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PERSPECTIVES

OVERCOMING CHALLENGES IN RISK AND FINANCE INTEGRATION

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The driving forces

In the ever-evolving landscape of the financial services industry, the integration of risk and finance functions is no longer just a strategic choice; it has become a lifeline to stability, growth and compliance. Traditional practices have seen these two crucial divisions operate independently, each with its unique objectives and responsibilities.

However, contemporary dynamics and challenges, such as changing regulations, evolving accounting standards, macroeconomic fluctuations and the need for enhanced managerial efficiency, necessitate a closer alignment between risk and finance. This article explores the complex terrain of integrating

risk and finance and delves into how technology can be leveraged to overcome the obstacles that often hinder this endeavour.

Regulatory and accounting standards drivers. The regulatory and accounting frameworks governing financial institutions (FIs) are the bedrock of the industry, serving multiple purposes. These frameworks facilitate economic growth, provide liquidity to financial markets, protect investors from unforeseen financial risks and act as payment systems. Compliance planning involves balancing numerous significant calculations and reporting requirements, including the implementation of Basel

III (often referred to as Basel IV) and adherence to International Financial Reporting Standard (IFRS) 9.

Basel III and the risk management imperative.

The Basel III framework underscores the paramount importance of effective risk management and financial control in ensuring capital adequacy. Risk management is the cornerstone of a sound FI. Without adequate risk mitigation strategies, banks can easily find themselves in a precarious position. This crucial aspect of risk management involves identifying, assessing and mitigating various types of risk, such as credit risk, market risk and operational risk. The finance department plays a pivotal role in planning and ensuring the bank's profitability, while the risk function defines the boundaries within which the FI must operate to remain sound and aligned with its profit targets.

The evolving landscape of Basel regulations. The demand for cross-functional collaboration between the risk and finance departments is intrinsically tied to changing rules and managerial requirements. Basel IV regulations, set to come into effect in 2025 with a phasing-in period spanning from 2025 to 2032, are poised to introduce new capital requirements and heightened standardisation. These regulations are a testament to the ever-evolving nature of the financial industry. They require a thorough reassessment of risk models and the way capital is allocated.

IFRS 9 and credit loss assessment. Another area where risk and finance integration is actively taking place is in impairment provisioning, mandated by IFRS 9. This regulation requires a dynamic credit loss assessment, necessitating collaboration between the risk and finance departments for accurate estimation and long-term financial performance strategies. IFRS 9 shifts the focus from incurred losses to expected credit losses. It emphasises forward-looking assessments, requiring banks to consider various economic scenarios and the probability of defaults.

Macroeconomic drivers. Efficient liquidity management is paramount for FIs, especially in times of financial stress. Increasing interest rates, as seen in the current scenario, present challenges to funding banks, impacting the market value of assets under management. Integration between the risk and finance departments allows comprehensive liquidity risk monitoring and forecasting in alignment with regulatory guidelines.

The significance of liquidity risk management. Liquidity risk management is an integral part of the broader risk management framework. It involves ensuring that a bank has access to sufficient funds to meet its obligations as they come due, without incurring unacceptable losses. Given the interconnectedness of financial markets, changes in interest rates and economic conditions can have a significant impact on a bank's liquidity position. Effective liquidity risk management necessitates

continuous monitoring and assessment of liquidity positions.

Managerial drivers. Aligning an organisation's business strategy with capital allocation is essential for fair internal profit attribution, optimal capital utilisation, and stress testing and scenario analysis. Risk-adjusted return metrics, risk appetites and capital allocation decisions all need to align. Stress testing and scenario analysis are instrumental in understanding the potential impact of adverse events on both risk exposure and financial performance.

The role of stress testing. Stress testing is a proactive approach to risk management. It involves subjecting a bank's portfolio to hypothetical adverse scenarios to assess how it would perform under stress. This process enables banks to identify vulnerabilities and make informed decisions about capital and risk management. Stress testing provides insights into how different stress scenarios impact financial metrics, helping banks prepare for unexpected events.

Implementation challenges and best practices. While the need for risk and finance integration is recognised, many firms grapple with execution due to cultural misalignment, organisational structure issues and technology constraints. In terms of

organisational structure, firms are urged to update it. Promotion of greater collaboration and alignment

“In essence, the success of risk and finance integration is contingent on a cutting-edge IT infrastructure.”

provides chief financial officers (CFOs) and chief risk officers (CROs) the opportunity to function as trusted advisers to the chief executive.

The significance of cultural alignment. Cultural alignment is of paramount importance. Fostering a culture of collaboration and open communication between the risk and finance teams is essential. It is especially pertinent for firms that have grown through M&A, which can bring together individuals from diverse company cultures and locations.

The organisational structure in modern banking. In terms of organisational structure, modern banks are reevaluating their hierarchies. The traditional silos that separated risk and finance functions are giving way to a more integrated model. This model



promotes cross-functional collaboration, where CFOs and CROs work hand in hand. The role of the chief data officer is gaining prominence in this context, as they ensure the consistency and integrity of data used by both departments.

When it comes to technology and data integration, several areas should be considered. These include technology platforms that facilitate seamless data sharing and analysis between the risk and finance functions, data governance frameworks that ensure data accuracy, consistency and compatibility across departments, and model governance frameworks that ensure independent review and timely updates of assumptions used in forecasting, stress testing, valuation and behavioural models shared across departments.

Leveraging technology for integration. The integration of risk and finance functions relies heavily on technology. Technology platforms are the linchpin of this integration.

These platforms enable seamless data sharing and analysis between the risk and finance functions. They provide a common ground for both departments to collaborate and work with the same datasets, reducing errors and discrepancies.

Data governance. Data governance is another pivotal aspect. It ensures that data used

by both departments is accurate, consistent and compatible. Inconsistencies in data can lead to erroneous decisions and reporting. Data governance frameworks establish standards and protocols for data management.

Model governance. Model governance frameworks come into play to ensure the reliability of models shared between departments. These models are used for forecasting, stress testing, valuation and behavioural analysis. Independent reviews and timely updates of these models are critical for maintaining their accuracy.

Business problems and best practices for potential solutions. FIs are grappling with a multitude of challenges stemming from global regulations, digitalisation, emerging risks, coronavirus (COVID-19) impacts and environmental, social and governance (ESG) considerations. Unpredictable events, such as macroeconomic and political shifts, serve as prime examples of unforeseeable occurrences, adding to the unpredictability. Additionally, customer expectations are evolving rapidly, driven in part by the influence of technology giants and FinTech innovations.

Meeting the challenges

There is an increasingly urgent need for a state of the art IT system that ensures data governance and consistency, complies with regulations like the Basel Committee on Banking Supervision (BCBS) standard

number 239, and goes beyond. In the complex landscape of risk and finance integration, speed is of the essence. A high-performance technology infrastructure is vital, providing the ability to run official calculations swiftly and efficiently. Eliminating data silos, this advanced system serves as a unified and accurate data source. Moreover, it offers tools that enable not only swift responses to requests from top management but also the fast execution of official calculations. It is paramount for supporting seamless updates to these models, ensuring they remain current and reflective of the dynamic financial landscape.

The incorporation of a high performance calculation engine further underscores the necessity for high-speed processing, enabling faster interactions between different departments, efficient data collection, historical data tracking for various scenarios, and the provision of near-real-time reports to analyse the impacts of different assumptions. In essence, the success of risk and finance integration is contingent on a cutting-edge IT infrastructure that not only meets regulatory requirements but also enhances operational efficiency through high-speed, real-time processing capabilities.

In addition, it is vital to have a system with the ability to properly manage different scenarios corresponding to different management actions so organisations can provide comparative analysis to

top management and let them choose the one that best fits with their corporate strategy.

Furthermore, the system should manage the workflow that facilitates interactions between different departments, data collection, historical data tracking for various scenarios, and the provision of near-real-time reports to analyse the impacts of different assumptions.

In summary, changing customer behaviours and increasing competition are being driven by evolving customer expectations, the entry of technology giants into the financial sector, regulatory changes and customers' rapid responses to macroeconomic shifts.

This dynamic environment requires FIs to adapt continuously. The integration of risk and finance functions positions institutions to navigate these changes effectively. However, to achieve this integration, it is crucial to address the challenges, embrace best practices and leverage the right technology.

Conclusion

Leading banks have been actively discussing the imperative of integrating risk and finance operations for over a decade, particularly in the wake of the 2008 financial crisis. This need for integration can be examined from multiple angles, including data sources, reporting and the planning process. A noteworthy example of this shift is found in a 2023

Celent global survey titled 'Modernizing Asset Liability Management'. In this survey, banks are recognised for their efforts to integrate balance sheet risk management with financial data, fostering collaboration between treasury, finance and business units.

According to the Bank for International Settlements (BIS), global regulators across the world are increasingly emphasising the importance of updated stress-test exercises that specifically focus on the integration of risk and finance functions. In the evolving landscape of finance, the synergy between risk and finance is not just a strategy; it is the lifeline to stability, growth and compliance. Organisations need to embrace integration, empower transformation and chart their course toward a future where opportunity meets preparation. **RC**



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