The road toward finance and risk alignment

It is not about compliance, it is about transforming your business

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BACK TO THE BASICS

**Risk. Return. Capital & Liquidity.** These words are at the core of each financial institution (FI) and have always been. Business leaders in the financial industry recognise that their strategic decisions have a direct impact on the position of an FI in the classic triangle of risk, return and capital & liquidity. They are also fully aware that these metrics are strongly interlinked: taking higher risks probably means higher returns but also implies the need to retain more capital for these risks. As a consequence, they know that their ability to better manage this triangle gives them a lead in their markets. Proper insights into these metrics are quintessential for making informed business decisions. Moreover, these insights are important for offering the best products and services to customers. In an era where transparency is higher than ever before – inevitably leading to fierce competition – using these insights for a client-centric strategy is simply indispensable.

However, something remarkable has been going on in recent years. Many management information in FI’s currently do not fulfil management needs to take these informed decisions. In practice, managers cannot (or can only partially) see how risks translate into returns and how these interlink with the need to build capital and liquidity buffers. The information – or its elements – in itself is available (from the organisation units dealing with it), but these building blocks do not create an integrated insight that is forward-looking. Those in the organisation that are responsible for this information maintain their own definitions, governance structures and systems, thereby hampering these integrated views. FI’s are slowly recovering from one of the most intense crises in the last 70 years. They are facing competition and continuously weak market conditions. As such, FI’s need to sail close to the wind. They must have integrated and forward-looking insights to take the right decisions. But the reality is: they have no such compass. The challenge: to reconnect the dots on the risk, return and capital & liquidity triangle, and build this compass.

Part of this challenge is about technique. We need to invest in the IT landscape to enable the connections. However, the hardest part is the cultural part. A seamless integration of risk and finance requires that professionals adapt new routines and broaden their views. They must work together and get a firm understanding of each other’s challenges and limitations. FI’s that are successful in remodelling their internal organisation will find that the necessary ideation and creativity is not ignited in people but in the cooperation between people. This will undoubtedly give them a head start in these rapidly changing market dynamics.
In the aftermath of the financial crisis, FI’s were left struggling to recapitalise, clean up their balance sheets, reduce costs and search for new profit streams. Capital positions weakened as a result of write-offs, adverse market conditions or increased solvency and liquidity requirements. Although liquidity is now in abundance, the prevailing capital scarcity and margin pressure require FI’s to be more diligent and conscious in allocating funds.

In order to become more diligent in capital allocation, FI’s need more accurate, relevant and timely financial and risk information. Serving the business in this way has proven to be difficult. The reality in many FI’s: focus on regulation has caused finance and risk departments to become more siloed. Stakeholders all look from multiple perspectives and simultaneously emphasise solid risk management, improved profitability and increased transparency. In addition, the functions often lack the information systems and new skill sets that support them in preparing reports that add value to the business. More than ever, FI’s are urged to break down the barriers of traditional organisational silos between client-facing activities, capital, finance and risk and to make the organisation truly agile, forward-looking and client-centric again.

This is by no means an easy challenge, mainly as a consequence of growing complexity. The financial sector is not unique in this respect. In nearly all segments of society, technological progress and innovation has unleashed unparalleled possibilities, but has also fuelled the need for highly specialist functions. Medical care, for instance, can only be provided in close alignment with specialists in different areas. ‘Connecting the dots’ is therefore the key to an optimal performance within this complexity: we need the specialists and we need people, structures and systems to connect them.
Let us dig a bit deeper into the drivers of complexity in FI’s. In our view, there are major drivers:

**External environment**

The financial crisis and associated bank failures as well as government interventions have put regulatory supervision of the FI industry firmly on the political agenda. The initial wave of new regulations significantly increased reporting requirements and associated supervision. In addition to supervisors, external stakeholders, including analysts and rating agencies, are also looking for more robust, detailed, prospective and comparable performance indicators. Newly imposed regulations have caused departments to become highly specialised, thus turning finance and risk departments into silos. Daily operations and changing requirements put pressure on the departments and there is hardly any time left to reflect on broader issues. In the meantime, the current market and business environment require convergence of these separate departments. For example, the submission of regulatory filings such as for banks FINREP and COREP and for insurance Solvency II QRT reports requires close collaboration and understanding between units.

One of the principles in many new reporting requirements is that FI’s must provide information that constitutes an economic reflection of the company and the choices made therein. The reports are more forward-looking and business risks are explicitly quantified in market values. This creates a sharper picture of the financial situation and the risks of an FI. However, in practice, these information requirements are met with a compliance angle, not from a strategic view.
Data and systems

The ownership of data remains a persistent issue within FI’s. Key business or departmental heads typically take little direct responsibility over data, leading to highly elusive data ownership structures, in which both IT and control functions are responsible for data. Following the organisational structures of entities, divisions and functions, each having different incentives, attitudes, and approaches to managing data, the datasets end up being inconsistent and scattered throughout the organisation. As a result, information used in this type of infrastructure is usually highly contextual (i.e. specific to accounting or other reporting frameworks) from an early stage, leaving little room for modifying, changing or crosslinking data for different purposes. Reshaping and adapting these highly contextualised sets of information often requires substantial effort.

The infrastructure of information systems presents significant hurdles for the preparation of more detailed and aligned finance and risk information. Information system infrastructures are complex due to legacy systems. In addition, many FI’s try to integrate different legacy systems stemming from mergers and acquisitions during the past two decades. The infrastructure typically lacks the flexibility to use the same data for different purposes, such as business, finance and risk.

FI’s are forced to invest more money, time and resources in a struggle to keep up with the mounting external requirements. FI’s are often stuck in a race to comply with the next requirement, leaving them little or no room for refocussing their business in a more holistic way, integrating data and forward-looking analytics.

Organisation

Decades of acquisitions, mergers and reorganisations have made FI’s not only large but also extremely complex. Simplifying a myriad of information systems, overlapping departments and inefficient or even duplicative organisational structures and processes has become a challenge.

Finance’s involvement in regulatory reporting is an understandable extension of its role as information broker to external stakeholders. However, an increasing part of regulatory reporting far exceeds the traditional responsibility and expertise of finance functions. The responsibility for regulatory reporting requires Finance staff to at least understand the principles of risk-weighting of assets and to have the ability to reconcile regulatory valuations with their accounting valuations.

Similarly, the Risk function mainly focusses on the developments per risk category along responsibility units. This information often does not answer the business need for detailed assessment of risks over product categories or even business lines. CEOs of business units mainly focus on return and margins. An integrated risk-return view, including capital and liquidity consumption, has often not yet been developed.
ALIGNING BLOOD GROUPS TOWARD JOINT INTERESTS

The big question is: how do we (re)connect the dots? What is the road toward improved alignment? Our vision of the change toward more alignment is based on the next three areas.

Creating awareness of the big advantages of alignment

Having integrated insights in risk and finance is key to winning the fierce competition battles and thereby key to a healthy future. Connecting the dots – integrating views on finance and risk perspectives – is the only way to be able to swiftly and flexibly react to changing circumstances and to embrace a client-centric approach. While it is more challenging to quantify the benefits than to calculate costs associated with projects to improve the alignment of key functions, it is important to appreciate the magnitude of the potential. This is the first step toward underpinning the importance of more alignment. The benefits of alignment projects are visible in three objectives shared by CEOs, CROs and CFOs:

First of all, alignment of the current organisational, data and system silos can dramatically reduce manual intervention. It improves the quality and speed of information delivered for decision-making and financial reporting, often speeding up reporting cycles by more than 50%. Intangible benefits include more strategic and longer-term thinking because the risk and return impact of a decision is considered more accurately. In addition, clear data ownership, accountabilities, roles and responsibilities allow for better control of the reporting processes. In the medium to long term, standardising and eliminating redundant processes reduces the costs of capital and finance structures. Decreasing data complexity and manual interventions in the processes can reduce headcount. IT harmonisation results in less complexity, reduced maintenance and license costs. In this manner, improvements in organisation and IT architecture and data structures can naturally result in leaner, more effective and cost-efficient organisations and contribute to improvements in profitability.

Last but not least, superior information can add value by optimising the utilisation of economic capital, regulatory capital, liquidity buffers and performance measures. It can improve business understanding of product pricing, profitability and analysis by offering more prospective analytics, complementing existing, retrospective management information. It also makes the FI more agile and responsive to changes in the external environment.
Embracing modern data techniques

We are witnessing a golden age in data analytics and new techniques for further automating administrative processes, improving the cost-to-income ratio and delivering new services to clients. As the main focus is still on compliance with new regulations, many FI’s are struggling to internalise these new developments. The technological advances are likely to substantially alter the industry and FI’s current operating model.

There are a few critical elements to consider to improve data management and the technical infrastructure:

- When storing information, it is essential to decide on the level of data contextualisation to facilitate future usability. Future changes in definitions, contexts and levels of aggregation should be easy to accommodate. To avoid all resources being spent on workarounds and database redesign, generic (‘context free’) and specific information (highly contextualised information) should be differentiated within the organisation. By redesigning their information infrastructure using generic data separated from data-independent logical models to obtain a broader set of specific information, FI’s will be able to equip themselves to deal with the constantly changing regulatory landscape, the data-driven supervisory approach and, most importantly, meet actual business needs.

- Given an environment in which continuing data-driven information requests are in sight, FI’s should establish a clear data management foundation that includes the management of data ownership, data governance and data quality. Once such a foundation has been established, it is necessary to develop a strategy that helps data analysts across the organisation in the process of managing generically structured data and modelling different contextual frameworks and subsequently combining the two. For this, institutions need to formulate a strategy that is focused on a fundamentally new infrastructure so as to:
  - store generic data, which is much more flexible, for different contexts,
  - facilitate modelling of logical structures (i.e. context modelling) through taxonomies across domains; this allows linking regulations, deriving interpretations and discussions based on the (data-independent) ‘context models’ and
  - equip a substantial number of staff members across various departments to link context models to generic data provided by domain experts (that is, clarify interpretations and logical structures).

In this way, the availability of data, its consistency and quality will not only enable better and quicker responses to information demanded by various stakeholders, it will also enable it to serve as a solid platform for any organisational model.

1 Generic information is generally used for a broad range of information requests, whereas specific information is used for a particular information goal and comprises several pieces of generic information.
Real change does not come from techniques or changing structures. It lies within people and their willingness to adopt new working routines. To improve alignment, we need to build an organisation where people from different units seamlessly work together. There is a paradox involved. On the one hand, the complexity of the world demands for specialisation in the area of data, models, parameters, processes and validation. On the other hand, it only makes sense if there is an integrated approach because the aforementioned risk and value thinking affects the entire business. Collaboration in multidisciplinary teams is therefore the way forward to tackle this paradox. It requires a lot of dialogue, much less technique. We must realise that not every team member needs to know the underlying model or have the specialist skills. More important is that everyone understands what is at stake for the organisation as a whole. This means that they must understand that the quintessential challenge for every FI is to optimise performance in the risk, return, capital & liquidity triangle and that they can only do so in close cooperation between disciplines.

Many FI’s have faced drastic restructuring operations in the past few years, driven by changing market dynamics. Building leaner and meaner organisations may have contributed to becoming a more competitive market player, but has it also contributed to building an organisation that is future-proof? We believe that it is time to innovate the internal organisation to find better ways to interact between disciplines, starting from the idea that creativity and ideation originates not in people, but in their dialogues and discussions. Traditional organisation concepts based on hierarchy make way for more fluid concepts where groups of professionals jointly take responsibilities for improving the organisation. Bridging the gap between risk and finance is therefore clearly a combination of techniques and tools on the one hand and change management on the other.

There is no standard recipe for doing this. Every FI has its own characteristics and deserves a tailor-made approach. In our view, they should begin by assessing their current position and their ambitions. From this starting point, they can start changing their organisation and assess what is necessary for a successful transformation.

New routines, new behaviour

“Optimizing the risk-return-capital & liquidity triangle is an important issue for financial institutions”
Risk professional of a Dutch insurance company
In 2013, KPMG International conducted a Global CFO Survey to understand the current state and future aspirations of finance functions. This survey is part of a series of research into the finance function trends and key developments conducted by KPMG since 2005. This presentation is a deep dive into the intelligent Finance function where it specifically provides a closer look into the survey results for the Financial Services (‘FS’) sector (Banking, Insurance, Leasing, Investment Management and Real Estate), including an analysis of results from high performing versus average performing FS organizations. High performing organizations are defined as those companies with more than 10 percent growth in revenues and EBITDA for the past three years.

Data and Systems - It’s a journey not just a destination

This article focusses on how insurers need to manage the often under-estimated systems and data journey to ensure they achieve a manageable and practical solution.

Reporting in an on-demand information environment in the banking industry

This white paper explores how the existing information infrastructure is causing banks to face ever-increasing challenges in adapting to the change in information demands. We also explore how banks can prepare themselves to fit into a data-driven- and on-demand reporting-environment.

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“I fully endorse the importance of a generic data model and the need to break through silos by creating multifunctional teams”

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