

# Governance, Risk and Compliance Disruption

Future Considerations



By 2025, expectations of banks and financial institutions, and engagements with these organisations, will be fundamentally different from what they are today.

Technology, and the ways in which it is used, will change the products, business models and services offered by banks and financial institutions. The mobility and transferability of customers will increase through technology.

Risk management, as a set of practices, and as a profession, must evolve and mature to support these organisations.

Question: how does risk management help an organisation 'win' in asymmetric, unknown and chaotic environments where we only have current capability, capacity and capital to prepare for, and respond to, events and behaviours?

## Current Status

### **Risk Management is a maturing profession.**

The positive benefits of effective risk management practices can be difficult to explain to internal and external stakeholders as it is often initially discussed in negative language and outcomes.

For a variety of reasons, a vast majority of organisations and functions often address risk management too late, reducing the benefits and pragmatic outcomes available. This reduced time and limited engagement often impairs the ability of risk management professionals to provide frank, fearless and pragmatic solutions.

Risk management reports and recommendations are frequently based only on what information is easily available. There is often an inability to identify, understand and use information across all areas of the organisation.

Risk management often performs activities and uses technologies separate from the organisations and functions it should support. There is a necessity for some degree of separation within the lines of defence and assurance, but excessive or defensive separation reduces the capability to identify, link and holistically respond to systemic or material concerns.

Risk management often applies industrial techniques to manual activities. Digital organisations and outcomes require digital solutions. The common state of play diverts focus and expertise onto the process itself, as opposed to applying judgement to difficult, complex problems. This diversion generates unnecessary procedural friction, delaying business activities.

Across the world, a variety of financial companies have been subject to heavy fines and penalties for failing to be compliant. According to Bloomberg, twenty of the world's biggest banks have paid more than US\$321bn in fines and compensation since 2008 for breaching a variety of financial regulations (Finch, 2017). To put this in perspective, this is roughly equivalent to one and a half times the gross national product of Ireland. The preventive steps commonly taken, involve shifting material

levels of resources to mitigate outcome, misconduct and regulatory risks, and spending billions on compliance and controls. This significant opportunity cost is not seen within the integrated lens of risk, technology, behaviour and more importantly, opportunity.

Assessing the likelihood and impact of global risks (World Economic Forum, 2018). Refer to The Global Risks Report 2018 13th Edition, page 3, Figure 1: The Global Risks Landscape 2018. [http://www3.weforum.org/docs/WEF\\_GRR18\\_Report.pdf](http://www3.weforum.org/docs/WEF_GRR18_Report.pdf)

## Customer expectations

Customers' expectations of banking services will increase as technology and new business models emerge and evolve. These expectations include on-demand delivery and response, security and privacy by design and default, as well as a stronger voice on the organisation's personal impacts and social licence to operate.

To be efficient in providing effective and useful financial services, a financial ecosystem must ultimately allow customers to make their own decisions, organise their own affairs, take informed risks and be accountable for the consequences of their decisions.

Regulatory frameworks and oversight attempt to instil and maintain trust and integrity in the financial system. This includes the provision of information and advice so that customers can make decisions, understand risks and participate with confidence.

Reputation will be critical to customers and investors in the future, as financial organisations will have a reducing influence on customer perceptions, juxtaposed against broader vectors to communicate failed delivery or outcomes.

## Risk outcomes

A trend away from industrialised operating processes towards better collaboration and more automated, near real-time outcomes supported by technological authentication will require more introspection and improved decision-making techniques amongst risk management professionals.

The use of sophisticated and complex algorithms is not a replacement for effective decisions, rather it is a way of identifying and leveraging the utility of all information available at the time that decisions are made. As a result, the risk function may be able to make better risk decisions at lower operating costs while creating superior business and customer experiences.

The goal of effective risk management is to recognise and transform the utility of all information in the organisation to make timely and informed risk decisions.

As all information can be used to support risk and business outcomes, information and decision flows must identify and support pragmatic commercial outcomes, with regulatory or internal compliance as by-products.

The utility must integrate strategy, capability, capacity, targeted behaviour management and a range of technological solutions to balance risk, reward, reputation, friction and capital. Improving the organisation's ability to identify and respond to the changing environment and risk imposts is critical to being able to take advantage of opportunities.

The volume and complexity of new and existing regulations have had the unintended consequence of encouraging organisations to overly focus on narrow compliance issues rather than ‘correct’ decisions. This narrow focus should be broadened to include business outcomes, customer outcomes, employee and supply chain behaviours, risk, reward and information mismatches.

In parallel, organisations are becoming too cautious and risk-averse to innovate due to regulatory uncertainties, undermining the development of new products and the deployment of pioneering technology.

The efficient and effective management of regulatory risks has always been an essential business management practice.

This view of compliance as the driver of business and risk decisions is narrow and self-limiting.

## Technology outcomes

Focusing on any one single technology or risk practice alone is not sufficient to identify, understand or respond to direct and unintended consequences.

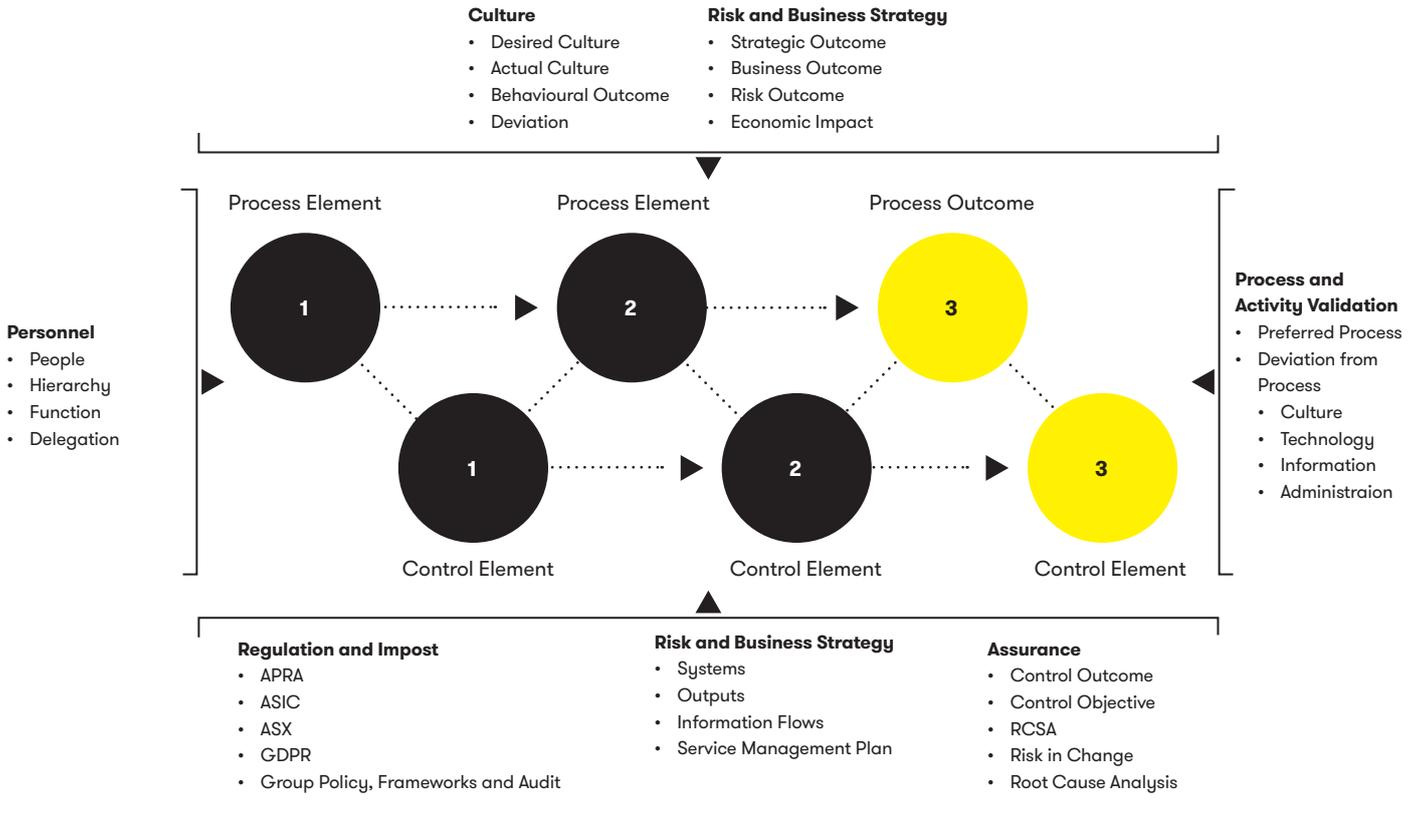
As with any potentially disruptive technology, neither blockchain nor AI are a panacea, and must be understood within the context of all other technologies that will affect how businesses operate and what behavioural cues inform decisions.

Evolving technology and advanced analytics are enabling new products, services, and risk management techniques, whilst debiasing approaches that improve decision-making will help facilitate better choices about risks.

Historically, financial institutions had the choice between using large, well-known vendor systems or building an in-house solution. In selecting and implementing products, different challenges arise. First, the solution must fit into the often complex and heterogeneous internal architecture of the organisation’s technological environment. Second, reporting and visualisation tools are typically used locally within different departments, and not governed centrally. Finally, regulatory pressures require a targeted implementation which often conflicts with financial firms’ development and transformation calendars and can create additional operational risks and challenges to be solved in parallel. These challenges can be seen in the 2018 Telsyte study commissioned by DXC: Security in the Age of Digital Disruption: An Australia and New Zealand Perspective, which illustrates the misalignments between risk, security and business strategies.

Technology is not a procurement decision but the result of holistic and integrated decisions.

Technological innovations continuously emerge, offering new risk and compliance solutions, and helping financial firms to comply and manage their risks at lower cost. One of the material concerns is whether organisations and risk management professionals understand the complete friction and opportunity costs associated with a simple decision to change either their processes to fit the solution or the solution to fit their processes.



**Figure 1.** Relationships to consider with governance, risk and compliance activities (McEvedy, 2018)

Generally, newer solutions tend to be cloud-based, meaning that data is remotely maintained, managed and backed up. Cloud solutions provide an enhanced flexibility through the ability to customise control over data access and sharing. In addition, simplified adding and removing of service features provides enhanced performance and scalability, while end-to-end data encryption can provide necessary security. The cloud is especially interesting as it provides the ability to offer pay-as-you-go pricing, which may make for deceptively simple decision points when the holistic view is not considered.

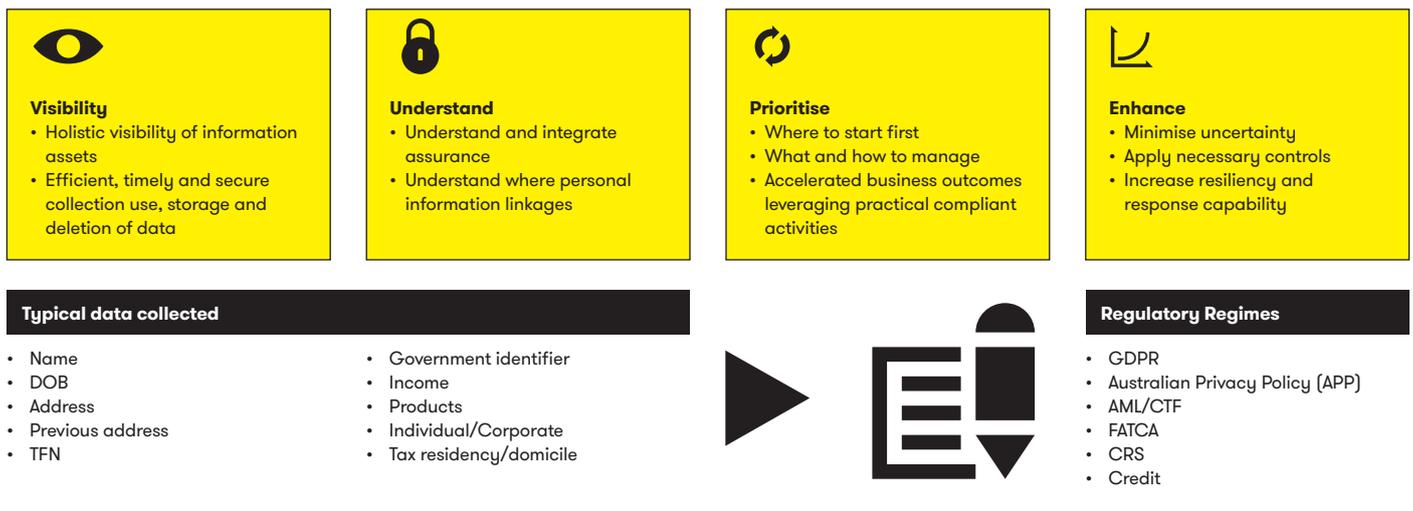
Cloud solutions also have an inherent conflict due to their attractive features. The requirement to store and host data in-country or within the constraints of extra-territorial requirements are material questions to be answered. The recent PageUp and Equifax data breaches are good examples, as many organisations would not know how their cloud service secures, supports or restricts their information obligations.

Cloud is often seen as the utopian solution to technology infrastructure and the same view is also applied to machine learning and artificial intelligence. The definitions of machine learning and artificial intelligence are different to each organisation and end user. For this paper, we are using the concepts set out in The New Physics of Financial Services (World Economic Forum, 2018b).

Machine learning and artificial intelligence are a collection of technology, capabilities, automation and processing power, augmented with a degree of supervised learning to help pattern recognition and exceptions to generate and apply ‘rules’ against ‘profiles’, and structured and unstructured data. These capabilities assist in how an organisation and its risk practices use, apply and mutually support other data and technologies to identify and communicate outcomes and actionable insights against specific criteria via different channels.

## Different methods, same outcome

General Data Protection Regulation (GDPR) and Common Reporting Standard (CRS) are good examples of the complexities that need to be considered for effective risk management. These regimes are not a pure compliance exercise but an opportunity to holistically review and challenge the strategy, justifications, practices and activities within an organisation.



**Figure 2.** Data utility considerations (McEvedy, 2018)

Complex, multi-jurisdictional business models and imposed regimes, matched with regulatory requirements for transparency and accountability, will increase the data demands and utility on organisations. Risk management can help organisations improve their vision of systemic risk, as well as of the behaviour of different agents involved in their financial ecosystem.

In order to gather, analyse and compute that data, institutions make use of a variety of technologies, yet the truth is that much of this work still heavily relies on manual processes involving considerable friction. The greater demand for transparency and rigour has brought the role of technology to the forefront, boiling the issue down to the following question: how should financial institutions address decisions with a mixture of customer impacts, misconduct and compliance in an efficient and less resource-consuming way while improving the quality of data reported to regulators and supervisors?

## Risk decisions

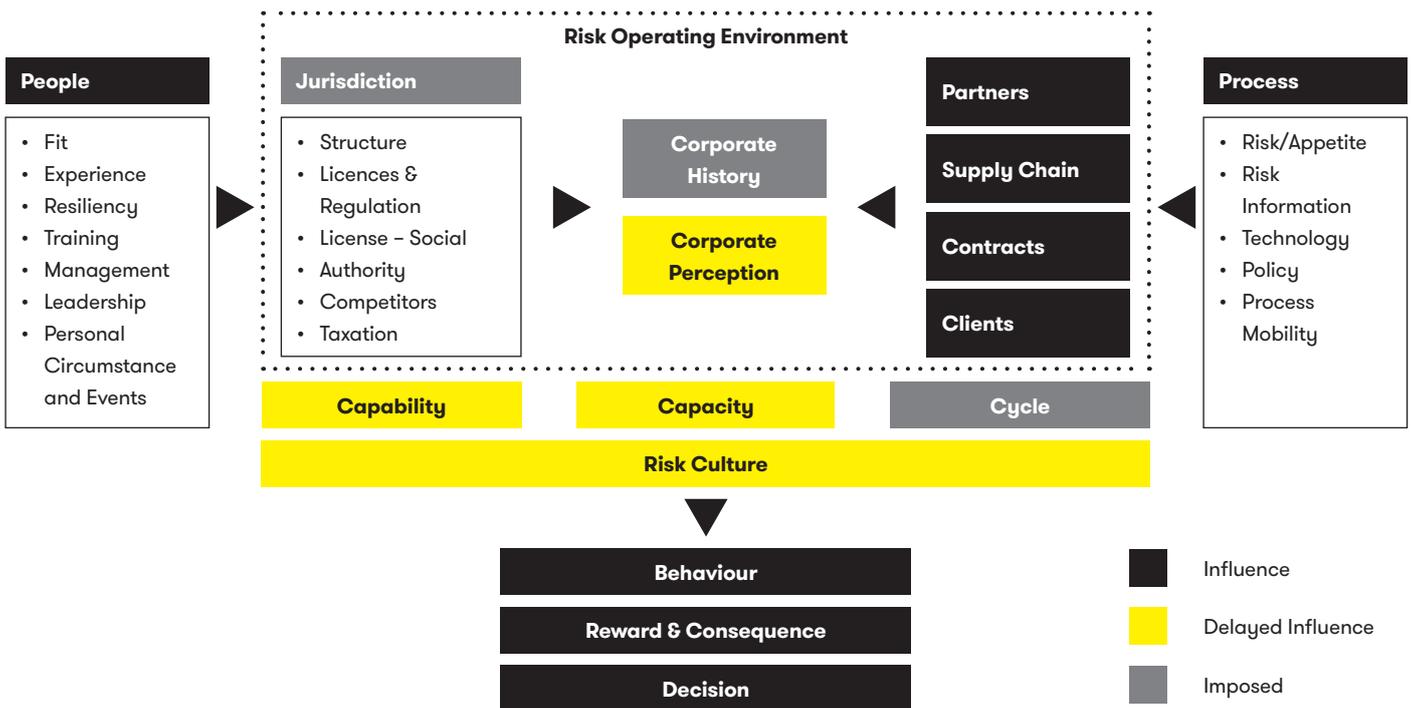
Fines and reputation impacts are key outcomes of ineffective risk management. The use of fines can be a visible deterrent; however, the use of regulatory design to change risk/reward decisions in the targeted population must improve and be consistently enforced to generate and maintain the desired behaviour change. This behaviour change must be reinforced with organisations using similar techniques and information.

The Commonwealth Treasury’s (2018) submission asks why misconduct occurs, noting that there is no straightforward or discernible formula for how the culture within a firm is established or how it evolves. This evolution reflects the imposts and influences that occur at all levels of the organisation. These imposts and influences are affected by technology, and as more ‘big data’ is used, all decisions become personal and targeted.

How organisations define, record and perform activities to get an outcome is a process. Process automation on an efficiency lens is a valid goal of many organisations. How and where controls occur is critical to understanding the risk environment and what the organisation can do to respond to deviations.

The ability to use different technologies to perform, validate and provide real-time assurance of activity and outcome must be a goal of risk management. Expanding this goal to include first and second order linkages for deviations is a critical next step. The final step is how to include behaviour management and secure proofs of activity/outcome.

People make decisions and are accountable for their outcomes, willingly or not. These decisions do not occur in a vacuum of input and output but amongst a range of personal, organisational, locational and reward structures. These structures are also subject to voluntary and involuntary imposts which are the result of basic strategic decisions and governance structures. For example, the type of clients and their locations, and the way in which interactions occur, are subject to a range of country, industry, licensing, mobility and contractual imposts. Operating within these boundaries is an element of compliance but this should not be the sole focus.



**Figure 3.** Influence and imposts on governance, risk and compliance decisions

Two examples of risk decisions are those of James Gorman, CEO of Morgan Stanley, which relates to personal and financial accountability (Durkin, 2018) and the contrast to evidence provided by ClearView at the Royal Commission. The ClearView example is an instance of using risk, behaviour, rewards, decisions and technology for ‘incorrect’ outcomes. Over 300,000 breaches of anti-hawking legislation were recorded and monitored within internal appetite, monitoring and performance structures set to only breach legislation in 4% of activities (Royal Commission into Misconduct in Banking, 2018).

## Risk management in the future

Risk management will have to improve its resiliency and capability to respond to evolving risks which will themselves require new skills, tools and ideas. The velocity and acceleration of risk realisation will reduce an organisation's capacity and capability to respond. In other words, you respond with the capability and systems you currently have, not what you wish you had.

Risk management needs to understand its role, who and what outcomes it supports, current and future influences and imposts, its decision process, and how emerging technologies are mutually reinforcing. As illustrated in the 2018 Telsyte study commissioned by DXC, *Security in the Age of Digital Disruption: An Australian and New Zealand Perspective*, there is a misalignment between the strategies and activities across risk, the business, security and technology. A key element for success is to understand the cognitive biases in decision-making and adjust integrated risk management activities and solutions accordingly.

The Commonwealth Treasury's (2018) submission notes that risk management is directly related to effective leadership, good governance and an appropriate culture aligned to good customer outcomes. Treasury noted that fit for purpose technology, understood processes, improved cultural norms and a more professional ethos within organisations will reduce the need for prescriptive regulation and responses to deliver a timelier alignment between community expectations and changing customer needs than is currently being achieved.

## What is the new normal?

There is agreement that certain regulatory hygiene and barriers to entry are a necessity. However, risk management and organisations need to understand that compliance should be the outcome, not the primary driver, of strategy, behaviour, decisions and activities.

The inclusion of decision theory, organisational psychology and personal behaviour change must also be understood if the organisation wants to achieve its objectives.

Risk management functions will be accountable for broader responsibilities, from increased strategic engagement to improved knowledge and technical skills, in order to generate and maintain stronger, collaborative relationships with business units.

The current risk management talent pool will need to increase its understanding and use of technology and be engaged earlier with pragmatic and commercial advice. There will be increasing use of technology and analytics, which will generate their own friction.

The ability to control information and meta-information is a serious consideration when accessing remote solutions. This question must also be considered holistically within the organisation's strategic and operational risk appetites and capabilities.

The ability to include risk, behaviour, decision, process and strategic outcomes must be modular, integrated and usable to support these different demands.

Organisations must embrace innovative solutions to face these heightened risk management challenges and capabilities.

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