



Risk Adjusted Performance Measurement

A TOOL FOR THE GLOBAL FINANCE INDUSTRY

- A Survey by the Professional Risk Managers' International Association (PRMIA), with SunGard BancWare

EXECUTIVE SUMMARY

MARCH 2007

www.PRMIA.org

PRMIA

SUNGARD® BANCWARE



ABOUT PRMIA

PRMIA is the Professional Risk Managers' International Association. Formed in January of 2002, PRMIA is the higher standard for risk professionals with more than 60 chapters around the world and over 39,000 members from more than 170 countries. A non-profit, member-led association of professionals, PRMIA is dedicated to advancing the standards of the profession worldwide through the free exchange of ideas. PRMIA offers the only globally endorsed Professional Risk Manager (PRM™) certification program, pursued by over 1,900 active candidates from more than 90 countries, more than any other risk certification program. More information can be found at www.PRMIA.org.

Contact PRMIA at surveys@prmia.org

SUNGARD® BANCWARE

ABOUT BANCWARE

A solution suite for integrated risk and performance management, BancWare is used by banks, mortgage and credit lenders, and other financial services institutions. Designed for finance professionals, BancWare's modular software and consulting solutions for asset/liability management, budgeting and planning, profitability, economic capital, operational risk and Basel II compliance provide a unified view of risk to help improve capital management and better business decision making at all levels of the organization. More information can be found at <http://www.sungard.com/bancware>.

Contact Alyssa Gilmore, Director of Marketing at bancware.marketing@risk.sungard.com

EXECUTIVE SUMMARY

IN LATE 2006, the Professional Risk Managers' International Association (PRMIA) and SunGard BancWare, brought together over 240 risk management professionals from 47 countries for a survey on the current use and future implementation plans for risk-adjusted performance measures in the business decision making process.

Eighty (80) Chief Risk Officers, representing a diverse cross-section of financial service firms, joined 110 other senior executives in providing the core input to the results received.

The data present an interesting perspective on both differences across industries as well as across geographic regions.

- Overall the survey results indicate an advancing use of risk-adjusted performance measures, particularly in the areas of deal execution, hedging and product pricing.
- Nearly 90% of respondents report that they either currently use risk-adjustment performance measures (RAPM) in some form or that they intend to.
- The greatest future uptake of RAPM is geographically in the Asia/Pacific region and, by sector, in Energy. The greatest current usage of RAPM is in Banking, Insurance and Alternative Investments.
- The highest implementation of RAPM calculations takes place at the organizational/line of business level, suggesting that the data available to most might not support further granularity until a later date. Supporting this conclusion, over 80% of respondents expected to employ RAPM measures at the product level within 24 months, while just 37% currently do.
- Only 33% of respondents classified their current risk management infrastructure as being carefully-structured and supported by senior management, while 13% still consider their infrastructure to "barely exist."
- RAROC continues to dominate RAPM calculations with EVA usage in distant second-place.
- Risk-adjusted performance measures are most frequently reported quarterly to the Board and monthly to Senior and Executive Management.
- Credit Risk is the most frequently and accurately incorporated risk measure in RAPM reporting.
- At firms where RAPM is not in use, the most frequently cited reason was a lack of funding.

INTRODUCTION

Risk-Adjusted Performance Measurement is Gaining Recognition as a Critical Focus Point for the Financial Services Industry

Globally, economic conditions and increasing regulation are creating a financial business environment in which it is ever more difficult to maintain profitable margins and manage operating costs. Therefore, many financial institutions are searching for opportunities to apply strategic risk management principles and practices that can help them increase profitability and accurately measure and forecast their risk-adjusted performance.

A recent study by Aite Group concluded that profitability solutions are increasing in acceptance across all banking tiers, and that investment in such tools is expected to increase by 10% year over year through 2010¹. Our survey results support this conclusion.

The Importance of RAPM

Once the realm of only the largest banks, over the past decade, Risk-adjusted Performance Measurement (RAPM) has been of growing importance to all financial institutions as a method of comparing themselves against peers and also of measuring individual internal departments. It allows units to be measured on their risk management and their ability to use capital effectively as well as their strength in growing revenues or profits.

RAPM compares financial measurements, i.e. profits, sales or revenue returns, associated with a particular activity, against the amount of capital required to produce those returns, and adjusts those measurements to take into account the amount of risk involved in the activity. The organization typically measures the amount of the return against a fixed sum of capital, known as risk-adjusted return on capital (RAROC), or the Economic Value Added (EVA), or Shareholder Value Added (SVA).

Financial institutions are now applying this information beyond the organizational dimension to product, customer and account levels. Examples of this include product structuring and pricing strategies on the retail portfolio, as well as more active customer management. For example, diversification across customers may allow for the more aggressive pricing of new business, while a better understanding of deal or customer risk may discourage the retention of business that is not accretive to the bank.

CONTINUED ON NEXT PAGE

ECONOMIC AND REGULATORY CAPITAL

Economic capital is the sum required to cover the unexpected losses associated with activities undertaken to achieve a return. Economic capital is used by financial institutions to influence decisions about the strategic direction to take, what types of business to follow or whether or not to take on a transaction. It thus allows comparison between companies and between operating divisions.

Historically, return on equity (ROE) has been used to measure and compare companies, but this has disadvantages. ROE does not take into account the risk inherent in any organization, nor does it allow comparisons between parts of an organization. RAPM, using RAROC, EVA or SVA, takes into account the riskiness of any venture and also allows intra-company comparisons.

Economic and regulatory capital are very similar in concept. The first is the level of capital that the organization perceives is needed to continue operations with an acceptably high level of probability; the second is the level that is perceived to be needed by a financial regulator – typically concerned with systemic risks – for the firm to continue operating and be solvent. Normally, but not always, economic capital is of a higher level than regulatory capital.

¹ Aite Group, *Profitability Analytics: Growing in Adversity* (December 2006)

RAPM and Regulatory Capital

Financial regulators are also interested in evaluating the amount of risk inherent in any financial organization and in ensuring that the organization has sufficient reserves, i.e. regulatory capital, put aside to cover these risks. Financial institutions therefore have to calculate their regulatory capital on the basis of risk weightings in order to satisfy their regulators. It makes sense, therefore, for banks to implement the calculation of economic capital in a risk-sensitive manner and to use this as input to their RAPM model.

By adopting RAPM, financial firms are able to use the same data they must generate for regulatory purposes to support their risk-management strategies: whether to take on more risk to increase returns within suitable risk tolerances, or to reduce risks (thereby reducing reserves and capital requirements) by focusing on customers and products that reduce overall risk. Banks can view regulations such as Basel II (or Solvency II in the insurance sector) not simply as a compliance issue or tax on their operation, but rather as an opportunity to introduce risk based performance assessment at all levels of the business and to constantly have an accurate view of the firm's performance.

PARTICIPANT PROFILE

By Job Function

Research participants included members of PRMIA managing at various levels within their organizations. Respondents designating their job function as “other” included: managers of operational and credit risk, compliance officer, risk regulators, independent consultants, business analysts, and educators. See Figure 1.

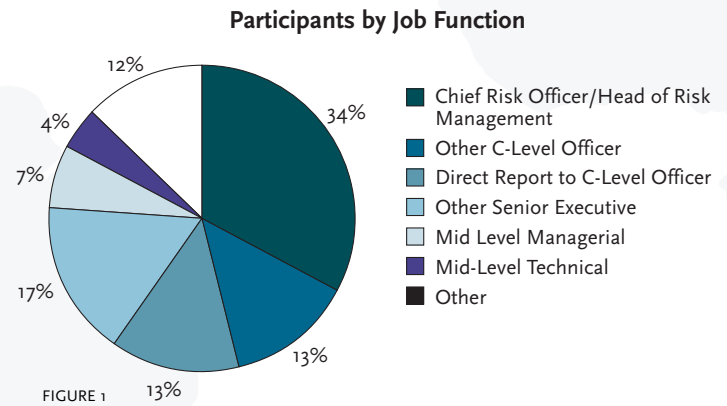
By Geography

Participation in the study was global, spanning 47 countries. By geographic region, respondents hailed from:

Europe/MidEast/Africa: 120 (44%)
 Asia/Pacific rim (APAC): 48 (18%)
 Americas (AMER): 102 (38%)

By Industry

The industry sectors listed under “other” include mortgage origination, alternative investments, fund of funds, merchant banking, education, government/public sector, non-profit, technology/software, and a securities and futures exchange. Nearly 15% of participants chose not to indicate their industry sector, resulting in a “N/A” designation in Figure 2.



Participants by Industry Sector/Region

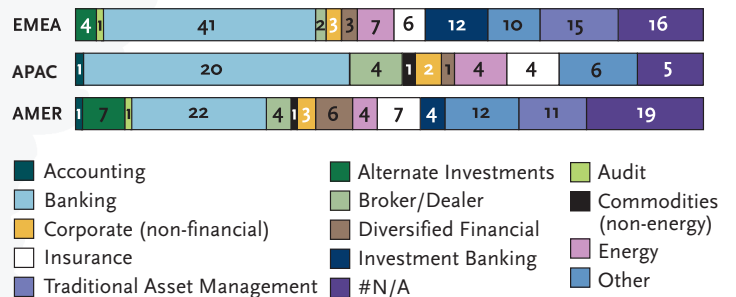


FIGURE 2

KEY FINDINGS OF THE SURVEY

- A large percentage of the respondents (44%) were already using RAPM in some capacity. A further 45% were in various stages of planning for RAPM in their organizations.
- The financial and highly quantifiable areas of the business such as hedging, deal execution and product pricing were favorites amongst the application areas chosen. Sixty-three percent of respondents are using RAPM, or are planning to use it in the next 12 months, in strategic planning – 84% will be using RAPM for this within three years.

The client facing areas – marketing/sales strategies, credit processing streamlining and relationship management were the least popular areas, but even here over 40% of respondents use, or plan in the next 12 months, to use RAPM.

- The most popular area for using the comparative benefits of RAPM to look at performance was across the organizational structure of the financial institutions, where 40% use it already and 88% plan to be using it in the next three years. Financial product comparison was the next favorite area.
- Forty-seven percent (47%) of boards of directors of companies that use RAPM for reporting are receiving RAPM-based reports on a quarterly basis, and, in these same companies, 14% of business unit leaders receive daily RAPM-based reports.
- Seventy-two percent (72%) of surveyed companies claimed to have integrated risk management into their organization; even among these, a majority questioned their own data accuracy and controls. A further 13% of participants reported having only the minimum required to satisfy the regulators. Nearly a quarter of all respondents (23%) claimed lack of funding and resources was the main obstacle in developing better systems.
- In the majority of cases (80%), the main corporate driver in the use of RAPM was the senior executives of the company or the central strategic units – risk management, treasury, finance departments, etc.
- RAROC and EVA (economic added value) were used by 80% of all respondents, indicating industry-level acceptance as standard practices.
- Significant numbers of respondents who have already implemented RAPM have extended their pricing models to incorporate lifetime calculations in the areas of credit and market risk (and a minority is also able to apply this to operational risk). In addition, we are seeing an early groundswell of incorporation of complex attributes – collateral, guarantees, rate caps and floors, etc – into their models. In addition, nearly three quarters (74%) have included, or plan to include, probability of default and loss given default in their models.

The full survey results are available to PRMIA Sustaining Members. You can become a Sustaining Member of PRMIA by visiting www.prmia.org, then click on the Membership tab.



SUNGARD[®]BANCWARE

www.PRMIA.org



PRMIA

