



Best Practices: Bank Leumi Embraces a More Integral Risk Function

IDC Financial Insights: Worldwide Risk Management Strategies

BEST PRACTICES

#WWRM01U

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IDC FINANCIAL INSIGHTS OPINION

In 2012, spending on risk management leads the way for IT budgets, with a forecast spending growth of 6.8%. It is critical for banks to institutionalize improvements in risk management, reduce the focus on "event management" in preference to working toward a more proactive outlook, and begin to deliver an "on demand" risk management enterprise.

With these imperatives in mind, Bank Leumi has taken significant steps to improve its operational capabilities through the creation of a more integral risk function while simultaneously ensuring high rates of return on capital. Importantly, such changes have not been orchestrated purely to satisfy the watchful eye of a financial regulator or internal compliance officer, but to help give the bank a tangible competitive advantage in the market. As Boaz Galinson, Bank Leumi's Head of Credit Risk Modeling and Measurement attests, the role of the unit is in "providing information that will help the business make the right decisions." To this end, risk management analysis must be woven tightly into the very fabric of the bank and continually leveraged, as opposed to being a rather awkward bolt-on element that is only consulted on a piecemeal basis.

By performing an assessment that was both comprehensive and rigorous, Bank Leumi clearly selected the vendor which was able to achieve the best degree of alignment against the bank's strategic vision for a single credit-risk database to support all aspects of the credit-risk management system. And by ensuring the engagement of representatives from various functional areas at an early stage in proceedings, Bank Leumi, in partnership with SAS, has delivered a system capable of meeting the current and future demands of its internal users and regulatory supervisors.

In a climate where risk management has assumed new degrees of importance, Bank Leumi is addressing the issue correctly through means of IT investment and adjustments to existing business processes. There is also an added bonus in the form of an overall capital ratio in the region of 14% to 14.5%. Given market conditions, Bank Leumi should be pleased with its achievements, as should SAS as the vendor responsible for the new credit-risk management system.

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IN THIS STUDY

This study highlights how Bank Leumi has sought to embed risk analysis and awareness into front-line business processes and decision making by leveraging the value of an integrated risk data and analytics platform. This document discusses how the bank's use of SAS technology has assisted in the development of a risk function that is more integral to the conduct of ongoing operations. In doing so it discusses the business rationale behind the decision to partner with SAS, the results attained, and the future plans of the bank to evolve both the technology stack supporting the risk function and the extent to which risk management can truly be regarded as a strategic partner to the business.

SITUATION OVERVIEW

Organizational Overview

Bank Leumi is Israel's leading bank, with a domestic market share of approximately 30%. It was established in 1902 in London and from that point on became central to the project to create a homeland for the Jewish people. Today the bank is very much regarded as a true multinational operation with five major subsidiaries in the United Kingdom, the United States, Switzerland, Luxembourg, and Romania. It has nearly 13,600 employees worldwide and approximately ILS366 billion (\$100 billion) in total assets.

Through a broad range of business units and entities, Bank Leumi offers retail and private banking services, as well as trading and brokerage capabilities through its capital markets division. However, its largest focus remains on corporate and commercial banking and the development of its lending portfolio, which caters to both international companies and middle market enterprises.

Traditionally Bank Leumi has regarded itself as essentially risk averse, a strategy that led it to escape the worst of the fallout from the global financial crisis. Generally the bank's approach to credit provision has been to try to remain focused on low-risk, high-return segments — the zenith for any lending institution. Its enduring target is to maintain an overall capital ratio of not less than 13.5%, which continues to be the highest in Israel and keeps it well above minimum Basel II standards. In addition, core capital ratio (first tier capital excluding complex capital instruments) must not be less than 7.5%. A higher minimum core capital ratio of 9% until 2015 and 10% until 2017 is set.

At the same time, senior management is also mindful of the need to deliver superior shareholder returns to ensure the continuing quality of that capital base. Over a five-year period to August 2010, returns were 16% higher than the Tel Aviv banking index and significantly higher than those of global developed-market indices.

Business Needs

Although Bank Leumi was able to restrict its losses from the financial crisis to relatively small amounts in comparison with other multinational institutions, the global systemic and countercyclical impact of the crisis raised a number of hugely important questions for the bank. Ostensibly these questions challenged many of the traditional assumptions that existed in relation to the bank's approach to risk.

As with many other financial institutions, Bank Leumi was forced to reevaluate the level of risk awareness and the appropriateness of the risk culture within the bank. It should be stressed, however, that this was not simply a case of reacting to the tsunami of regulation that has swept through the industry — although there is little doubt that regulation certainly focused the minds and attention of senior management in the bank. Nevertheless, Bank Leumi's approach was (and continues to be) to go beyond a compliance-centric view and use the lessons from the crisis as an opportunity to redefine the value that the risk function can deliver to the business.

In the face of this fundamental challenge, what was absolutely apparent to senior risk executives at Bank Leumi was that the risk function was operating very much on the periphery of the business. This was most evident in the fact that risk managers were largely unable to adequately challenge the business on the risk implications of any deal before that deal was executed. In this sense, risk was operating retrospectively, mitigating losses rather than helping to optimize the performance of the lending portfolio. To all intents and purposes, risk was not sufficiently integrated into the credit process purely because relevant risk information was not available in a timeframe that was appropriate to the conduct of the business.

The inability to obtain a timely view of the risk implications of any front-line business decision was fundamentally a technical issue but one that in turn reinforced a cultural barrier between risk and the business. Effectively the risk function was hamstrung by a combination of inconsistent risk data and slow-running analytical processes. Quite simply risk wasn't operating in the context of business operations, which undermined its authority as well as its ability to effectively integrate risk into the credit process.

Management Challenges

From Bank Leumi's perspective, it is imperative for risk management to possess the ability to support the business within the process of decision making. Having the mandate and mechanisms(s) in place to independently challenge the analytical assumptions of the bank's different functional areas is essential, as the "business is the first line of defense." As a component part of accomplishing this, Bank Leumi combines different dimensions of enterprise risk management (ERM), and continually assesses its capital management and risk-adjusted return on capital (RAROC) position.

To help foster a material improvement in internal risk management practices, Bank Leumi added a chief risk office (CRO) to its top tier organizational structure. The overarching objective of the CRO is to foster a deeper culture of risk aversion and "to try to do things [related to risk management] differently." For example, prior to key decisions being taken, the risk "opinion" is put onto the table as a pivotal discussion point. While this may not sound particularly radical, for Bank Leumi this development equated to a "revolution."

One of the main challenges Bank Leumi faced was overcoming the commonly held internal perception that historic risk management policies, practices, and processes were perfectly adequate for the task at hand: why change something that is not — or does not appear to be — broken? Persuading skeptical executives that operational, cultural, and technological changes to the bank's risk management activities was essential proved to be a major achievement. Indeed, something of a love affair (with the new framework) has commenced, as senior managers can now understand what type of business questions they can answer with confidence (and which they would have struggled to respond to before the new system was implemented). Understandably, this performance improvement has helped bring executives onboard in support of the enhancement of Bank Leumi's risk management capabilities.

Decision-Making Process and Vendor Selection

In finding an appropriate IT solution to improve risk management, it was critical for Bank Leumi to understand how specific technologies would fit with the overall process of formulating a comprehensive long-term strategic vision. To this end, one of the explicit purposes of the RFP issued in 2008 was to translate this vision into reality.

Particular emphasis was placed on building the optimum analytical models, business processes, portfolio management, concentration limits, and RAROC. Interestingly, Bank Leumi did not feel a single system existed in the market capable of meeting the aforementioned requirements.

Of equal interest was Bank Leumi's hesitancy about selecting "best-of-breed" individual components for the new risk management system: it was afraid of going in this direction, and its preference was instead for "best-of-fit."

During the initial discovery and selection phase, Bank Leumi identified problems with creating consistent data sets between systems supplied by different vendors. The bank required one credit risk database capable of supporting all credit processes and through which other interrelated systems could draw their data from in order to achieve consistency and efficiency.

As is often the case, Bank Leumi's existing risk management technologies were a mixture of vendor supplied/customized and internal developments. In order to overhaul these in an effective manner, it was necessary for all (replacement) projects to be synchronized. This included a standardized internal ratings-based approach system for Basel II, the replacement of an internal ratings system, and the broadening of portfolio management capabilities.

Solution and Implementation

Bank Leumi opted to purchase a system from SAS, which comprised two separate components for statistical and ratings tools and a portfolio management function (with models built by SAS). Bank Leumi favored SAS' capabilities in preference to other vendors, with particular emphasis on the capacity to both produce the complex analytical models and put them into operation. On this occasion, the deep heritage of SAS in providing solutions for statistical analysis has paid dividends. This has been reflected in the bank's abilities to tackle tasks which were previously beyond its reach, such as measuring concentration risk in loss terms rather than volumes.

The implementation budget was provided by Bank Leumi's credit risk function, with SAS the sole vendor supplying the technological solutions and consultancy services. The project was complex — which is entirely understandable — and there was a need for internal users to become familiar with SAS terminology. However, many of Bank Leumi's internal users soon developed fluency with the "language," and therefore it was possible to avoid a potential barrier to adoption. We believe it is also worth noting that Bank Leumi's IT department did not raise any major objections during the selection and implementation phase(s), and the underlying architecture was not adversely affected by the changes made.

Although Bank Leumi did not use a formal satisfaction scoring system to measure implementation "success," there was a committee, with business-side representation, to discuss key activities and issues and in a timely manner.

THE BEST PRACTICES

Business Value and Lessons Learned

Since its inception, the transformation project has created tangible, measurable business value and the bank perceives it has helped deliver competitive advantage(s). But rather than resting on its laurels, there is still more to come, and executing the aforementioned long-term strategic vision continues.

Bank Leumi also recognizes the need to overtly demonstrate success, both qualitative and quantitative. Success, of course, has to be appraised by internal end users, and this is a good example of alignment between business and IT (often a rare commodity in the

banking industry). The bank has been developing and implementing a quantitative tool — in the form of a dashboard — for use by senior members of the risk management team. This allows the sophisticated, fast, and nimble analysis of operational performance anomalies, and helps users get to the heart of a problem before it has a detrimental impact.

In terms of lessons learned, Bank Leumi speaks openly of the critical importance of bringing all the key parties — business, IT, and finance — to the table from day 1, as "everyone needs to contribute decision making and creating an ongoing dialogue is essential." This approach, while eminently sensible, is, in our opinion, all too often missing from IT transformation projects in the banking industry, and it is far better to get the buy-in of different functional areas before the journey commences rather than mid-flight.

With the benefit of hindsight, what, if anything, would Bank Leumi do differently? The creation of a single (credit risk management) system as a component part of a big (bank-wide) vision and the synchronization of processes from the outset are the main elements which would be included in a perfect world.

FUTURE OUTLOOK

Bank Leumi has not yet achieved all of the vision articulated for IT. But there is proverbial light at the end of the tunnel, and it is encouraging to hear the will exists internally to maintain the momentum which has been built since the credit risk transformation program started. In order to deliver on the objectives and commitments, each project has adequate budget, time, and resources allocated to it, along with the appropriate governance and reporting mechanisms required to track progress.

The bank's next big step is to optimize RAROC modeling, which will help instill greater discipline to lending decisions and ensure reward is consistently linked to risk.

ESSENTIAL GUIDANCE

Actions to Consider

Financial institutions wishing to improve their risk management capabilities by means of technological enhancement(s) would do well to study the experiences of Bank Leumi. This case study has demonstrated that a successful outcome is dependent on the full engagement/involvement of business-side end users throughout the transformation project (or program) life cycle, with sophisticated IT solutions — such as the ones provided by SAS — acting as enablers in order to achieve predetermined strategic goals. Therefore, banks must continue (and in some extreme cases start) to forge a strong business-IT working partnership if they wish to deliver enhanced operational performance levels amid challenging market conditions (which will remain in place for the 2010s).

Furthermore, certain banks will have to finally acknowledge that existing technological solutions and accompanying business processes are inadequate preventative measures for risk avoidance and mitigation in today's operating environment. In recognizing that gaps exist, steps can subsequently be taken to ameliorate these shortcomings. Rather than bravely "going it alone" and attempting to fix complex risk-related problems in isolation, we believe financial institutions should call on the statistical modeling and analytics expertise of specialist technology vendors to jointly address the challenges that exist.

Finally, banks must champion the notion that risk management is the duty of every employee regardless of whether they have the word "risk" in their job title or not. New technologies and associated processes can be implemented ad infinitum, but if the underlying culture of banking remains cavalier rather than calculated, where risk is concerned, such changes will only remain skin-deep. And, given where banking finds itself at present, that situation cannot be tolerated in the medium to long term.

LEARN MORE

Related Research

- *Business Strategy: Global Risk Roundtable — Insights From IDC's Global Risk Analyst Team* (IDC Financial Insights #FIN232524, January 2012)
 - *Worldwide Risk Technology Spending — 2011 Analysis and Forecasts* (IDC Financial Insights #FIN230641, October 2011)
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Synopsis

Bank Leumi has significantly improved its credit-risk management capabilities through the implementation of new analytics technologies from SAS. This report examines the activities performed by Bank Leumi, identifies best practices, and summarizes the outcomes and lessons learned.

"Bank Leumi, in partnership with SAS, has made tangible improvements to its credit-risk management practices, and is leveraging new technologies and supporting business processes in an effective and efficient manner. In the current climate, peer institutions are well-advised to understand the factors which influenced Bank Leumi's strategy, its implementation experience, and the measurable outcomes," said Alex Kwiatkowski, research manager, EMEA Banking, IDC Financial Insights.

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