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cutting through complexity

Being the best: Inside the *intelligent* finance function

Finance/Risk alignment – Breaking down the silos

KPMG INTERNATIONAL

5. Finance/Risk alignment — Breaking down the silos

> “Companies that can break down these silos can win confidence that their business decisions will be more balanced over both the short and long terms, giving them an edge over their competitors.”

The 2008 financial crisis has been attributed to many factors, but clearly a widespread breakdown in balanced assessments of risk and reward bears some of the blame. Since the crisis, rising pressure from stakeholders and regulators has challenged companies to find new ways to balance risk and reward on a more sustainable basis. To meet this challenge, a good starting point is to align the activities of finance and risk — two important support functions charged with safeguarding this balance.

A combination of cultural, organizational, linguistic and system barriers has traditionally divided these functions, each having its own reporting line to senior management (i.e. the CFO and the chief risk officer (CRO)). Companies that can break down these silos can win confidence that their business decisions will be more balanced over both the short and long terms, giving them an edge over their competitors.

For example, some leading insurance companies, driven by new Solvency II requirements, have made significant improvements in the governance of their finance and risk functions by spreading their actuaries across the so-called ‘three lines of defense’. This involved:

- putting actuaries in the business to help with product pricing and profitability analysis (1st line of defense)
- tasking the finance and risk functions to help calculate and report the technical liabilities and reserve (2nd line of defense)
- tasking their internal audit department to review the reported results and underlying controls (3rd line of defense).

Finance executives have always recognized the importance of managing risk in today’s complex environment. Previous KPMG surveys of CFOs clearly showed the rising importance of the risk management agenda. At the same time, organizations are still struggling with this challenge. In response to KPMG’s 2013 survey of senior finance executives, 30 percent of respondents feel that processes for risk management are the most difficult processes to improve (second only to talent retention and recruitment).

High-performing organizations seem to have more success in this area; only 22 percent found improving these processes to be most difficult. In fact, high-performing organizations identified “processes for risk management” as one of their top three strengths.

Additionally, 41 percent of all respondents and 45 percent of high performers feel that their organizations have significant financial risk management policies aligned across the key market (treasury and commodity) risks.

Contributor

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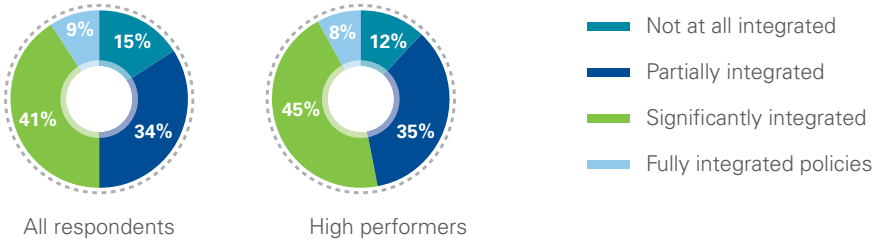
To what degree are the finance and risk management functions and processes aligned in your organization?



Source: KPMG International CFO survey 2013

While managing risk remains a key concern for finance executives, most organizations have yet to realize the benefits that closer alignment of the finance and risk departments can bring. Successfully aligning the two functions' objectives, activities and processes can produce:

- better quality decisions based on balancing returns received with risks taken within risk appetite limits defined by senior management, rather than solely based on (financial) growth, revenue, cost and margin targets
- better, risk-weighted capital allocation methods that are aligned with the organizational strategy and commercial opportunities, again within the risk appetite limits defined by senior management
- better understanding about true profitability across the business in terms of capital used and risks taken
- cost savings for regulatory reporting, management reporting and capital management by integrating similar processes and activities (e.g. data quality, assumption setting, modeling, and reconciliation) and by optimizing and rationalizing technology
- better awareness of different stakeholder needs, paving the way for more integrated reporting (also with other areas outside finance and risk, e.g. HR, IT, marketing and compliance).

Many of the alignment issues facing the traditional finance and risk functions stem from their different roots. Finance functions date back as far as the Renaissance and have since evolved into modern bookkeeping and reporting factories. They operate under well-defined and well-understood sets of rules that primarily focus on retrospective reporting requirements.

However, systematic approaches to risk management only emerged in the 1960s. Risk functions primarily prepare prospective reports using statistical data, requiring very different skill sets to process and interpret, and they operate under a range of rapidly evolving regulatory requirements and business models.

The two functions also tend to attract distinct — and not always compatible — personality types. Over time, they have developed their own definitions, processes, data flows and systems, which can hinder a more integrated reporting and control environment.

So how do you create the right conditions for alignment? Based on experience, KPMG believes that finance and risk need to take a close look at how they can further improve their current operating models in order to deliver the benefits of alignment. This desired end-state is best captured in a functional TOM (see page 9), which should highlight (at minimum):

- a governance model with clear roles and responsibilities that facilitate better alignment between finance and risk people at all levels in the organization
- the process and system interdependencies for each operational area
- where changes to functional process flows and/or systems are needed to facilitate better alignment
- what training is needed for people to use the improved processes and systems.

Designing and implementing an aligned TOM for both functions will create a more integrated management framework that enables better, quicker and more balanced business decision-making. So how can this be achieved?

> “As a first step, risk and finance teams need to educate each other about how they fulfill their joint roles as processors and suppliers of information for decision-making.”

Consider end-to-end activities, not departmental functions

As a first step, risk and finance teams need to educate each other about how they fulfill their joint roles as processors and suppliers of information for decision-making. Developing an end-to-end, activity-based view of the finance and risk operating models helps to identify interdependences and determine interlinked processes for both functions. Understanding which activities need to be performed by which function, and where those activities start, stop, interface and overlap with each other, can help the teams design more effective and efficient end-to-end processes and systems and put the right governance framework in place to support them.

It is best to first select a number of core processes with the highest impact or greatest urgency for improvement, such as Common Reporting (COREP) processes for capital and risk reporting and Financial Reporting (FINREP) processes for financial reporting, as mandated by the European Union under the Basel 2 and 3 regime for the financial sector. An effective practical application technique is to map the entire end-to-end reporting chain and ask ‘customers’ or stakeholders at all points in the chain to define what they need from the ‘vendors’ within the chain. This usually results in a better understanding of bottlenecks and helps point the way toward further alignment.

Data consistency is key

Creating an integrated data warehouse supported by a master data repository will ensure data is captured only once and used consistently across the reporting chain. The warehouse should be designed so that only single data streams (from the transactional source systems) feed into it in order to avoid multiple data flows and conflicting information, which would go against the 'single version of the truth' design principle. Making this information readily available provides greater transparency and enables tighter controls and flexible reporting. It is also important to understand the current systems landscape, including what functionality resides where and any technical limitations to data sharing, to avoid issues down the road related to data traceability or lack of drill-down capability.

For the risk function, the use of risk and actuarial models is critical. The data warehouse should provide the input data for these models, eliminating manual intervention as much as possible. Similarly, reporting systems linked to the data warehouse should be able to provide virtually all reporting needs, without excessive use of bespoke stand-alone systems or spreadsheets.

Clarifying roles and responsibilities

With constantly changing internal and external reporting requirements, it is important to have clarity over who is responsible for the data sources and information flows, and how the different roles played by each function interact. Again, the key is to take an activity-based, end-to-end view, rather than a departmental view, by organizing new functions around the job instead of the people. This will help to break down organizational silos and clarify departmental definitions.

Improving communication

Improved communication is needed to facilitate better cooperation so that people can speak the same language and understand each other's field of expertise. Cooperation between finance and risk requires removing silos to create a culture that supports open attitudes, awareness and respect for each other's roles.

Common goals and priorities

Management should set shared priorities and needs to stimulate operational cooperation between the finance and risk functions. Doing so will compel them to combine forces in their efforts to be a business partner and ensure their efforts are better aligned with the business's strategic objectives. This approach can also help ensure that finance, risk and the business take the lead in building a new integrated finance and risk systems architecture, rather than the IT department. For example, preparing for new regulatory reporting requirements is a challenge that people will manage better when the shared objectives, priorities and roles of each department are well known and understood.

Achieving the right balance

Aligning the finance and risk functions does not necessarily require a large transformation program. In our experience, taking small, practical and coordinated steps toward a common goal can be just as effective. In this way, each step can tackle a specific and definable issue that delivers immediate and tangible results.

For example, the first step toward more aligned finance and risk functions is the **cooperation model**, where roles and responsibilities are clarified and well documented and overlapping activities are kept to a minimum, but both functions remain as separate entities. The next step could be the pursuit of an **integration model**, marked by deeper agreement on aligned processes and common definitions, resulting in parts of the separate functions working closely together in multifunctional teams responsible for selected end-to-end processes (e.g. treasury, product development). The ultimate alignment stage is the **embedded model**, where the operations of both functions are truly integrated and support embedded, end-to-end business processes and systems that cut across the traditional functional boundaries.

Whatever the preferred approach, companies that succeed in aligning their finance and risk functions will enjoy a more sustainable reporting environment where all aspects — the data, systems, processes, organization and culture — are in optimal balance, enabling improved business performance.

> “Companies that succeed in aligning their finance and risk functions will enjoy a more sustainable reporting environment.”

Is CFRO the way to go?

Does it make sense for companies to appoint one person to lead both finance and risk functions? Some companies have succeeded in improving coordination and cooperation by installing a chief finance and risk officer (CFRO). But in others, the conflict between the two roles and divergent technical skill sets required has been too difficult to surmount, despite the ‘countervailing power’ benefits of a combined role. Regulators in some countries even forbid combining both functions in a single person (normally at the board level).

Success usually depends on the technical and leadership skills and cooperative mindset of the people involved rather than their job title. Rather than expecting a single person to control everything from the top, the better way to safeguard success in the finance and risk domain may be to appoint leaders and staff with the right skills and aspirations to meet the increasingly complex demands of the different roles.

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