Strengthening governance, risk and compliance in the banking industry

An Economist Intelligence Unit white paper
Sponsored by SAP
Preface

*Strengthening governance, risk and compliance in the banking industry* is an Economist Intelligence Unit report sponsored by SAP. The Economist Intelligence Unit bears sole responsibility for this report. The Economist Intelligence Unit’s editorial team conducted the interviews and wrote the report. The findings and views expressed in this report do not necessarily reflect the views of the sponsor. Dan Armstrong was the editor of the report and Mike Kenny was responsible for layout and design. Our thanks are due to all of the survey respondents and interviewees for their time and insights.

March 2009
In absolute terms, banks have progressed farther than companies in many other industries in automating financial processes, and yet their gains may be proportionately smaller in terms of the needs of a financial services industry sector. Banks have more to lose from inefficient financial processes and they have faced intensified regulatory compliance demands, both in the case of general regulation such as the Sarbanes-Oxley Act in the United States, the globally mandated industry-specific demands of Basel II, and region- or country-specific directives such as the United Kingdom’s Financial Services and Markets Act or the anti-money laundering provisions of the USA PATRIOT Act. Banks have increased their process automation efforts in response to those pressures, but in doing so they have failed to distinguish themselves from the general trend to focus on the negative aims of cost control and avoidance of regulatory sanctions. This conservative approach has ironically increased banks’ exposure to risk at the enterprise level even as it contributes to stronger risk management practices within functions and business lines.

Through governance, risk and compliance (GRC) initiatives, some banks have begun to take a more strategic view of financial processes that has both a defensive and an opportunistic aspect. GRC programs seek to embed rules and controls throughout the enterprise to enable greater visibility of financial processes at all levels and a unified picture of risk at the top. Banks with effective GRC multiply the efficiency advantages of more conservative automation efforts while providing accurate and timely insight into the entire financial picture of the enterprise in order to support better decision-making by senior executives.

**About the survey**

In the fourth quarter of 2008, on behalf of SAP, the Economist Intelligence Unit surveyed 446 senior executives from ten industries about their views on their financial processes and their attempts to improve them. Of this total, 71 came from banks. It is the responses of these executives upon which this paper is based.

Of the banking respondents, 46% hailed from Europe, 20% from North America and 18% from the Asia/Pacific region. One-quarter had positions in the C-suite and another 41% were vice-presidents, directors or heads of business units. Most respondents served in the general management, finance, risk, IT, or strategy/business development functions.
The ability to clearly understand one’s company-wide risk exposure is imperative today, in an industry devastated by the credit crisis. Debate continues about which combinations of factors brought down some of the world’s largest financial institutions and crippled others. Industry observers offer different theories about what should have been done to avert the recent catastrophe and what ought to be done to avoid a future crisis. There is little debate, however, that banks need to develop a more rigorous approach to GRC. Banks have internal incentives for better risk management, and they will also face retooled capital adequacy requirements from the Bank of International Settlements, greater ongoing scrutiny from the Federal Reserve and new compliance requirements from new regulatory bodies chartered to measure systemic risk to the global financial system.

Banks clearly have a great deal of work to do both to meet new regulatory demands and reassure stakeholders of the soundness of their decision-making. Banks are not strangers to accurate and timely reporting, but their success in this respect has tended to occur sporadically within lines of business or within internal control and auditing functions. As Figure 1 demonstrates, banks rank the proliferation of manual processes as the greatest problem with their current financial processes. Conversely, as shown in Figure 2, banks anticipating the benefits of automation give top marks to the decreased incidence of error caused by manual processes.

However, those benefits are not easily achieved, especially for large banks with multinational
Figure 2: What would be the biggest benefits of an initiative to standardise and automate your financial processes? 
Select up to three. (% respondents)

- Cutting back on manual processes, decreasing risk of error: 63%
- Enhancing data integrity: 51%
- Reducing costs: 31%
- Freeing staff from routine number-crunching, redeploying into higher-value activities: 30%
- Meeting compressed deadlines/improve response time: 28%
- Standardisation of methodologies around the enterprise: 23%
- Higher productivity: 20%
- Better compliance with regulatory requirements: 13%
- Better visibility into origin of numbers and how they are calculated: 11%
- Able to identify and resolve bottlenecks: 10%
- Able to set risk thresholds, data access and other controls centrally: 8%
- Fewer opportunities for fraud: 7%


Figure 3: What would be the biggest drawbacks of an initiative to standardise and automate financial processes? Select up to two. (% respondents)

- High level of investment required: 59%
- Difficulty of modelling complex financial processes: 30%
- Organisation is too diverse in its business lines: 25%
- Multiple regulatory regimes make compliance rules unique by business and/or region: 21%
- Difficulty of getting buy-in from senior management: 18%
- Difficulty of getting buy-in from business lines/regions: 13%
- Financial processes are sufficiently fast, efficient and accurate now: 8%
- Business model and operations are unique: 4%
- Other: 4%

presence. Banks struggle with the difficulty of managing complex financial processes, such as those required to track a given borrower’s obligations and dynamically gauge their impact on enterprise risk. Banks also report the difficulty managing the diversity of lines of business and multiple regulatory regimes. However, As Figure 3 shows, their greatest concern is simply the cost of the systems and process redesign necessary to achieve standardised and automated financial processes.

The integration imperative

If banks have agonised about making such investments in the past, they are likely to be less hesitant now. In order to avoid the kinds of exposures that humbled some of the largest institutions in the world, banks clearly need a more integrated approach than they have traditionally followed.

Traditionally risk management has been undertaken within silos corresponding to lines of business units and control functions dedicated to monitoring credit, market, liquidity, operational, legal and compliance risk. The fruits of these governance, risk and compliance efforts were then factored into decisions at the most senior levels, typically depending on diverse systems feeds and manual interventions in order to reconcile discrepancies and present a more or less unified financial picture.

If this approach seemed “good enough” prior to the financial crisis, that is no longer the case. Banks without standardised controls and the ability to coordinate risk on an enterprise level also lack the ability to enforce uniform risk rules across lines of business. For example, a bank might enforce a conservative policy with regard to subprime risks on the mortgage-lending side of the business, and yet have a more aggressive posture toward collateralised debt obligations (CDOs) within its trading operations. Even in cases where banks exercised due diligence in evaluating the risks of instruments such as CDOs, few were in the position to execute the stress testing necessary to determine the potential impact of CDOs on the entire portfolio in the event that the market froze and the investments’ paper value plummeted.

The challenge banks face is to dynamically track risks both in isolation and in terms of their interdependencies. This requires not only learning the specific lessons about credit and liquidity risk precipitated by the financial crisis but also institutionalising a collaborative culture of risk. To a significant extent, this can be achieved by realigning existing responsibilities within an integrated structure.

“Institutions have grown in size and complexity through acquisitions or through just sheer internal growth and they realised that they cannot continue if systems cannot talk to each other or that rely heavily on manual intervention,” comments the former compliance chief of a major US money center bank. “They need to attack this and create a more efficient process.”

Banks’ traditional silos of risk management need to give up the platforms that they have developed within their fiefdoms and work in concert, the source argues. From an organisational point of view, each tier of risk management constitutes a line of defense; the first is the business itself in its control self-assessment capacity; the second comprises the various independent control functions corresponding to
the different categories of risk; and the third is the independent internal audit function.

“Ideally, each line of defense should draw on information captured within a single database, and many banks are already moving toward that state,” the former compliance officer says. “Optimal collaboration between the lines of defense will also require standardised processes.”

Compliance-related controls are by nature costly, and a manually intensive environment multiplies those costs. In the absence of uniform and integrated processes, unnecessary controls and low risk thresholds can result in excessive alerts. According to Luca Pighi, CFO, GE Capital Finance (Italy), too many red flags can introduce confusion rather than clarity. Fragmented, redundant processes result in a glut of data, causing delays in recognising and reacting to risks. Pighi emphasises the need to align risks and controls properly at the outset and refine them continually as the business changes.

It would be a mistake, however, to imagine that banks can entirely eliminate manual processes and the occasion they present for error or fraud. Acknowledging that inevitability, GE Capital Finance introduced a structured system of authorisation in which line staff could only make manual journal entries with the approval of senior managers, according to Mr Pighi.
Conclusion

The ravages of the credit crisis have raised serious doubts about banks’ ability to effectively manage risk. Bankers now face arduous challenges as they attempt to restore the confidence of regulators, analysts, shareholders and customers. To the extent that senior managers have focused more heavily on governance, risk and compliance over the last five years, they may be tempted to despair about the possibility of anticipating potentially devastating risk exposures. However, a sober appraisal of banks’ efforts will reveal that cost considerations have limited the extent to which manual processes have been eliminated and, far more importantly, that sophisticated GRC isolated within lines of business or internal control functions are no substitute for an integrated, enterprise-wide approach to risk management.

The good news for banks is that their efforts to standardise and automate processes within operational silos have prepared the ground for the next stage. In terms of lessons learned, what hasn’t killed a given bank will make it stronger. Banks who incorporate that learning into an enterprise GRC culture and continue their evolution to a unified technology platform will be better prepared to avoid catastrophic exposures. Equally importantly, banks that have a more real-time view of their enterprise risk picture will be better prepared to competitively match their risk appetite to the opportunities of the marketplace.
Appendix: Survey results

What are the biggest problems with your current financial processes? Select up to three. (% respondents)

- Too many manual processes 48
- Inconsistent methodologies around the organisation 38
- Complex procedures which are difficult to model or automate 37
- Lack of visibility and accountability 27
- Controls which are too numerous or restrictive 24
- Incompatible technology (e.g., customised spreadsheets, databases and commercial products) 25
- The need to reconcile inconsistent or redundant data from multiple sources 25
- Boundaries between departments, with departmental managers trying to hold on to authority 24
- Portions of the process depend on individuals who are not always available 17
- The need to document audit trails 4
- Other 1

What would be the biggest benefits of an initiative to standardise and automate your financial processes? Select up to three. (% respondents)

- Cutting back on manual processes, decreasing risk of error 61
- Enhancing data integrity 51
- Reducing costs 31
- Freeing staff from routine number-crunching, redeploying into higher-value activities 30
- Meeting compressed deadlines/improve response time 28
- Standardisation of methodologies around the enterprise 28
- Higher productivity 23
- Better compliance with regulatory requirements 20
- Better visibility into origin of numbers and how they are calculated 17
- Able to identify and resolve bottlenecks 12
- Able to set risk thresholds, data access and other controls centrally 10
- Fewer opportunities for fraud 7
- Financial processes are sufficiently fast, efficient and accurate now 7
- Business model and operations are unique 4
- Other 4

What are the biggest problems with your current financial processes? Select up to three. (% respondents)

- Difficulty of modeling complex financial processes 30
- Organisation is too diverse in its business lines 29
- Multiple regulatory regimes make compliance rules unique by business and/or region 24
- Difficulty of getting buy-in from senior management 18
- Difficulty of getting buy-in from business lines/regions 13
- Financial processes are sufficiently fast, efficient and accurate now 9
- Business model and operations are unique 4
- Other 4
In the past five years, which of the following tasks has your organisation attempted to address by improving its financial processes? Select all that apply.

(%) respondents

<table>
<thead>
<tr>
<th>Task</th>
<th>Percentage</th>
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<td>Increase level of automation for processes in general</td>
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</tr>
<tr>
<td>Increase level of automation for internal controls</td>
<td>58</td>
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<tr>
<td>Prioritise controls based on risk assessments</td>
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<tr>
<td>Reduce redundancies</td>
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</tr>
<tr>
<td>Realign segregation of duties</td>
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What improvements, if any, have resulted from these attempts? Increase level of automation for processes in general

(%) respondents

<table>
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<th>Improvement</th>
<th>Much higher</th>
<th>Higher</th>
<th>No change</th>
<th>Lower</th>
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What improvements, if any, have resulted from these attempts? Increase level of automation for internal controls

(%) respondents

<table>
<thead>
<tr>
<th>Improvement</th>
<th>Much higher</th>
<th>Higher</th>
<th>No change</th>
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<td>15</td>
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<td>28</td>
<td>44</td>
<td>18</td>
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What improvements, if any, have resulted from these attempts? Reduce redundancies

(%) respondents

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<td>3</td>
<td>41</td>
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</tbody>
</table>
Appendix

Survey results

Strengthening governance, risk and compliance in the banking industry

Economist Intelligence Unit 2009

What improvements, if any, have resulted from these attempts? Realign segregation of duties
(% respondents)

<table>
<thead>
<tr>
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<th>Higher</th>
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<td>12</td>
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<td>20</td>
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<td>Number of poor-quality decisions</td>
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<td>16</td>
<td></td>
<td>64</td>
<td>4</td>
<td></td>
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</tbody>
</table>

What improvements, if any, have resulted from these attempts? Prioritise controls based on risk assessments
(% respondents)

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<th>Much higher</th>
<th>Higher</th>
<th>No change</th>
<th>Lower</th>
<th>Much lower</th>
<th>Don't know</th>
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<td>Time required</td>
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<tr>
<td>Control errors</td>
<td>3</td>
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<td>26</td>
<td>49</td>
<td>6</td>
<td></td>
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<tr>
<td>Audit costs</td>
<td>3</td>
<td>16</td>
<td>40</td>
<td>26</td>
<td>6</td>
<td>11</td>
</tr>
<tr>
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<td>11</td>
<td>23</td>
<td></td>
<td>51</td>
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</table>

Does your organisation regularly include risk evaluations as part of its financial processes?
(% respondents)

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>Don't know</th>
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<tbody>
<tr>
<td></td>
<td>90</td>
<td>6</td>
<td>4</td>
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What are the results of these risk evaluations?
(% respondents)

<table>
<thead>
<tr>
<th></th>
<th>Much better</th>
<th>Better</th>
<th>No change</th>
<th>Worse</th>
<th>Much worse</th>
<th>Don't know</th>
</tr>
</thead>
<tbody>
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<td>Quality of decisions</td>
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<td>78</td>
<td>16</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Efficiency of processes</td>
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<td>61</td>
<td>24</td>
<td>8</td>
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<tr>
<td>Prioritisation of controls</td>
<td>6</td>
<td>69</td>
<td>18</td>
<td>2</td>
<td>4</td>
<td></td>
</tr>
</tbody>
</table>
In which country are you personally located? (% respondents)

- United States of America: 15
- United Kingdom: 14
- Canada: 5
- Singapore: 5
- Belgium: 3
- Finland: 3
- Hong Kong: 3
- Japan: 3
- Malaysia: 3
- Netherlands: 3
- Pakistan: 3
- Spain: 3
- Switzerland: 3
- Turkey: 3
- Austria: 2
- Bahrain: 2
- Brazil: 2
- Cambodia: 2
- Greece: 2
- Hungary: 2
- Ireland: 2
- Italy: 2
- Kazakhstan: 2
- Latvia: 2
- Luxembourg: 2
- Malta: 2
- Mexico: 2
- New Zealand: 2
- Poland: 2
- Puerto Rico: 2
- South Africa: 2
- United Arab Emirates: 2
- United States Virgin Islands: 2
- Zambia: 2

In which region are you personally based? (% respondents)

- Western Europe: 46
- North America: 20
- Asia-Pacific: 18
- Middle East and Africa: 9
- Latin America: 6
- Eastern Europe: 0

What is your primary industry? (% respondents)

- Financial services: 100

What are your organisation’s global annual revenues in US dollars? (% respondents)

- $500m or less: 19
- $500m to $1bn: 13
- $1bn to $5bn: 12
- $5bn to $10bn: 13
- $10bn or more: 43

In which sub-sector of financial services does your organisation belong? (% respondents)

- Banking: 100
Appendix
Survey results

Strengthening governance, risk and compliance in the banking industry

Which of the following best describes your job title?

(\% respondents)

<table>
<thead>
<tr>
<th>Job Title</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board member</td>
<td>0</td>
</tr>
<tr>
<td>CEO/President/Managing director</td>
<td>8</td>
</tr>
<tr>
<td>CFO/Treasurer/Comptroller</td>
<td>11</td>
</tr>
<tr>
<td>CIO/Technology director</td>
<td>0</td>
</tr>
<tr>
<td>Other C-level executive</td>
<td>3</td>
</tr>
<tr>
<td>SVP/VP/Director</td>
<td>37</td>
</tr>
<tr>
<td>Head of Business Unit</td>
<td>6</td>
</tr>
<tr>
<td>Head of Department</td>
<td>10</td>
</tr>
<tr>
<td>Manager</td>
<td>21</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
</tr>
</tbody>
</table>

What are your main functional roles?

Please choose no more than three functions.

(\% respondents)

<table>
<thead>
<tr>
<th>Function</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
<td>59</td>
</tr>
<tr>
<td>Risk</td>
<td>42</td>
</tr>
<tr>
<td>General management</td>
<td>18</td>
</tr>
<tr>
<td>IT</td>
<td>18</td>
</tr>
<tr>
<td>Strategy and business development</td>
<td>18</td>
</tr>
<tr>
<td>Marketing and sales</td>
<td>18</td>
</tr>
<tr>
<td>Operations and production</td>
<td>17</td>
</tr>
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<td>Customer service</td>
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<td>Information and research</td>
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<td>Supply-chain management</td>
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<td>R&amp;D</td>
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