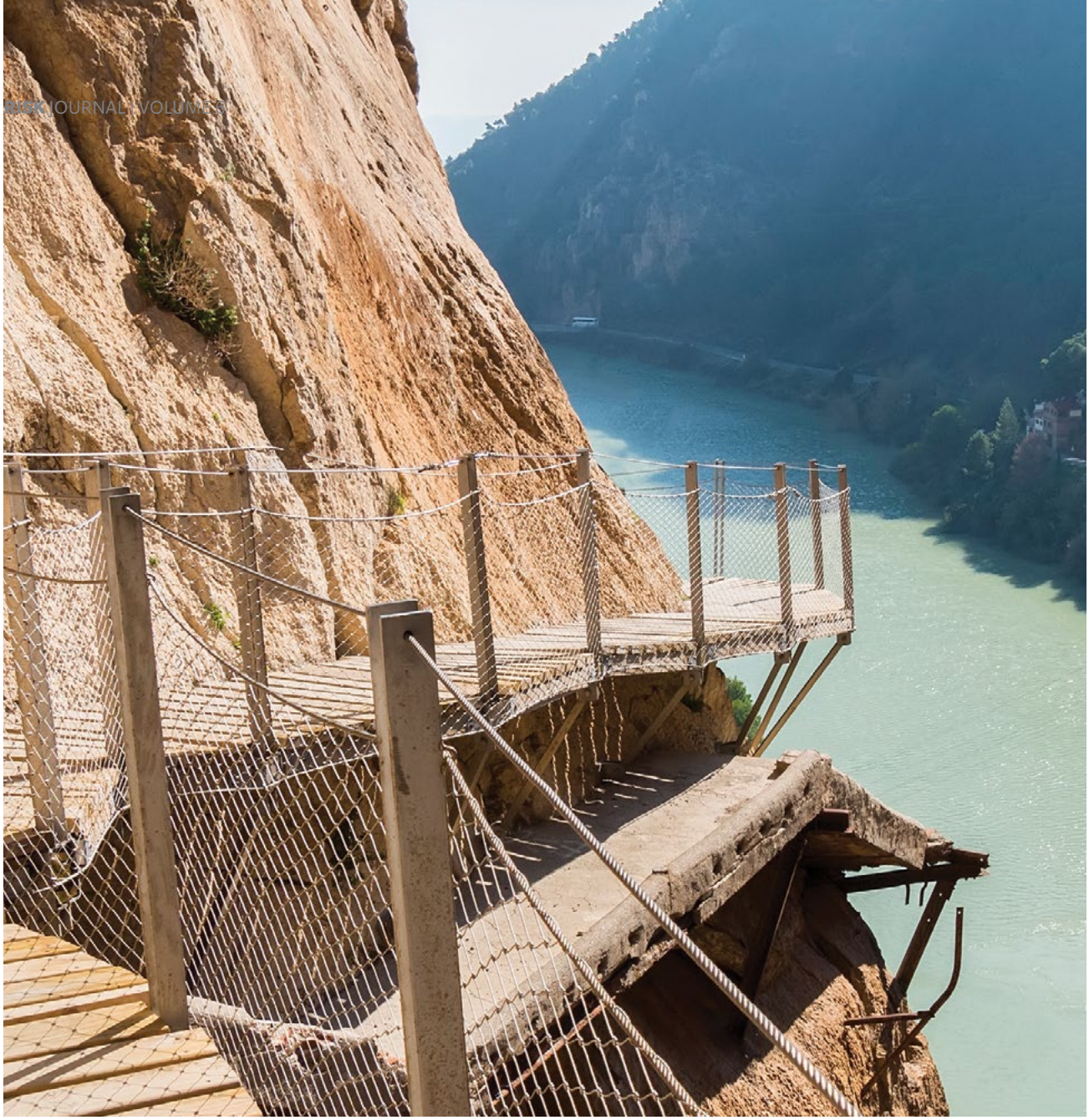

RETURN ON RISK MANAGEMENT

THE VALUE OF INFORMATION SPENDING RESTS ON THE INSIGHTS IT DELIVERS

Douglas Elliott • Ugur Koyluoglu • Dominik Weh

Maximizing the return on risk-management spending at financial institutions is crucial in a way it never was before. Risk management ballooned in size, importance, complexity, and expense after the global financial crisis, responding to regulatory pressures and the internal recognition of problems revealed by the crisis. We estimate over $50 billion will be spent on one-off regulatory initiatives this year, and ongoing expenses associated with enlarged risk functions will account for about 4 percent of the operating costs of an average bank.

As investment in risk management increases, the value of this spending becomes an issue of ever greater importance. A bank is legally required to comply with new risk regulations, but the way it achieves this operationally and the use it makes of "compliance processes" is left to the bank's discretion. The bank may decide it should spend the bare minimum to comply with some regulations, yet go well beyond what regulators demand in other areas to gain a competitive advantage. As is the case with any important activity, senior executives must think about risk management investments strategically.

A FRAMEWORK FOR INVESTMENT DECISIONS IN RISK MANAGEMENT

Analyzing the return on investment in the risk function depends crucially on the value of the risk assessments and the insights it delivers. Economics tells us that the value of information is equal to the probability-weighted increase in net worth as a result of making better decisions using the additional information. This depends on five primary variables: the size of the exposure, its measurability, the potential for improved accuracy, the extent to which the assessment can be used to improve actual decisions, and the cost of obtaining and using the information. (See Exhibit 1.)

The most obvious driver of return-on-risk investment is the *materiality* of the risk exposure – the cost of getting risk assessment wrong. For risk assessment to matter, it must significantly improve the *understanding* of the potential for losses. Spending money on information that does not help in enhancing the assessment of risks cannot be justified, unless required for compliance. A large homogeneous portfolio of loans might merit a simple actuarial analysis to assess the risk of the portfolio under different conditions. A more heterogeneous portfolio might warrant more detailed models that are able to discriminate along the risk spectrum. Some portfolios might benefit from a combination of models and expert overlay. But the key point is to ensure that each layer of the process is adding to accuracy, not just to cost.

Finally, the cost of gathering the additional information must be lower than the benefits. This balancing act affects *where* the money is spent, in addition to *how much* is worth spending. For instance, when considering strengthening one line versus another in the context of "three lines of defense," a comparative return-on-investment analysis is needed.

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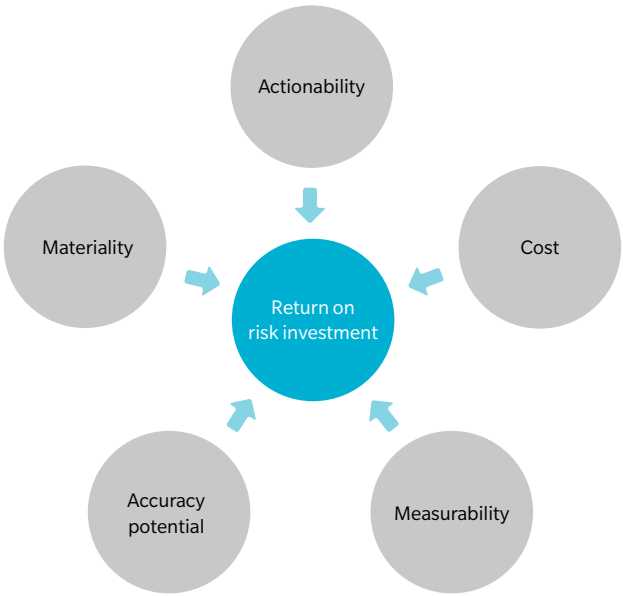
EXHIBIT 1: GETTING THE MOST OUT OF YOUR RISK INVESTMENTS

THE VALUE OF RISK-RELATED INFORMATION IS EQUAL TO THE INCREASE IN NET WORTH THAT COMES FROM MAKING BETTER DECISIONS BASED ON FIVE ELEMENTS



Source: Oliver Wyman analysis

Deciding a bank's overall strategy and making the right risk-return decisions within the risk appetite of the bank can be thought of as solving simultaneous equations. Luckily, a good risk department is endowed with the analytical resources to tackle such problems in a disciplined fashion. In addition, strategy and risk functions have been working much more closely since the global financial crisis.

Regardless of the overall strategy, however, the return on risk management can only be optimized through a sound and detailed analysis of the major types of risks, their probability distributions, the potential for improving a bank's understanding of the probabilities, and an overall approach that maximizes the flexibility of better execution based on better information. These steps require the structuring of a vigorous framework, robust databases, and information technology; additionally, there must be an analysis and comparison of multiple scenarios, the incorporation of expert judgment from both inside and outside the bank, efficient organization of the bank, a focus on results, flexible responses to a changing world, and a sound and well-understood strategy for the bank.

Optimizing the strategy and allocation of risk-management resources also requires excellent coordination between the risk and strategy functions – and indeed between them and other key areas, such as the finance function.

WHAT THIS MEANS IN PRACTICE

The role of the Chief Risk Officer: Many banks are now working on a 2020 Vision. The CRO should be part of the core team, as he or she is able to explain what a particular strategy will mean in terms of regulatory and economic capital costs, liquidity requirements, earnings volatility, and reputational danger. No one is better positioned to make sure that the strategy is consistent with the desired risk profile of the bank and that the risk function has the capabilities to monitor and control any new risks.

Getting off the hamster wheel: Many risk staff, including the CRO, are still overloaded, and spending has sometimes been guided by the imperative to comply with new regulations, rather than by a strategic vision and best use of new technologies.

Understandable as this is, it will prove wasteful over the long run as short-term fixes usually prove to be under- or over-investments.

CROs and their senior team need to get off the compliance hamster wheel and devote a material portion of their time to strategic matters. The cost of poor risk strategizing far exceeds the modest increase in staff costs that is required.

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A leadership mindset: CROs must not think of themselves as the most senior "analytical type" in the bank, but as a leader with as much influence on the bottom line as C-suite peers. The CRO must step up to provide the strategic thinking as it relates to the bank's risk profile and broader business activities, if he or she is not already doing so.

Douglas Elliott is a New York-based partner in Oliver Wyman's Financial Services practice. **Ugur Koyluoglu** is a New York-based partner and Head of the Finance and Risk practice and Public Policy practice, Americas. **Dominik Weh** is a Frankfurt-based principal in Oliver Wyman's Financial Services practice.