

OLIVER WYMAN



Indian Banks' Association

Finsight Events

The banking events division of **SP MEDIA**

Financial Services

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Risk Appetite Embedding for value creation

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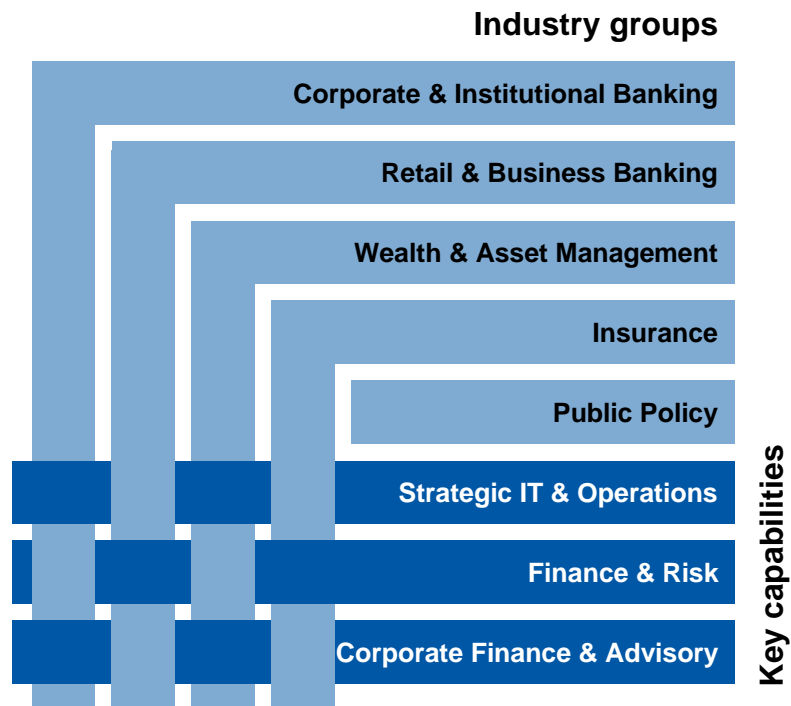
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Section 1

Introduction to Oliver Wyman

Who are Oliver Wyman Financial Services?

Oliver Wyman Financial Services key practices



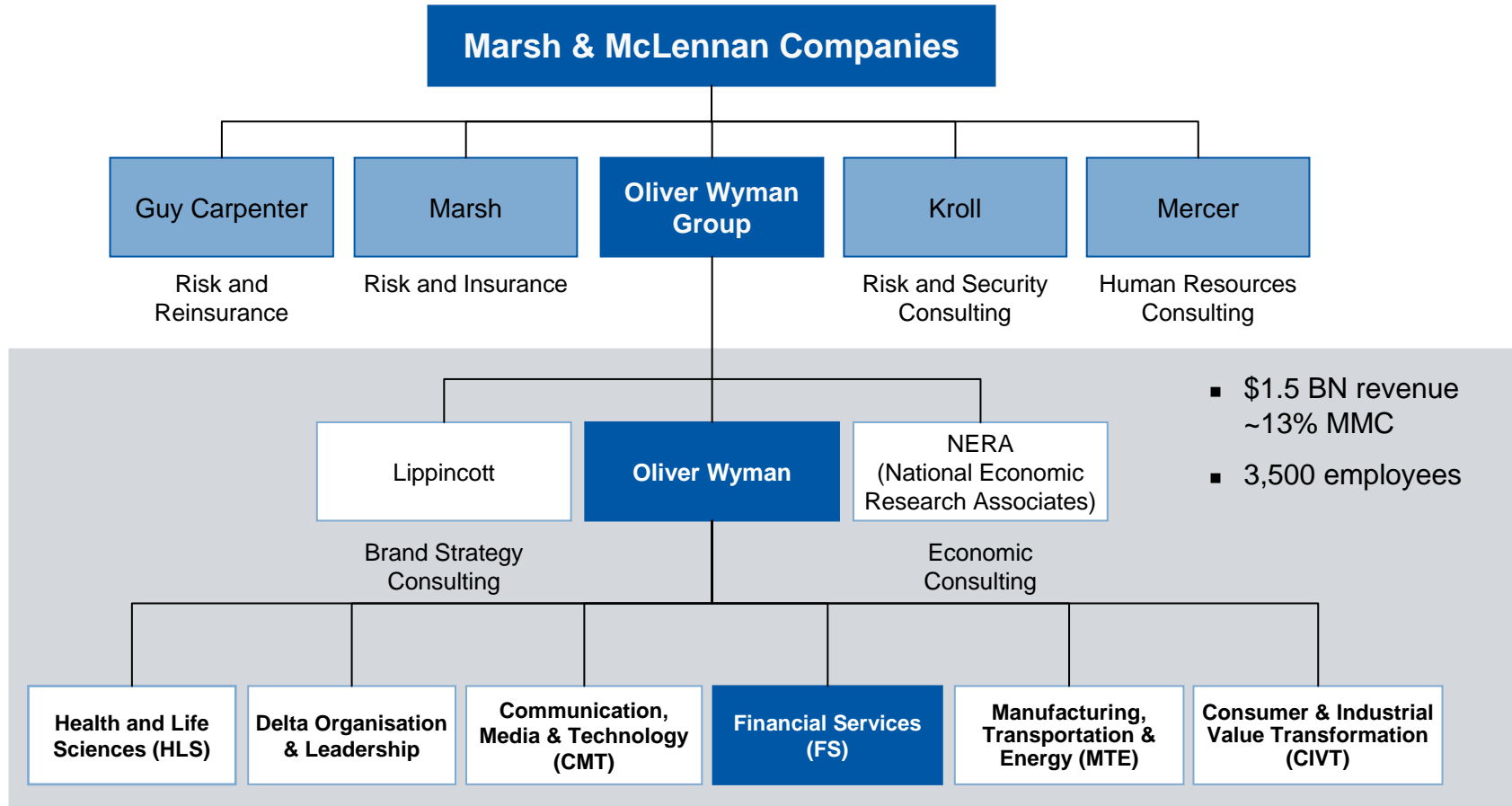
Leading strategy consulting firm dedicated to financial services strategy and risk management

- Dedicated and specialised practices within financial services
- Work with global leaders including the majority of top 150 financial services firms
- Much of our work is to improve performance

Our approach is content-led, based on technical expertise guided by industry knowledge

- Deep analytical and technical expertise – heritage of the firm to produce new insights
- Industry knowledge – reinforced by financial services focus and global operating model
- Impact – experience and processes to get things done in complex organisations

Oliver Wyman is a member the Marsh & McLennan group of professional services companies



Marsh & McLennan is a leading global provider of financial services with revenues of \$12 BN and over 55,000 employees

Section 2

Risk Appetite: the business case

Risk is central to the business of any bank; Risk Appetite provides the anchor for risk, strategy and finance

Aligning risk, finance and strategy: “Risk Appetite”



Key principles

- Having considered a range of plausible downside scenarios, boards need to
 - Approve strategy
 - Determine growth targets
 - Set limits on various dimensions
 - Commit capital
 - Regularly monitor risk against limits
- Management must establish actionable mechanisms for ensuring that day to day decisions are aligned to group strategy/limits
- Performance measurement is critical to strategy implementation; risk and return on risk need to be core elements and explicitly factor into incentive/compensation schemes

Globally, Risk Appetite and Tolerance have risen in prominence as a result of the weaknesses revealed by the financial crisis

Maas Committee

*“The Supervisory Board should approve, and where necessary adjust, the bank’s **Risk Appetite** at least once a year. The Supervisory Board should regularly discuss the bank’s actual risk profile.” (1.24)*

*“The Risk Committee of the Supervisory Board should prepare the decision-making and discussions in the Supervisory Board about the bank’s **Risk Appetite** and actual risk profile.” (1.25)*

...

Walker Report

*“..board-level engagement in the high-level risk process should be materially increased with particular attention to the monitoring of risk and discussion leading to decisions on the entity’s **Risk Appetite and tolerance**“ (P 9)*

*“In preparing advice to the board on its overall **Risk Appetite and tolerance**, the board risk committee should take account of the current and prospective macro-economic and financial environment” (P 15)*

Industry view

- Pressure from many stakeholders to upgrade Risk Tolerance framework:
 - Crisis responses (Maas, Walker, Turner...)
 - Internal/external auditors
 - Regulators
 - Investors and analysts
- Risk Tolerance accepted as **the** bedrock of Risk Management
- Most institutions already have implicit/explicit Risk Tolerances...
- ...however the crisis has demonstrated weaknesses
 - Limited integration of “Business vs. Risk” and “return vs. risk”
 - Lack of control or visibility over Tolerance, and “surprise” at crisis impact

A key lesson of the recent crisis is that outperforming banks were those whose executives could clearly transmit their risk appetite to risk takers and managers

(RMA/OW Risk Appetite Survey)

RBI has set out requirements for Risk Appetite within the context of ICAAP, placing clear responsibility on bank directors

“The ultimate responsibility for designing and implementation of the ICAAP lies with the bank’s board of directors ... The structure, design and contents of a bank’s ICAAP should be approved by the board of directors to ensure that the ICAAP forms an integral part of the management process and decision making culture of the bank.”

– RBI Master Circular, para. 11.3.3

“[Banks must provide] a clear articulation of the bank’s [board-approved] Risk Appetite, in quantitative terms, by risk category and the extent of its consistency (its “fit”) with the overall assessment of bank’s various risks

Stress tests undertaken on a bank-wide basis enable the Board and senior management ... to develop or choose appropriate strategies for mitigating and managing the impact of those situations”

– RBI

Requirements for Boards

- a) Set the tolerance level for risk
- b) Ensure that the senior management of the bank
 - i. Establishes a risk framework in order to assess and appropriately manage the various risk exposures of the bank
 - ii. Develops a system to monitor the bank’s risk exposures and to relate them to the bank’s capital and reserve funds
 - iii. Establishes a method to monitor the bank’s compliance with internal policies, particularly in regard to risk management
 - iv. Effectively communicates all relevant policies and procedures throughout the bank
- c) Adopt and support strong internal controls
- d) Ensure that the bank has appropriate written policies and procedures in place
- e) Ensure that the bank has an appropriate strategic plan in place, which, as a minimum, shall duly outline
 - f) The bank’s current and future capital needs
 - g) The bank’s anticipated capital expenditure
 - h) The bank’s desired level of capital

Master Circular – Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework (NCAF) 11.3.3

Done right, risk appetite can support transformation of the culture of the bank

Risk becomes an integral and high profile part in key business decisions and performance management

- Embedded in portfolio management and annual planning/budgeting
- Performance management that explicitly recognises risk and allows “apples-to-apples” comparison across businesses
- Risk accountability permeates risk *and* business functions
- More consistent allocation of resources (capital and liquidity)

Enable senior management to effectively discuss key risks

- Actionable “Risk Dashboard” highlighting risk positions *vis-à-vis* tolerances
- Mechanisms for escalating discussion of emerging risks
- ‘Tangible’ metrics -- Board can make real risk-related decisions concerning appetite for “once in a career” type definitions of key risks rather than 1 in 2,000

Explicitly linkage of external and internal views of risk

- Ensuring no disconnect and thereby facilitating confident external communication (analysts, regulators, rating agencies)

Pragmatic risk oversight over business unit initiatives

- Group confident that overall risk profile is appropriate and monitored

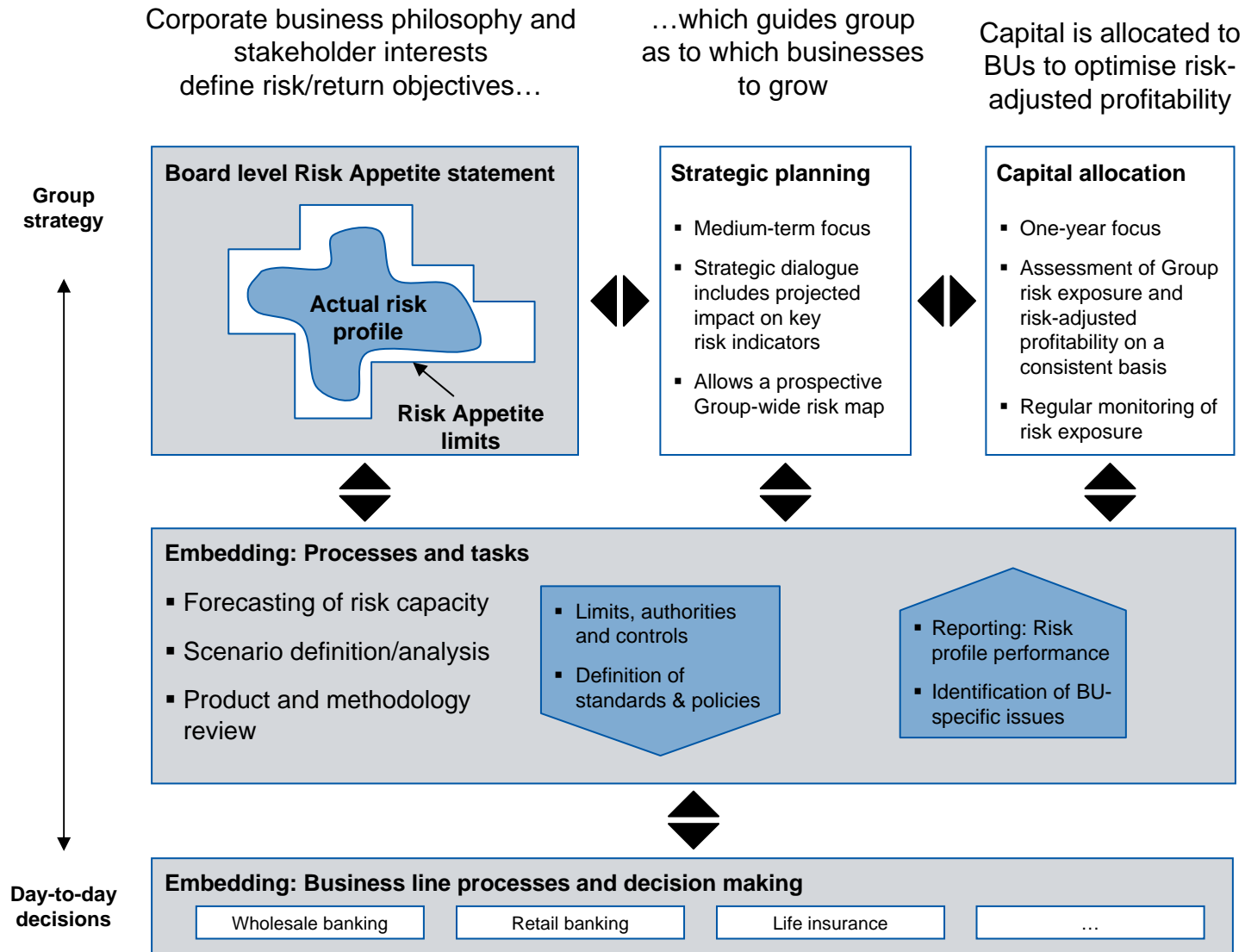
Enforcing risk discipline at senior management level

- Clear articulation of risks considered “on strategy” and “off strategy”
- Clear articulation of acceptable levels of risk (through their impact)

Section 3

Embedding Risk Appetite

Key elements of a best practice Risk Appetite Framework



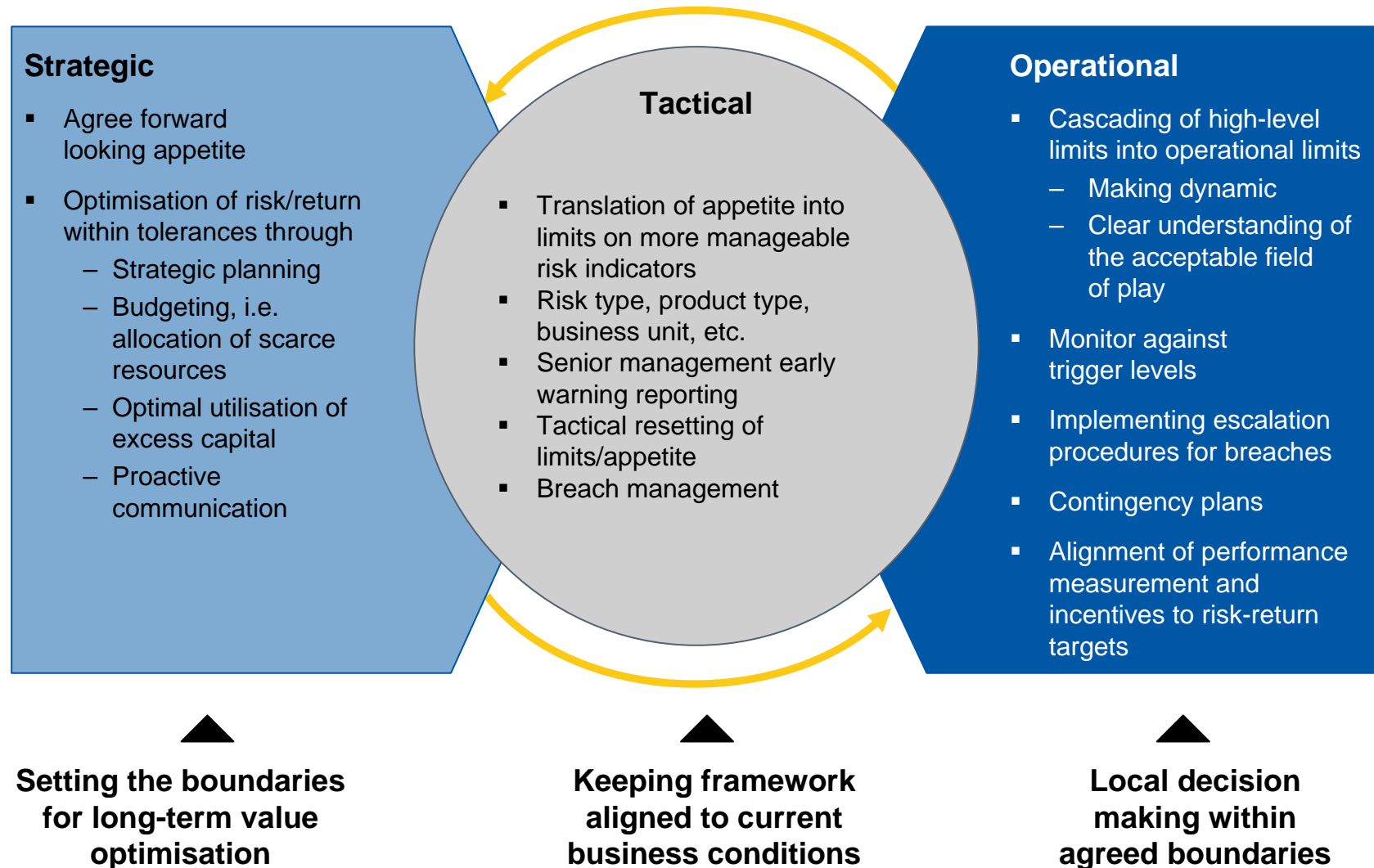
The Risk Appetite statement should be clearly defined and link to potential management actions that can impact risk profile

Client example

Disguised client example Risk Appetite statement

	Metric	Illustrative definition	Management options	Key stakeholder
Quantitative	Target debt rating	<ul style="list-style-type: none"> We target a Moody's rating of "XXX" on our senior debt, at all times staying above "YYY" 	<ul style="list-style-type: none"> Granular measurement of Economic Capital Monitoring key metrics (e.g. AFR, liquidity, etc.) 	<ul style="list-style-type: none"> Debtholders Rating agencies
	Earnings volatility	<ul style="list-style-type: none"> We will not miss consensus earnings forecast by more than "X"% at a "YY"% confidence level We will aim to consistently target dividend of "XXX" 	<ul style="list-style-type: none"> Quantitative stress testing of business plans 	<ul style="list-style-type: none"> Shareholders
	Maximum loss	<ul style="list-style-type: none"> We do not wish to see a loss of more than "XXX" at the "YY"% confidence interval 	<ul style="list-style-type: none"> Bottom up risk measurement 	<ul style="list-style-type: none"> Management
	Liquidity headroom	<ul style="list-style-type: none"> Available liquidity resources to meet requirements at "XX"% confidence interval 	<ul style="list-style-type: none"> Liquidity model to measure and forecast requirements 	<ul style="list-style-type: none"> Regulator Shareholders Debtholders
Qualitative	Reputation	<ul style="list-style-type: none"> Ensure that the highest ethical standards are followed at all times 	<ul style="list-style-type: none"> Ethical policy written to be followed by all staff all the time 	<ul style="list-style-type: none"> Customers Regulator
	Regulation	<ul style="list-style-type: none"> Have no significant instances of regulatory breach 	<ul style="list-style-type: none"> Compliance department 	<ul style="list-style-type: none"> Regulator Shareholders
	Governance	<ul style="list-style-type: none"> Ensure appropriate policies and processes are followed at all times 	<ul style="list-style-type: none"> Internal/external audit 	<ul style="list-style-type: none"> Regulator Shareholders
	Growth	<ul style="list-style-type: none"> All new business opportunities to follow appropriate risk controls 	<ul style="list-style-type: none"> Strategic Planning Process Avoid portfolio concentrations 	<ul style="list-style-type: none"> Shareholders

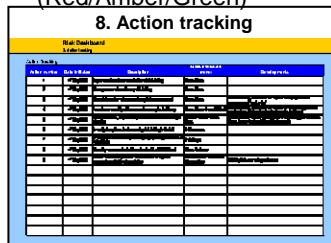
Embedding needs to consider three core dimensions – strategic, tactical and operational



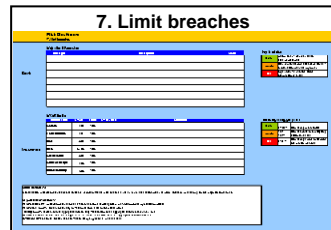
Reporting: Risk dashboard example

Client example

- Core metrics (Earnings at Risk, Capital at Risk)
- Indication of status relative to threshold value (Red/Amber/Green)

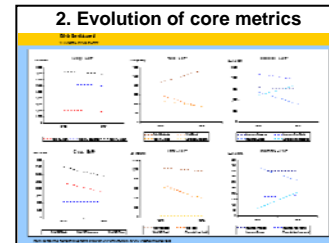
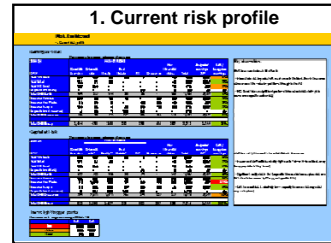


- Action tracking summary
- Identifies developments from one report to the next

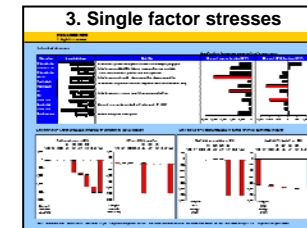


- Breaches of major limits
- Enables all board members to track mitigating actions

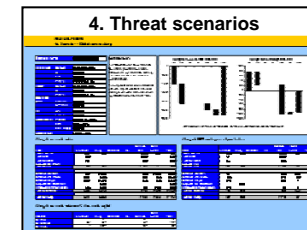
- Concentrations at name, sector and country level
- Includes both credit and equity exposure



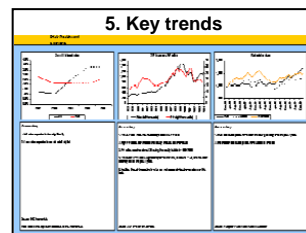
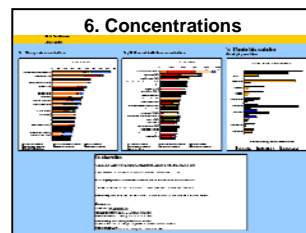
- Evolution of EaR and CaR for bank



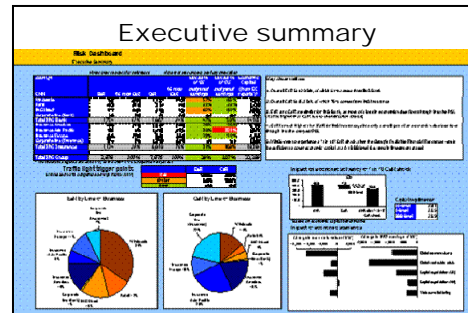
- Impact of single risk drivers (e.g. interest rate drop, fall in equity returns)



- Impact of realistic threat scenarios impacting multiple risk drivers



- Evolution of key risk drivers over time
- Economics Bureau forecast of likely trajectory and link to threat scenarios

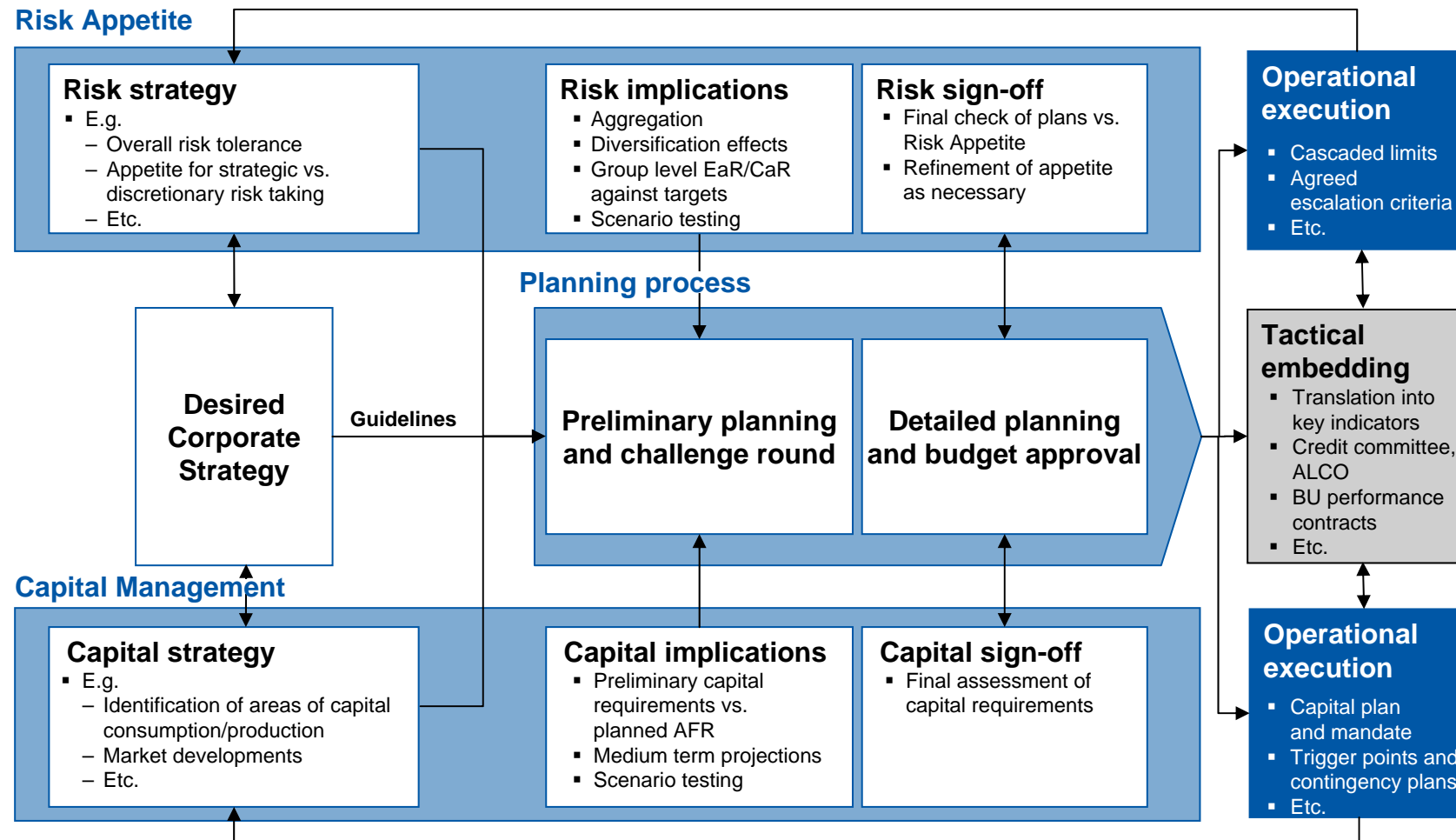


- Executive summary of key information
- Links to other sections of Dashboard where more detail is presented

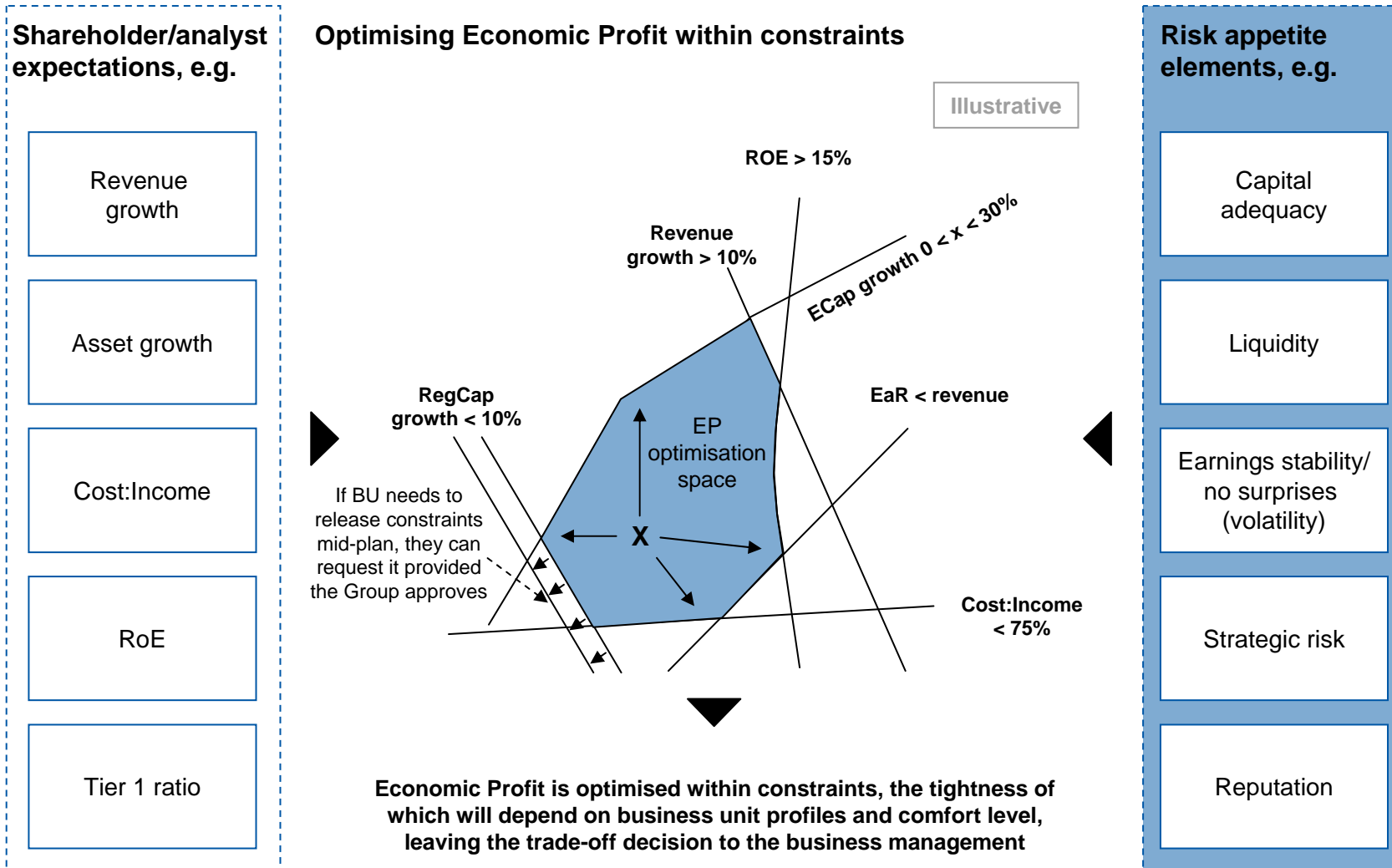
Leading banks have established integrated processes for Risk Appetite, capital and strategic planning

Client example

Risk and capital management interaction with annual planning process



In the strategic planning process, various risk appetite elements present constraints *vis-à-vis* general performance expectations



Benefits of introducing a risk-aligned strategic planning process

Typical issues in strategic planning

- **Lack of integration** between (qualitative) strategy and (quantitative) planning process and hence lack of early consideration of Risk Appetite
- Insufficient explicit focus on Economic Profit, RAROC or other **risk-adjusted measures**
- The **level of analytical support is insufficient** to facilitate fact-based consideration of alternative value-based strategies at either the BU or Group level
- The **prioritisation** of competing initiatives is **not supported by an objective analytical process**
- There is **insufficient linkage between strategy, risk and finance** within the Group and BUs



Benefits of risk-aligned strategic planning

- **Better process encouraging a richer strategic debate**
 - Integration of bottom-up plans and top-down targets/opportunities
 - Integration of stress-testing and valuation
 - Full Incorporation of capital and risk strategy
 - Tighter linkage between strategy and planning
 - Open challenge and debate
- **Deeper understanding of what generates value and what does not**
 - Identification of key value drivers
 - Comparison of relative value contribution of businesses
 - Ability to assess the value impact of strategies
- **Deeper understanding of the market economics**
 - Estimation of market size (profit pools)
 - Benchmarking of current market position
 - Analysis of trade-offs between strategic variables (e.g. margins vs. growth)

Section 4

Parting thoughts

Risk Appetite should promote a new perspective on risk culture

Insights from RMA-OW Risk Appetite survey

- For Risk Appetite framework to be impactful, it needs to be able to enable a broader transition towards a “risk culture” across the organisation
- A transition from a corporate/business view of risk as a compliance function to a view of risk as a key driver of strategy and decision-making
- Increased external pressures on risk management
 - High profile failures of risk management causing greater attention to be paid to riskiness of activities
- Need for risk thinking to be key component of business activities
 - First level of risk management comes from the business itself
 - Every employee must view world through a risk lens
- Transition from reactive approach (risk identification, measurement, compliance) to proactive approach (limit setting, measurement, remediation, strategy updates)

“You can’t measure everything, so in some ways [culture]’s more powerful than just the metrics. At the end of the day, you have thousands of people making big and little decisions, and the culture is holding it together.”

- RMA/OW Risk Appetite survey participant

Going beyond compliance, the goal should be to make explicit an appropriate level and nature of risk the institution is prepared to accept in pursuit of its desired strategy

- **Build confidence (internal and external)**
 - Clear “field of play” for operations
 - Comprehensive and robust basis for external communication
- **Force explicit consideration of the risk implications of strategy choices, and vice versa**
 - Provoke dialogue: “how much is too much?”
- **Raise internal awareness of potential issues**
 - “Plain English” description of risk management
 - Facilitate debate on potential future risks
- **Pre-position for future events**
 - De-risking to bring reality in line with expectations
 - Early warning measures feeding up to senior management
- **Build mechanisms for implementation**
 - Develop risk management “levers”
- **Leverage significant compliance investments**



- Don't be taken by surprise...
- ...and don't take stakeholders by surprise
- Don't allow “separation from the herd”
- Prevent inaccurate external rumours



Lessons for Indian banks

- Banks have invested heavily in IT and MIS to support Basel II Pillar 1 implementation
- While much technical work towards advanced approaches, Pillar 2 and “Basel III” remain, the larger challenge going forward will be the transformation of Culture and Governance
- Risk Appetite is a vehicle, but not a ‘solution’ for promoting this change
- Implementation should be proactively bank-driven
 1. Engagement of Board in expression of risk aspirations
 2. Assess existing capabilities
 3. Build/align mechanisms for embedding into business processes
 4. Integrate Risk Appetite into

Appendix

About Oliver Wyman

Oliver Wyman FS has an exceptional client list in matured and emerging markets

Oliver Wyman – Client examples



American banks	European banks	Asian/Australian banks	Emerging markets	Private Equity	Central Banks/ NGOs
<ul style="list-style-type: none"> ▪ Citi ▪ Bank of America ▪ Goldman Sachs ▪ JP Morgan ▪ Wells Fargo ▪ WaMu ▪ Morgan Stanley 	<ul style="list-style-type: none"> ▪ Barclays ▪ BBVA ▪ BNP Paribas ▪ Credit Suisse ▪ Deutsche Bank ▪ HSBC ▪ RBS ▪ UBS ▪ Unicredit 	<ul style="list-style-type: none"> ▪ ANZ ▪ CBA ▪ DBS ▪ HSBC ▪ OCBC ▪ NAB ▪ Standard Chartered ▪ SunCorp 	<ul style="list-style-type: none"> ▪ Banco Real ▪ Bangkok Bank ▪ Bank of Moscow ▪ ChinaTrust ▪ Garanti ▪ ICICI ▪ Uralsib ▪ Nedbank ▪ Standard Bank ▪ ABSA ▪ Diamond 	<ul style="list-style-type: none"> ▪ Actis ▪ Advent ▪ Apax ▪ Blackstone ▪ Cerberus ▪ KKR 	<ul style="list-style-type: none"> ▪ World Bank ▪ IMF ▪ MAS ▪ FDIC ▪ Dutch Regulatory Authority ▪ Gates Foundation

Source: Oliver Wyman

Oliver Wyman FS is recognised as one of the foremost thought leaders in research in the Financial Sector

“Payback time for Basel II”



“Operational Risk Management : The State of the Discipline”

“The Evolution of Financial Services”

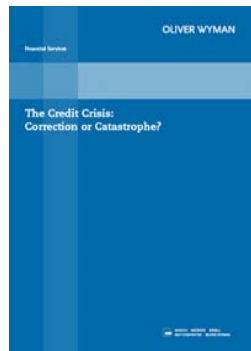


“World Economic Forum 2009: The Future of the Global Financial System: A Near-Term Outlook and Long-Term Scenarios”



“Finance & Risk Management Commentary – Issue 4”

“State of the Financial Industry - 2009”



“The Credit Crisis: Correction or Catastrophe?”

“What We Know, Don't Know and Can't Know about Bank Risk (Joint with Wharton and FED)”



“India Financial Services: Good Long-term Potential but Structural Weaknesses Need to Be Addressed”

Oliver Wyman has a strong network which provides access to global experts

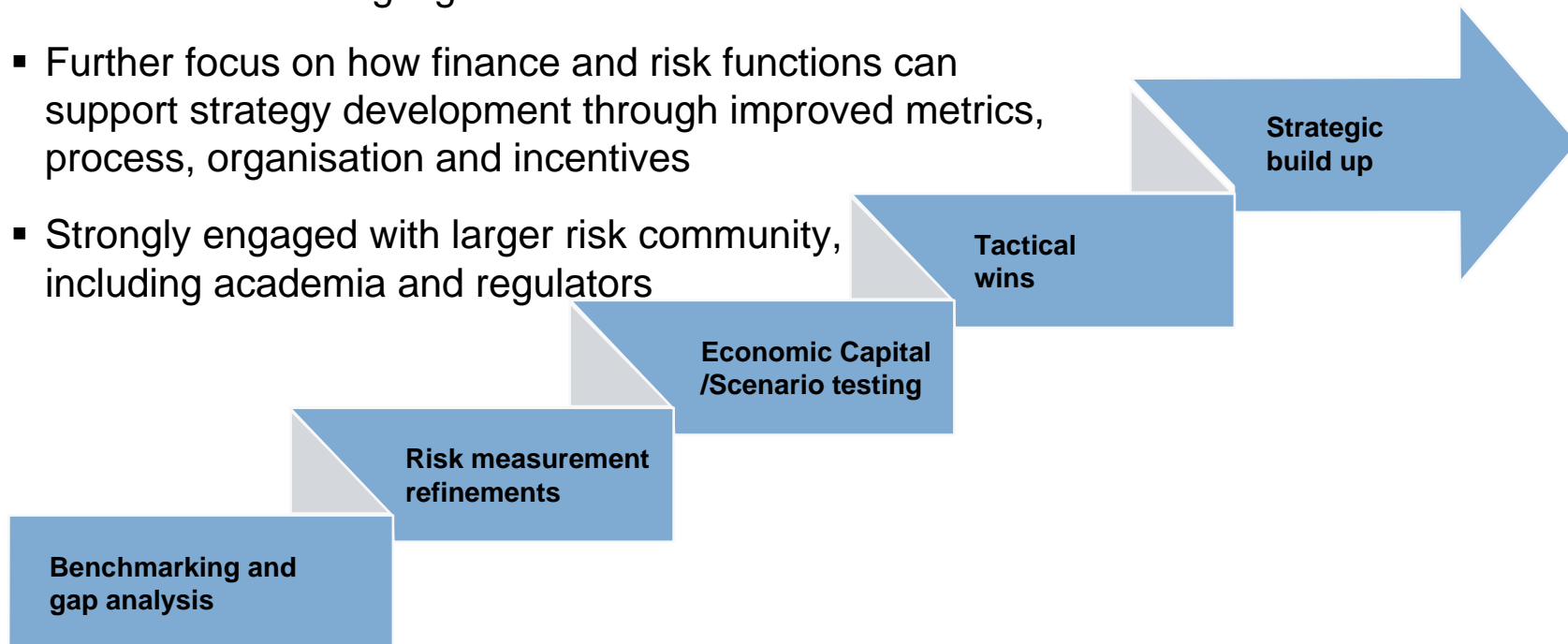
We have over 35 years of experience serving Global 1,000 clients

40+ offices worldwide



Finance & Risk (Risk Management) is our largest practice area, focusing on key issues on CRO and CFO agendas

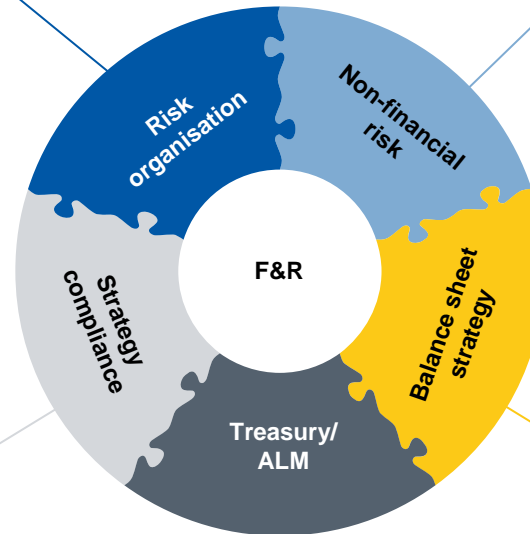
- Largest practice area within Oliver Wyman
- Client base includes more than 75 of the global top 100 financial institutions
- Widely regarded as the pre-eminent risk management practice in the industry
- Pioneered integrated risk and performance measurement and management frameworks that highlight the true economics of activities
- Further focus on how finance and risk functions can support strategy development through improved metrics, process, organisation and incentives
- Strongly engaged with larger risk community, including academia and regulators



Case Study summaries

Finance and Risk

- Carried out a risk function cost effectiveness review and process improvement for a European universal bank
- Conducted an 18 month program to develop full operational risk management capability and help management shape the future operational risk management vision for a major North American retail lender
- Over the past four years, Oliver Wyman has completed 195 Basel II-related engagements for leading financial institutions across the globe. Our clients include the top ten largest banks from Asia Pacific, North America and Europe
- Carried out a compliance and internal security review and restructuring for a US retail financial institution
- Supported the “national Basel II program” for an emerging markets regulator, including development of a multi year master plan for both the regulator and the industry as a whole and development of both regulatory guidelines tailored to Emerging Markets and system-wide reporting initiatives



- Reviewed strategy, organisation and risk management structure of a large Indian private banking operation
- Delivered economic capital methodology and model for US top 20 bank



How we work with clients

- We bring **unrivaled global industry experience**, given that our consultants work exclusively with financial services clients
- Our teams have access to global thought leaders and experts to be able to bring **cutting-edge methodology** suited to client requirements
- Our global **pool of experts** staffing approach allows us to bring on board the right skills set for each engagement
- Our solutions, though based on best practice methods, are fundamentally tailored to the client situation – **no ‘cookie cutter’** approaches are used
- We view each relationship as a **partnership**, embedding our teams with our clients’ teams, making the most of the shared expertise and promoting effective knowledge transfer
- We are neither accountants nor IT ‘solutions’ providers. Our recommendations are based on a balanced assessment using of data, judgment and benchmarking, *not* on checklists or ‘product’ targets