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Your Approach to Enterprise Risk Management Could be Holding You Back

Effective Risk Management Lies in Systems that Drive Cross-Silo Collaboration

Global financial meltdown and subsequent front-page risk management failures highlight that financial services firms have still not developed effective systems for truly controlling risk. New regulations spawned in the wake of the meltdown are exacerbating the problem for these companies by further complicating their operations and overburdening existing inflexible IT systems. Continuing the practice of installing a new system and new staff to deal with each new regulatory program increases complexity while degrading the customer experience, opening the way for companies that can meet this challenge to take away business. The winners in financial services in the coming years will be the firms that change their approach and leverage technology that can be easily modified to fit new regulations and can support social collaboration to drive more transparency.

INTRODUCTION

The repeal of the Glass Steagall Act removed the dividing line between commercial banks and securities firms, freeing both organizations to pursue new lines of business. But the removal of the divider put the onus on firms to effectively manage the new risks they could now take. The recent financial system meltdown showed that the systems for monitoring and controlling risks put in place at the largest financial institutions failed across the board. Bear Sterns, Lehman Brothers, and Merrill Lynch paid the ultimate price for their risk management failures. The rest of the large companies managed to survive, but not without taking drastic measures. Subsequent incidents like the $6.2B that the "London Whale" cost JP Morgan in 2012 show that major gaps still exist even in improved risk management systems.

Because the financial meltdown demonstrated wholesale risk management failure, governments world-wide introduced new regulations, such as the Dodd-Frank Act and the Volker Rule, aimed at forcing effective risk controls on financial services firms. Some organizations deemed "systemically important" will see an even higher level of regulation and control than others. These new regulations are all on top of previous regulatory

initiatives like Anti-Money Laundering (AML) and Know-Your-Customer (KYC). Other issues such as continued tax dodging have spawned additional new compliance programs like FATCA.

Banks also need to comply with self-regulatory measures. The Basel III Accord provides standards for bank capital adequacy, stress testing, and market liquidity risk with final rules just recently released by the Federal Reserve. To comply with Basel III, bank leaders need the ability to access data and monitor events across all lines of business both within and outside the company. Incidents require rapid collaboration between the Heads of Risk, Compliance, General Counsel, Portfolio Management, Counter-Parties, Regulatory Agencies, and other key stakeholders.

Compliance with these regulatory requirements is a cost of doing business that these companies need to pay, one way or the other. Financial services must either spend money getting systems in place to collect, filter, and report compliance information as needed, or be prepared to pay big fines like Standard Chartered did in August, 2012 when it paid $670M for hiding over 60,000 transactions for Iranian entities.

Companies are trying to develop adequate internal controls, but the siloed nature of their existing IT systems makes compliance with all of these regulations a challenge. Continued front-page regulatory breaches show that progress is slow. On top of the silo problem, the underlying rules are constantly changing, making it difficult for companies to systematically adapt and stay in compliance. For example, the Dodd-Frank bill has 16 Titles requiring an estimated 400 rules to be written by regulatory agencies across the full spectrum of financial institutions. Not all have been written yet, making it a challenge to build systems that support compliance both today and in the future.

The unfortunate part of all this regulatory activity is that customers don't see direct benefits from the new controls and regulations. All they see are more forms, more delays, and more repeated requests for the same information when different arms of the same financial institution clearly aren't communicating. New customer opportunities are fleeting as competitors move quickly to steal away potential new clients with faster responses and narrow margins on investment opportunities through their own trading. The winners in the post-melt down financial services world will be the companies that can design and implement systems to quickly ferret out inappropriate risk while minimizing customer response delays and shortening the required time to on-board assets.

WHY PAST ERM INVESTMENTS FAILED

Given the systemic failures of the past few years, it is almost ironic that major financial services companies have already invested hundreds of millions of dollars in heterogeneous risk, trading, position management, portfolio management, and other control systems.

While these technologies do an adequate job of streamlining processes, normalizing data, and managing complex business events, one of the reasons they aren't saving their firms from compliance trouble is that they only work within particular organizational silos. When intra-day adverse events occur, most Enterprise Risk Management (ERM) and compliance systems respond with single-threaded, point-to-point communications whereby alerts are sent to email accounts or published to non-proactive portals and reporting dashboards.

The result is that key risk information does not automatically flow to decision makers. Even with complex integrations, these individual systems cannot be combined into a single unified and coordinated technology platform that can automatically socialize risk events and opportunities securely to all key stakeholders. If new information can't move quickly, the window for action to prevent losses will close fast. Financial services firms are capturing key information somewhere, but that data does not make it to the place where it can get used quickly enough to have value. This brings to mind the old riddle – If a tree falls in the forest, but no one is there to hear it, did it make a sound? At some financial institutions, the risk tree is definitely falling, but constrained IT systems mean no one is close enough to hear it.

The increasing number of regulations is only making things worse as financial services firms typically meet each new regulatory requirement by creating a new separate control system with its own staff and procedures. Not only does this create more siloed systems, it leads to processes happening in serial, rather than parallel, fashion. This unnecessarily lengthens sales and onboarding processes. For example, KYC and AML each require certain actions by the firm. If these are handled by different groups, information can get lost in the handoffs, leading to repeated requests for the same data. This is inefficient for the firm and frustrating for its customers.

The longer sales and on-boarding time also costs the firm money since asset management fees can't kick in until the assets are transferred. Unhappy clients are susceptible to competitors' offers while in this state, increasing the chance the firm will lose some clients before they ever get on-boarded.

CAN'T WE JUST THROW MONEY AT THE PROBLEM?

As the financial meltdown taught us, the cost of not effectively managing risk is potentially huge. Financial institutions are willing to spend significant amounts of money to effectively manage risks, so it's not a lack of funding that's keeping them from achieving the ideal risk management state. What bogs these firms down are the traditional approaches to IT system development, either through commercial-off-the-shelf (COTS) purchased applications or a custom developed system, and the resulting brittleness of the solutions. Throwing more money at the problem won't help unless the fundamental approach changes.

Here's an example. Many of the steps needed to comply with KYC and AML occur during the on-boarding process for new customers. The best way to drive compliance with minimal effort as these regulations are updated would be to modify the information technology systems used to onboard new clients. With minor modifications, the additional information is captured and additional steps happen naturally and in parallel. But this is easier said than done. While the COTS systems in use for on-boarding do get updated by their vendors for new requirements, they cannot be adapted to fit the specific processes and needs of each customer. Changes to the core of these applications to meet new requirements could actually increase the challenge of compliance for some users rather than making it easier. This is due to the way these systems fit within each customer's overall process. (They technically can be adapted, but only with large payments to the vendor and a risk of falling off the product upgrade path.) Custom developed applications can be modified, but not easily and not without technology risk, time delay, and expense.

Further compounding the situation is the rapid growth of mobile communications. To truly accelerate key processes, software systems must support mobile process participation and enable automatic push notification of compliance issues. But few existing applications (either COTS or custom) are mobile-enabled. While mobile applications can be created for these systems, it either requires separate development for each mobile

platform (simultaneously on iOS and Android) so that native features of the device can be used, or HTML5-based approaches which have limited capabilities. Even if these apps are fully mobile-enabled, they would still be individual applications, requiring users to manually switch between them to take action.

Social collaboration is another key new technology proving its business value through use of stand-alone platforms like Yammer and Jive, but since these applications aren't directly integrated into work processes, they rely on users to initiate all communications. Without processes and events pushed directly into the social feed, financial institutions are missing out on an opportunity to speed communication and action to resolve intra-day issues.

SOCIAL COLLABORATION CREATES THE ADAPTABLE FINANCIAL SERVICES ENTERPRISE

"The real impact of regulation—its true competitive meaning—lies not in the dry detail of its prescriptions but in how imaginatively and creatively institutions can respond to the competitive opportunities it presents."

–CEB Council on Financial Competition, 2011

The fine print in most financial products warns, "past performance is not necessarily an indicator of future performance." But the industry should recognize that the past pattern of increasing regulation and control is likely to lead to even more regulations. Layering new processes and applications on top of old to address new regulations will only make matters worse. The most profitable financial services companies in the next decade will be the ones who figure out how to make their IT systems easily adaptable to meet new regulatory requirements by accelerating cross-silo processes that impact risk and profitability – without negatively impacting the customer experience.

How will these firms do it? It won't be by following the traditional approaches of hard-coded custom development or relying on COTS applications. Both of those approaches have proven flaws. The answer will come from adopting new technologies that are fundamentally more flexible, adaptable, and are already enabled to change the way communication and collaboration flows within the enterprise via integrated social and mobile capabilities. The software technology that supports the winning financial services firms will enable business users to work hand-in-hand with their IT counterparts designing workflow applications and adapting them as needed to dynamic risk and compliance mandates. By having business leaders drive the definition of enterprise risk management business processes and applications (not coders who lack context for the users' needs), there is a much greater chance that rules and processes will be implemented optimally, increasing the odds that these firms will be the winners. This technology will also provide a common interface across all COTS and custom developed applications for risk, trading, position management, portfolio management, accounting, ERP, and other systems.

As adverse intra-day risk and compliance events occur, these winning financial services firms will resolve issues via "collaborative information streams" where the business problems immediately find the right stakeholders, define their to-do tasks, and create an auditable record of the individuals and the enterprise documents and other content involved in remediation of issues. This collaborative way of working increases transparency and accelerates response through secure streams of information designed just for the target audience, with automatically defined tasks to address or resolve a risk or compliance adverse event.

CONCLUSION

Success in the changing world of financial services, and its ever-increasing regulations, requires streamlining processes to achieve the speed and responsiveness necessary to win new business while also achieving effective enterprise risk management. Firms that do this will develop substantial competitive advantage as the world is only likely to get more and more complex. The answer lies in effective use of new technology to build information systems that make this possible. The industry needs to recognize that the traditional approaches of single purpose COTS applications and custom development are no longer paths to success. Recognizing that a "worksocial" state of rapid collaboration across silos can be achieved is the first step. Those firms that quickly take the next two and three steps down that path will be the winners.