Ninth annual EY/IIF global bank risk management survey

Accelerating digital transformation

Key risk oversight issues for bank boards

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Contents

The ninth annual EY/Institute of International Finance (IIF) global bank risk management survey, *Accelerating digital transformation*, examines how banks are faring in their 15-year post-crisis transformation journey.[1] The report highlights some key areas of focus for bank boards and their risk committees.[2]

Bank directors worked tirelessly over the past decade to strengthen risk management. They challenged chief risk officers (CROs) to implement strong risk frameworks and controls, and first-line business leaders to be more accountable for the risks they create. They sought assurance from internal audit that risk frameworks meet evolving supervisory expectations and keep pace with industry practices.

The board-level risk management dialogue with management is now changing. As banks move from rationalizing their organizational structures and processes, they are now seeking to reinvent themselves. As this year's survey shows, this is happening faster than expected, reflecting the increasing pace of digital transformation in the financial services industry and beyond. The fact that this transformation is taking place within the context of broader global changes makes the challenges of board risk oversight that much harder. Surveyed banks point to major shifts in geopolitics, macroeconomics and social issues.

Accelerating digital transformation sets out four imperatives that boards, senior management and CROs will have to address to successfully achieve their digital transformation ambitions:[3]

1. Adapting to a risk environment and risk profile that is changing faster and more intensively than ever
2. Leveraging risk management to enable business transformation and sustained growth
3. Delivering risk management effectively and efficiently
4. Managing through and recovering from disruptions

Boards will play an important role in challenging management to address these imperatives over the next decade.

[1] The survey includes 74 banks from 29 countries.

[2] For the remainder of this report, "board" will be used to mean either the board or the risk committee, depending on how a bank's governance process operates.

[3] Moving from analog to digital: a new paradigm for risk management, www.ey.com/risktransformation, 2018.

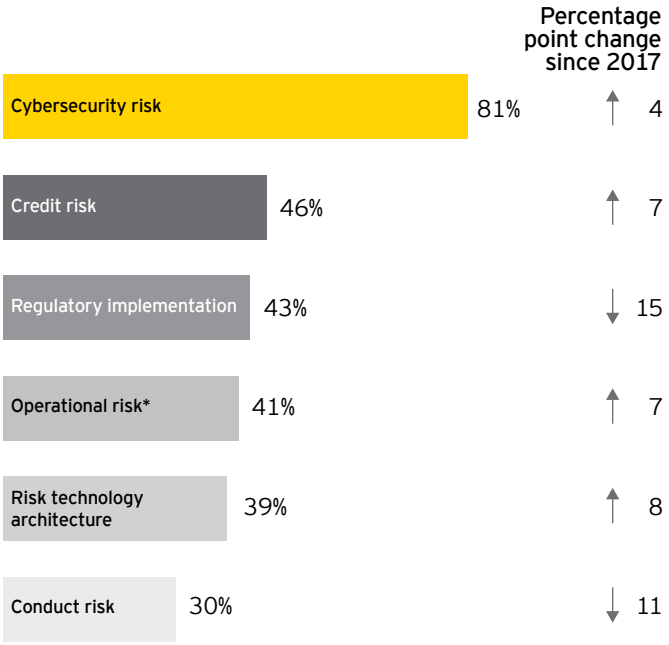
1 Adapting to a risk environment and risk profile that is changing faster and more intensively than ever

While near-term risks tend to change on yearly basis, two key trends have endured over recent years:

- Cybersecurity continues to accelerate to the top of board and CRO agendas.
- Implementation of new regulations or supervisory expectations remains important but continues to move down the agenda.

However, while the pace of new regulation has slowed, regulatory matters remain important for banks globally with the IBOR transition,[4] Basel III agenda and Brexit developments – in addition to finalizing the implementation of the post-crisis reform agenda. Each of these presents challenges for boards.

Figure 1: CRO risk priorities over next 12 months



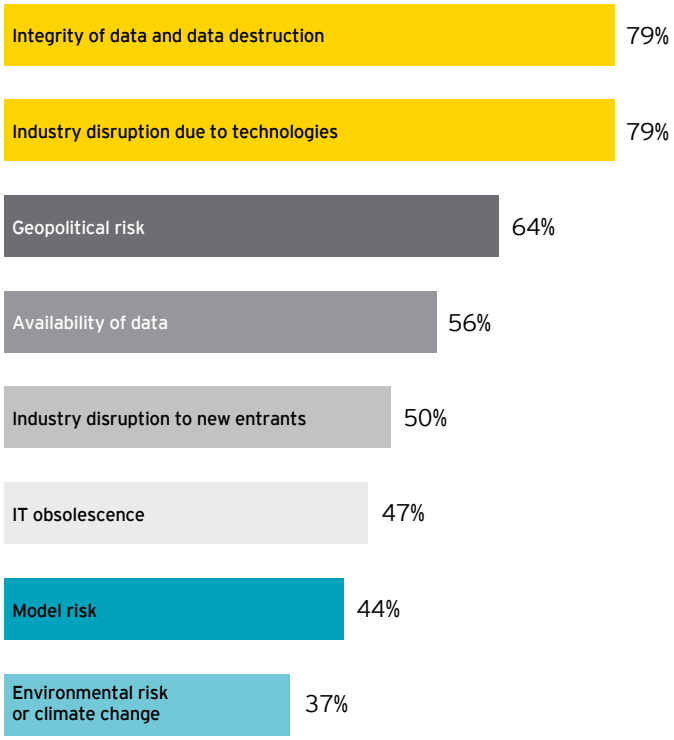
* Excluding cybersecurity

Act proactively to spot risks and opportunities

Data risk – notably data destruction and availability – has emerged as a significant risk for the next five years, as has disruption from new technologies and entrants. The impact of macroeconomic conditions influenced by the political and external environment on bank economics also necessitates an active role by risk management. Boards should ask management how they view and manage these, and how banks' strategies, operating models, and products and services need to evolve.

[4] IBOR transition: a certainty not a choice, https://www.ey.com/Publication/vwLUAssets/ey-ibor-transition-a-certainty-not-a-choice/$File/ey-ibor-transition-a-certainty-not-a-choice.pdf, 2018.

Figure 2: CRO view of emerging risks over the next five years



Be future-ready

Boards need to challenge bank management to consider longer-term global trends, even if they appear many years away. For investments with a horizon of 20 to 30 years, risk management needs to partner with the business to support long-term sustainability and identify and plan to mitigate potential risks from the impact on customer demand for financial services products and services from a range of long-term global shifts. These include the impact of climate change; sensor technology and the connected Internet of Things; urbanization, population growth and mass migration; and broad-scale use of artificial intelligence and virtual reality.

Innovate with non-financial risk metrics

Boards often feel that risk reporting is too detailed or too long and not sufficiently forward-looking. Accordingly, they remain very much focused on the need for enhanced reporting. Banks continue to adapt how they measure and manage non-financial risks, but implementing insight-rich and forward-looking indicators is difficult, particularly for risks such as cybersecurity, reputational, third-party and conduct.

2 Leveraging risk management to enable business transformation and sustained growth

As the financial services industry undergoes a massive transformation, focusing on downside risk alone will be a risk for risk management. Boards need to help CROs and the risk team balance their roles and focus on capturing opportunities in a risk-informed manner, as much as helping avoid undesirable risks.

As a CRO succinctly put it, when describing the broader role for risk management professionals: "The business is now saying, 'Don't tell us why we can't; tell us how to do it.'" Boards should quickly and increasingly encourage risk management to play a critical role in the bank's growth and digital strategy, in addition to helping manage risks.

Areas where boards can push risk management to take the lead in driving the bank's long-term strategy and sustainable growth include linking strategy with risk appetite; identifying forward-looking, emerging risks; assessing strategy and business model viability; and influencing risk culture and behaviors.

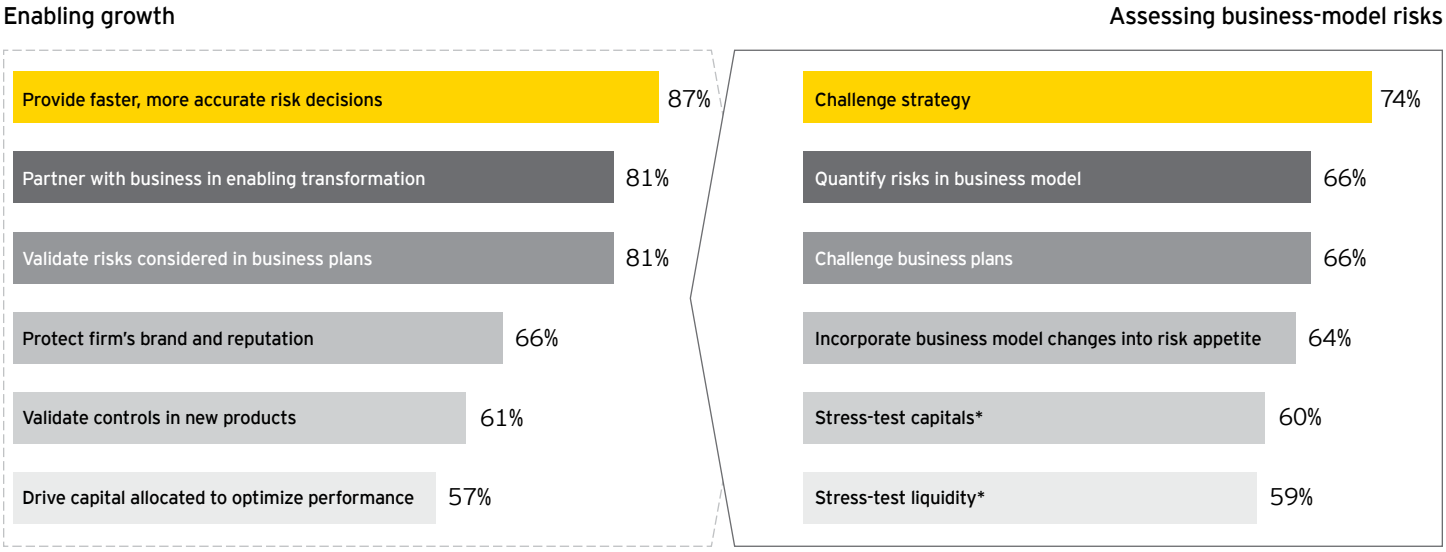
Embed risk management with technology

While banks are deploying new technologies to achieve an industry-average of 11%-15% return-on-equity targets over a three-year period, a corresponding set of new transformation-related risks is emerging that requires unique metrics and mitigation strategies. Boards should seek to understand how risk management groups are aligned with and influencing the IT and digital strategy, and make sure business-line and technology management consider the interconnections between the fast-changing digital world and the regulatory landscape.

Another upside risk that risk management professionals should increasingly embrace is the agile-development approaches[5] that banks are adopting to develop products and technology. Boards need to validate that such fast-paced development approaches are tightly linked with the bank's risk management strategy, and vice versa. Thus far, the involvement of risk management in agile development has been slow — more than two in five (42%) banks acknowledge that involvement remains inconsistent.

[5] Agile development is a set of principles on which to base software development and employs a highly disciplined, collaborative, cross-functional approach. Thus far, the main focus of financial institutions has been using this approach well beyond the domain of software development to better meet consumer demands, but increasingly it is being seen as a means to reduce risk and respond to rapidly changing external forces.

Figure 3: Risk management's role in enabling growth and assessing business-model risks



* In the context of business-model viability

3 Delivering risk management effectively and efficiently

Banks have focused on effectiveness to strengthen risk management in the first and second lines of defense over the last 10 years. This was important for restoring trust in the financial system post-crisis, and it remains critical. Yet, it is now incumbent on risk management to drive to become not just more effective, but also more efficient by leveraging the immense potential of technology and adapting the talent strategy.

As transformational reinvention grips almost every sector, banks need to move away from their conservative approach to only using new technologies in a highly limited way to fully explore the broad range of areas where technologies will have a material impact. Partnerships with FinTech firms (including so-called RegTech firms) will need to be broader and deeper than is currently targeted.

Another critical contributor to efficiency is the deployment of data analytics for more real-time risk detection, more informed and granular risk and reward optimization, and better and more aggregated reporting across the entire organization. In terms of their risk data management priorities over the next three years, banks are focused on improving data quality (93%), automating processes (74%), and updating data lineage (i.e., data across the life cycle from origin to processing) and controls (57%).

Need for a new talent strategy

Bank boards need to determine how risk management's operating model is evolving to allow for the use of more technologies and data analytics. They also need to ask how the talent strategy is changing. Banks continue to add new specialist talent in second-line risk management, especially in areas linked to technology and cybersecurity, and third parties.[6] Banks increasingly recognize that if they don't adapt their talent strategy quickly, efforts to adopt new technologies and data analytics will stall.

[6] Cyber risk management across the lines of defense, https://www.ey.com/us/en/industries/financial-services/banking---capital-markets/ey-cyber-risk-management-across-the-lines-of-defense, 2017.

Figure 4: Banks identified a range of areas where new technologies will have a material impact:

4 Managing through, and recovering from, disruptions

Bank boards are well-aware that firms seem to be experiencing more frequent and impactful disruptions. Even if their institution has not experienced such disruptions in recent years, they have seen competitors experience significant cyberattacks, vendor or technology outages, or more extreme weather-related events.

Boards have seen some firms failing to manage those disruptions adequately – surveyed banks point to a range of reasons why this mismanagement likely occurred. Lack of preparedness and slow decision-making play a role, including instances where boards and management are ill-informed about their own role in crises.[7] Not surprisingly, boards are increasingly asking to be included in table-top simulations, so they can be more knowledgeable of what will be expected of them when major disruptions occur.

A new resilience operating model

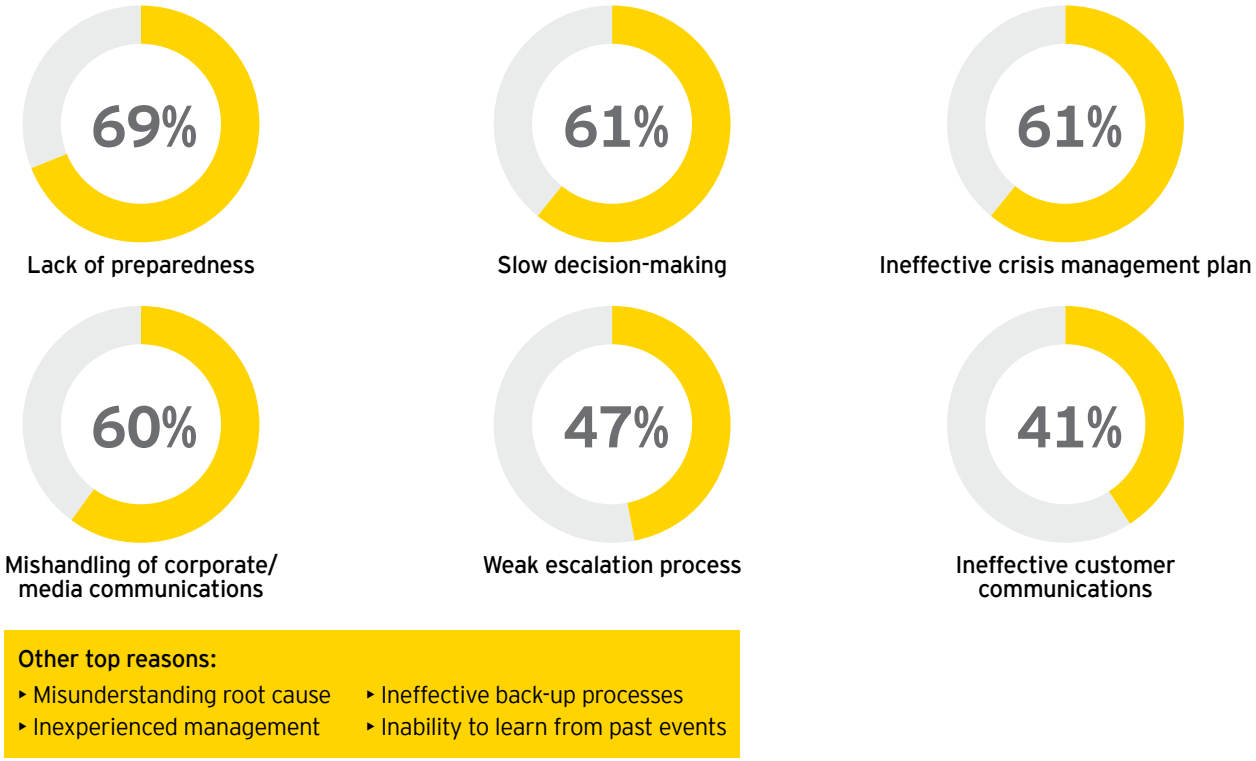
Increasingly, banks recognize that their continuity activities are disparate and unconnected. They often have countless overlapping activities across business continuity, disaster recovery, cyber incident response and crisis management. Often, myriad and overlapping crisis and contingency plans exist across lines of business, technology, human resources and other areas. Few plans are connected or consistently applied, and few have common or consistent triggers for escalation and decision-making at the senior management and board levels.

Banks are starting to address these issues directly, and boards can play an important role in supporting the multiyear effort to achieve operational resilience, much as they did over the past decade in achieving higher levels of financial resilience. Banks have started to centralize their enterprise-wide resilience activities in the first line. The role of second-line risk management is also changing to include active participation in the crisis management plan (82%), providing effective challenge of the first line's implementation of the firmwide resiliency framework (71%), and setting and monitoring enterprise-level risk appetite for resilience risk (56%) and enterprise-level resilience risk metrics (50%).[8] At the heart of these changes is stronger focus on the resilience of key services delivered to customers and the markets.

[7] Managing through crises: preparation is key, https://www.ey.com/Publication/vwLUAssets/ey-managing-through-crises/$File/ey-managing-through-crises.pdf, 2018.

[8] Getting serious about resilience: a multiyear journey ahead, https://www.ey.com/Publication/vwLUAssets/ey-getting-serious-about-resilience-a-multiyear-journey-ahead/$File/ey-getting-serious-about-resilience-a-multiyear-journey-ahead.pdf, 2018.

Figure 5: Banks cite a range of reasons why they think other firms struggled to manage through past crises:



Conclusion: transforming the digital future to address risk imperatives

Over the past decade, bank boards have overseen risk management's successful efforts to restore and protect franchises and the industry at large. They now need to help risk management shift gears to undertake a much more substantial and broader transformation. Risk management is perhaps the only part of the firm that has the remit and capabilities to properly consider how changes in the market or firm conditions impact economies, clients, customers, sectors and, most importantly, their firms. It should leverage this unique position to lead in enabling business transformation, adapting to a fast-changing risk environment, and helping the firm manage through and recover from disruptions.

Risk management must proactively engage in the digital transformation process, from strategy to implementation, and bring its expertise to drive value and earn a credible position in this industry-wide transformation. Boards need to help risk management balance their critical — and sometimes competing — roles of managing risk and supporting growth.

Questions for boards of directors

Adapting to a risk environment and risk profile that is changing faster and more intensively than ever

- What risks does risk management view as most important over the short term (next 12 months), medium term (12 to 36 months) and long term (5 to 10 years)? How often does the CRO discuss medium- and long-term risks with the board?
- What board-level deep-dives on emerging risks are needed over the next year?
- How is risk management improving its risk reporting, especially on non-financial risks?

Leveraging risk management to enable business transformation and sustained growth

- What role does the risk group play in the bank's strategy and growth plan? Does it have a seat at the table? Does risk management need to do more to validate corporate and business-line strategies and appropriately capture risks and opportunities?
- How does risk management inform the firm's IT and digital strategy? How does it monitor the degree of change within the organization and the new risks created by digital transformation?
- How is risk management adapting its operating model to get more involved in the organization's efforts to adopt agile-development principles and development?

Delivering risk management effectively and efficiently

- Does the board have a good understanding of how risk management is going to deploy new technologies? Has the board reviewed how the risk management operating model will adapt to properly leverage the potential of new technologies and FinTech partners?
- How is risk management transforming its use of data analytics?
- How will the risk management talent strategy evolve over the next five years? What new skills are most critical in that timeframe?

Managing through and recovering from disruptions

- How does the board gain a better understanding of the firm's crisis-management decision-making process? Is the board involved in the bank's table-top simulations so they are better prepared?
- How is management evolving its approach to achieving operational resilience? How does the bank make sure business-line management is fully accountable for resilience? Is second-line risk management sufficiently involved?

EY contacts

Global

Bill Schlich
EY Global Banking & Capital Markets Leader
Toronto
bill.schlich@ca.ey.com
+1 416 943 4554

Jan Bellens
EY Global Banking & Capital Markets Deputy Leader
Singapore
jan.bellens@sg.ey.com
+65 6309 6888

Dai Bedford
EY Global Banking & Capital Markets
Advisory Leader
London
dbedford@uk.ey.com
+44 20 7951 6189

Keith Pogson
EY Global Banking & Capital Markets
Assurance Leader
Hong Kong
keith.pogson@hk.ey.com
+852 28499227

Americas

Tom Campanile
Partner, Financial Services
New York
thomas.campanile@ey.com
+1 212 773 8461

Adam Girling
Principal, Financial Services
New York
adam.girling@ey.com
+1 212 773 9514

Paul Haus
Partner, Financial Services Center
for Board Matters
New York
paul.haus@ey.com
+1 212 773 2677

Gary Kozlowski
Latam Financial Services Leader
New York
gary.kozlowski@ey.com
+1 212 773 1011

Bismark Rodriguez
Partner, Financial Services Risk Management
Panamá
bismark.rodriguez@pa.ey.com
+507 208 0160

Mario Schlener
Partner, Financial Services Advisory
Toronto
mario.schlener@ca.ey.com
+1 416 932 5959

Mark Watson
Executive Director, Financial Services
Boston
mark.watson@ey.com
+1 617 305 2217

Asia-Pacific

Gary Mellody
Partner, Financial Services
Singapore
gary.mellody@sg.ey.com
+65 6309 6519

Doug Nixon
Partner, Financial Services
Sydney
douglas.nixon@au.ey.com
+61 2 9276 9484

Sameer Rege
Partner, Financial Services
Hong Kong
sameer.rege@hk.ey.com
+852 28499458

David Scott
Partner, Financial Services
Hong Kong
david.scott@hk.ey.com
+852 26293070

Yoshio Wagoya
Partner, Financial Services Advisory
Tokyo
yoshio.wagoya@jp.ey.com
+81 3 3503 1110

EMEIA
(Europe, Middle East, India, Africa)

Frank de Jonghe
Partner, Financial Services
Brussels
frank.de.jonghe@be.ey.com
+32 2 774 9956

John Liver
Partner, Financial Services
London
jliver1@uk.ey.com
+44 20 7951 0843

Ivica Stankovic
Partner, MENA Financial Services
Kuwait
ivica.S@kw.ey.com
+965 22955000

Abigail Viljoen
Partner, Financial Services Africa
Sandton
abigail.viljoen@za.ey.com
+27 72 566 3555

Max Weber
Partner, Financial Services Risk
Stuttgart
max.weber@de.ey.com
+49 711 9881 15494

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EYG no. 012265-18Gbl
1811-2943309
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The Institute of International Finance (IIF)
1333 H St NW, Suite 800E
Washington, DC 20005-4770
USA

Tel: +1 202 857 3600
Fax: +1 202 775 1430

www.iif.com
info@iif.com