Risk Function transformation

KPMG market insights and next steps for Irish banks

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Your Partner For What's Next

Introduction

Risk Functions are transforming

KPMG practitioners world-wide observe that several economic and market challenges put pressure on banks' Chief Risk Officers (CROs) to increase their function's efficiency, whilst maintaining unprecedented levels of effectiveness and facing increasing pressures to create and demonstrate value.

KPMG market study

Our survey of CROs' transformation agendas looked to understand the risk management transformation initiatives and banking industry trends to help prepare CROs and Risk Functions for 2030 and beyond.

Some of these trends and responses we observe include:

Global megatrends in the banking industry

Performance and cost pressure

Different ways of working need to be adopted to reduce the large cost base while providing more value-add for the business

Digital solutions and process automation

Risk is lagging the business in adoption of digital, and needs to automate processes and adopt new technology solutions

Customer demands – the continuously changing customer

The current understanding between Risk and the business is not mature enough to meet future customer needs

New risk types

New or volatile risk types (e.g. ESG and Cyber) need to be identified and managed

Change fatigue after regulatory waves

In order to fulfil regulatory requirements, many Risk Functions have become over-effective, e.g. through "gold-plating" of policies and processes.

Evolving capabilities – new skills, behaviours and personal characteristics required

Risk Function leaders with fungible skillsets rather than SMEs

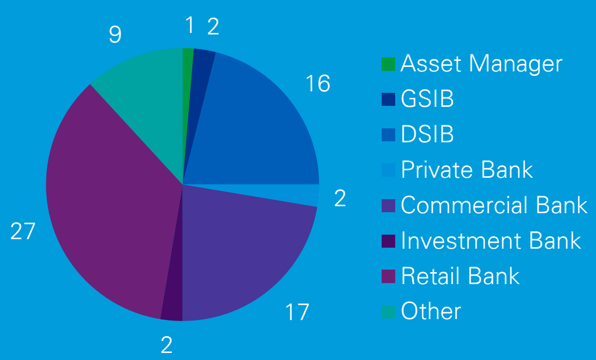
Responses

- **Headcount reductions**
- **Alternative sourcing options, e.g. offshoring or outsourcing**
- **Reduction/de-risking of balance sheet**
- **Re-organisation of functional design**
- **Convergence of risk programmes across the enterprise**
- **Conception of agile development and management methods**
- **Increased reliance on cross-skilling**
- **Investment in digital offering**

Overview of participants, types of questions and Irish overlay

Overview of the participants

A total of 76 banks participated in the survey, ranging from small and medium-sized banks to some of the key players in the international banking industry. A total of 62 banks were from the EU and 7 of those banks were Irish.



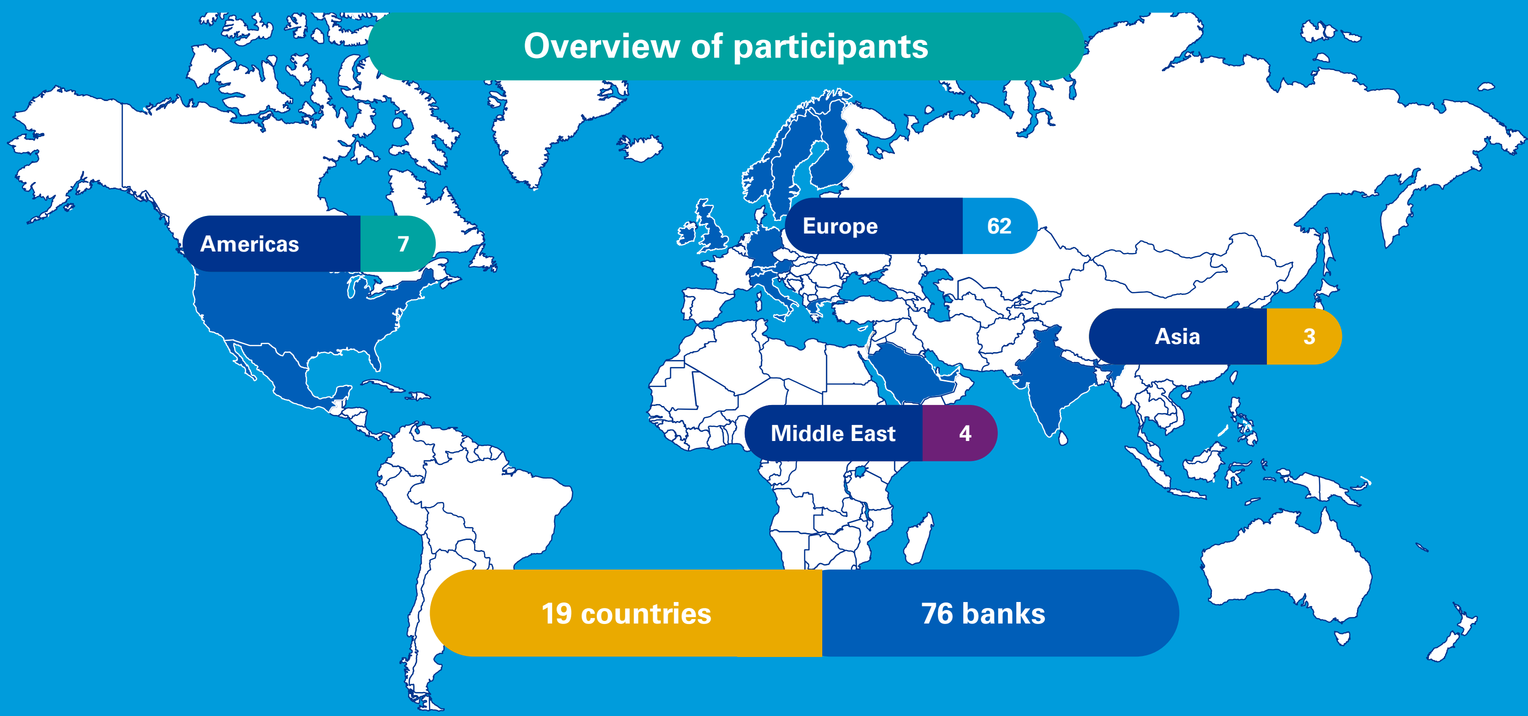
Overview of types of questions

Questions asked broadly covered the following aspects:

1. What are key items on your agenda for the transformation of your Risk Function, such as optimisation of risk processes, modernisation of IT architecture, improving data management, and capturing emerging risks like ESG Risks?
2. How far along are you on the transformation journey regarding those aspects?
3. What are the key pain points being addressed by transformation programmes?

Irish market overlay

We considered global and European trends and contrasted them with Irish specific responses to identify key themes and market considerations applicable to the Irish banking sector.



Next steps for Irish banks

Five key Risk Management transformation trends applicable to the Irish market

Although there are some differences, KPMG's market study confirmed that many of the global risk management transformation trends are also applicable to the Irish banking sector. In this article, we outline the five key risk management transformation trends and initiatives that will likely shape the risk transformation agenda for CROs in Ireland and globally in the next 10 years and beyond.

1

Capturing emerging risks like ESG Risk requires effort by almost all banks globally and in Ireland, especially with many regulators (including the ECB) issuing concrete timelines.

In most markets, climate change and other ESG aspects are increasingly on the political and social agenda. As a result, Banks are acting to integrate ESG Risks into existing frameworks.

KPMG's market study shows that large banks have started to act, while medium-sized and smaller institutions will need to start soon.

Key challenges

- Banking regulators are reacting, with specific expectations and timelines. Regulators in Europe have set concrete expectations and timeframes regarding the integration of ESG Risks into existing risk management frameworks.
- As part of this, EU and Irish Banks are expected to price ESG risk to their clients, and are expected to understand the materiality of such risks for banks´ business models and structures.
- In 2022 the ECB is expected to fully review banks' ESG practices.

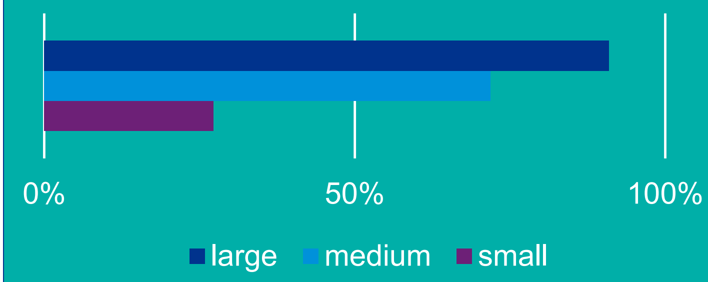
KPMG market insights and how are Irish banks responding?

In Ireland, ESG action is evenly distributed. While about half of the banks surveyed across all sizes have started to respond and implement changes, all have reported that there is still significant work to do. The remaining institutions will need to start soon. We expect banks to capture climate risk and other ESG Risks fully and methodically by focusing on three areas:

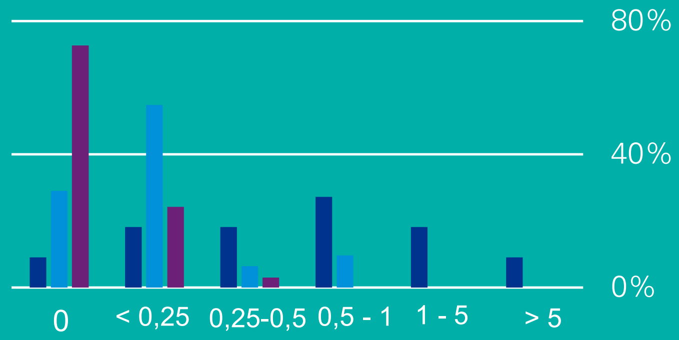
1. Implementation of initial climate risk stress testing methods.
2. Alignment of credit governance and processes with ESG Risk.
3. Full integration of ESG Risk in existing Risk Management Framework.

CRO Survey

Do you have a **dedicated programme** for the transformation of your Risk Function, which incorporates **emerging risk** incorporation (e.g. **ESG**)?



How much did you **invest in 2019** on capturing emerging risks such as ESG Risks?

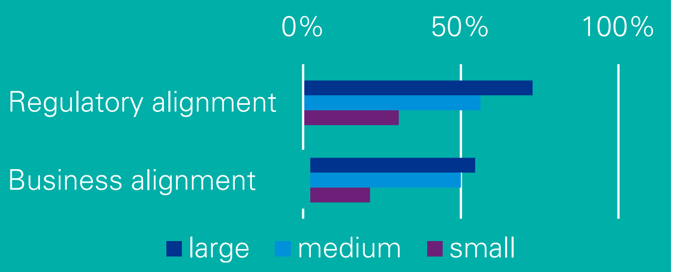


2

Unlike most banks around the globe, Irish banks do not consider business alignment of risk to be nearly as important as regulatory alignment. We expect this to change soon as banks take decisive steps to remain competitive.

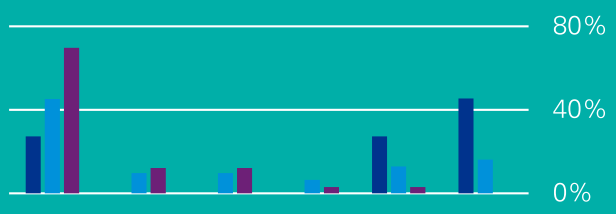
CRO Survey

Do you have a **dedicated programme** for the transformation of your Risk Function concerning

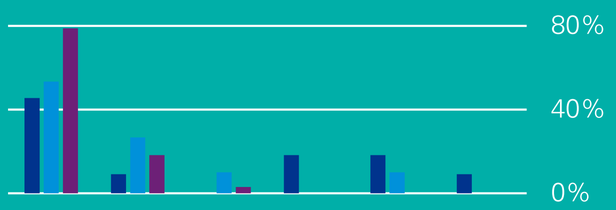


How much did you **invest in 2019** in order to increase:

a. the capability to align with increasing **regulatory requirements?**



b. **alignment with business needs?**



Globally, KPMG's market study shows that business alignment of Risk has become almost as important for banks as regulatory alignment. Still, annual investment on business alignment is significantly behind spending on fulfilling regulatory requirements.

Key challenges

- Performance and cost pressure, evolving capabilities, customer demands and digital solutions are strongly influencing the banking world, including Irish Risk Functions.
- Headcount growth has been driven by increasing regulatory requirements, and operational excellence has not been a driver for Risk Functions.
- Many core activities (such as risk reporting) are typically distributed across different units, causing inefficiency and blurring responsibilities across 1st and 2nd line of defence teams.

KPMG market insights and how are Irish banks responding?

Unlike other banks around the globe, for Irish Banks, business alignment of Risk has yet to catch-up in importance with regulatory alignment. However, despite few dedicated programmes being in place, Irish Risk Functions are seeking to increase impact and value add, which will involve optimisation of the 3LoD model. In our view, they can do so by acting in the following areas:

1. Re-shaping of the 3LoD model to increase effectiveness of collaboration between 1st and 2nd line of defence teams.
2. Transforming the organisational design of the Risk Function towards increased operational excellence.
3. Optimising end-to-end risk processes, aligned with the organisation.

3

Modernisation of Risk IT architecture is becoming an integral part of Global and Irish CROs transformation agendas. Effective solutions do not necessarily "break the bank".

Flexible and scalable Risk IT architecture, addressing issues of End User Computing (EUC) applications, owned and operated by Risk Functions, as well as legacy IT structures, is a key component of a sustainable target vision for modern risk management. As a result, Risk IT architecture modernisation is a top priority for CROs around the globe.

KPMG's market study shows that Risk Functions in large banks have started to prioritise IT modernisation, while medium-sized and smaller institutions will need to consider how Risk IT architecture will be adapted to support longer term growth strategies.

Key challenges

- Efficiency topics such as insufficient system scalability and slow release cycles are common pain points. For Irish Banks the main IT effectiveness pain point relates to the extensive use of EUC applications.
- Projects are expensive (resource and time wise) and some solutions get in the way of the required flexibility.
- Heterogeneous system landscapes, mixtures of vendor systems and EUC applications, prolific data Extract Transform, Load (ETL) processes, and also cloud migrations not taking process and data flows into account.

KPMG market insights and how are Irish banks responding?

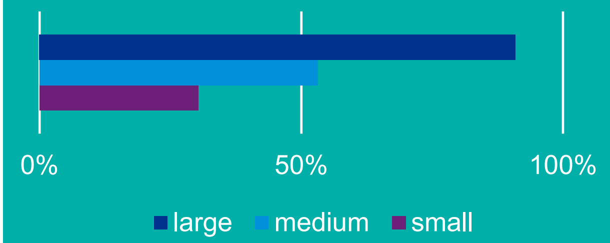
Our market study shows that the modernisation of Risk IT architecture by Irish Banks is a top priority for around half of the banks surveyed. Like other banks around the globe, investment in this area represents the largest spend across risk transformation initiatives for Irish Risk Functions, with those who have programmes in place spending between $1m - $5m.

Key global trends we observe to tackle existing challenges include:

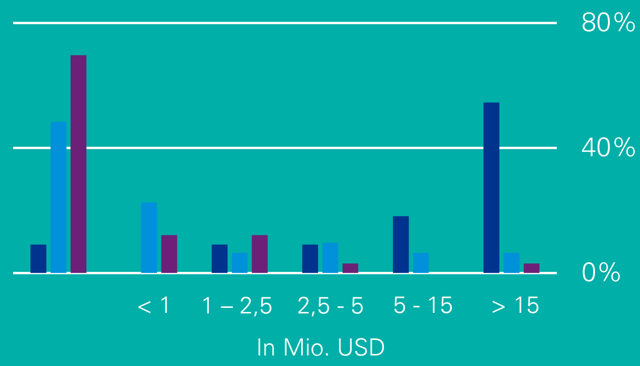
1. Use of flexible and scalable microservices architecture, mostly cloud-based, often employed for specific use cases like scenario analysis and stress testing.
2. Use of third-party vendor systems harmonising ERM systems and methods.

CRO Survey

Do you have a **dedicated programme** for the transformation of your Risk Function concerning **IT modernisation**?



How much did you **invest in 2019** for modernising the Risk IT architecture?



4

Global and Irish Risk Functions are looking to innovate, using efficiency and effectiveness levers to deliver increasingly sophisticated risk outcomes without increasing costs.

Globally, CROs are deploying dedicated efficiency and effectiveness programmes to free resources from repetitive, simple tasks and re-allocate them to deliver sophisticated and often new technology and analytical based activities. In our view, innovation will be at the heart of Risk Functions from here onwards. We believe that the use of advanced technology such as bots and analytical capabilities such as AI will be front and centre for banks around the globe.

Our study shows that many CROs have started to systematically increase efficiency and effectiveness of risk, especially in IT, data management and risk processes, while dedicated cost reduction programmes are not currently common practice.

Key challenges

- The regulatory "tsunami" since the global financial crisis has shifted more and more tasks to Risk Functions over the past decade. In many cases, Risk Functions have grown heterogeneously and as a result operate on bloated cost bases.
- Increasing regulatory requirements (such as new risks like ESG), continued margin pressure, uncertainty in the post-COVID environment, management of increasingly more complex tasks which require new skillsets, add to the challenges of banks and their Risk Functions.
- In summary, CROs will need to do more, for less, while overcoming constraints imposed by legacy infrastructure which often impedes adaptability towards new technological requirements.

KPMG market insights and how are Irish banks responding?

Similarly, to banks around the globe, our study shows that Irish CROs have also started to systematically increase the efficiency and effectiveness of Risk Functions, especially in data management, risk reporting processes and use of technology. Although dedicated cost reduction programmes are also not common practice, we expect this to change in the short term in line with global trends.

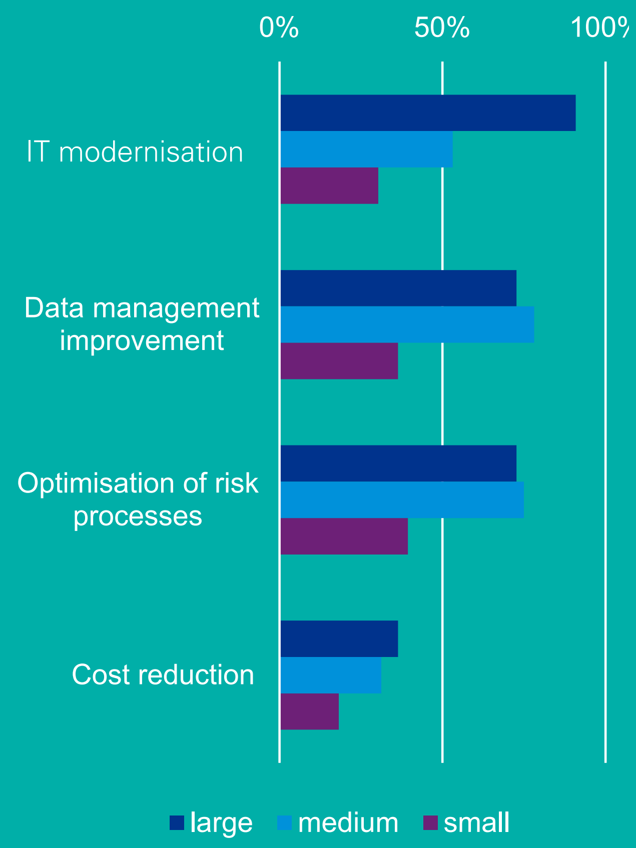
For Irish Banks, data management pain points mainly centre on poor data quality in risk reports and issues relating to prolific manual interventions and corrections, managing an excessive number of systems and interfaces, and lack of harmonisation across risk types. While the main opportunities to optimise risk processes include (1) establishing an integrated end-to-end perspective for key risk processes such as RCSAs, (2) alignment of the 3LoD model, (3) reducing the current substantial levels of manual input; (4) standardising repetitive tasks; and (5) minimising redundancies due to lack of centralisation.

In general, to tackle the above, we observe that many banks have seized opportunities after the first wave of the COVID pandemic to:

1. Consolidate the status quo and design a structured target vision for the Risk Function to help them to prioritise investment and identify levers to optimise the allocation of resources to sophisticated and often new tasks.
2. Define "red lines" of effectiveness, in some cases leading to a reduction of the service catalogue, a re-calibration of the 3LoD model, and a sharpening of the functional mandate.
3. Streamline data management activities, optimise and where possible automate risk processes.

CRO Survey

Do you have a **dedicated programme** for the transformation of your Risk Function, which incorporates one or several of the following aspects?



5

For Irish Banks, targeted process optimisation programmes in Risk Reporting, Model Development, Compliance Processes, Credit Processes, and Non-Financial Risk (NFR) Management, offer substantial opportunities in efficiency.

Transformation of the risk organisation and its IT architecture are important but cannot work without systematic improvement of risk processes aligned with the new organisation and IT, using typical levers of standardisation, centralisation, and automation.

KPMG's market study shows that optimisation of processes such as Risk Reporting and Operational Risk Management are on top of the agenda for banks around the globe. Our study also shows that many solutions, especially for automation, have already arrived in the Risk Function but there is a variety of possibilities and solutions between Robotic Process Automation (RPA) and workflow automation that are viable especially for smaller and medium-sized institutions.

Key challenges

In our experience common key pain points and root causes that normally limit optimisation potential across risk processes include:

- Risk Reporting. Poor data quality, prolific manual interventions and corrections, and managing an excessive number of systems.
- Model Development. Increase in the number of models used, triggered by an increased use of digitalisation and machine learning / AI models.
- Compliance Processes. Highly manual on-boarding tasks and duplication of activities and controls particularly around AML, Credit Risk Processes and Conduct risk.
- Credit Risk Processes. Deficiencies in documentation and data quality; Substantial manual effort in filling of forms and applying corrections; Duplicate or erroneous entries; Lack of automated controls and testing.
- Operational Risk and NFR Management. Low degree of confidence on the quality of control environments due to inefficient and ineffective RCSA process including control assurance, oversight, and reporting. Too often RCSA processes contain too detailed and granular risk and control content without an appropriate materiality process lens.

KPMG market insights and how are Irish banks responding?

For Irish Risk Functions, KPMG's market study shows that risk process optimisation needs are similar and include six key areas: Model Development, Compliance, Conduct Risk, Risk Reporting, Credit Risk Processes, and Operational Risk and NFR Management. The importance placed on optimising these areas is largely driven by domestic banks. Our study shows that the main risk processes that banks are looking to optimise are:

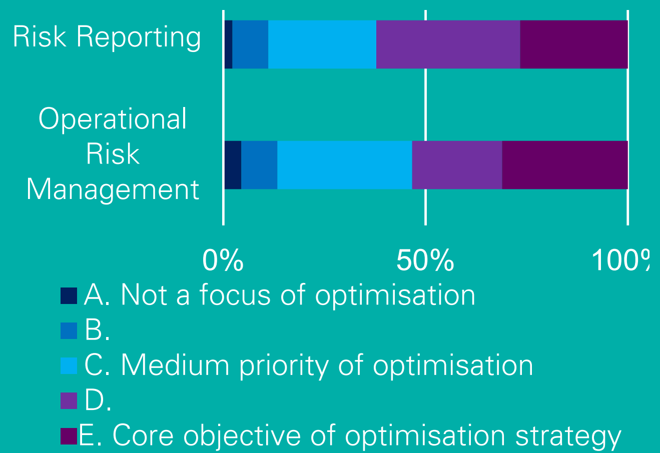
- Core objective: Risk Reporting
- High priority: Compliance (incl. Conduct, Data Protection, AML) and Model Development
- Medium to high priority: Credit Risk, Operational Risk and NFR Management

Our study also shows that automation and standardisation maturity levels are relatively low for both domestic banks and international banks. Only 2 of the 7 Irish banks surveyed have implemented simple automation solutions like RPA. As a result, in our view Irish Banks will benefit from:

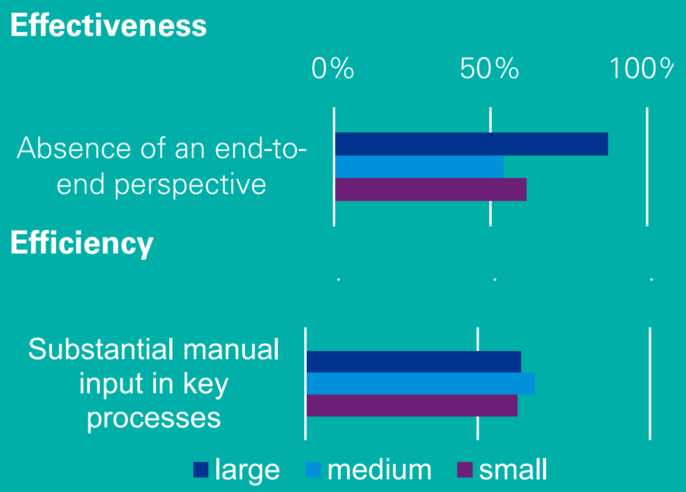
1. Implementing more holistic automation strategies. For example, using RPAs or bots to streamline credit processes by automating the transfer of existing data, fully or partially automating the identification and transmission of documents.
2. Identifying use cases by risk types best suited to specific analytical techniques such as AI. For example, AI techniques could be used for compliance purposes to identify non-compliant products or services by scanning specific attributes across large populations and examining years' worth of data quickly and accurately.

CRO Survey

To which degree do you focus on the following processes in your optimisation programme?



What are your key pain points when addressing the optimisation of risk processes?



How can KPMG help?

KPMG's Risk Consulting experts advise a range of banks and financial services firms in Ireland, Europe and Internationally. From DSIBs, LSIs and International Banks to disruptors and new entrants.

Examples of the type of help we can provide include:

Assessing and benchmarking the effectiveness and maturity of Risk Functions and Risk Management Frameworks (RMF). By carrying out a structured maturity assessment for the Risk Function and RMF to analyse effectiveness and efficiency while comparing you against peers and regulatory expectations.

Optimising risk processes for any risk type. Carrying out process benchmarks, process mapping and process mining to identify and leverage potential for efficiency gains including automation, use of RPAs and workflow automation.

Implementing Next Generation GRC systems. Helping to digitise the delivery of risk and control frameworks and content. Working with our strategic alliance partners, to build a single, centralised tool to manage, monitor and report risk and control data.

Redesigning 1st and 2nd Lines of Defence Target Operating Models (TOMs) and R&R. Helping to redesign TOMs and implement activities-based risk related roles and responsibilities for cross functional risk types.

We help firms improve the effectiveness of Risk Functions to meet regulatory expectations; we support Risk Functions to be more efficient and effective in the way in which they manage specific risk types such as NFR, Conduct and Credit risk; and we are increasingly being asked to support Boards and CROs on how to deploy advanced technological and analytical capabilities to help Risk and Compliance functions be more efficient and be able to demonstrate the value they add, preserve value and reduce costs. Examples of the type of help we can provide include:

Implementing and embedding improved control frameworks and testing plans. Working with Risk Owners and Risk Functions to design and embed effective control environments, including smart testing using bots and machine learning.

Using advanced technology and analytical techniques to anticipate risks and increase efficiency and effectiveness. Though the use of in-house KPMG tools including (1) Intelligent Platform for Automation (IPA). KPMG's proprietary technology platform containing automated bots, applications, and Artificial Intelligence (AI) solutions developed to assist Risk Consulting engagement activities; and (2) Product Assurance Framework (PAF). KPMG's proprietary method which uses advanced analytical tools such as Python and SQL to carry out population wide testing on products to minimise Conduct related risks.

Improving Risk Reporting structures. Building data aggregation and reporting solutions to support the quality, timeliness and reliability of Risk Reporting.

Designing and implementing ESG structures. By working with your teams to design, implement and embed new ESG governance, risk identification and assessment (incl. stress testing) and controls and integrate these into the existing Risk Management Framework.

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