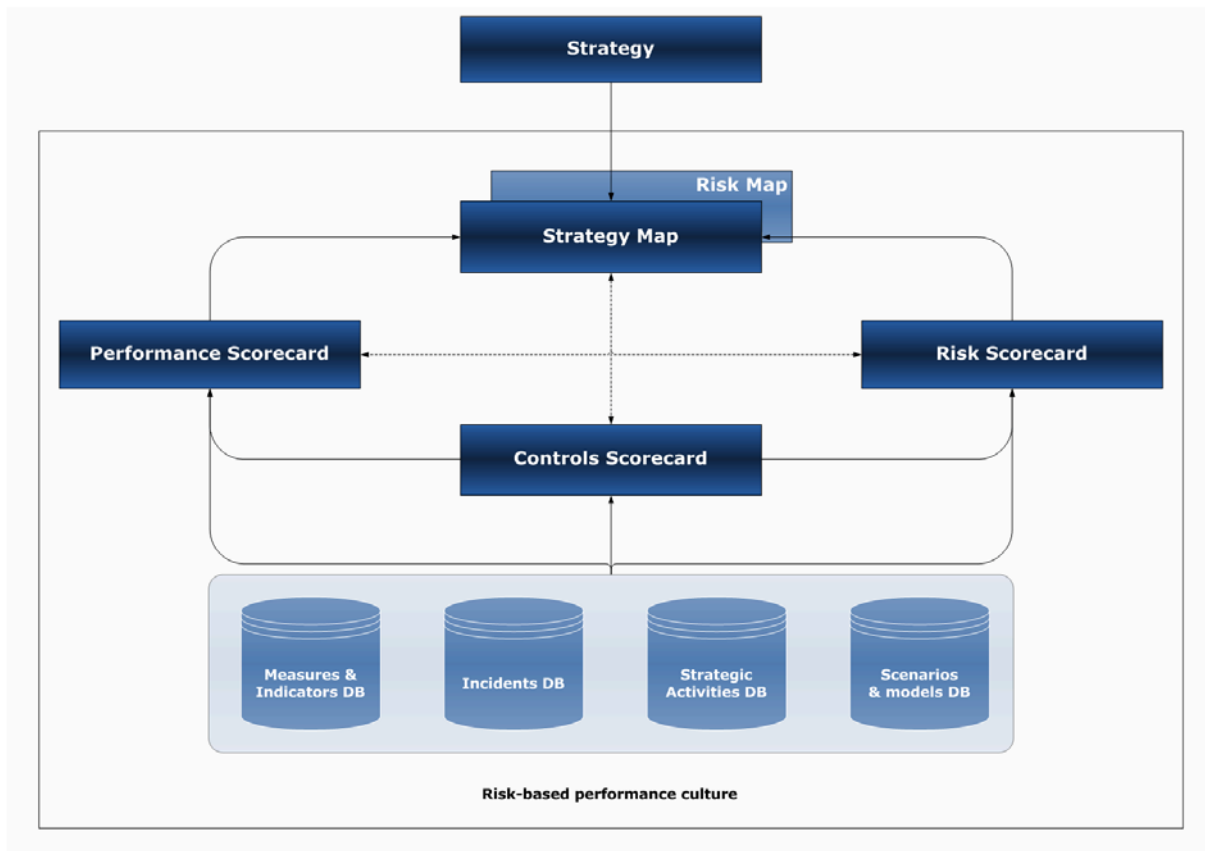


Risk-based Performance

Managing with one eye on performance and one eye on risk

Introduction and Research Summary

March 2008



"Linking the scorecard to manage operational risk seems like an excellent idea"

– Professor Robert Kaplan, father of the Balanced Scorecard

Executive Summary

This summary report introduces the Risk-based performance methodology and provides a summary of a year-long research project that refined and validated the methodology. It also summarises a project where Risk-based performance was implemented in an investment bank.

The Risk-based performance methodology is designed to integrate and align performance management and risk management, with an emphasis on strategic and operational risk; enhancing strategic execution through improved management discussions, decision-making and action-taking.

Building on widely used methodologies the Balanced Scorecard and COSO frameworks, Risk-based performance provides an integrated methodology that enables organisations to address the performance and risk challenges presented in today's increasingly regulated and competitive business environment.

The Risk-based performance methodology was developed with clients to enable them to meet the challenges of implementing BASEL 2 (AMA) and Sarbanes Oxley whilst attempting to meet performance goals in an increasingly competitive market. In more recent months, the credit crunch has added another set of challenges when considering performance and risk management processes.

Manigent's research identified a number of factors that reduced the quality of performance and risk management information whilst pushing up its cost. Many of these factors can be traced back to the practice of implementing performance and risk management processes as isolated, silo processes.

Our research also shows there is significant potential for major cost savings and reduction in regulatory capital requirements through the use of robust performance and risk management processes. Additionally our clients and research highlight a number of benefits from the use of the Risk-based performance methodology, including;

- Enhanced strategic execution,
- Reductions in risk-related losses,
- Cost savings through eliminating duplicated processes and removing complexity,
- Significant enhancement in the quality and actionability of management information,
- Potential to reduce regulatory capital and the cost of capital.

Generally, there is significant room for improvement within the UK financial service industry in relation to performance and risk management and the integration of these processes to enhance strategic execution.

With its emphasis on addressing performance and risk via an integrated approach, added to the fact it is built on existing methodologies, Risk-based performance was seen as an appropriate method for financial service organisations to improve their performance and risk management processes.

Key Challenges

The financial services industry, like many industries, is becoming increasingly regulated (both by government and non-government organisations) and competitive. Over the past few years the industry has had to meet regulatory demands such as BASEL 2 and Sarbanes-Oxley whilst meeting the expectations of an ever more demanding market and shareholder community.

In more recent months, the industry has been hit by the credit crunch, which continues to expose strategic, performance and risk management failures.

To meet these challenges management teams need timely, accurate information to inform their discussions, drive decision-making and action-taking. Unfortunately, often management information lacks clarity due to the lack of an integrated management framework and the existence of multiple isolated, silo performance and risk management processes.

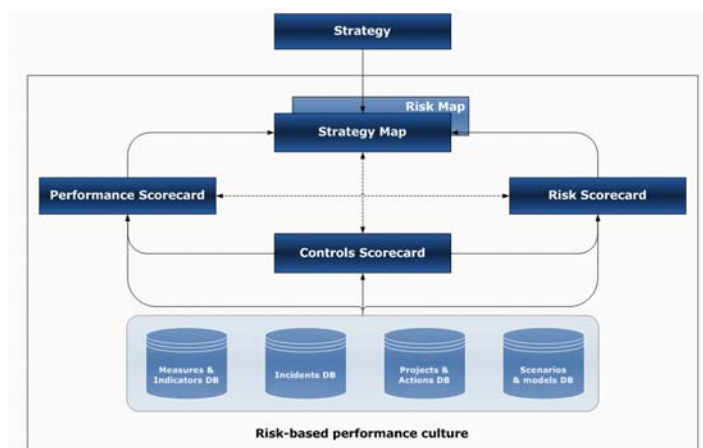
Risk-based performance

Building on the Balanced Scorecard and COSO frameworks, Risk-based performance integrates performance and risk management processes and tools to provide the information demanded by executives to manage the trade-off between risk and reward, and drive strategic execution.

Moving beyond the traditional silo approach whereby processes are performance focused or risk focused, Risk-based performance provides a comprehensive framework integrating these closely related processes.

Taking a pragmatic and 'keep it simple' approach, the methodology addresses some of the traditional issues within performance and risk management. These include: the challenge of embedding risk and performance management into organisational culture and daily decision-making, too much data and not enough information, and too many measures but few true indicators.

Figure 1 - Risk-based performance methodology



Key features of the Risk-based performance methodology include:

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- Combining specific data-driven indicators with management judgment and experience via the interaction of the Strategy Map and Risk Map.
- Clarity of information through differentiating between different types of indicators such as KPIs, KRIs and KCIs, and also differentiating between indicators and measures.
- Combining historical information, measures, indicators and incidents with future-oriented information such as programmes, projects, scenarios and strategic models.

Case study

One of the early adopters of the Risk-based performance methodology was the global IT function within a London based investment bank.

In addition to the dual challenges of meeting BASEL 2 and Sarbanes-Oxley, the global IT function was faced with delivering an enterprise-wide risk and controls project and overcoming internal cultural issues, specifically around achieving buy-in and embedding the planned processes into everyday culture.

Initially traditional Risk and Controls matrices were developed and implemented using ad-hoc processes supported by spreadsheets, however problems were quickly identified. As there was a Balanced Scorecard already in place, there was particular concern about the duplication of processes and information, and the negative impact on staff of yet another data capture process.

At this point, Manigent suggested a more strategic and integrated approach that would build on both the existing Risk and Controls matrix and the Global Balanced Scorecard.

The Risk-based Performance methodology was introduced to provide a conceptually sound framework to guide the development of an integrated performance and risk management process supported by a specialist software application. The resulting system and processes were implemented in 32 centres around the world, providing information to multiple levels of management and also reporting to multiple regulators and external stakeholders.

Applying the principles and approaches within the Risk-based performance methodology, the final solution achieved a high level of buy-in and support because the IT function was able to reduce process and reporting complexities whilst delivering a focused set of management scorecards, dashboards and reports. Delivering risk identification and assessment within the context of the organisation's strategic objectives allowed them to reduce the number of key risks from hundreds to tens, with similar reductions in the number of measures, indicators and volume of data.

In the face of tighter market conditions as a result of the credit crunch, the Risk-based performance methodology is now being implemented more widely within the bank to address its current performance and risk management issues.

Research project

The Risk-based performance methodology was developed working with financial services clients and was refined and validated through a year-long academic research project.

The hypothesis behind the research project was that financial services organisations generally implemented performance and risk management process (specifically operational risk processes) as isolated, silo processes. Given that the data, processes, systems and ultimate consumers of the management information from these processes are the same or very similar, we believe that organisations would benefit significantly from taking an integrated approach, as supported by the Risk-based performance methodology. Additionally we believed that taking a silo approach leads to significant reduction in the quality of management information and significant increase of related costs.

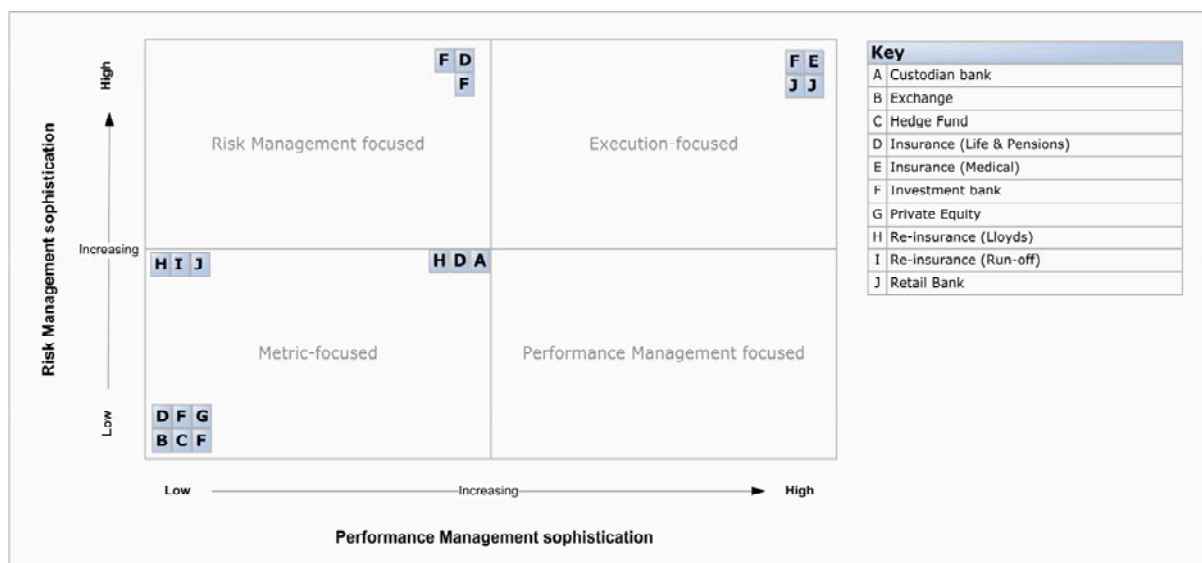
The research project involved 21 executives from 19 UK-based financial services organisation. There was a balance of different types of organisations and participants from different roles: finance, risk management, operations and IT roles. Supporting the field research was extensive literature and case research.

Key findings

The key findings from the research project are perhaps unsurprising to those in the performance and risk management fields.

The research confirmed the financial services industry is becoming increasingly regulated and competitive. We also found organisations are largely metric-focused, reacting to regulatory demands more readily than competitive demands, demonstrating a lack of a strategic approach. The metric-focus is highlighted below.

Figure 2 - Performance & Risk Matrix



In addition our research confirmed or found the following:

- Performance and risk management processes are generally implemented as isolated, silo processes. Nine research participants identified this as a major issue.
- There is a lack of clarity around the boundaries between risk and compliance functions. Whilst this was an issue for a number of organisations, two participants provided solutions. They suggested the risk function should focus on the organisation's strategic agenda whilst compliance focuses on the regulatory agenda.
- The four execution-focused organisations shared a number of common characteristics, including disciplined reporting and review processes and engaging in organisational learning as a key part of their performance and risk processes. Interestingly, two of these organisations had experienced headline-making risk events.
- The Balanced Scorecard is not being adopted as widely as business literature suggests. Only two organisations, both execution-focused, indicated they used a Balanced Scorecard, with another three stating they 'might' use one and 10 saying they did not use one.
- Given the previous point, it is perhaps not surprising we found the industry takes a tactical, indicator-driven approach. Eight participants confirmed this approach. A strong focus on Key Performance Indicators (KPIs) to report on everything, including risk and controls, while there was a minimal use of strategic objectives.
- Developing the 'right' culture and embedding performance and risk considerations into daily decision-making and action-taking was highlighted as major issue. Seven participants characterised the 'right' culture as 'open, honest, no surprises' and four participants suggest performance and risk management should be 'everyone's job'.
- A lack of maturity in relation to performance and risk management processes and practices was clearly identified, with 14 participants highlighting this issue.
- There is a perception performance and risk processes must be totally data-centric, leading to many organisations being data rich but information poor. Often management teams are somewhat overwhelmed by data but lack actionable information and a mechanism to incorporate management judgement and experience.

Key benefits

Our research found that adopting an integrated approach to performance and risk management produces significant benefits for improving strategic execution, as well as reducing risk-related loss, cost savings, and improved management information.

The following figures highlight the scale of these benefits:

- 40-70% of organisations fail to successfully execute their strategy.
- One study found the average short-term financial loss on large risk events (greater than US\$1m) is US\$65m, with a tail loss after 120 days climbing by a factor of 12 – an average of US\$780m.
- Another study between 2001 and 2005, found Risk related losses at the top 12 US banks represented 4-5% of their net income.
- A study of operational risk losses at 200 financial services organisations between 1997 and 2002 found 150 cases of significant financial distress at 90 organisations.
- More surprisingly, these three studies generally agree that 50% of these losses were caused by factors within the organisations control, thus they were preventable.
- It is estimated a 25% reduction in regulatory capital can be achieved by implementing performance and risk processes and systems to meet the demands of BASEL 2 (AMA).
- One leading expert suggests reducing operational losses offer the potential for greater cost savings than tradition cost-cutting approaches.

Clients and research participants saw the Risk-based performance methodology as an appropriate framework for enabling these benefits to be realised and allowing many of the current issues around performance and risk management to be addressed. It is a proven approach to addressing many of the challenges financial services organisations face in relation to management information, such as:

- Risk-related losses,
- Inflated costs due to duplicated processes and unnecessary complexities,
- Poor quality and inactionable management information,
- Poor strategic execution,
- High regulatory capital and the cost of capital.