at breaking risk out of its compliance silo (see Figure 8). Aggregating across all financial sector firms surveyed, risk's number one role is seen to be compliance: close to 60% of respondents say risk's role in driving compliance is "critical" (dashed blue box). Masters, by contrast, are able to add additional objectives to the remit of risk. "It's like Maslow's 'Hierarchy of Needs,'" says Accenture's Culp. "Compliance is at the bottom of the pyramid, and once you have that bottom locked down you are able to do more." Hence, Masters are most likely to report that the risk function is "critical" in reducing losses, followed by sustaining profitability, managing external volatility, and managing organizational complexity. For Masters, assuring compliance is a given, and is at the base of the hierarchy, according to Culp.

How do Masters elevate the risk function from a compliance role into one that provides business value-added? Some of the senior risk and finance executives we interviewed pointed to the use of economic capital models, which are often established via a coordinated risk and finance effort. These are increasingly used to steer the company towards a portfolio of business that offers the greatest risk-adjusted return. "Economic capital is clearly the critical thing, but just having the finance people calculate it is not the issue," says Aviva's Spencer. "It is more important to drive economic capital into your core business processes, such as pricing and any large deal, and make sure that it's being used as a core metric in making a decision." In a similar vein, Nationwide's Mahaffey says that, "in measuring risk, capital, and exposure to large loss, the cost of that capital is linked to every product we design and sell, product by product—and I think we've gotten much smarter about the required rates of return by segment."

In many financial firms, the shift towards risk-finance input into strategy is still ongoing. "The need for a clearly described risk appetite that actually influences your strategic planning is a relatively new thing," says Chubb's Hardwick. "Just the idea of having an appetite statement that the board had written down and approved is a big culture change." He describes as a "further evolution" a scenario where that appetite more explicitly drives decision-making around strategy.

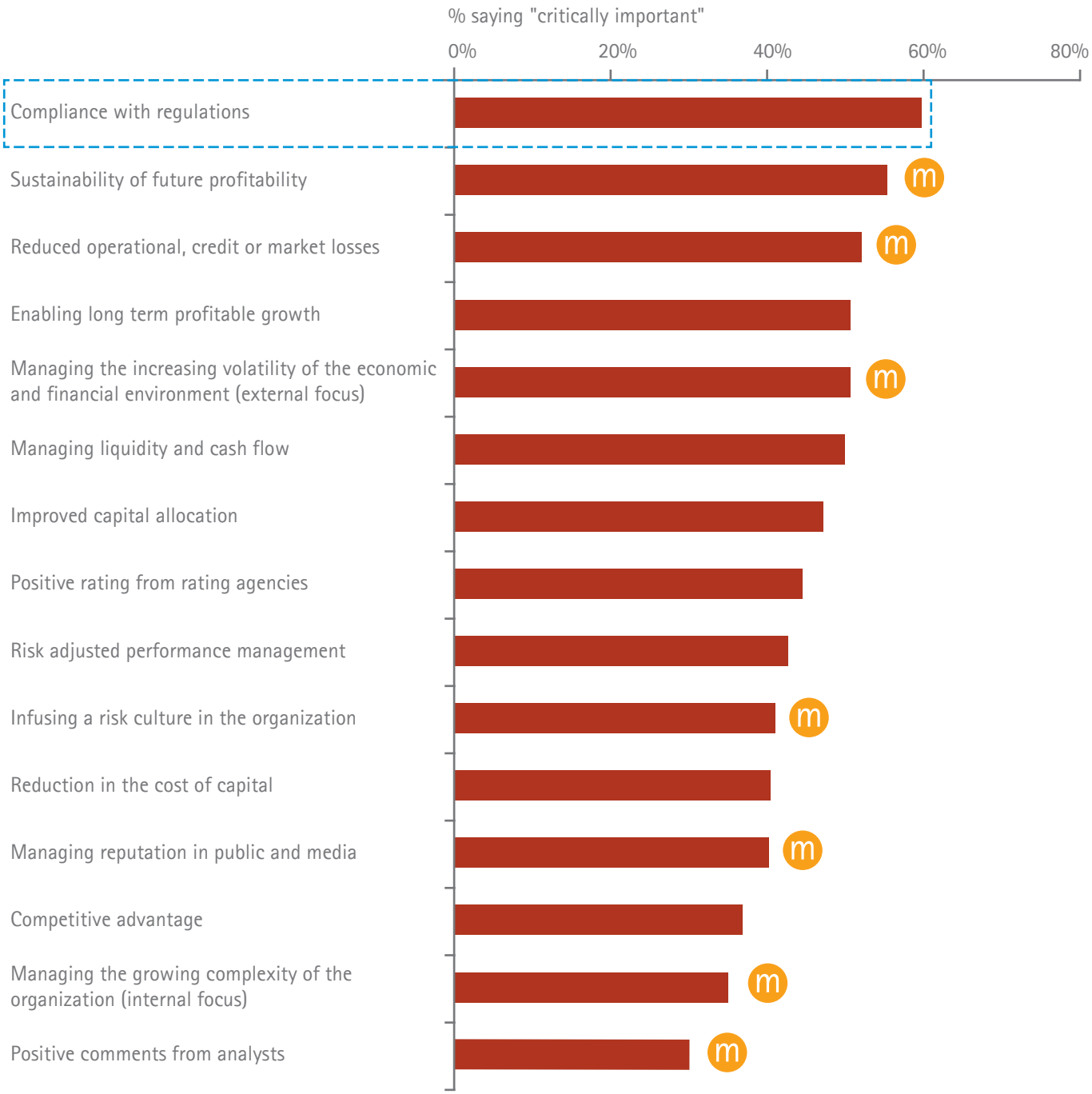
One reason that a risk appetite has strategic implications for insurers is that the function of an insurance company is to take on and pool its policyholders' risk exposures. If the board expresses an appetite for a particular type of underwriting risk, this may imply that the business should seek to add that risk to its books. Moreover, the business should execute the best possible approach to adding the risk, balancing associated capital requirements, associated "unwanted" risk exposures (such as credit risk), and the board's appetite for these other risk exposures. Achieving such a complex balance implies a sophisticated integration of risk and finance with strategic planning.

Senior risk and finance managers participating in our interviews also stress the limits of modeling. "For risk capital management, we use a 99.95% VaR based on a stochastic integrated risk model," says Tokio Marine's Kawamura. "But we also see the limit of stochastic approaches and thus are now putting more emphasis on other complementary risk measures, such as scenario approaches, stress testing, and reverse stress testing." Allstate's Verney agrees that by "looking through multiple lenses we won't get blinded by low VaRs. It's not about abandoning models; it's about not relying exclusively on models." Generali Germany's Meister concurs that "actuaries ought not to take over the steering of an insurance company, and models are not a substitute for decision-making—the role of models is to support management by shedding light on certain financial aspects."

Different interviewees emphasize different levels of risk-finance involvement in the business decisions associated with these models. In many cases, it is a matter of risk setting a framework and then stepping back. Swedbank's Berg likens this framework to a rainbow, with a "red area" that is set based on the risk appetite limit of the Board of Directors where, based on risk probability and impact, his firm does not want to be. But within the area where Swedbank does want to operate, "the CFO steers us to the best risk-return business," he explains. Partner Re's Winands notes that "risk management adds value by identifying gaps in the risk strategy, which can be addressed by optimizing the structure of the portfolio or adopting strategic decisions." But he notes that in the traditional non-life reinsurance business, "most of the capital allocation decisions into which risk has input are made in the first quarter of each year.

In many financial firms, the shift towards risk-finance input into strategy is still ongoing. "The need for a clearly described risk appetite that actually influences your strategic planning is a relatively new thing," says Chubb's Hardwick.

Figure 8. How important is the risk organization as a driver of...



Source: Accenture Risk Management Survey (2011)

Allstate's Verney agrees that by "looking through multiple lenses we won't get blinded by low VaRs. It's not about abandoning models; it's about not relying exclusively on models."

At Allianz, "risk management is involved in the strategic and planning dialogue, but it is in their daily activities as the second line of defense, with responsibility for the risk frameworks, that the closest interaction occurs," notes Wilson, the company's CRO. Risk sets RAROC-based pricing thresholds, limits, minimum standards of underwriting, and participates in the new product approval processes. But while risk develops the frameworks and tools that are used, it is the operating entities that have to implement these tools and parameterize them. The actuarial function is then responsible for reviewing and signing off model changes, often coordinating with their annual reserve reviews.

Overall, when it comes to steering the business, financial firms differ in terms of whether they emphasize as the most important goal, the integration of risk, finance, and strategy; or the independence of risk. Some senior risk managers argue that if risk is not actively integrated into business steering committees, steering will tend to favor commercial objectives at the expense of risk objectives. Others contend that only the board can take decisions surrounding the integrated management of solvency, liquidity, and profitability, as tradeoffs are inevitable. Thus, the debate on the role of risk and finance and steering the business appears to be far from settled.

Personnel and culture

In the period since the global financial crisis hit, the attractiveness of the risk and finance functions, specifically, as places to work seems to have increased. This, in turn, has helped make personnel and recruitment strategies an effective tool for achieving risk-finance coordination. Aviva's Spencer puts it most bluntly: "I've got absolutely no doubt that risk used to be, quite frankly, the home of C talent, but now is the home of A and B talent—people want to come and work in the risk function." This leads to people moving increasingly between the risk, finance, product, and pricing areas, which leads to more effective coordination. Standard Bank's Hartwell reports the same phenomenon. "We are seeing a regular fluidity of people between risk and finance," he says. "That's good, because it helps cement the relationship." Hartwell also points out that this tends to give staff a more holistic view about how the bank operates, as opposed to a silo view.

Some firms have put in place explicit risk-finance rotation programs. Prudential's Silitch endorses such initiatives, underscoring that it's critical to have staff from the business come into risk and vice-versa, so as to have rotational-type assignments. The CRO of a leading global bank observes that "there are people within finance now who frankly spend an awful lot of time in the risk world, and people in the risk world—especially on the reporting, modeling, and system side—who interface daily with finance." At Allstate, "developing a broad base of talent in terms of people who can take on either of these roles [in finance or risk] was very conscious," says Verney. "It's not processes and committees that create a working relationship, it's having risk and finance people who have sat on both sides of the issue."

The importance of staff rotation carries up to the most senior levels. "We are really in a unique position in that both the CFO and the CRO are named Steve," jokes Allstate's Verney. More seriously, he adds, "we have both sat in many of the same seats in the financial leadership roles of the company, sometimes with one of us literally following the other, so there's a shared experience base." Verney argues that this shared experience is actually more powerful than operational measures, such as shared data, in enhancing the effectiveness of the partnership. In a similar vein, DBS Bank's Pattijn says that, since the senior risk and finance staff "had a game of musical chairs," rotating into each other's positions, "there's a lot of empathy for each other's positions, and knowledge about each other's work as well."

One factor that has helped foster more creativity in staffing strategies in the risk and finance functions—and has given a spur to staff rotational programs—has been the tendency to recruit more people in risk following the financial crisis. According to Swedbank's Berg, this occurred because it was recognized that risk was an area needing a lot more resources and competencies—in contrast to other areas that have tended to see staff cutbacks.

One factor that has helped foster more creativity in staffing strategies in the risk and finance functions—and has given a spur to staff rotational programs—has been the tendency to recruit more people in risk following the financial crisis.

"In general, it is hard to find the right people for specific finance and risk roles; however, we currently do not have problems locally to recruit the right people," notes Unicredit Bank AG's Hofbauer. Similarly, regulatory pressures have helped give the finance department more clout in its recruitment. Chubb's Hardwick cites growing awareness within the insurance sector that "we can't mess around with compliance, or cut corners, as we've had firms that try to do that and literally come unstuck in front of the regulator." These shifts have also created staffing challenges, of course, as the growing need for experienced risk managers has contributed to salary inflation for that position. "There is a demand-supply mismatch for skilled risk and compliance people, which we are seeing even in our recruiting," agrees Accenture's Lumb.

Changes in risk and finance roles also have imposed new demands on the CRO. A CRO of a major insurance firm notes that this is a challenge because "we have a whole group of risk managers out there who think that models are the 'be all and end all'–they don't recognize the business behind it and they don't bring common sense." Swedbank's Berg agrees: "Future CROs will need to have more business understanding than previously, because they are working together with the CFO on how to steer the business." Similarly, Chubb's Hardwick predicts that, in the future, a CRO will need to be as much a businessperson as anyone else on the board or committee, because he or she will need to make the connection between the risk thinking and business strategy.

Risk working as an integral part of the business also demands softer skills from the CRO. Effective communication is an incredibly important skill, argues Nationwide's Mahaffey. "You need to be able to take the quantitative complexity that we deal with every day and boil it down to the salient points and communicate it in a convincing, persuasive fashion."

These kinds of soft skills are absolutely crucial to the job of a CRO who is involved in steering a business, agrees Prudential's Silitch, highlighting the need for a CRO who can understand the firm's business well, while also being willing to engage in discussion around limits, and opening himself up to debate.

SCOR's Trainar agrees, quoting the existentialist philosopher, Jean-Paul Sartre: "The CRO is 'condemned to be free,'" he says, indicating that independent CROs who fail to recognize the limits of the tools available to them, and the uncertainty inherent in their analysis, will not last long in the job.

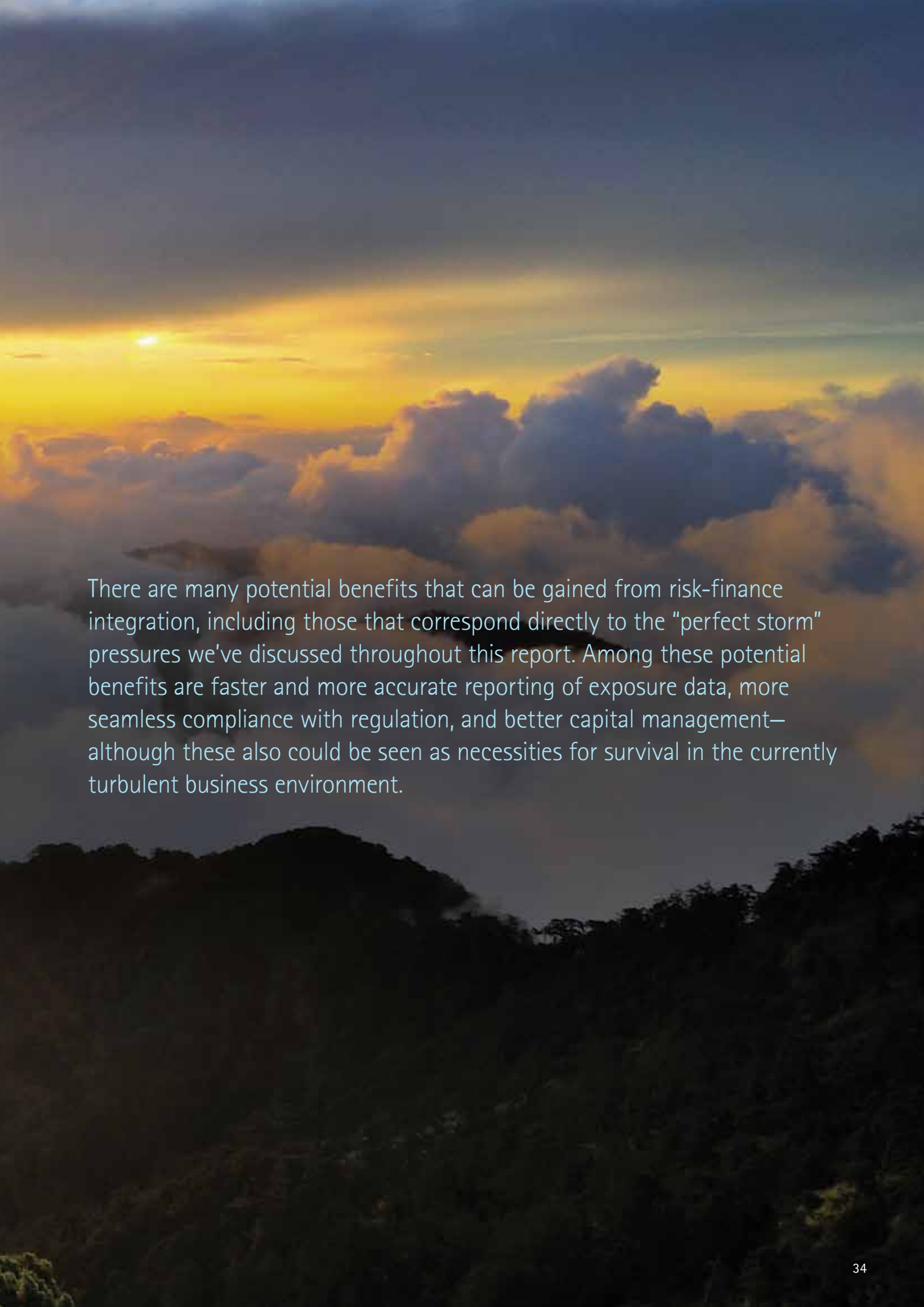
In general, although perspectives shared during our discussions focused less on the evolution of the CFO's position, Chubb's Hardwick argues that the CFO has got to have a much more explicit grasp of risk today, than in the past, when their grasp "could be rather more intuitive and gut-feeling." He attributes this change in the CFO's role to the way in which data gets used for risk thinking, describing this as "a whole new dimension."

These changes are being partly driven by the fact that these are increasingly sought-after attributes across the full range of C-suite titles. "When you're at C-suite level in a bank, you accept that you have certain responsibility—to look out not just for yourself, but for a whole bank," says DBS Bank's Pattijn, adding that this requires a combination of skills. Commenting more specifically on qualities needed for CFOs and CROs, Pattijn says that, "you cannot be a CRO without looking at the revenue side or where the opportunities are, and you cannot be a CFO without understanding what risks as a firm you need to take to meet your budget."

A final point of agreement is the need to spread a culture of risk management from the risk function throughout the organization. "Culture, at the end of the day, is the secret ingredient—not models," says Nationwide's Mahaffey. Aviva's Spencer draws on the example of a three-day residential course for his firm's senior management, where more than 600 people focused on risk management, economic capital, and return on risks. "It was all about trying to inculcate that risk culture," he says.

Allianz's Wilson also emphasizes the importance of culture. Even the best-designed risk framework is useless, he notes, without the right values and principles behind it. "Just because you have right things on the bookshelves—the processes and the documentation—doesn't mean that you are a good institution," he says. "It just means that you are good relative to the tick boxes."

The benefits of a strong partnership



There are many potential benefits that can be gained from risk-finance integration, including those that correspond directly to the "perfect storm" pressures we've discussed throughout this report. Among these potential benefits are faster and more accurate reporting of exposure data, more seamless compliance with regulation, and better capital management—although these also could be seen as necessities for survival in the currently turbulent business environment.

Executives surveyed also mention a number of specific benefits of a strong CFO-CRO partnership. First among these is an improvement in risk-adjusted returns. "Steering business to where we are getting a better risk-return ratio has led to restructuring our home mortgages quite significantly," notes Swedbank's Berg. Measuring risk-adjusted returns and deploying this measure in business decision-making can result in removing high-risk assets from the balance sheet and taking on lower-risk assets to create sustained profitability. Similarly, Standard Bank's Hartwell says the key area where a closer partnership between risk and finance has been felt is in the business units, where there is now much greater transparency of risk-adjusted performance. In addition to changing behavior on the corporate side of the bank, Hartwell also points to changes in the retail bank's home loan portfolios. "A potential benefit of a strong partnership is lower volatility in results despite the volatile external environment," says Accenture's Lumb.

Our survey results suggest that financial sector firms with highly-integrated risk-finance functions are likely to experience performance-related benefits (see Figure 9). The chart reviews the potential benefits resulting from strong performance of the risk function, ranging from better compliance to an increased likelihood of sustained profitability. A highly-integrated (hi) tag, introduced for this chart only, breaks the survey respondents into companies in which risk and finance are highly integrated, and companies in which risk and finance are not integrated. (Highly-integrated companies are defined based on the degree to which the risk management function is integrated into financial decisions including M&A, capital projects evaluation, financing decisions, and budgeting.) As the figure shows, highly-integrated companies are significantly more likely than the average company to report a number of performance benefits, including higher sustained profitability, better management of the volatile external environment, and positive comments from analysts, the media, and rating agencies. "Financial firms who take proactive steps to drive integration in their finance and risk capabilities have a strategic advantage," says Accenture's Boulanger.

Discussions with senior risk managers at insurance firms show similar enthusiasm about the impact of risk-finance collaboration on improving risk-adjusted performance measures. "Once you understand the drivers, then you can start managing them, through hedging, risk avoidance, or through risk mitigation strategies," says Aviva's Spencer, "to try to make sure that your return on economic capital goes up."

The second specific benefit of risk-finance integration is greater competence in risk management. Chubb's Hardwick notes that risk-finance integration has produced a "holistic" approach to risk management at his firm, by bringing together credit risk, market risk, liquidity risk, and operational risk. "Traditionally, how concerned would the finance department have been over operational risk?" he asks. Today at Chubb, operational risk has become just another class of risk, actively managed on an enterprise-wide basis.

Risk-finance integration has also helped develop the value added by risk management tools such as stress testing. Standard Bank's Hartwell points out that risk has been working closely with finance at his firm for a number of years to better understand the stress testing environment. "The set of data we work with today overlaid with stress testing gives us a much clearer view of our risk tendency against our risk appetite and indeed our overall risk capacity," he says. This enables more active management of the company's risk portfolio.

In a similar vein, improved, integrated analytical tools have given Nationwide "greater awareness before an event of the magnitude of the loss, should it occur," says Mahaffey. If the Eurozone currency union were to break up, or a hurricane were to strike a given geography, the company knows its exposures and the implications of the potential losses from a capital perspective. These competencies have been used to help inform difficult decisions, from development of hedging programs to moving out of some lines of business. "Excess capital is a fuzzy number," notes Tokio Marine's Kawamura. "But after 2008, we have been able to take measures which cost real money, to protect that number."

Another benefit of effective risk-finance integration is improved reporting. "Financial accounting reports the form of the business, and risk reporting adds the substance," says SCOR's Trainar. Hence, better coordination improves the quality of information available to stakeholders, including the board, regulators, rating agencies, and financial analysts. A high standard of process cooperation can lead to accurate messages regarding underlying risks to the business. An effective CFO-CRO partnership may also limit the number of issues of secondary importance that must be escalated to board level.

The final specific benefit relates to personnel. Risk and finance departments that are integrated in business decisions are better able to attract top people. The increased ability of staff to move between risk and

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finance is another potential benefit. "Certainly, there's been evidence over the last couple of years that it helps us retain people, because we've been able to offer them a more diversified career development program," says Standard Bank's Hartwell. This pairing of risk and finance has not been in existence that long, but it does make talent rotation within the company much easier, adds Verney of Allstate.

With more joined-up talent comes greater staff effectiveness, notes Verney. "When senior leaders are genuinely telling the same story, it's much more powerful," he adds. "The more you have a congruent philosophy espoused in meetings where the other department is not present, the more people start to believe that's really what we're trying to accomplish—and are willing to go out on a limb in that direction."

Figure 9. To what extent have risk capabilities helped your organization achieve the following?

hi = response significantly more likely to be provided by companies in which risk and finance are highly integrated

Source: Accenture Risk Management Survey (2011)

Another benefit of effective risk-finance integration is improved reporting. "Financial accounting reports the form of the business, and risk reporting adds the substance," says SCOR's Trainar.

Conclusion
Lessons learned

The topic of risk-finance integration remains complex and even sensitive at times. On the one hand, pressure to ensure the operational and reporting independence of the risk function remains strong in the wake of the global financial crisis. On the other, the move toward the risk-adjusted capital models that are at the heart of current banking and insurance regulation is driving greater operational integration of risk and finance.

These pressures are not necessarily contradictory, but it can be challenging to respond to both simultaneously—all the while managing in a business environment of "permanent volatility."

Within this complex issue area, based on extensive interviews and survey research, we have identified several lessons learned for enhancing the CFO-CRO partnership—while recognizing that some firms have adopted alternate approaches to reaching this goal.

1. Establish integrated and shared data sources.

This recommendation was made most frequently in our discussions. Pragmatism seems to be one of the main drivers of this move toward common and shared data sources among global financial services firms. If risk and finance are going to be independent, sometimes adversarial, and yet work together effectively, there is little scope for discussions that commence with disagreements over basic facts as a result of using different data sets. Collaborating to solve data quality issues, including the development of shared data processes and systems, can be an effective way to reduce a common area of conflict and improve the risk-finance working relationship.

2. Collaborate in developing risk and capital models, which can enhance the risk-finance partnership at the operational level.

For both functions, improving efficiency means eliminating redundancy in process and technology, as well as data. At the same time, it is important to safeguard the independence of risk's oversight role as it relates to model assumptions and calibration.

3. Strike the right balance to promote good interdependence and cross-leverage between risk and finance.

A healthy CFO-CRO partnership can sometimes mean agreeing to disagree. The progress the risk function has made in increasing its independence and "gaining a seat at the table" should be preserved. It is important for risk to maintain the ability to push back against finance if commercial and risk objectives come into conflict.

Maintaining independence of the CFO and CRO functions can often provide a strong impetus for operational integration.

4. Ensure risk has input into strategy.

For some interviewees, "aligning" risk and finance is a bridge too far, suggesting an end to the independence of the risk function. However, many compelling success stories, such as Tokio Marine's maintenance of its rating in the face of widespread downgrades in the sector, and Aviva's improved returns on economic capital, are attributed to coordinated action involving risk, finance, and strategy. Even when working in close cooperation with other departments, allowing risk to retain its independent perspective is important. But in navigating the "perfect storm," an effective CFO-CRO partnership can be crucial.

5. Increase the value-added provided by the risk function.

While perhaps more controversial, many executives participating in our interview discussions, as well as survey respondents from risk and finance Master companies, agree that risk should go beyond a compliance role to focus on providing value-added to the business. Elements of this value-added include developing advanced risk analytics and modeling capabilities, having a perspective on risks emerging from the volatile global environment, and providing enterprise-wide risk input into management of operational, emerging, and even strategic risks.

6. Rotate personnel between risk and finance.

Even if risk and finance personnel sometimes find themselves in opposition on an issue, speaking a common language and having common experiences can help enhance operational effectiveness. That said, it is important to consider the independence of certain staff areas such as risk control.

Overall, our interviews and survey research reveal a CFO-CRO partnership that is in transition, and faces considerable uncertainty, but for which some patterns are clear. Perhaps the key element of uncertainty is the dramatically reduced profitability for some financial sector business activities, which may lead to radical restructuring of how these functions are carried out (as well as divestitures and business unit closures). Another element of uncertainty is regulatory change. While general themes are clear—holistic reporting, use of risk-adjusted capital metrics, and the independent authority of the risk function—many specifics of implementation and enforcement remain untested.

Amidst these elements of uncertainty, the CFO-CRO partnership will continue to evolve, sometimes in unexpected directions. Our interviews and survey research indicate some likely paths. For instance, the CFO-CRO partnership is increasingly a partnership of equals, and healthy debate is increasingly emphasized as a mechanism to produce the best information when decisions that entail tradeoffs must be made. At the same time, in order for the partnership not to become needlessly adversarial, companies are focusing on the operational integration of risk and finance, creating shared services areas around data, systems, and modeling, as well as programs for the rotation of personnel. These efforts seek to prevent unproductive misunderstandings and disputes over facts. This type of integration also enables companies to respond more fluidly and confidently to the demands for holistic reporting and use of risk-adjusted capital models in strategic decisions. Indeed, this type of integration, especially around shared services, may be a leading indicator of the future evolution in the finance industry, as the sector seeks new business models that can regain profitability and steer an unwavering course in stormy seas.

Further Reading

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