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REPRINTED FROM:

RISK & COMPLIANCE MAGAZINE

OCT-DEC 2021 ISSUE

Published by Financier Worldwide Ltd
riskandcompliance@financierworldwide.com

www.riskandcompliancemagazine.com

PERSPECTIVES

PRACTICAL STEPS FOR BANKS TO TRANSFORM THEIR APPROACH TO RISK MANAGEMENT

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Emerging technologies are transforming every aspect of financial services, and COVID-19 has only accelerated banks' implementation of their digitalisation ambitions. From the way customers complete transactions, to how banks make decisions, digital tools are bringing greater speed, efficiency and transparency to many aspects of the financial workflow.

A survey of 300 financial services professionals we conducted in partnership with Longitude in January and February 2021 found that many banks are lagging in their adoption of digital solutions for risk management. This is limiting their ability to forecast future trends and improve decision making across their business. Additionally, we also conducted in-depth interviews with four senior banking executives, to understand the experiences in their respective organisations and vision for risk management.

More positively, our research revealed that a group of banks (20 percent of the total sample) have a more mature approach to risk management. We named these banks 'risk management leaders', and their investments are paying off, with a focus on automating risk modelling (either completely or to a great extent). They are adopting all of the following tools to at least some extent: integrated balance sheet management, a scenario-based risk analytics platform, modelling-as-a-service, an enterprisewide data analytics platform, and real-time risk management.

Why should banks be looking to transform their approach to risk management?

Currently, only one in 10 banks surveyed strongly agree that their approach to risk modelling is a competitive advantage. Yet over half (52 percent) say COVID-19 has accelerated their plans to modernise the risk modelling lifecycle. The data reveals that the impact of the COVID-19 pandemic is the number one factor influencing banks' approach to risk modelling, making it even more influential than regulatory requirements.

Increasing complexity

The modernisation of risk management is essential to maintaining resilience and strategic focus. According to our research, the institutions that are leading this transformation and managing the complexities presented in managing risks in a digital economy, are already seeing strategic benefits, including the ability to generate data-driven insights, more quickly and in greater volumes, in an increasingly uncertain marketplace.

Yet, only a minority of respondents (37 percent) have started modernising all phases of the risk modelling lifecycle, and only a small minority have fully automated activities, such as credit risk monitoring, underwriting and stress testing. Improving risk modelling, and through this, decisioning, is not just vital for protecting the business and responding to regulatory requirements, it also enables banks to provide a faster and more seamless experience to their customers, for example through faster onboarding and lending decisions.

Business impact

The lack of digitalisation in banks' risk management processes is a barrier to better decisioning. Only 19 percent of banks can forecast profit and loss (P&L) more than two years ahead, and only 14 percent rate the accuracy of P&L forecasts as 'very high'. Furthermore, only 36 percent of banks surveyed have a combined view of their risk and their finance measures.

How can this transformation be accomplished?

The question many start with is: what are the key risks that the bank is facing? But more specifically, what are banks doing to strengthen risk management and decision making?

Attention should be focused on the following five transformation areas in risk management to help improve banks' ability to meet their business objectives.

First, standardise and modernise the risk modelling lifecycle. Risk models are used for a wide range of decision making, including regulatory models that are used for capital, provisioning and liquidity, as well as models supporting the onboarding process, account management and collections management. The range of risk models has further expanded in recent years, with the addition of artificial intelligence and open source models that can be applied to anything from computer vision to natural language processing.

To rapidly build, deploy, scale and update models, banks must modernise their risk modelling and decisioning lifecycle. For many banks this will mean creating a central repository, so they always know how many models they have, and what the interactions are between them. Modernising the risk modelling and decisioning lifecycle can reduce the time it takes to build and deploy a model, from a few months to a few weeks, a critical difference in today's fast-changing marketplace.

To add to the modelling challenge, the COVID-19 pandemic has significantly challenged models, in many case, due to the range moving outside what the model was designed to do.

Myriad other challenges have also amplified the importance of model governance across the modelling and decisioning lifecycle; a model's outcome needs to have an explanation and you need to understand that explanation. Banks cannot take the risk of running their risk management processes based on models they do not understand.

Banks are expected to be able to deliver decision outcomes much more quickly; going through a systematic and automated model approach makes the process more efficient. In the end, models empower, but this should not be at the cost of using models outside of context and discounting human inputs and judgment, which is why model risk management is an important discipline.

"Hosting risk-related decision making in the cloud offers dynamic, on-demand scalability, flexibility and cyber security, ensuring banks can rapidly adjust to changing market conditions."

Second, integrate risk management with business planning activities. The value of risk management is amplified when it is integrated with business planning activities, such as forecasting. Tools such as data analytics platforms and integrated balance sheet management can enable this, and research shows that many banks plan to invest in such technologies.

The integration of processes that could be part of a quick win needs to be identified and obviously, you

will have to define exactly what business benefits are expected. Maybe you start by integrating with collections, then with fraud, or vice versa. It is all about putting a plan in place. The key to integrating risk management with business planning is having the capacity to understand the business holistically and having the right people to put together the right process.

It is the case, however, that the level of integration possible differs globally, as banking cultures are quite different. Economies with more sophisticated regulations tend to produce more sophisticated risk departments. Because they must prepare themselves to answer to the regulators, they end up preparing themselves to support the business as well. In Europe, there are lots of good examples where banks were able to answer the regulations effectively, as well as achieve business improvements.

Third, invest in cloud infrastructure and automation. The ever-present primary challenge in delivering better risk management is, data. It is true to say that banks have access to a lot of data, especially as digital economies expand. To leverage the vast amounts of data they now have access to, banks are increasingly harnessing the power of the cloud. A key objective to using this data is to improve risk-related decision making, and simultaneously capitalising on the lower cost, flexibility and faster data insights gained by using a cloud-based analytics environment.

Hosting risk-related decision making in the cloud offers dynamic, on-demand scalability, flexibility and cyber security, ensuring banks can rapidly adjust to changing market conditions. Deploying a streamlined, sophisticated risk modelling and decisioning process in the cloud, leads to improved capital allocation, accelerated revenue growth, a stronger competitive position and reduced exposure.

A primary deployment issue when using cloud-based data is legal access to the data. In many countries, data is protected. How do you get personal data in Europe, for instance, with the General Data Protection Regulation (GDPR) in place? It will be different from one country to the other. So, it is important to work with your software and cloud providers to comply with data privacy protection regulations when accessing this data across the bank's cloud-supported businesses.

Fourth, focus on quick wins vs. large-scale transformation. For many banks, large-scale transformation of risk management processes is too disruptive to be feasible. Yet by identifying key areas where modernisation can deliver the greatest value, banks can pilot lower-risk projects and use the results to inform and guide further transformation.

Leading banks have adopted a mindset of continuous experimentation and exploration, rather than one big bang approach to deliver a new solution. It is an iterative, fast-moving process rather than a single overarching objective. So, banks will experiment in individual sectors, such as small and medium business lending by region, to test using alternative sources of data within its operations.

However, as our survey highlighted, many banks are behind where they should logically be on the risk management transformation journey. Customers and regulators expect a digital response from the bank and expect to receive it quickly.

When responding to these demands, banks need to make sure they are not building something that is simply a tactical, one-off exercise. Banks need their risk-related decision making delivered in a consistent framework that can manage risk management decisions.

Finally, recruit the right talent. While increased deployment of models and a more automated approach will give banks the ability to be more effective from a business perspective, people are integral to success when adopting new risk modelling lifecycle practices.

Feedback from our survey indicated that investing in the right skills and capabilities will be vital for banks to strengthen their approach to risk management. This is likely to involve investing in both traditional 'quant' skills, as well as in digital and data analytics skills. Identifying which activities can be automated will also be vital, enabling banks to deploy employees where their skills are most needed.

Increased usage of data and modelling by various departments means they will need the appropriate expertise. Today, that expertise is sought after.

Conclusion

To better understand the risks in today's fast-changing markets, banks need access to the right data, state of the art modelling analytics and integrated balance sheet management, and the advantages of moving from legacy systems to cloud-based platforms. This will enable banks to be more responsive and open to opportunities to deploy new digitalised products and services that clients demand.

It is also important that the bank's risk management culture extends beyond the risk function. A strong risk management culture involves all lines of defence, and creates a strong ownership of risk within the first line of defence. R&C

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