

# OLIVER WYMAN



Financial Services

December 17

## **The evolving role of risk management function**

Murat Abay, Principal



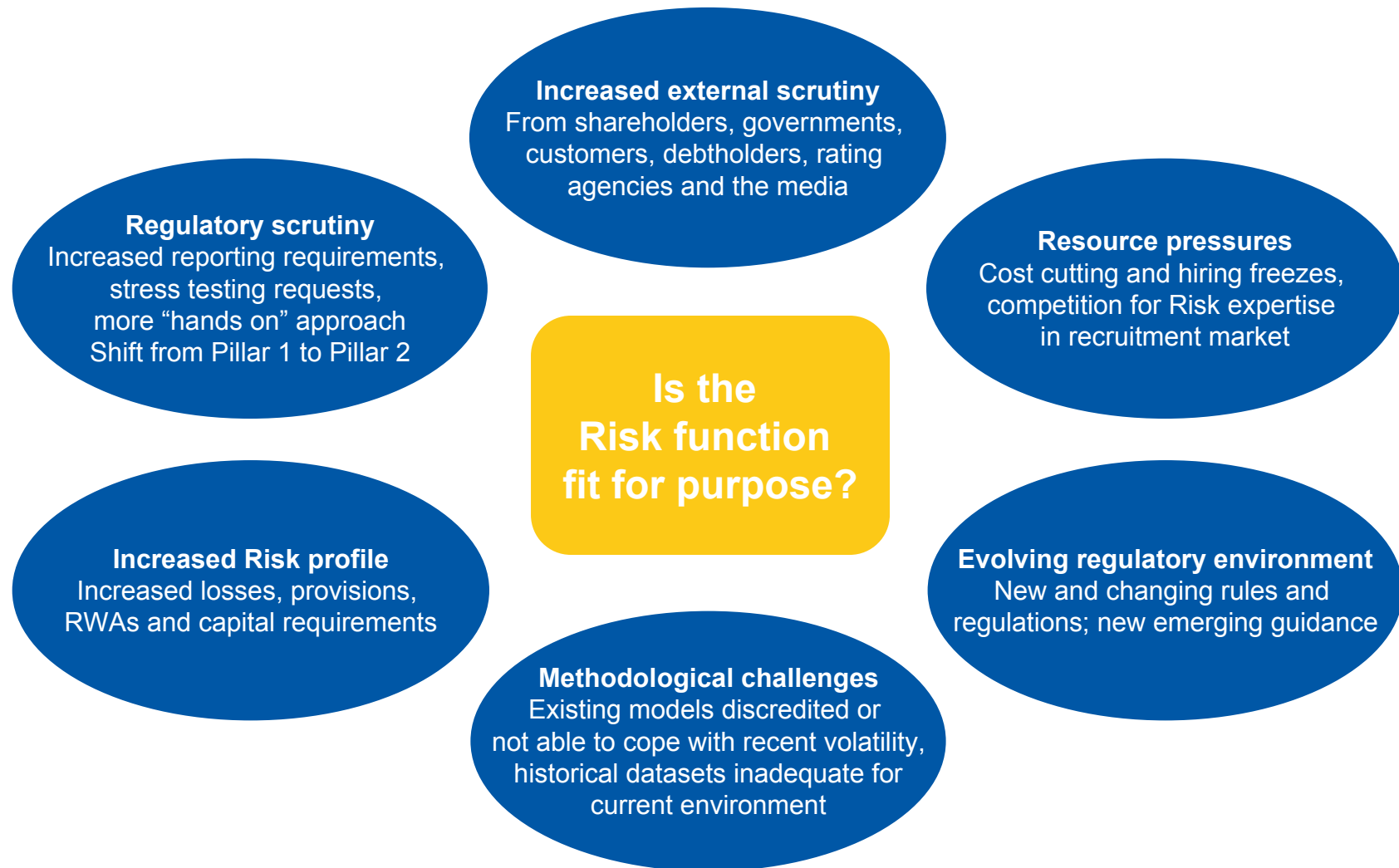
## **Confidentiality**

Our clients' industries are extremely competitive. The confidentiality of companies' plans and data is obviously critical. Oliver Wyman will protect the confidentiality of all such client information.

Similarly, management consulting is a competitive business. We view our approaches and insights as proprietary and therefore look to our clients to protect Oliver Wyman's interests in our proposals, presentations, methodologies and analytical techniques. Under no circumstances should this material be shared with any third party without the written consent of Oliver Wyman.

Copyright © 2009 Oliver Wyman

## Risk management functions at banks around the world are facing unprecedented challenges





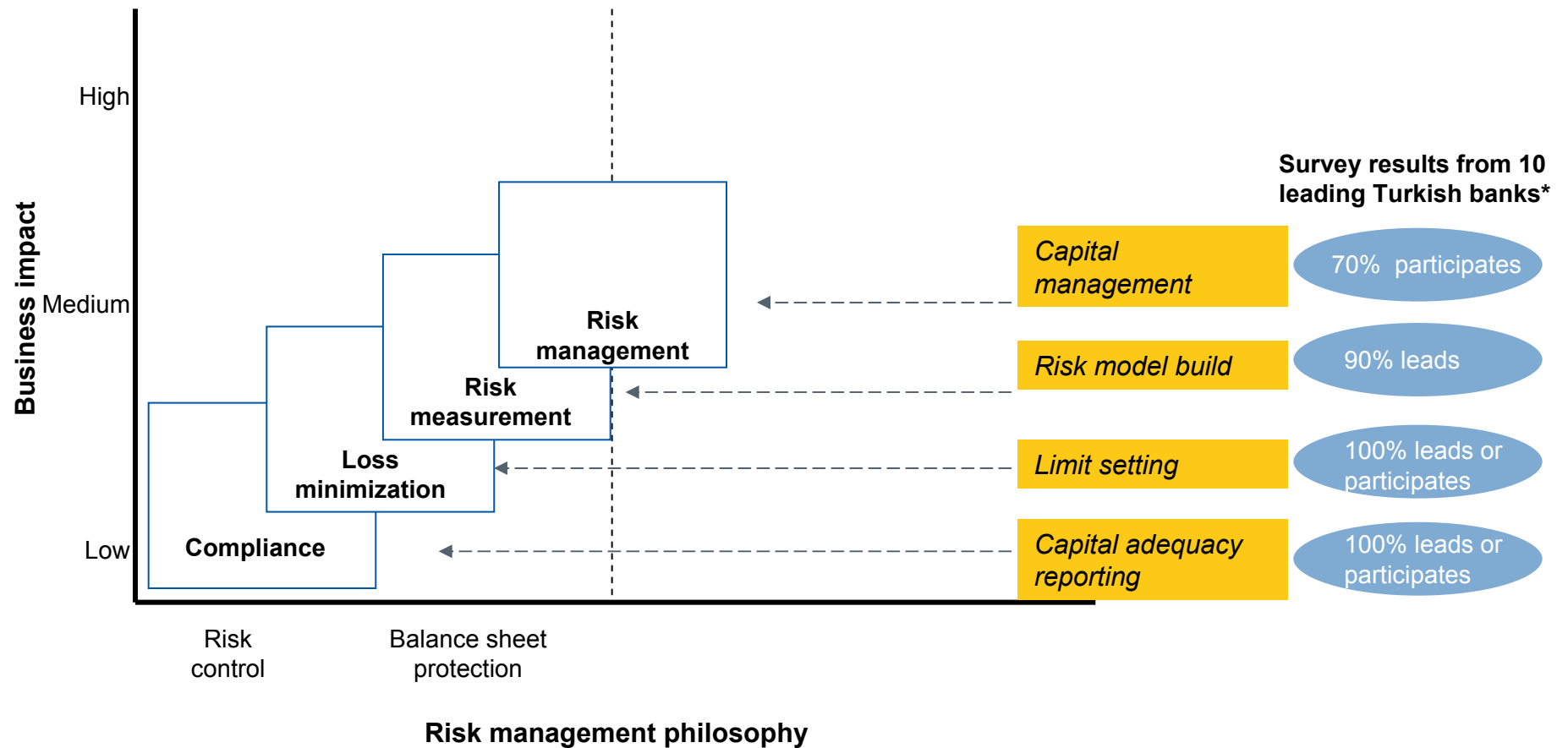
**The crisis has only minimally impacted Turkish Banks, but if it had been more severe, how would have your bank's risk function weathered the storm?**

- Can the risk function govern the risk taking decisions at your bank?
- How much do you trust your risk models?
- Do you have enough budget and resources for risk management?
- Can you provide stress test results that truly reflect the characteristics of your bank's portfolios?
- Can you accurately forecast future losses?



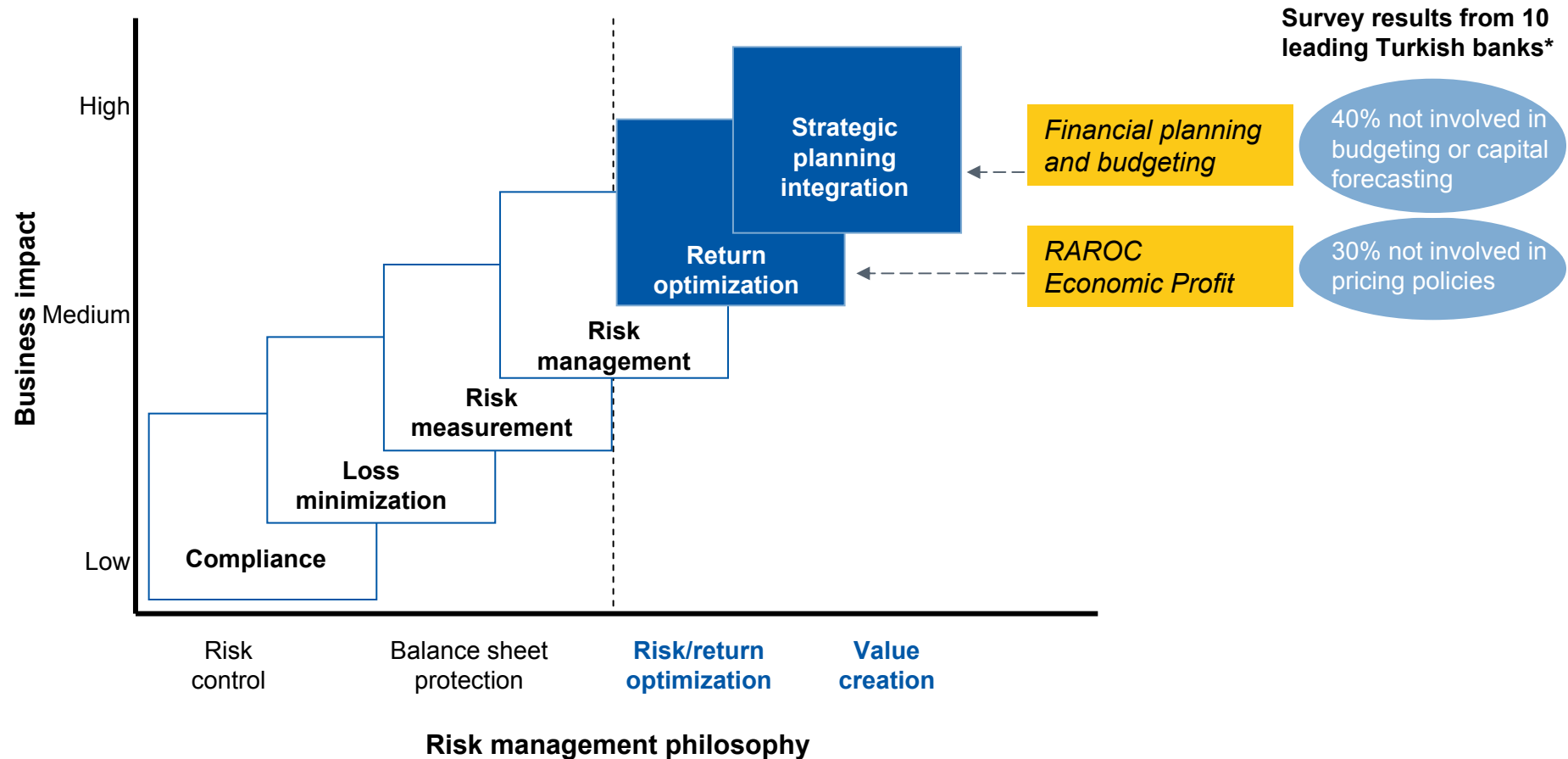
**It is important to drive lessons from global banks and prepare for tougher times**

## Risk management in the Turkish banking industry has come a long way...



\* Oliver Wyman survey participated by Akbank, Finansbank, Garanti, Halkbank, ING, İş Bankası, TEB, Vakıfbank, Yapı Kredi, Ziraat

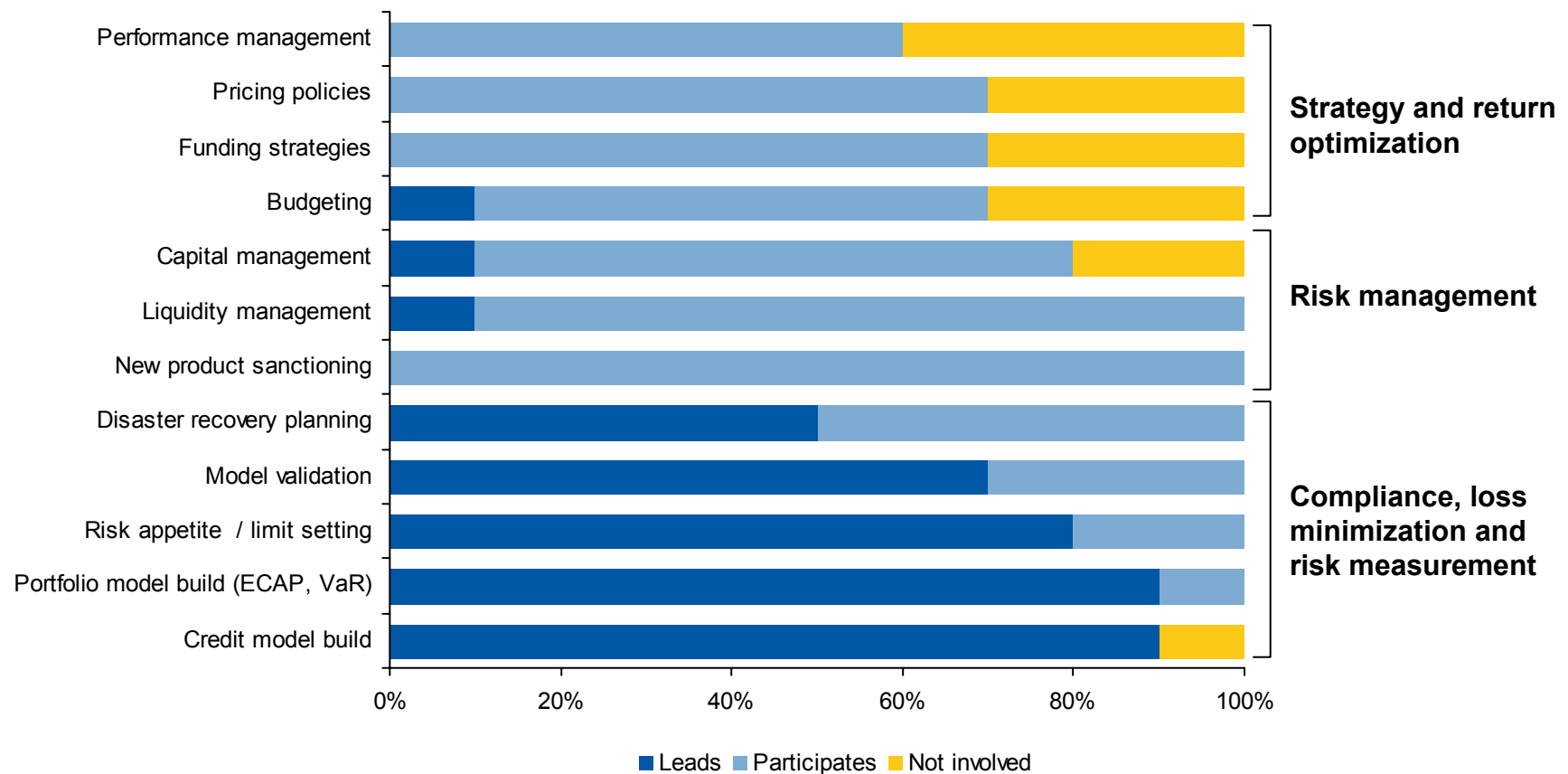
...But it still needs to make important steps to increase its business impact



\* Oliver Wyman survey participated by Akbank, Finansbank, Garanti, Halkbank, ING, İş Bankası, TEB, Vakıfbank, Yapı Kredi, Ziraat

## Involvement in higher impact business decisions is not a general practice across Risk management functions in Turkey

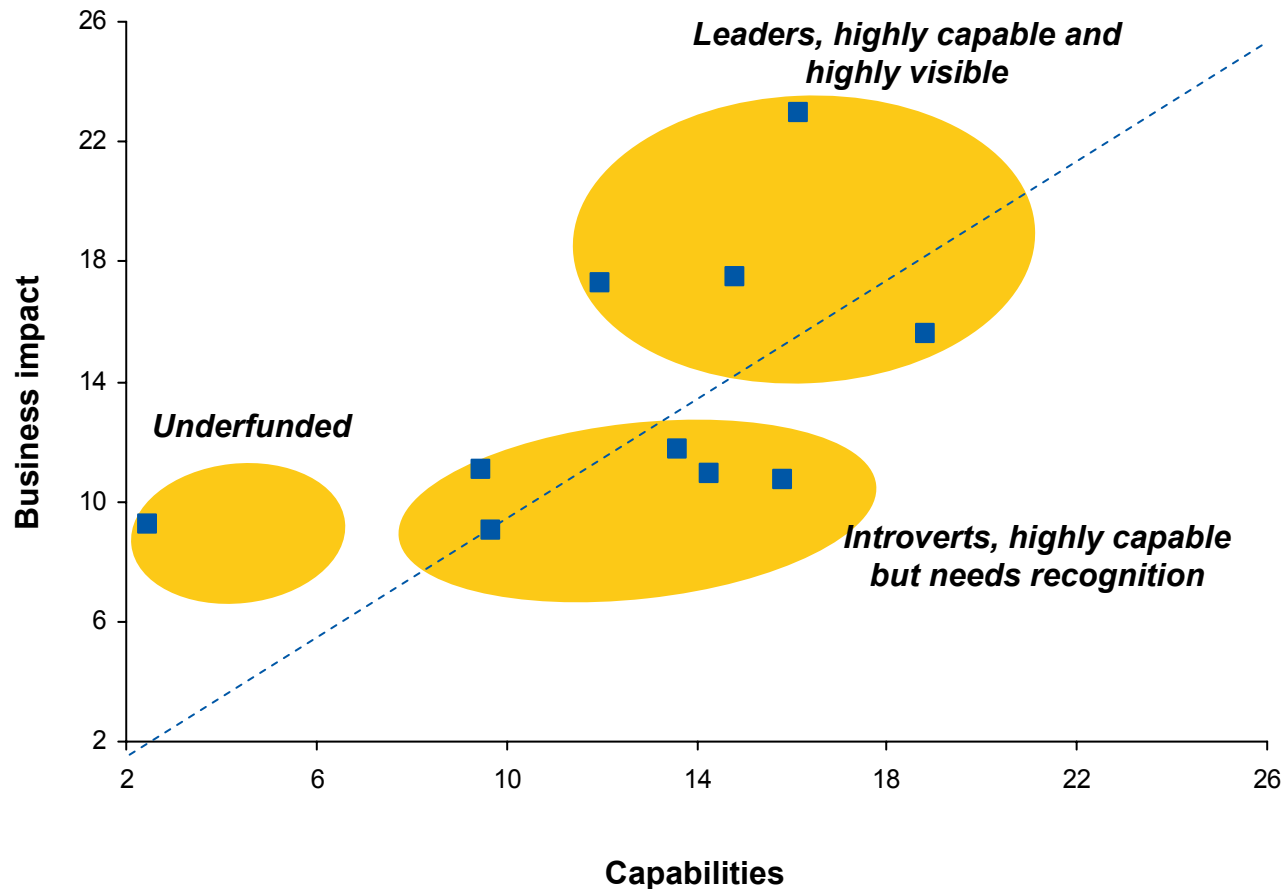
In addition to internal and external reporting roles, which of the following roles is your risk management function involved in?\*



\* Oliver Wyman survey participated by Akbank, Finansbank, Garanti, Halkbank, ING, İş Bankası, TEB, Vakıfbank, Yapı Kredi, Ziraat

When we assess the risk function at different Turkish banks with regards to their capabilities and the level of business impact they have, we see significant differences

Assessment of risk functions at 10 leading Turkish banks based on responses to OW Survey\*



- Business impact reflects factors such as participation in management committees, role in business decisions, department size
- Capabilities reflect factors such as availability of risk models, complexity of risk measurement methodologies

\* Oliver Wyman survey participated by Akbank, Finansbank, Garanti, Halkbank, ING, İş Bankası, TEB, Vakıfbank, Yapı Kredi, Ziraat



## Turkish banks need to take important steps forward

1

**Move Risk Function closer to business**

Reporting line to the Board instead of the CEO does not necessarily create a prudent organization

2

**Integrate risk into strategy and planning**

Strategic plans and annual budgets should be prepared with an understanding of their risk implications

3

**Establish a clear risk appetite framework**

A clear risk appetite statement should be put in place to govern the actions of risk takers

4

**Introduce risk based performance metrics**

Performance management and, as a result, compensation should take into account risk adjusted performance metrics

5

**Complete the arsenal of risk models**

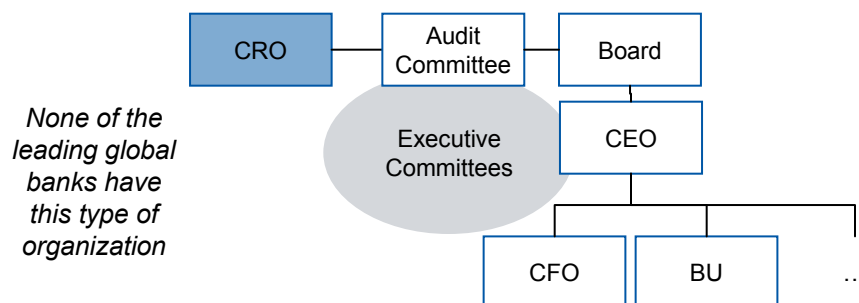
All missing models should be developed; all current models should be validated on an annual basis

1

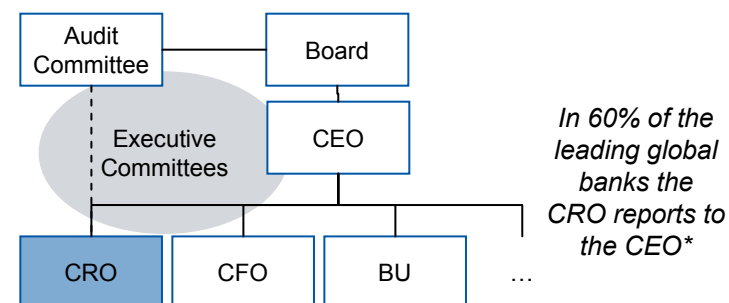
## Move Risk Function closer to business in order to increase its impact

Reporting line to the Board instead of the CEO does not necessarily create a prudent organization, on the contrary it limits risk awareness in the organization

### Current organizational setup as required by the BDDK



### Alternative organizational setup



#### Key role

- The Controller CRO
  - CRO operates a risk-controlling staff office on behalf of the Board

#### Key role

- The Executive CRO
  - CRO is a member of the executive team as a peer to the CFO etc.
  - CRO can only be hired/fired by the Board and has dotted reporting line to the Audit Committee

#### Description

- With an engaged Board, elevates control topics to the highest level
- With a disengaged board, function becomes a periodic reporting unit
- CRO may be left out of strategic decisions and cannot instil a risk culture in the organization

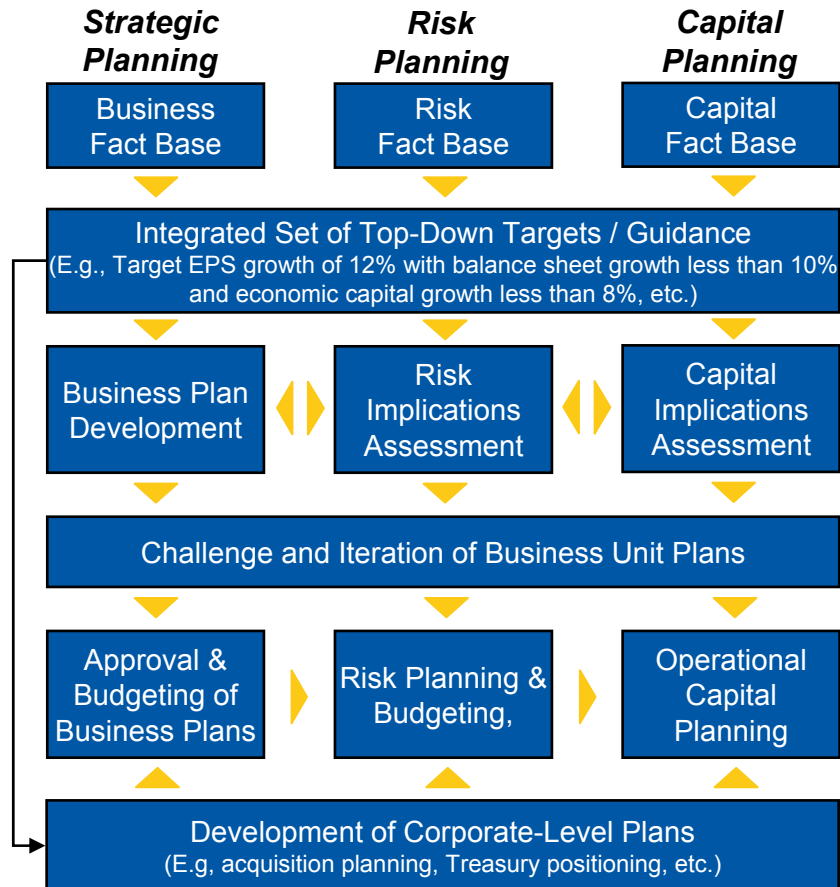
- Gives CRO authority and organisational power
- Provides a direct and independent channel to the board
- Viewed well by rating agencies and regulators
- Requires strong leadership and influencing skills as well as technical expertise

**Board level governance could be improved through better and more frequent reporting and enforcement of the risk appetite**

\* Based on Oliver Wyman survey of 29 leading global banks

## Integrate risk into strategy and planning

Strategic plans and annual budgets should be prepared with an understanding of their risk implications



“How do we identify the “good” growth options?”

### Strategic planning

(Owned by CEO)

“Where should we place our bets?”

### Risk planning

(Owned by CRO)

“How much risk should we take?”

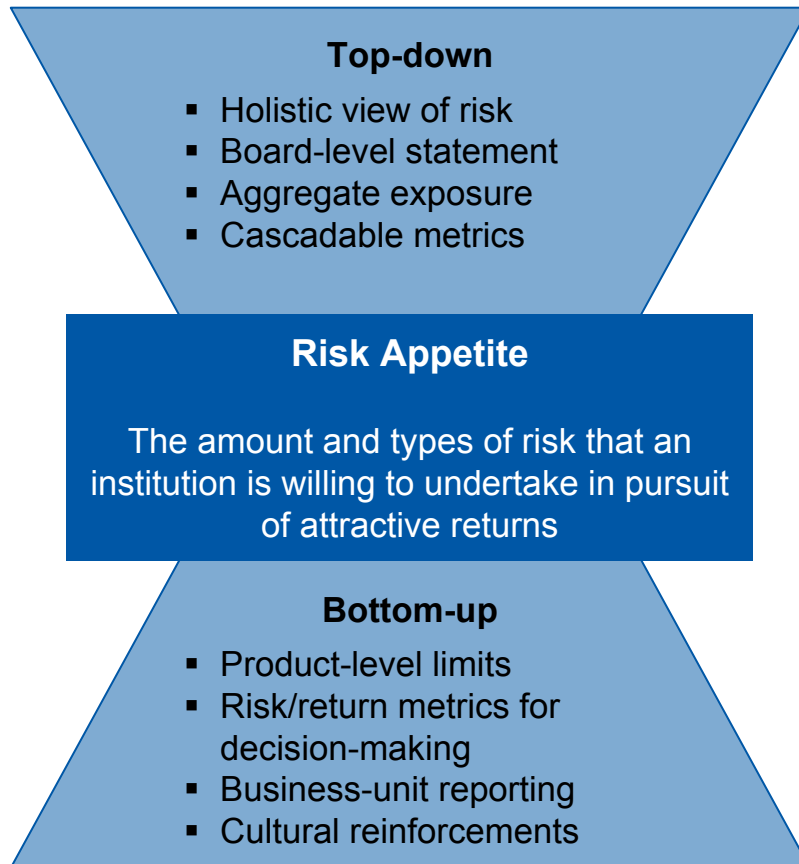
### Capital planning

(Owned by CFO)

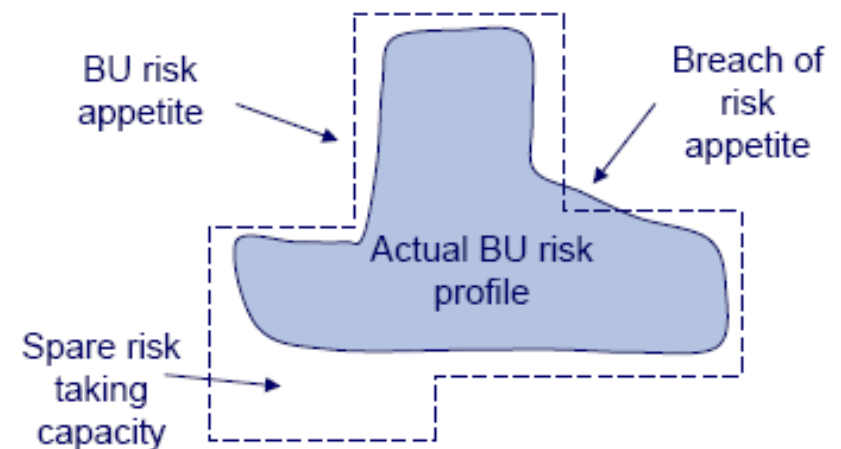
“How much capital do we need?”

## Establish a clear risk appetite framework

A clear risk appetite statement should be put in place to govern the actions of risk takers



### Illustration of risk appetite by ING\*:

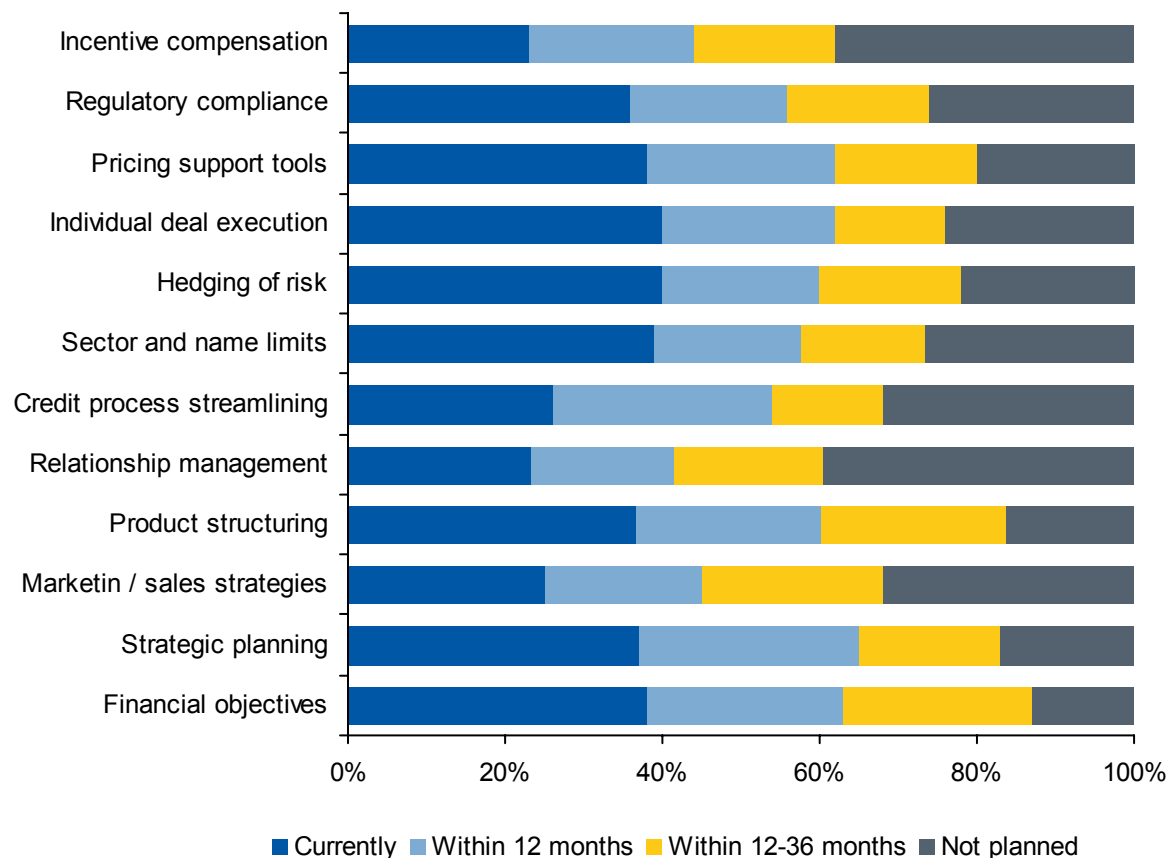


\*Source: Risk Management at ING: Investor Relations Symposium presentation, 2007

## Introduce risk based performance metrics

Performance management and, as a result, compensation should take into account risk adjusted performance metrics

### Processes supported by risk based performance metrics \*



### Key areas where risk based performance metrics can have significant impact

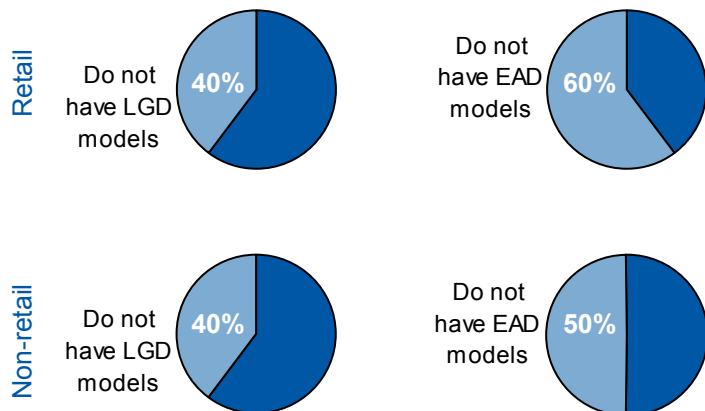
- Strategic planning
- Pricing
- Incentive compensation

\* Based on survey of 270 banks worldwide by PRMIA/Sungard, 2007

## Complete the arsenal of risk models

All missing models should be developed; all current models should be validated on an annual basis

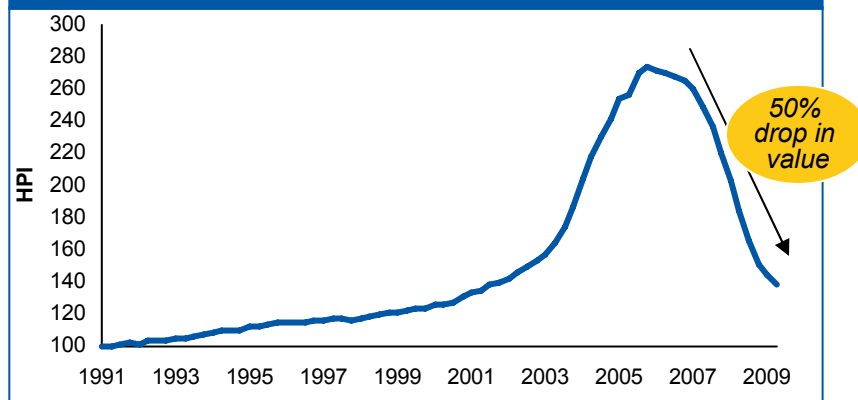
- A significant percentage of Turkish banks is lacking LGD and EAD models



- Only 50% of the banks validate all their credit risk models annually – 30% validate none.



Housing prices  
Nevada, USA



- Including all other costs (e.g. collection, time value, legal) this can mean LGDs of 75% or higher
- A bank that does not have LGD models would probably 'assume' LGDs of 30% when underwriting mortgage loans in Nevada
- Quotation from a subprime lender in the US in 2007:  
***"...our customer ratings are weaker for subprime but we have a strong collateral base. Our lending to individuals are backed by low LTV mortgages"***