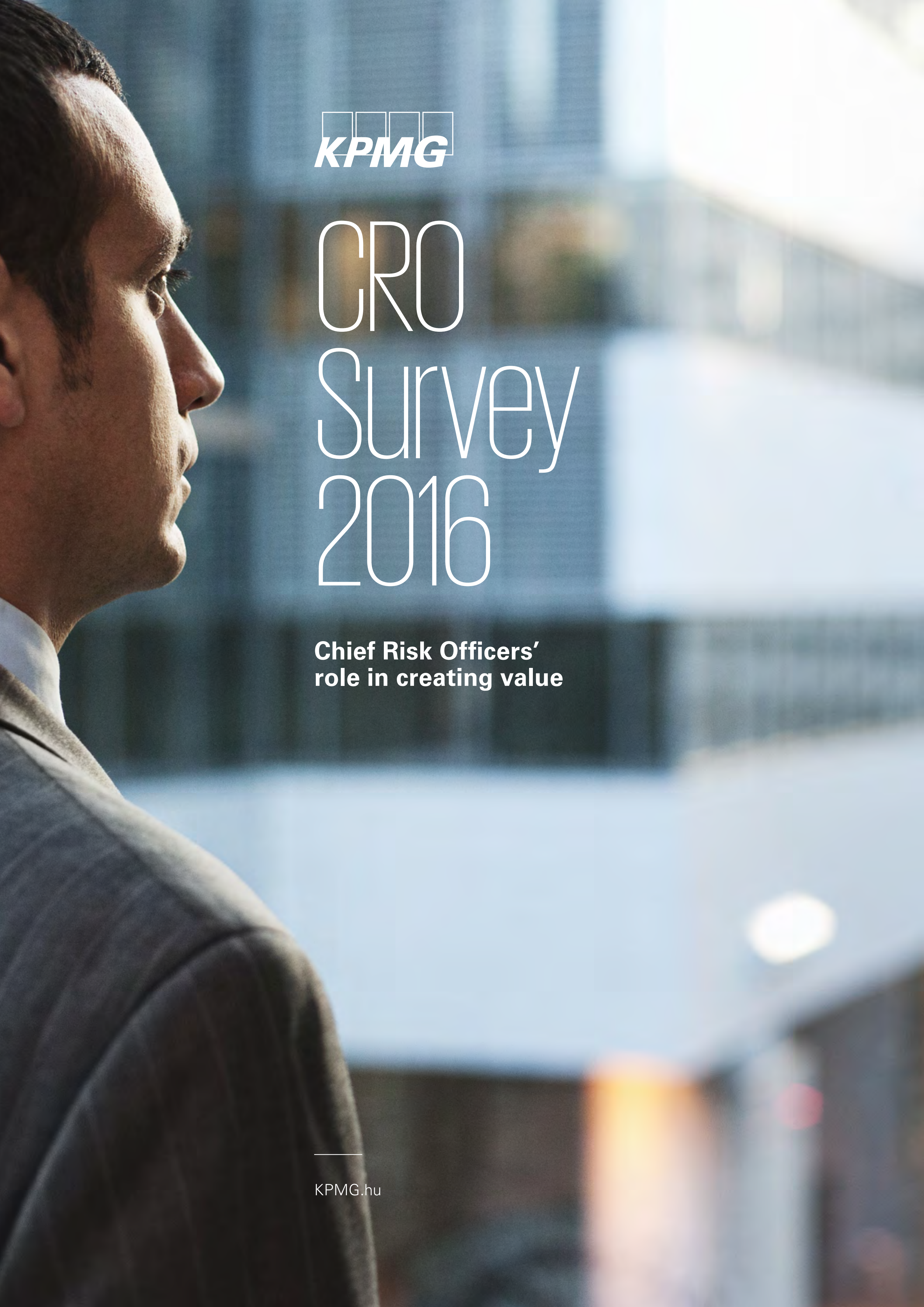


CRO Survey 2016

Chief Risk Officers' role in creating value

KPMG.hu

Content

Executive summary

The business environment under which the banking and insurance sectors operate has undergone significant change in recent years. While in 2012, when our last survey was published, we were concerned that public debt issues could lead to a new crisis within the financial services sector, and the downturn affecting the real economy showed no signs of improvement, today the economy has resumed a path of growth: Hungarian public debt as a proportion of GDP is shrinking and the storms jeopardising European financial stability have passed. In 2012, chief risk officers (CROs) at banks were still busy clearing up the debris, but today the emphasis has shifted towards defining the directions and frameworks of a successful operating strategy, albeit portfolio restructuring, which is set to remain a priority in the long run. Complying with regulatory authority requirements has incurred huge costs in the recent past, and is expected to absorb significant resources in the years to come — particularly IFRS and Solvency II requirements — while the need for incorporating the risk function in value creation is also a clear priority. In the insurance sector, participation in new product development, and participation in defining the terms of newly launched lending within the banking sector, call for close integration of the risk area within organisational operations.

We have prepared our analysis by gauging the opinions of CROs from 26 institutions — 13 banks and 13 insurance companies — and would like to express our gratitude for their contribution. Their responses clearly show a growing trend in risk-awareness and in the importance of the role of CROs. This is attested to by the fact that while 46% of CROs were only in charge of risk control and risk assumption authorisation within the organisation in 2012, this figure has increased to 69% according to the current survey, reaching 92% within the banking sector.

The greater influence of CROs was reflected in multiple areas, which differ by sector and size. The greatest increase occurred in the case of large institutions, specifically in the category of product development strategy decisions (88%). In addition, the influence of CROs saw a significant rise in terms of the management of resources, access to information and capital allocation. The growing influence of CROs within the Hungarian insurance sector is more perceptible compared to the banking sector. Within the insurance sector, 76% of CROs reported an increase in their influence in strategic decision-making on product development, compared to only 40% reporting an increase in influence in the two most dynamically expanding areas (capital allocation, strategy making) in 2012.

The future prospects of CROs underpin these trends. In the insurance sector, 46% of CROs believe that their development resources will increase in the future, while 77% of the banking industry CROs expect no change. In line with this, 84% of insurance sector CROs expect a continued rise in their organisational role and influence in the coming two years, compared to only 54% in the banking sector.

Respondents' opinions on the best form of value creation according to risk function vary significantly by sector. Bank executives deem that the risk area can create the most added value by accurately measuring risk and pricing it appropriately. This is echoed by the fact that they wish to allocate their resources to measuring/reporting risks and improving risk systems/data quality. Insurance industry CROs see the strengthening of risk-awareness and risk culture within the entire organisation as the main area of value-creation, so it comes as no surprise that they view their success being most accurately measured in terms of their participation in strategic decision-making.

A major change is that in 2012 CRO respondents indicated a shortage of resources as the main factor hindering their success; according to the latest survey, IT system shortcomings are now clearly the main hindering factor. This is explained by the increasing data requirements of the risk area and the postponement of IT developments in recent years due to the crisis. There are major differences in data quality issues based on company size: 33% of small institutions consider it an issue, compared to 100% of medium-sized institutions and only 13% of large institutions. This may stem from the lower data requirements at smaller companies, as opposed to the large volume of data required at medium-sized enterprises, coupled with a lack of development compared to their larger peers. There are also differences in data quality issues according to sector. Among banking industry CROs, 62% consider data quality issues as a hindering factor, ranking them second, while this figure is only 38% in the insurance sector. The increasing requirement for larger volumes of high quality data started earlier in the banking sector; the absence of such data is a major hindrance. This trend has been increasingly apparent among insurance companies: in 2012 only 15% of respondents assessed data quality issues as an obstacle.

In terms of the risk environment, respondents perceived the greatest increase to be with regulatory risk. According to both sectors, regulatory requirements tightened most in the fields of customer management/consumer protection. Broadly speaking it is banking sector CROs who mostly perceived tighter regulations.

According to respondents, the deteriorating tendency in credit risk has come to a halt, and a small proportion of respondents experienced a decrease in credit risk, confirmed by sectoral data reflecting a slow improvement in the banking system's portfolio quality (see Financial Stability Report, National Bank of Hungary, November 2015).

A marked increase was seen in the country risk category from the perspective of parent institutions. An improvement based on country risk indicators is not yet reflected among parent institution priorities; Hungary still has a poor regional ranking in terms of the central distribution of development/investment resources. In the other categories — market, insurance, operational, liquidity/ALM risk — a slight increase in risk exposure was registered overall.

The above findings also show that the CRO function is a mature role within the banking sector, but its priorities and challenges are constantly changing. In the insurance industry, the CRO function is undergoing very dynamic development, clearly also in response to the requirements of the Solvency II regulation. We hope that this publication and our observations on the development of risk organisations/processes/methods and tools will be useful for many chief risk officers and banks and insurance companies undertaking risks.

Csaba László
Senior partner

Gábor Hanák
Director

Andrea Nestor
Director

Péter Szalai
Senior manager

About the survey

In the context of KPMG Tanácsadó Kft.'s CRO Club, following publication of the 2012 edition we have undertaken a survey of chief risk officers (CROs) in the banking and insurance industry, querying their views on risk management in Hungary and market trends.

The questions posed can be grouped into four broad categories:

- role of the CRO at institutional level,
- general role of the CRO at sectoral level,
- available resources and skills,

general market trends.Participants comprised 26 CROs, spread evenly between banks (13) and insurance companies (13). The respondents included small (9), medium-sized (9) and large (8) institutions. The majority of respondents completed the survey in 2015.

We compared these responses with findings from the 2012 survey of banking and insurance industry CROs conducted by KPMG Tanácsadó Kft.

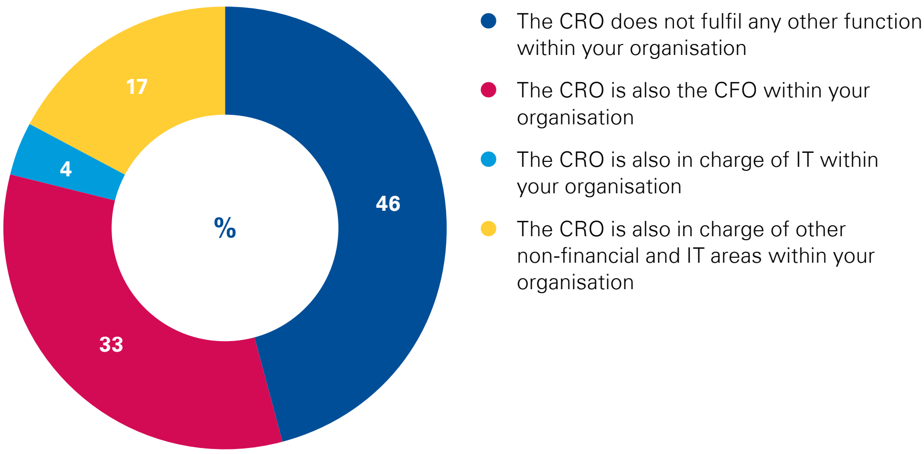
The following KPMG staff members took part in the survey and in evaluating the responses: Fanni Firon, Gábor Hanák, Gergely Szabolcs, Péter Szalai and Gergő Wieder.

Role of the CRO at institutional level

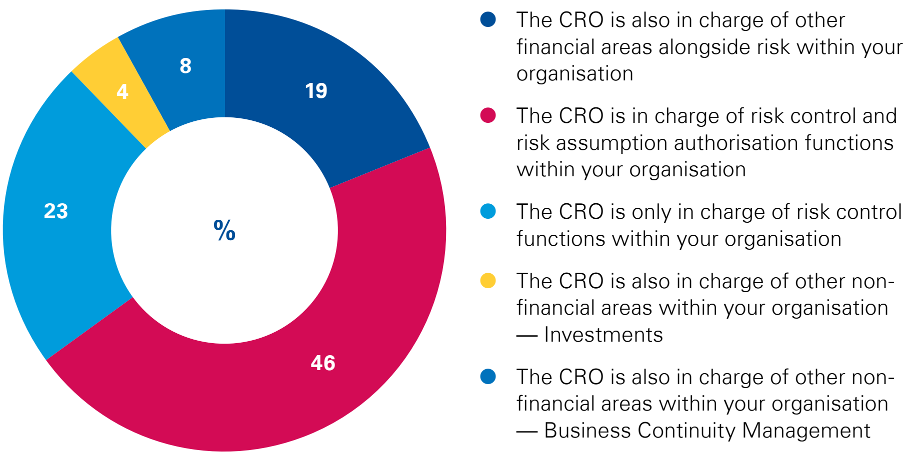
1. Organisational role of CRO

A further increase in risk-awareness can be observed since 2012 within the financial sector, as indicated by a change in the organisational role of CROs. While 46% of CROs were only in charge of risk control and risk assumption authorisation within the organisation in 2012, this figure has increased to 69% according to the current survey. Meanwhile, CROs are often in charge of other financial areas (19%), and the role of chief risk officers exhibits substantial differences across sectors.

Organisational role of CRO in 2012



Organisational role of CRO in 2015



According to the latest survey, CROs occupy similar roles within the banking sector, with 92% being in charge of risk control and risk assumption authorisation functions. One reason for this may be that in the banking sector the role of CRO has been in existence for many years thanks to stricter and longer-standing regulatory reforms, and by the fact that bank management recognised the importance of risk management earlier on. This explains the independent CRO function within the banking sector.

By contrast, a comprehensive reform of insurance industry regulations has recently been undertaken, as a result of which the role of chief risk officer has been undergoing continuous transformation and is gaining importance. This is confirmed by the fact that in contrast to that in the banking sector, the role of CROs in the insurance industry varies substantially, due to the fact that the function still lacks maturity. In addition, the risk management function comprises fewer people compared to that of the banking sector, so it is often linked to other functions, where the CRO function is only secondary. However, compared to the 2012 figure (38%), there is still an increase in the ratio of individual roles. According to the latest survey, 46% of respondents' role is focused solely upon risk control and risk assumption authorisation functions.

However, the percentage of CROs within the banking sector in charge of only risk control — fully implementing independent control — is just 8%. This proportion is far higher in the insurance industry, at 38% of respondents. This difference mainly stems from the fact that most banking sector CROs are senior managers, therefore they are more subject to the considerations of economies of scale.

Organisational role of CRO

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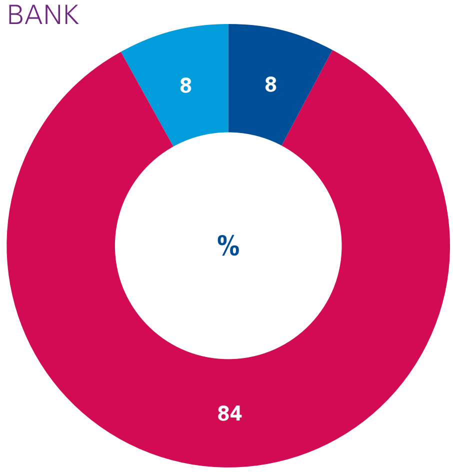

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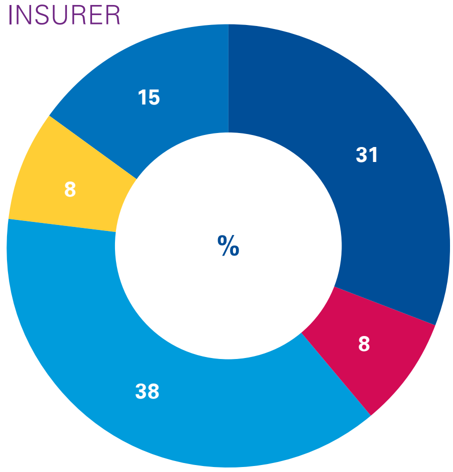

- The CRO is also in charge of other financial areas alongside risk within your organisation
- The CRO is in charge of risk control and risk assumption authorisation functions within your organisation
- The CRO is only in charge of risk control functions within your organisation
- The CRO is also in charge of other non-financial areas within your organisatio — Investments
- The CRO is also in charge of other non-financial areas within your organisation — Business Continuity Management

2. Changes in degree of influence of CROs over past two years

The majority of respondents reported that the influence of CROs has increased in several areas over the past two years. However, responses vary by sector and company size. Respondents indicated the greatest increase in the case of large institutions, specifically in the category of strategic product development decisions (88%). In addition, the influence of CROs saw a significant rise in terms of the management of resources, access to information and capital allocation. In total, 75% of respondents reported an increase in the influence of CROs on capital allocation, 62.5% of which experienced a significant increase.

Among Hungarian insurers, respondents reported a pronounced change in the influence of CROs; it is particularly worth noting that 76% reported an increase in their influence on strategic product development decisions. The responses reflect a significant change since 2012, when only 40% reported an increase in their influence in the two most dynamically expanding areas (capital allocation, strategy making). One driver of this significant change may be the fact that the insurance industry has recognised the importance of the role of CROs, which nevertheless remains a new area for development and thus has yet to see an increase in influence.

Changes in degree of influence of CROs over past two years in following areas
(scale of 1-5, significant increase – significant decrease)

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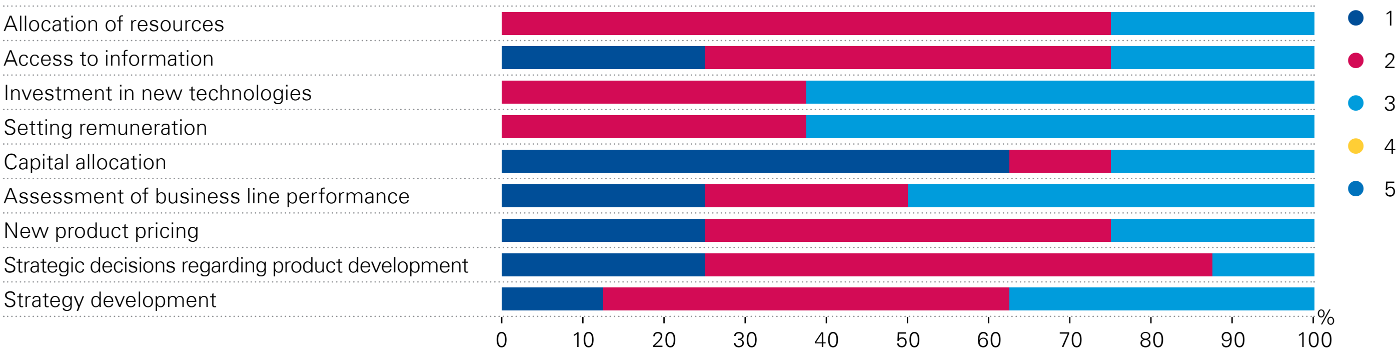

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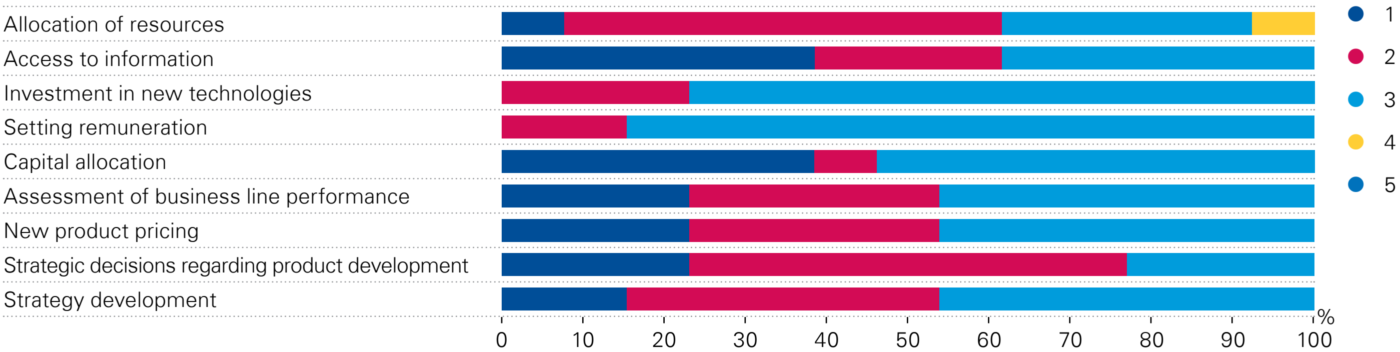

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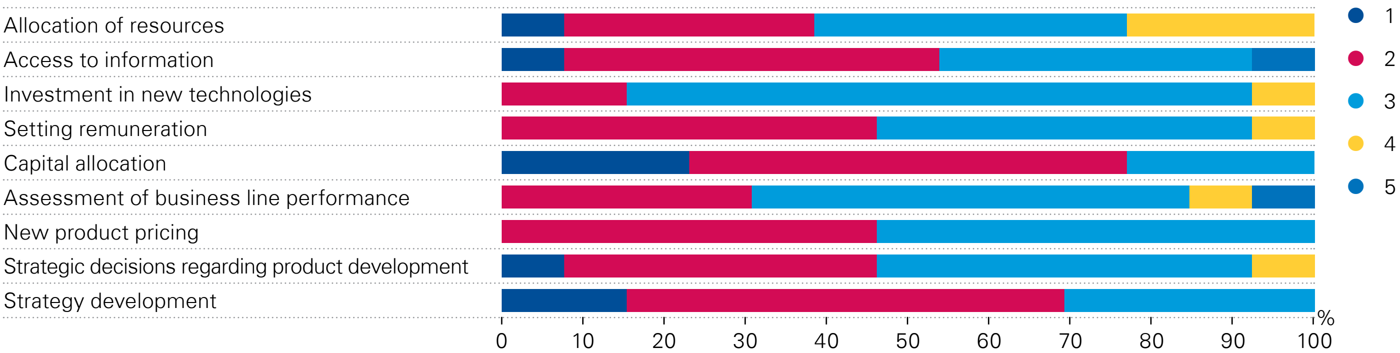


Due to the further tightening of banking sector regulations, respondents within the sector perceived the greatest increase in influence to be in the field of capital allocation. The fact that strategy development was the second-ranked category where the greatest increase was exhibited testifies to high risk-awareness.

Broadly speaking, banking sector CROs perceived a slightly smaller increase in influence compared to their insurance industry peers. If we compare these results to the 2012 survey, fewer banking sector respondents reported an increase in influence, which may stem from the fact that the CRO function has reached maturity within the sector.

Similarly to 2012, respondents perceived the smallest increase in the influence of CROs in the domain of remuneration. In our view, it would be prudent to increase the influence of CROs in this field since, according to KPMG's 2009 international survey[1] bank executives identified inadequate remuneration systems as the leading cause of the financial crisis.

3. Efficiency of information sharing and communication

Efficient communication and the sharing of data and information among organisational units are indispensable elements of the CRO's role. Based on the survey's responses, the vast majority of CROs generally believe that their channels of information and communication currently operate efficiently. According to aggregate data, no significant change has occurred since the 2012 survey, when most categories indicated efficiency in communication.

According to the survey, CROs appear to believe (similarly to the 2012 survey) that cooperation between the risk committee and the audit committee is least effective in the financial sector. One possible reason for this is that while risk committee members are generally financial institution executives, most of the audit committee members represent the owners of the institution. The formal and informal communication channels between the two bodies are generally less developed than those within the organisation. There is also a lot of room for improvement in the efficiency of communication with business areas, which means work for both areas in our estimation.

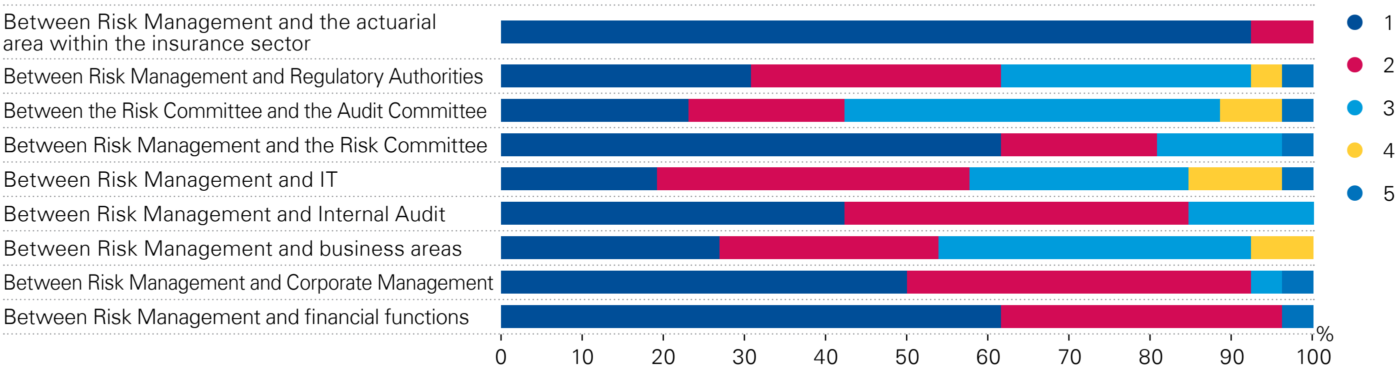
On the face of it, the CROs of large institutions gave the highest values to the efficiency of communication, which may come as a surprise. This may stem from the fact that they perceived the importance of access to information due to their size and therefore invested more resources into developing this area and fostering an information-sharing culture. The responses may also confirm that IT investments and organisational culture development can yield measurable results in terms of improved communication efficiency.

Banking industry CROs reported a minimal deterioration in information sharing and the efficiency of communication in the particular areas relative to 2012, but no significant change has materialised. Communication between risk management and IT showed to be the least efficient, and IT system shortcomings are mentioned as the factor hindering CROs to the greatest degree (see next question). This may stem from the high data requirement of bank risk management and that many large IT projects were postponed in the wake of the crisis.

For insurance companies, however, most categories saw a slight improvement over the past years, presumably arising from the gradual acceptance of the role of CROs within the insurance sector and an improvement in their organisational recognition. This is corroborated by the category exhibiting the greatest growth — communication with management — which 100% of respondents qualified as efficient or very efficient. The responses revealed that communication is most efficient with the actuarial area, closely linked through multiple ties, and is considered very efficient according to 92% of respondents.

1 Never again? Risk management in banking beyond the credit crisis, KPMG International, 2009

Efficiency of information sharing and communication with following organisational units
(scale from 1-5, very efficient – not efficient at all)



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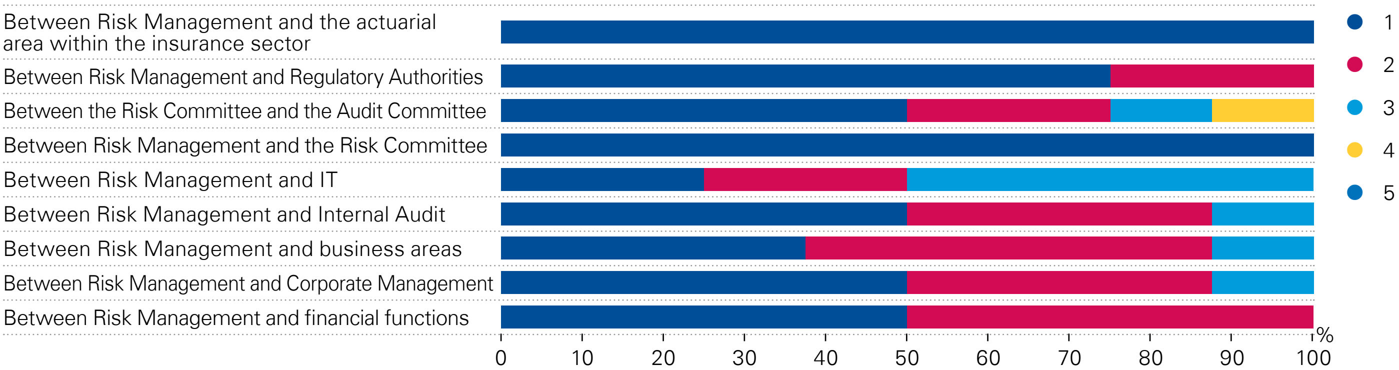

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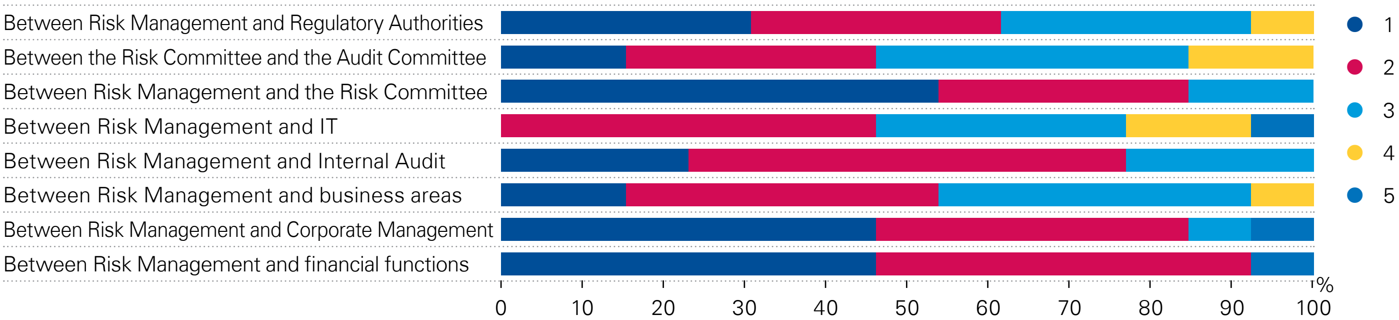

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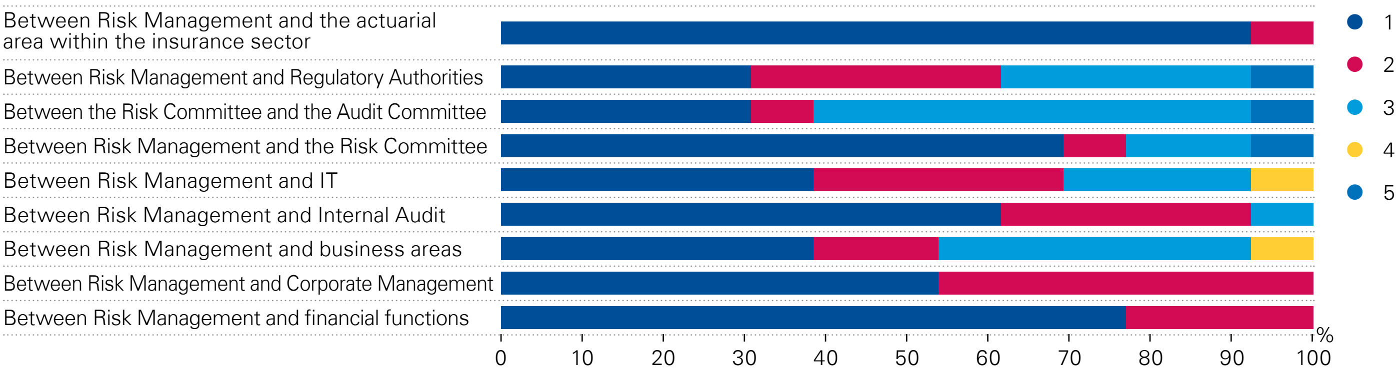


4. What impedes CROs the most in their work?

While CROs mentioned a shortage of resources as the main factor hindering their success in 2012, according to the new survey, IT system shortcomings are now clearly the main hindrance. This is explained by the increasing data requirement of the risk area and the postponement of IT developments in recent years due to the crisis.

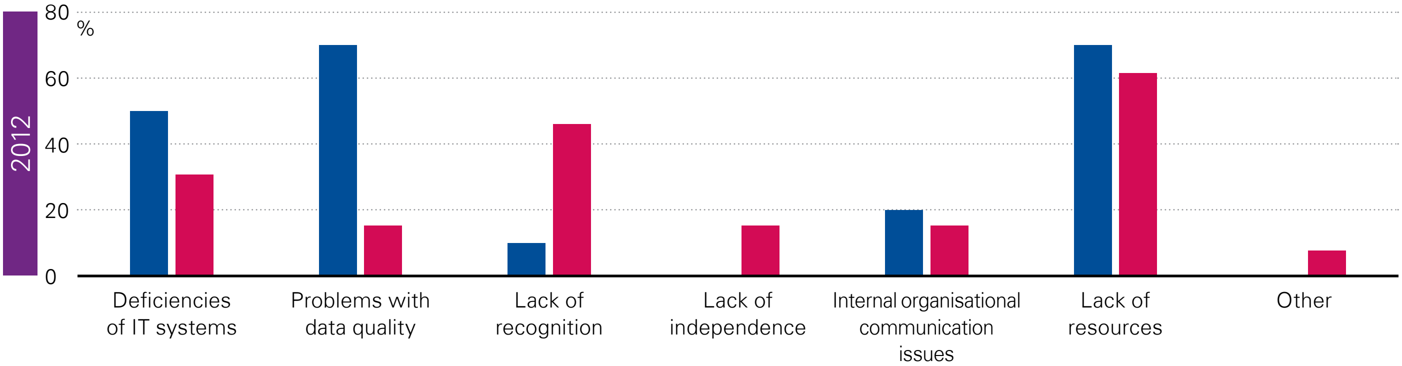
In terms of hindering factors, responses vary according to institution size. Scarce resources are a main barrier for small institutions, while the significance of this factor decreases as size increases (67%/56%/25%). The same trend applies to IT system shortcomings (78%/67%/25%), which may be correlated with the previous category given that IT system investments/developments require significant resources.

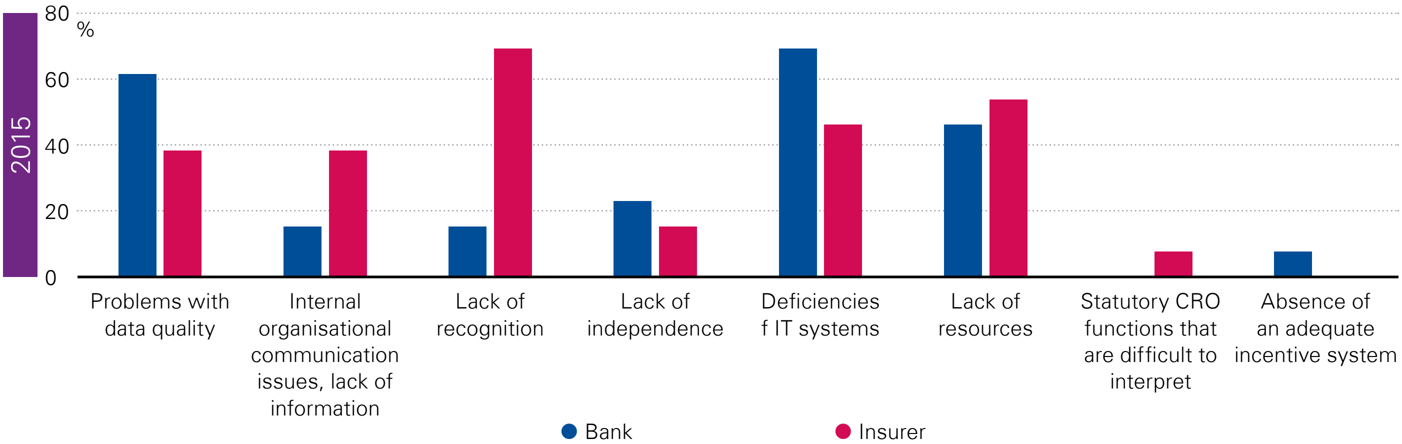
There are major differences in data quality issues based on company size: 33% of small institutions consider it an issue, compared to 100% of medium-sized institutions and only 13% of large institutions. This may stem from the lower data requirements for smaller companies — whether the result of justified or excessively simplified approaches — as opposed to a large volume of data required by medium-sized enterprises coupled in their case with a lack of development compared to their larger peers.

Data quality issues also vary across sectors. Among banking industry CROs, 62% consider data quality issues as a hindering factor, ranking them second, while this figure is only 38% in the insurance sector. The difference may derive from the fact that the increasing requirement for larger volumes of high quality data started earlier in the banking sector, and the absence of such data is a major impediment. This trend appears to be cropping up increasingly among insurance companies: in 2012 only 15% of respondents assessed data quality issues as an obstacle, compared to 38% at present.

The most conspicuous sectoral difference emerges with regard to the lack of recognition, which 69% of insurance sector CROs identified as a stumbling block, compared to only 15% of their banking sector peers. This difference was also observed in 2012, and no significant progress has been made in the insurance industry.

What impedes CROs the most in carrying out their work successfully?

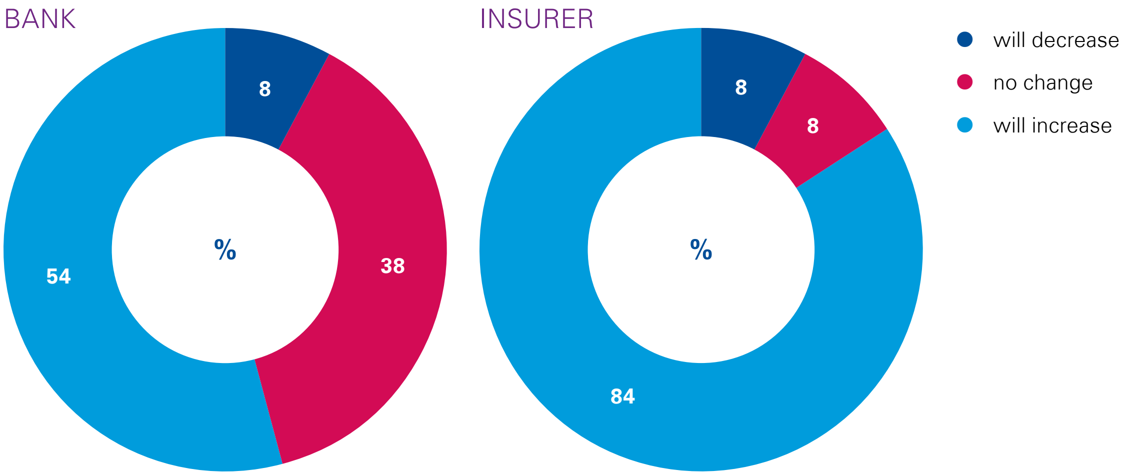




General role of the CRO at sectoral level

1. Change in the CRO role within organisations in the next two years

Significance, influence and decision-making authority of the CRO role in organisations in the next two years



Respondents remain broadly optimistic regarding their own organisational function. The majority report that the importance, influence and decision-making authority of the CRO role will continue to increase in the next two years. Relative to 2012, the picture is more nuanced given that in 2012 95% of respondents expected an increase irrespective of sector. This may be warranted by the fact that — particularly in the banking sector — the significance of the role of CRO is approaching the level deemed necessary and therefore a smaller increase is called for. Along these same lines, insurance sector CRO expectations regarding a rise in their future influence are more positive, and according to the previous question, they deem the lack of recognition as a barrier.

2. What is the best measure of CRO performance?

How well can the success of a CRO be measured using the following indicators?
(1 – very important indicator, 5 –completely unsuitable indicator)

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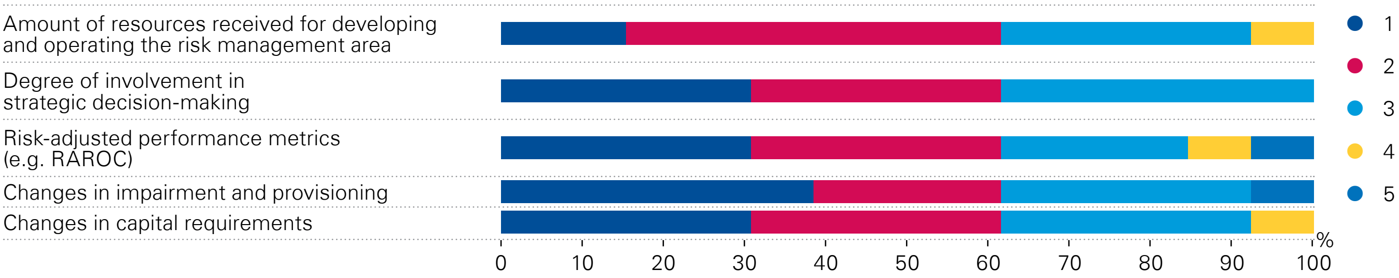

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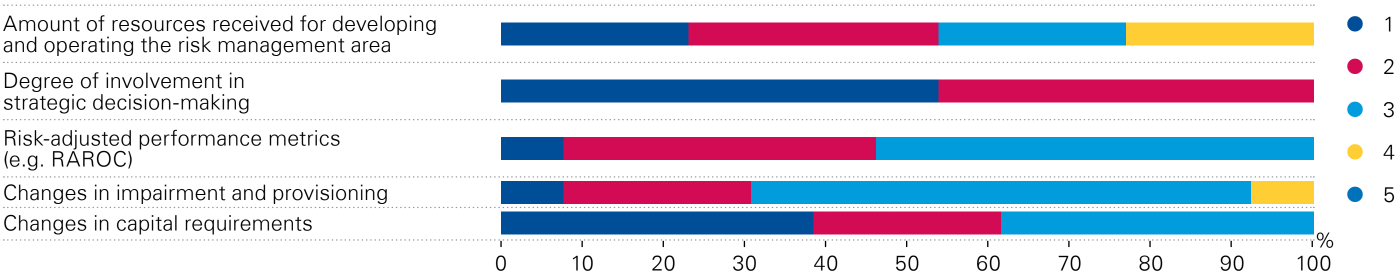

In order to gain insight into CROs' assessment of their own work, we asked them which of the used and listed indicators they deemed most suitable for measuring their success. No trends can be identified based on size in the responses, however, there are substantial differences between the banking and the insurance sectors.

Banking industry CROs gave a relatively uniform assessment of the various indicators, suggesting that the role of CRO is a mature function within the sector. Over 60% of respondents assessed every indicator as important or very important in measuring success. The indicator with the worst rating (unsuitable or entirely unsuitable according to 15%) was RAROC, which may be due to the fact that this metric gives an aggregate picture of business line performance rather than reflecting the work of the CRO.

In contrast to the banking sector, the assessment of the indicators used for measuring the success of CROs exhibits a broader range of opinion in the insurance sector. Changes in impairment and provisioning was mentioned as the least suitable indicator, which may stem from the fact that this task is typically performed by the actuarial function within the insurance industry and therefore carries less significance for CROs. Based on the responses, participation in strategic decisions is the most important indicator, which echoes the earlier finding that the role of CRO is not yet a mature function within the insurance sector. The main factor hindering their work is a lack of recognition.

3. What is the best form of value creation by the risk function?

What is the best form of value creation by the risk function in terms of the institution's long-term successful operation in the upcoming two years?
(scale of 1-5, best form – worst form)

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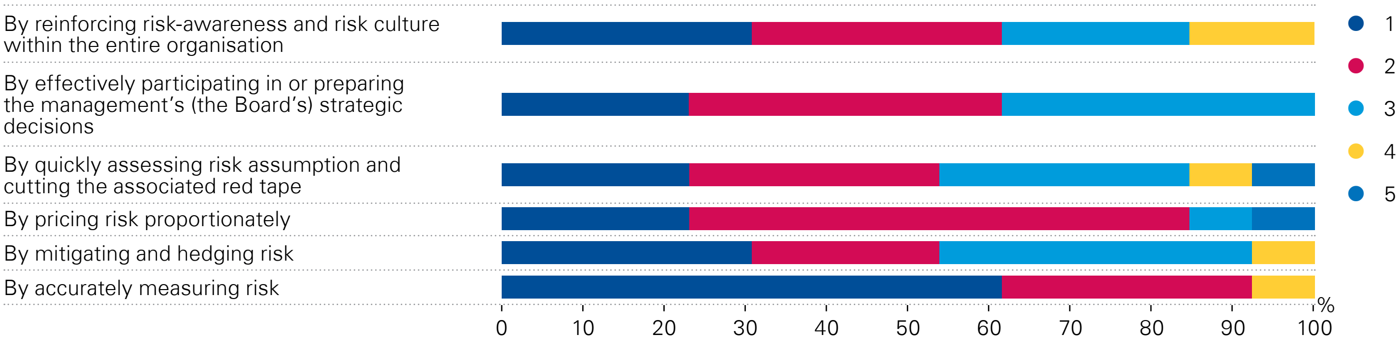

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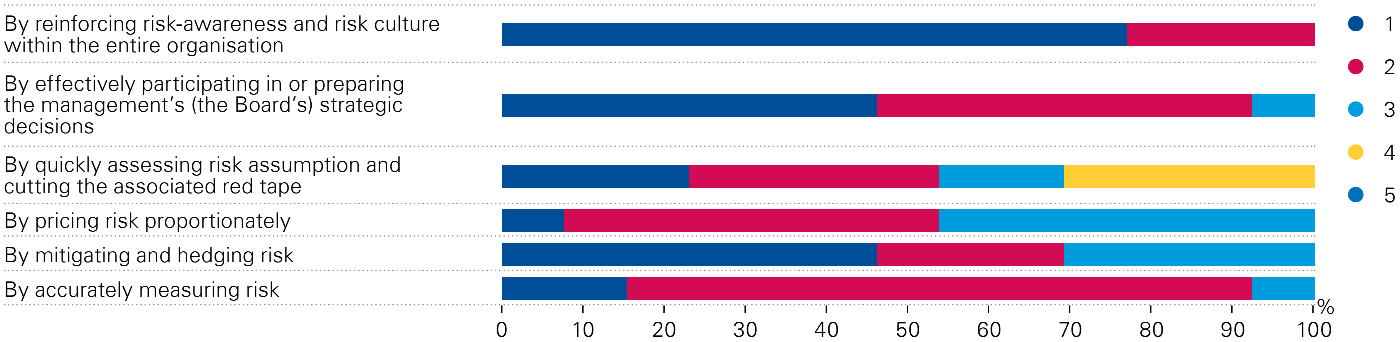


Regarding the role of risk management and value creation, we asked CROs how the risk function could best contribute to value creation in their view, in terms of long-term successful operation.

Based on banking industry CRO responses, the most important task is to accurately measure and price risk. Among those surveyed, 84% reported that value can best be created in the long run by pricing risk proportionately, and 92% said this can be done by accurately measuring risk.

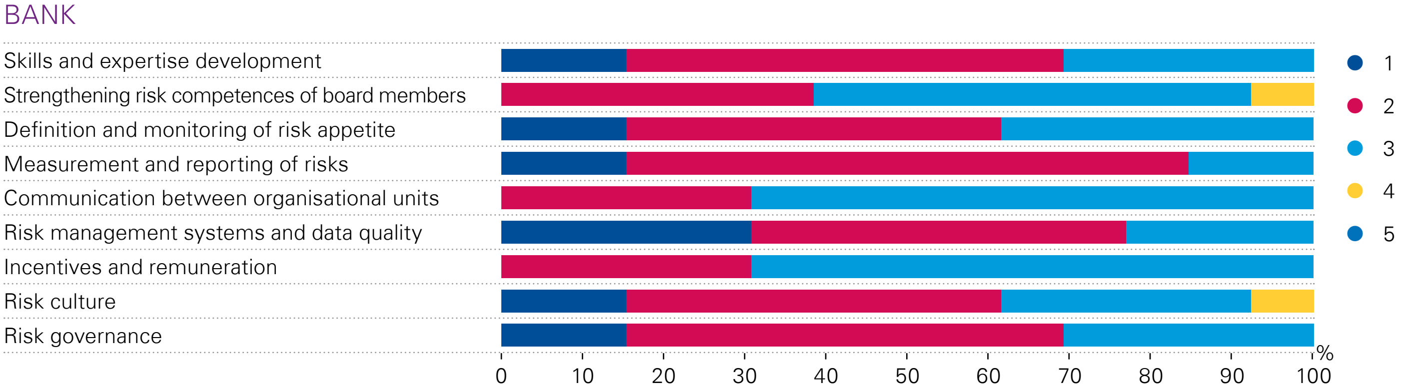
Based on the responses (and in contrast to banks'), respondents assessed the value creating capacity of the risk function as positive in several areas. This may reflect the trend, mentioned earlier, whereby the risk function is still in development in the insurance sector, and recognition and influence need to be further improved. Insurance industry chief risk officers deemed risk-awareness, risk culture and participation in preparing strategic decisions as among the most important areas. Similarly to their banking industry peers, 92% of insurance industry CROs reported that the risk function can create value by measuring risk, but only half of respondents reported this for the pricing of risk. The difference may emanate from the fact that in the insurance sector, the pricing of risk is typically designated to the actuarial function.

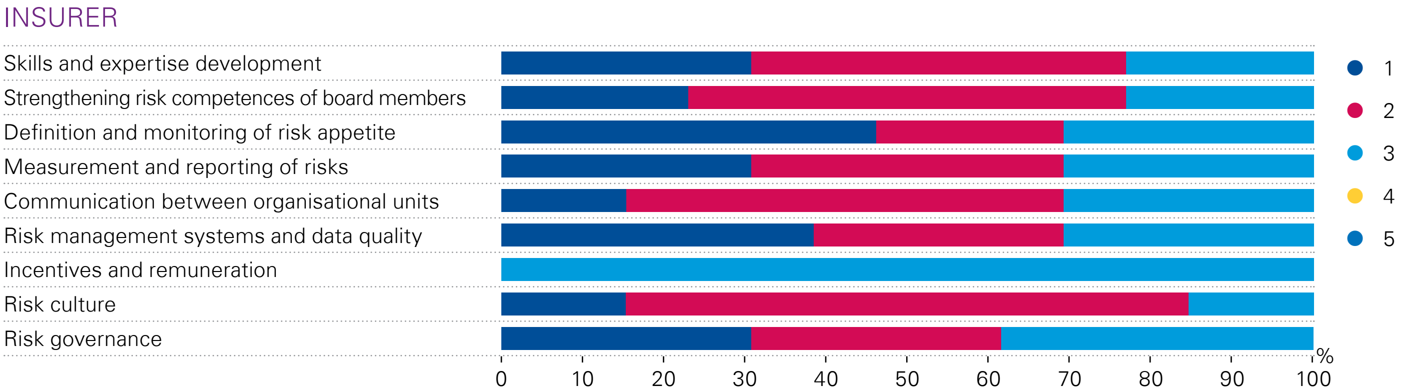
Banking and insurance industry CROs identified the quick assessment of risk assumption and cutting the associated red tape as least important in terms of value creation. We believe, however, the increasing social/economic need for acceleration and simplification will require the reform of risk management methods and processes, and pioneers in this area will gain a fundamental competitive advantage.

Available resources and skills

1. How do you plan to allocate your resources in the coming year?

How do you plan to divide your resources in the coming year?
(on a scale of 1 to 5, significantly increase – significantly reduce)





To gain insight into the preferences and resource utilisation of CROs, we asked them how they planned to allocate their resources in the upcoming year. Broadly speaking, the vast majority of respondents plan to increase their resource utilisation across all areas. This stems directly from the aforementioned scarcity of resources.

Based on the responses, banking sector CROs plan to increase resources in the categories of risk measurement and reporting, and risk management systems and data quality. This is partly linked to the fact that data quality and system shortcomings were the most significant issues reported. It also stems from the fact that value creation by the risk area mainly takes on the form of the accurate risk measurement.

Among insurers, an increase in resources is planned in more areas proportionately speaking. Within the categories, the majority — over 80% — indicated developing risk culture, followed by improving the risk competences of board members and developing expertise. The responses — over and above the aforementioned factors — show that CROs plan to allocate resources primarily to developing and creating the necessary frameworks for the effective carrying out of their function.

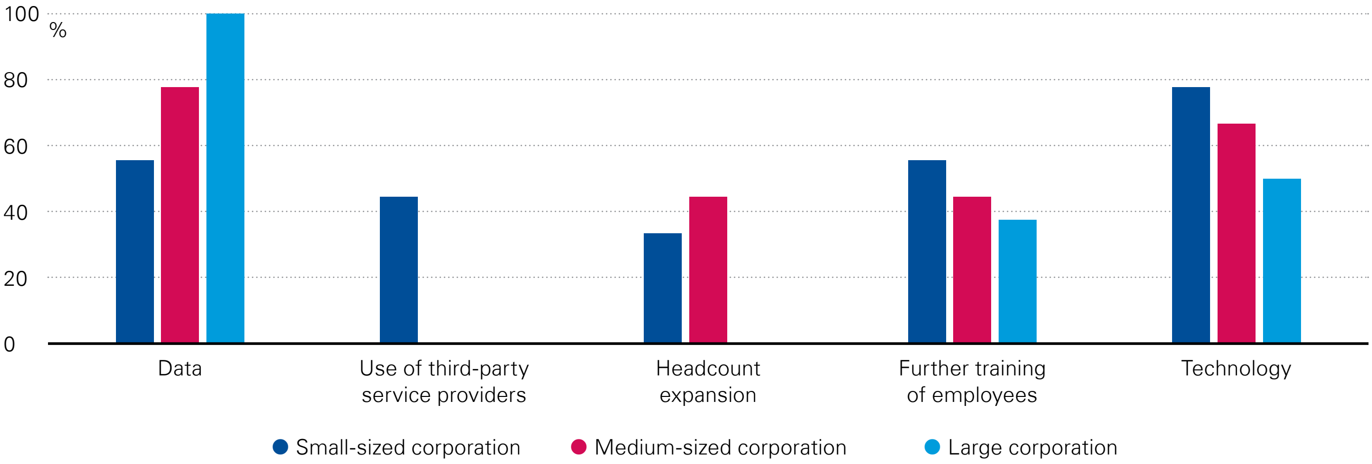
2. What would you like to use your development resources for next year?

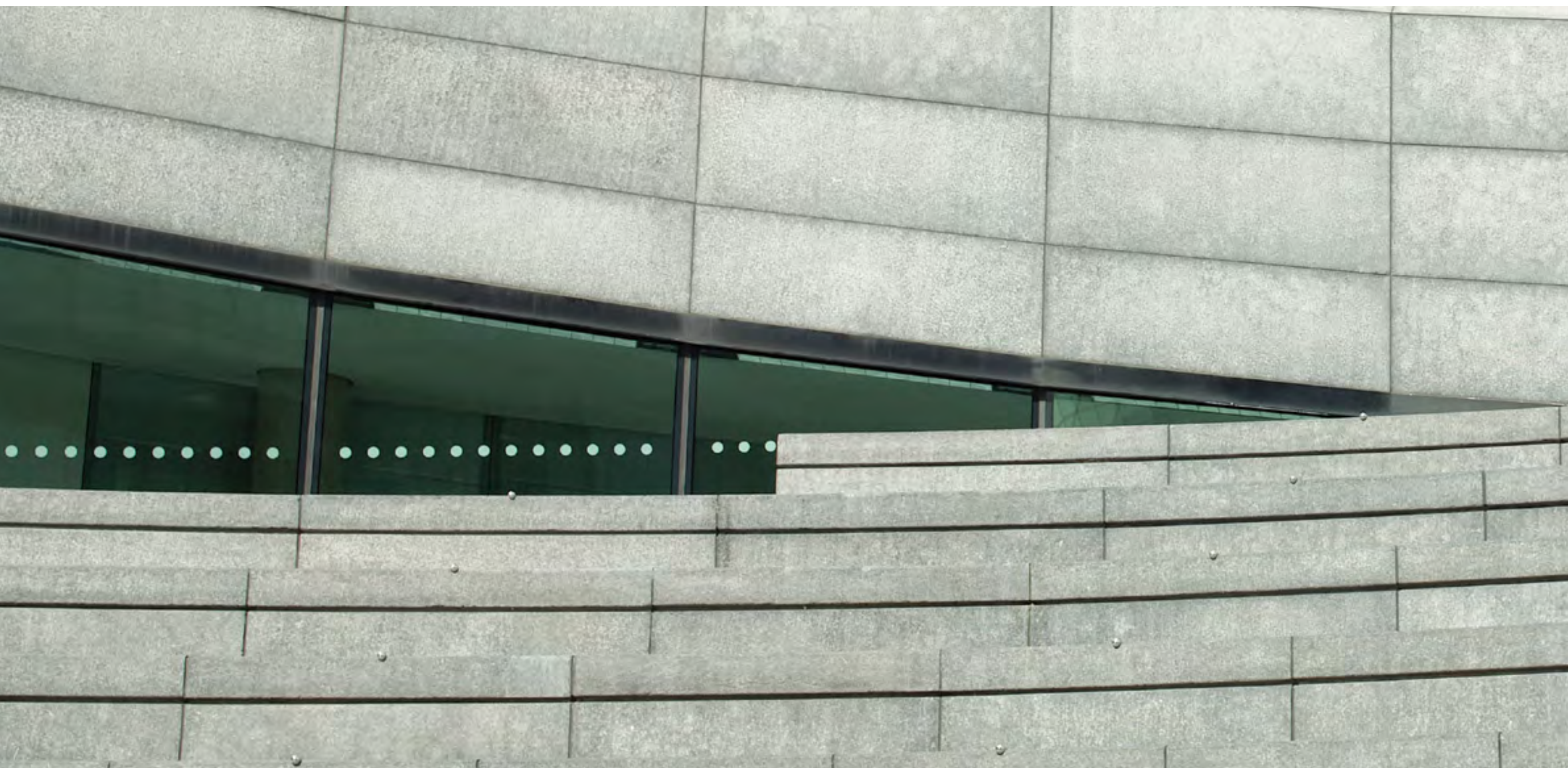
The main focus of planned developments is clear based on CRO responses: data and technology are the primary investment targets. This coincides with the fact that data quality and IT system shortcomings are mentioned as the main hindrances across all categories.

In addition, there are also differences across sectors and company size. Characteristically, insurance companies and smaller institutions plan to allocate resources to increasing their headcount and using third-party services, i.e. to expanding means. Meanwhile, banks plan to allocate resources to improving data quality.

There is a change in terms of company size compared to the findings from 2012. Earlier, all three groups planned to allocate development resources to third-party service providers, while at present, only small enterprises gave account of such plans. In addition, the order has reversed based on company size in terms of resources to be allocated to employee training. Earlier, the proportion of CROs who considered further training important grew in parallel with company size, while the proportion is now increasing as company size decreases.

What would you like to use your development resources for next year?





3. How will development resources change in the future?

Regarding development resources, the majority (62%) expect no change in the future, which is far more pessimistic than the 2012 outcome, when 47% expected an increase in resources. As a sectoral difference, 46% of insurance industry CROs expect an increase, compared to only 8% in the banking sector.

Based on size, the expectations of the CROs of small and large institutions are more or less the same, while a significantly higher proportion of CROs at medium-sized enterprises expect an increase (22%/33%/25%). In addition, the optimism of CROs of small institutions regarding an increase in their influence is not reflected in their outlook for development resources — 88% expect an increase in their influence in the upcoming two years, while according to the above findings, only 22% expect an increase in development resources.

How will development resources change in the future?

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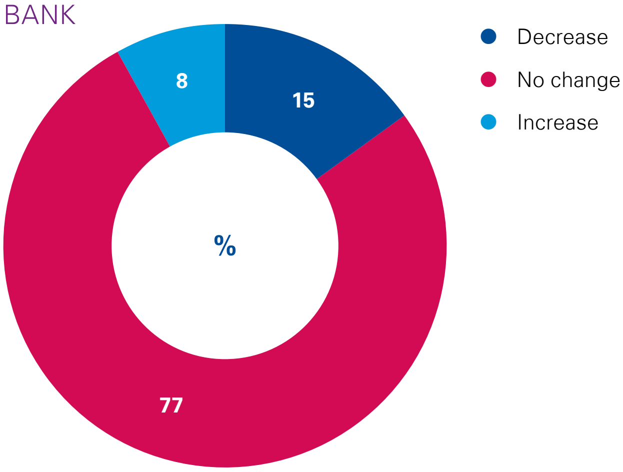

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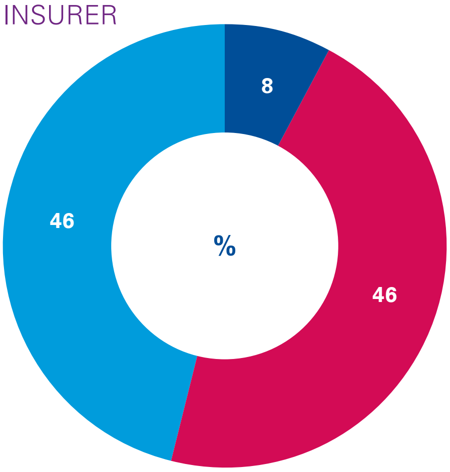

General market trends

1. Change in regulatory requirements

In your opinion how have regulatory requirements changed in the following areas in the last two years? (scale of 1-5, significant tightening - no tightening)

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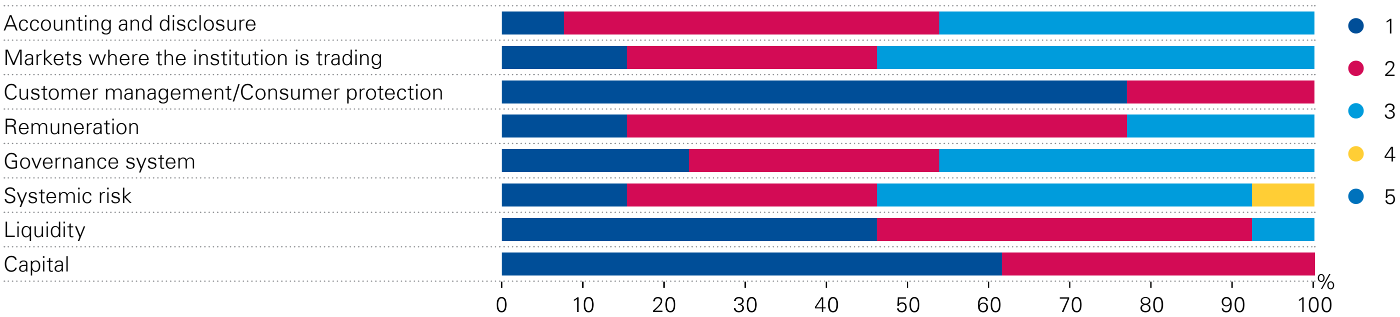

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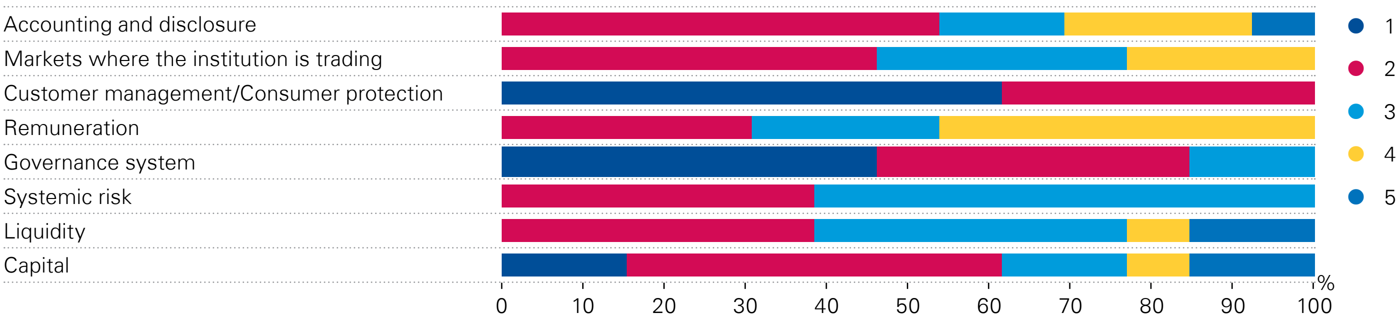
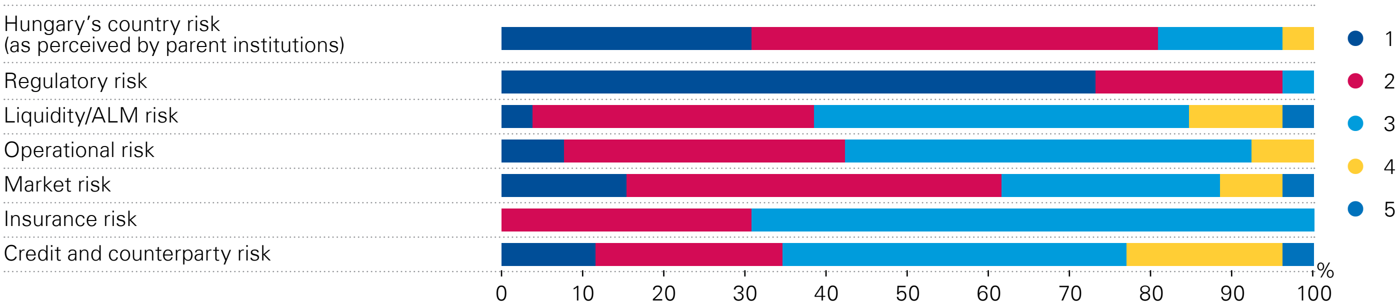


The responses clearly indicate that respondents perceived a significant tightening of bank regulation requirements over the past two years. With the exception of systemic risk, none of the respondents indicated an absence of tighter requirements. The results clearly show that over the past two years, the adopted regulations have affected the area of consumer protection to the greatest degree. In addition, a very high proportion of respondents reported a significant tightening of capital adequacy and liquidity requirements.

In contrast to the banking sector's sentiment, the situation is less straightforward in the insurance industry. Similarly, the most significant change was perceived in the area of consumer protection in this sector as well, with respondents reporting a significant tightening of requirements. Regulations related to governance systems also underwent significant tightening according to respondents. Besides these two categories though, the responses contradicted each other, stemming for example from the fact that the introduction of Solvency II entailed improvements in the capital adequacy position of many insurers.

2. Changes in the risk environment

In your view, how has the risk environment changed over the past two years for the following risk types?
(scale of 1-5, significant rise in risk exposure - significant decrease in risk exposure)



We also queried CROs as to how they perceived the changes in the Hungarian risk environment over the past two years. Their replies indicated that the regulatory risk category underwent the greatest increase. This rise in risk exposure is linked to the dynamic change of Hungarian regulations, and complying with them creates a significant burden for both banks and insurers.

Similarly, a pronounced increase was experienced in the country risk category from the perspective of parent institutions. An improvement based on country risk rating is not yet reflected among parent institution priorities; Hungary still has a poor regional ranking in terms of the central distribution of development/ investment resources. This holds particularly true for insurance companies where developments and investments have ground to a halt and parent companies often strive for the cheapest solutions. This process also applies to banks, but has taken place earlier, i.e. not in the past 1-2 years. The improvement in the various country risk indicators and the expected upgrade is expected to filter through to parent institutions' strategic thinking rather later.

In the other categories, a slight increase in risk was broadly observed, and no significant deterioration was reported in the credit and counterparty risk categories.

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