

The opportunities of regulation

The increased complexity of financial products and markets poses greater challenges to the ability of corporate treasurers, bankers, regulators and supervisors to keep pace with the evolving risks to markets and corporate enterprises. Corporations are now facing regulatory fatigue – even exhaustion, with the snowstorm of regulation and compliance initiatives that show no signs of slowing down.

One response to the new regulation is to view the regulatory requirements as a cost burden on the business. An alternative response, however, is to use them as a lever for change, to adopt a business benefit driven approach in parallel to achieving regulatory compliance.



Recent financial turmoil has demonstrated the need for business leaders to make sure that the risk management and control framework within their companies is able to keep pace with the changes in financial instruments, markets, changing business models and the pace of technological change affecting the way business is managed and transacted.

Risk expert Myles Shevlane, SAS UK, argues it is essential that firms do not engage in activities without having adequate risk controls in place to protect the long term profitability and sustainability of the business. The skills of risk managers need to be continually updated to keep up with the pace of business, market and technological change. The avalanche of new rules could create an opportunity for a 'spring-clean' and even a sunny future for firms that grasp the opportunities they present.

Competitive advantage

The art of Judo is all about leveraging the strengths of an opponent in your favour, the same can be said about extracting competitive advantage out of the growing welter of rules that, at first glance, seem designed to distract firms from their core activity of making money.

Firms have faced an avalanche of new regulation in the past few years, particularly in the financial sector, with new financial reporting obligations arising such as the new IASB reporting standards (US FASB rules for US based firms). This has come at a time when the financial industry is also going through wholesale change in Risk Management practices with new regulatory frameworks being introduced including Basel II, to improve risk management for banks, MIFID, introducing single market for financial securities across the EEC, SOX driving increased focus on business and accounting controls and Anti Money Laundering...to name just a few.

Recent pronouncements from the Financial Stability Forum indicate that existing financial industry regulations across the globe will need further strengthening in the light of the current turmoil in financial markets, arising from the US sub-prime crisis, and its knock on effects to global financial markets. Areas singled out for increased focus include: incremental trading risk, off-balance sheet risk, liquidity and funding risk, need for greater transparency and reporting of risk exposures, need for improved stress testing and a move towards developing more sophisticated and integrated approaches to risk management.

How should firms greet this increasing level of regulatory oversight? Is this a burden or opportunity for strategic business change? To-date many firms have taken the view they will

treat these regulations as a business burden, an overhead to be minimised, just looking to spend sufficiently in order to achieve a basic level of regulatory compliance.

There is another way of looking at this, that's not all 'stick' but some 'carrot' too that can be leveraged to help companies grow more profitable and serve their customers better. Compliance is one thing, but turning it around to competitive advantage is another – the two objectives are however linked through quality data and analytics that can enable firms to obey the rules and drive up profit at the same time.

When new regulations loom upon the horizon many firms go into a 'denial' phase because they believe they've already adopted 'risk management' systems in response to these regulations. Invariably they have all manner of systems in place to monitor such things as operational risk, market risk, credit risk and sensitivity analysis, that are necessary to determine the level of economic capital that needs to be held.

Then comes a 'compliance' phase when the new challenge sinks in. This often means the shoring up of existing systems to provide a series of silo-style, tactical solutions to make them compliant. But this is not a great way of doing things because firms can end up with a series of processes, and changes to people and what they do, which merely creates friction and drag on future progress.

Underlying all that is the data issue. Generally speaking, risk managers believe that there is a software package to handle every regulatory compliance issue. Unfortunately, getting real insight into how to gain competitive advantage from these systems and getting the most out of its data does not always register as an issue.

Given the size and history of many large finance firms, they have data everywhere and it can be 20 or 30 years old and of dubious quality. And then there's the problem that data captured in the past is of little use in taking the business forward.

Companies are in the business of making money and creating shareholder value rather than compiling data purely to become compliant. The two, however, can be done simultaneously and the emphasis on how to achieve this is subtle, but very different.

It's in the data

Change management nets millions for experts in the field. Going back to the 'Judo' analogy, if an external change is forced upon you, it's best to accept it and use the weight behind it to drive through real corporate change to remain competitive.

Historically, compliance officers have been caricatured as 'tick-box' drones that stand in the way of the business buccaneers who want to trade. All that changed with Sarbanes-Oxley in the US and Basel II in Europe, which passed the buck to the boardroom. As a number of high-profile cases have shown, you might have five homes and a Lear jet but if you don't do compliance - you end up in jail. As a result, compliance officers now have more 'clout' because the board has to back them and they are no longer considered the equivalent of corporate traffic wardens.

Senior managers tend to regard compliance as a "challenge" rather than an opportunity to create real, sustainable competitive advantage and drive value. By definition "compliance" means doing the same as everyone else, and management tends to resent the heavy hand of the regulator. But they may be looking at the issue down the wrong end of the telescope. It's only when you look at the broad picture painted by enterprise data that you appreciate the value that can be gained.

Regulation and compliance presents new opportunities for data mining because of the volume of data that needs to be held on criteria such as order volumes, sizes, costs, price spread and client classification. Rather than just 'towing the line' to meet the requirements of the FSA, companies should aim at analysing it for themselves to predict customer buying strategies and future highs and lows to help balance the ebb and flow of commerce.

In most cases competitive advantage is short lived; a strategy can be copied, technology can be reproduced, and people can be poached. By contrast, data is absolutely unique to a

business. It cannot be copied. If firms exploit this differentiation creatively, they can generate a sustainable competitive advantage. It is the data in a risk management system that offers business opportunities, not the ability to tick off a list of compliance criteria. The main objective should be to surface knowledge that will enable companies to manage the business proactively. Data can help customers by giving firms a better insight into what they want and the risks they are prepared to take. Matching clients' risk to the investment risk provides opportunities for selling more and higher value items.

For example, the recent investments in building the data stores to reach Basel II compliance can now be turned into competitive differentiation. With an extra amount of small investment, the risk and the finance data can be integrated to move towards developing a risk adjusted performance management business model. The same Basel II data can now be used for further Enterprise Risk Management (ERM) requirements including development of more granular and sophisticated Asset & Liability Management & liquidity risk management analysis. Valuable customer risk data can be used to drive customer value management including risk based pricing and risk adjusted customer profitability analysis. This data in turn can then be used to inform marketing and sales processes and determine which customers to target with which products.

Accepting change

So, rather than being a straightjacket, new regulations can unlock the door to new business, providing that quality data and the right analytics to exploit it are in place. Firms in the corporate sector need to learn the lessons of those firms in the financial sector. The smart firms are changing the way they implement regulatory change, looking to identify the business synergies, in some cases completely driving the change based on business performance goals, which both deliver higher performance and compliance at the same time. Whilst this more strategic approach is often more costly initially, the payback is significant when you consider the major savings as new regulations emerge, which can easily be assimilated into the new strategic business architecture. These new strategic business architectures can be designed to streamline, integrate and optimise business processes that incorporate a risk based performance management framework.

Regulators want firms to integrate risk management processes and tools, including stress testing and scenario analysis, into the day to day business affairs and ongoing business planning process. They are looking for firms to take a far more sophisticated and integrated approach to risk management moving towards Enterprise wide risk management approaches. ERM approaches today incorporate strategic risk management where the business is viewed from a portfolio perspective and capital management, liquidity management and financial performance is integrated into the overall process.

These new ERM based approaches require risk platforms capable of assessing multiple risk types, all taken into consideration together, including risk factors arising from market, credit, operational, liquidity, interest, funding, FX, and trading risk.

The growing number of sophisticated financial products available to corporate firms to hedge financial risks and manage overall financial performance is both an advantage and a burden. Lessons in the financial sector point to the need for business leaders to ensure they achieve transparency to the business risk they are facing and the optimum business decisions that need to be taken to address them.

The involvement of senior management in the development of economic and business scenarios, and the effective translation of the analysis into business strategy and action, is critical to achieving higher business performance and regulatory compliance.

The bottom line is that senior decision makers need to step back from the compliance issues and consider the economic value that can come out of transforming the way their firms manage risk and performance together. Only then will the large compliance expenditures be turned into competitive business tools to drive shareholder value.

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