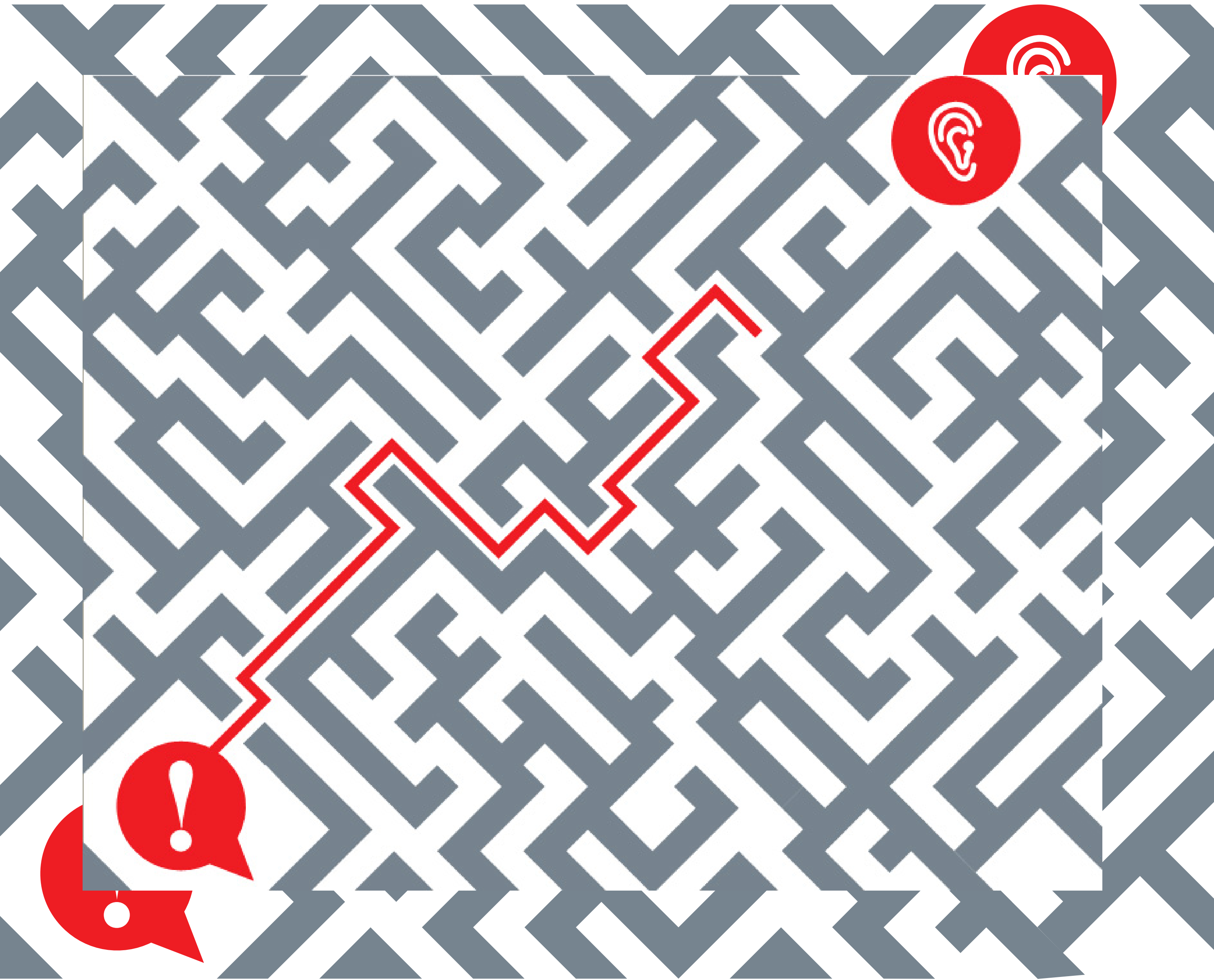
The Economist Intelligence Unit

Closing the communication gap

How institutional investors are building risk-aware cultures



An Economist Intelligence Unit survey
Commissioned by State Street

STATE STREET

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Introduction

This is the age of the risk-aware organisation. Private and public entities across the globe have scrambled to improve their approach to risk in the wake of the worst financial crisis in 80 years. Investment institutions—for which risk assessment is a fundamental role—are particularly enthusiastic proponents of the risk-aware enterprise. But what does risk-awareness mean to asset owners and asset managers? To what extent are risk processes actually embedded in organisations and communicated across them? Are corporate officers responsible for risk effectively conveying information across the organisation? Do business managers and risk officers view the performance of the risk function, and the value it delivers, similarly?

This research, conducted by the Economist Intelligence Unit and commissioned by State Street, examines how well risk structures are performing at investment institutions. The report examines:

- The quality of information the business receives from the risk function;
- How effectively the risk function communicates with other areas of the business;
- Whether the risk function is well understood;
- How well managers and staff are incentivised to achieve risk objectives;
- How these findings compare globally.

The findings are based on a survey conducted in the first quarter of 2013 of 297 employees of investment institutions. Some 52% of respondents are either executive board members or C-level executives and 30% are vice-presidents, senior vice-presidents or department heads. By type of institution, asset managers form the largest group, some 48% of respondents, while asset owners (including insurers, pension funds and sovereign wealth funds) account for 35% and intermediaries for 18%.* In terms of geography, 39% of respondents come from investment institutions headquartered in the Asia-Pacific region, 33% are from Europe, 19% are from North America and 9% are from other regions (Figure 1).

* Percentages may not add up to 100 in this report either due to rounding, or because respondents could pick more than one answer.

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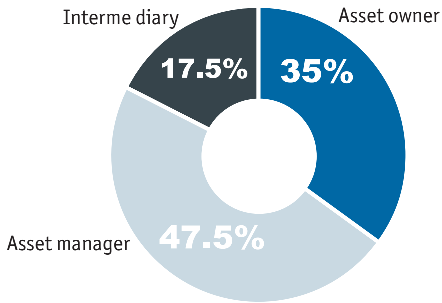
Figure 1

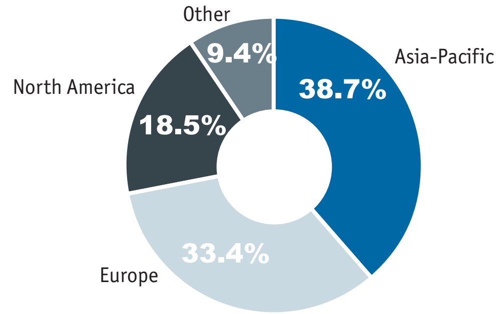
Survey demographics

(% respondents)

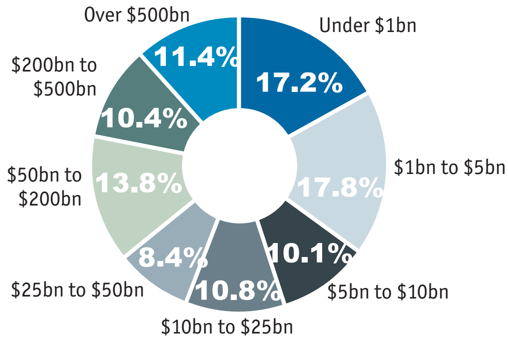
Survey respondents by institution



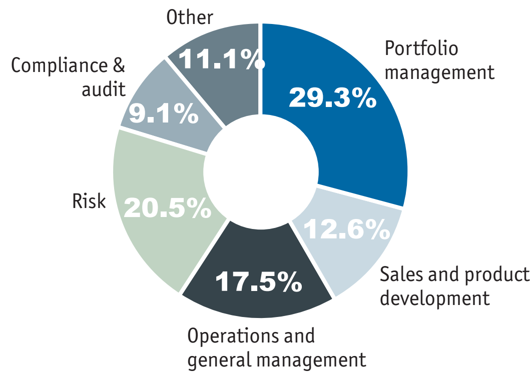
Survey respondents by geography



Survey respondents by AUM
(US$)



Survey respondents by function



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Key findings

Investment organisations are hugely more risk-aware than before the financial crisis

It is hardly surprising that risk awareness among asset owners and asset managers has increased since 2007. But the extent of this increase is startling. Whereas only 30% of investment organisations made risk their highest priority in 2007, 78% of respondents say their organisation has a very risk-aware culture today. This represents a significant cultural change. The perception of risk professionals—who are closest to the coalface—is that change has been more pronounced than the industry as a whole recognises. Only 23% of risk managers believe that risk was given the highest priority before the financial crisis, compared with 75% now.

By geography, employees of organisations based in Europe, in particular, say risk was low on the agenda in the pre-crisis period: just 25% of them think risk was accorded the highest priority, compared to 78% today (Figure 2). It is notable that investment institutions headquartered in Asia have seen almost as dramatic a change in risk awareness as elsewhere, despite the fact that the region was not as badly affected as others either by the global financial crisis or recent problems in the Eurozone.

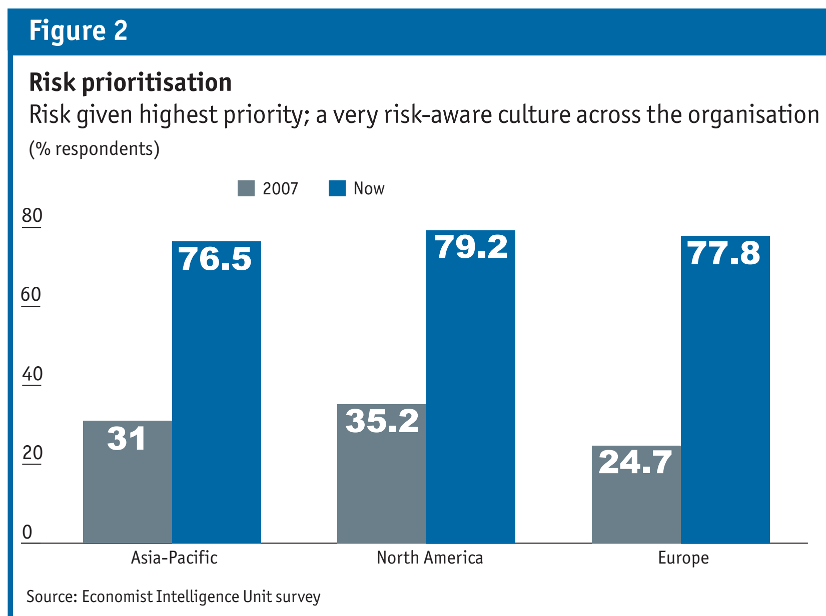
* In this report market risk refers to systematic volatility inherent in markets, or beta, whereas investment risk relates to the decisions and skill of individual investment managers, or alpha.

Figure 2

Risk prioritisation

Risk given highest priority; a very risk-aware culture across the organisation

(% respondents)



Source: Economist Intelligence Unit survey

Reputational risk ranks as highly as market risk

Reputation ranks alongside market risk* as the highest priority and is viewed as one of the top-three key risks facing their organisations by 56% of respondents (Figure 3). This is ahead of investment risk (46%), regulatory risk (34%) and counterparty risk (24%). This finding reflects the response of investment organisations to the financial crisis and a series of scandals since that have blighted the public perception of the financial services sector.

Geography plays a part in how organisations prioritise risk. Those headquartered in the Asia-Pacific region put more emphasis on market risk, perhaps due to the fact that markets in Asia have been more volatile historically. Regulatory risk is seen as especially important by 38% of institutions headquartered in Europe, where the European Commission has rolled out a number of game-changing regulatory changes in recent years, with more in the offing. Similarly, product suitability risk—which includes risks

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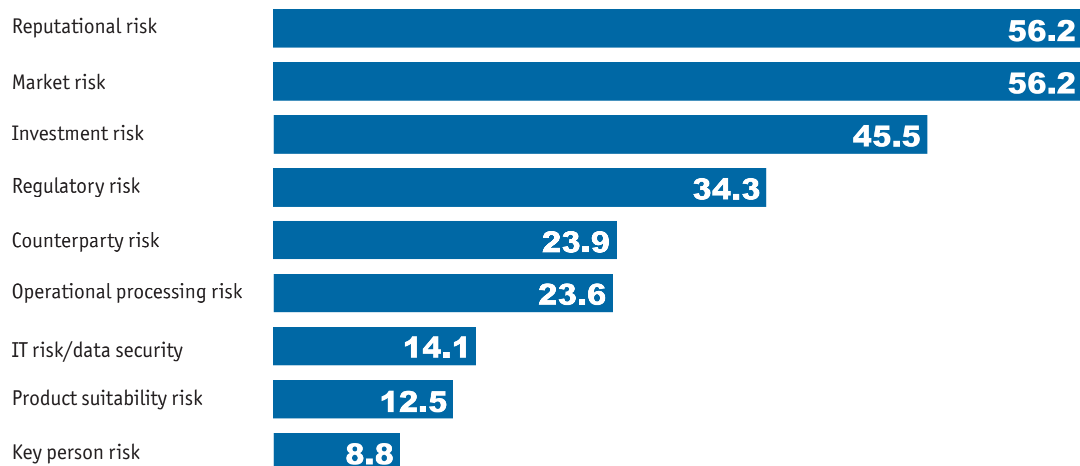
Figure 3

Biggest perceived risks—all respondents

(% respondents selecting in top three)

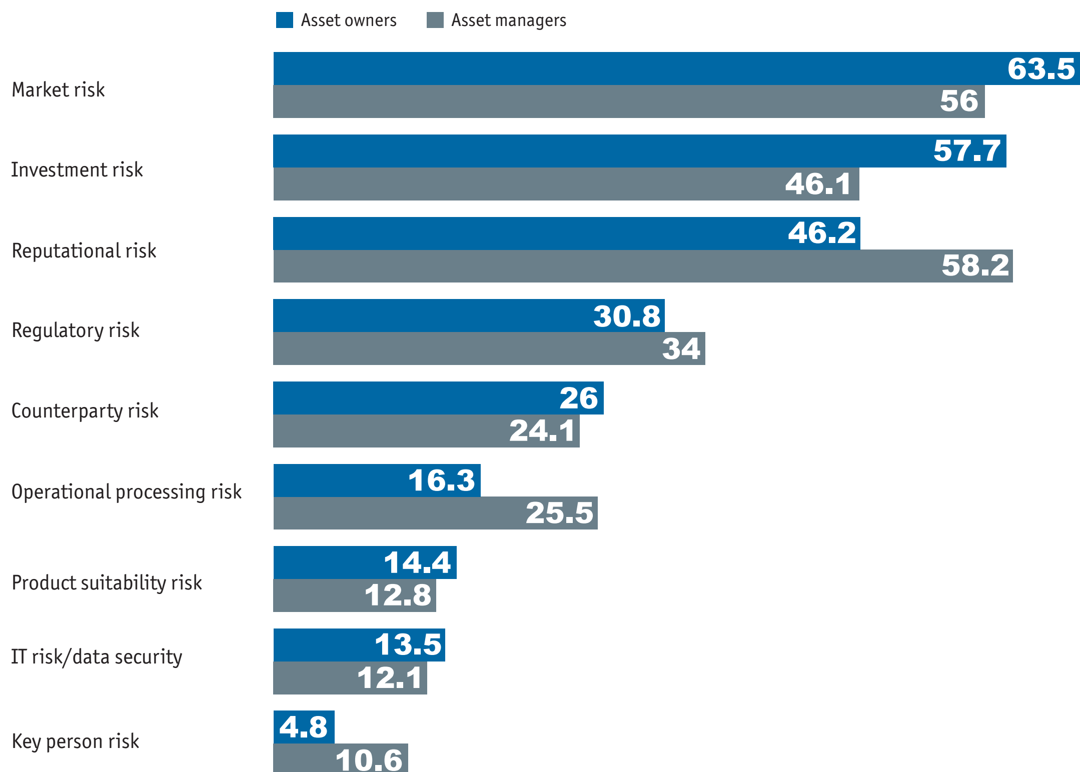


Source: Economist Intelligence Unit survey

Figure 4

Biggest perceived risks—asset owners v asset managers

(% respondents selecting in top three)



Source: Economist Intelligence Unit survey

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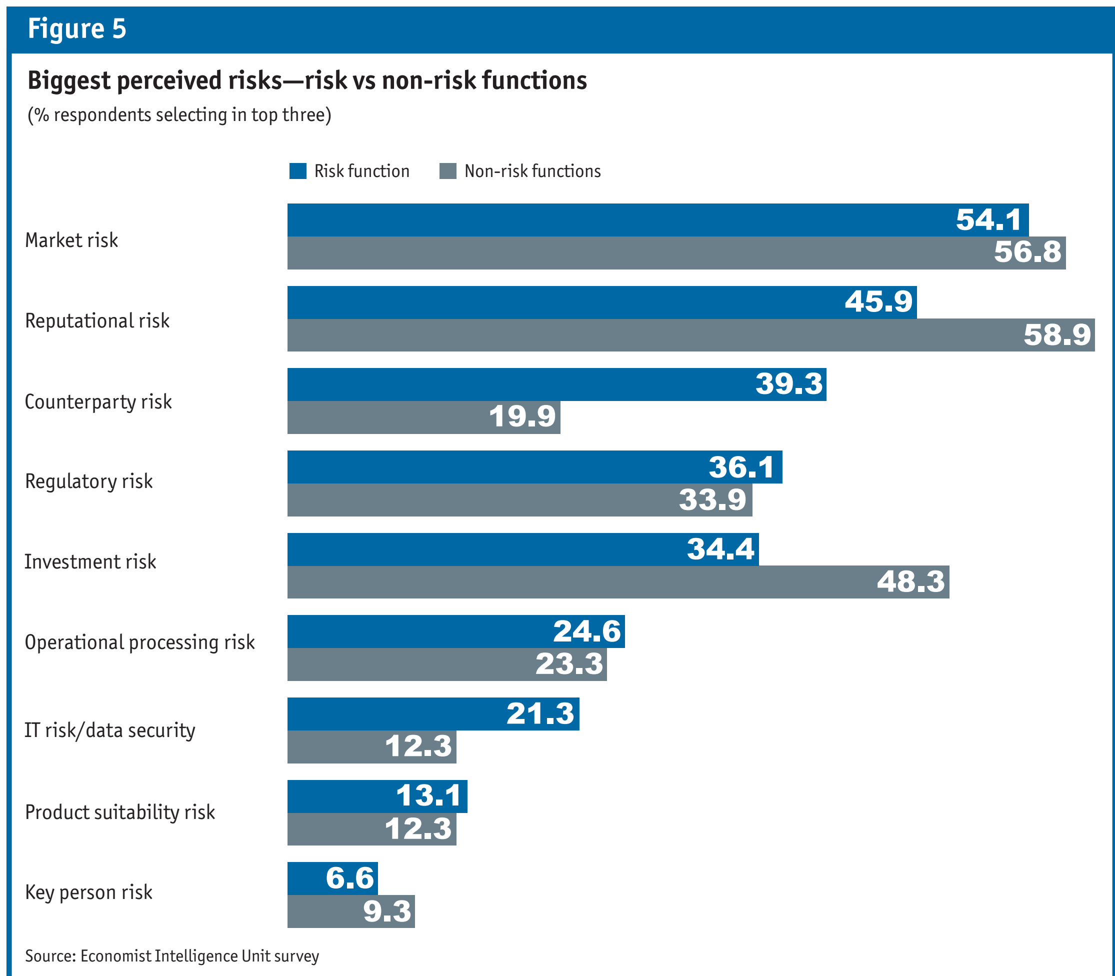
associated with possible mis-selling—is viewed as important by 15% of respondents in Europe (perhaps because of recent customer protection regulations), but only 11% in the US and 9% in Asia. That this is seen as a low priority in Asia is something of a surprise given widespread mis-selling scandals in the region in the wake of the financial crisis.

Asset owners are more preoccupied by market and investment risks, whereas asset managers are most concerned about reputation. Less than one-half of asset owners (46%) rank reputation as a top risk, but this rises to 58% among asset managers (Figure 4). While for asset managers investment risk and reputation are inextricably linked, given that their reputation depends on performance, it may suggest a difference in perception of potential concern to asset owners that contract third-party asset managers.

Splitting survey responses by function, it is evident that the priorities of risk managers and other executives are not always aligned. Risk managers, for instance, rank counterparty risk as their third most significant risk, whereas it is ranked sixth by executives in other functions (Figure 5). This is an example of a risk for which the risk function has taken much greater responsibility in recent years. This contrasts with investment risk, which is ranked third by non-risk executives but only fifth by the risk function.

There is confusion over the role of the risk function and the mission of risk managers

There is a real and unsettling disconnect at many institutions between business and risk. For instance, there are fundamental differences of opinion about the role of the risk function.



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Whereas a majority (52%) of non-risk staff think the risk function exists primarily to fulfil regulatory obligations, only 30% of risk professionals think this (Figure 6). Risk professionals clearly believe their remit should go beyond compliance-type activities.

Moreover, less than two-thirds of respondents, 61%, think that their organisations' business managers have a clear understanding of the role of risk managers, and just 16% strongly agree with this statement. Those in the risk function are less confident that this is the case—just 56% agree (and only 12% strongly agree), compared to 62% of non-risk executives.

These findings suggest that risk managers are not fully communicating their mission to the wider organisation, and also that the risk function itself is keenly aware of this. It indicates a certain amount of frustration from both perspectives, possibly hindering the development of risk-awareness across the enterprise. Given that regulators are increasingly concerned that risk processes are embedded within investment institutions, it appears that more progress is necessary in cultivating an awareness of risk and clarifying the role of the risk function in other areas of the business.

Risk managers at European institutions are less successful at winning the trust of the business

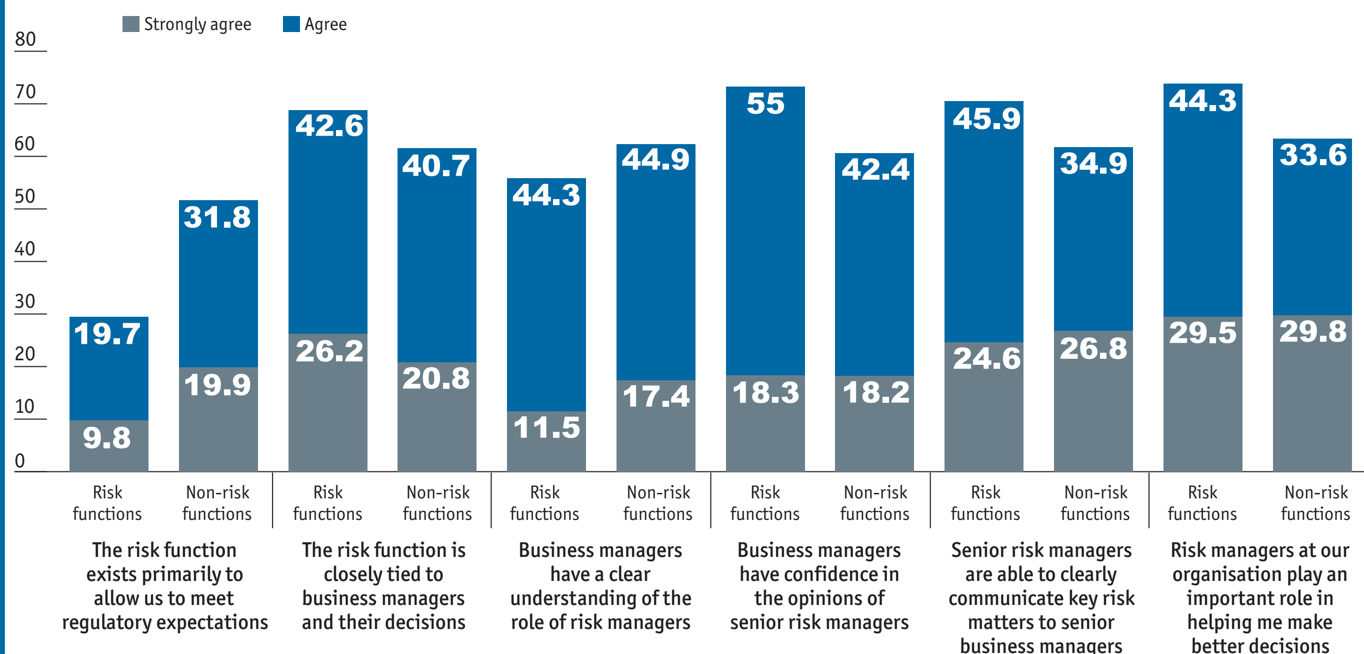
Although correlation cannot prove causation, the survey suggests that the greater the integration between the risk function and the business, the more likely it is that business managers have confidence in the risk function. And by these measures, European investment institutions are doing poorest.

Nearly two-thirds (65%) of respondents globally agree that business managers in their institutions

Figure 6

Differing opinions

(% respondents)



Source: Economist Intelligence Unit survey

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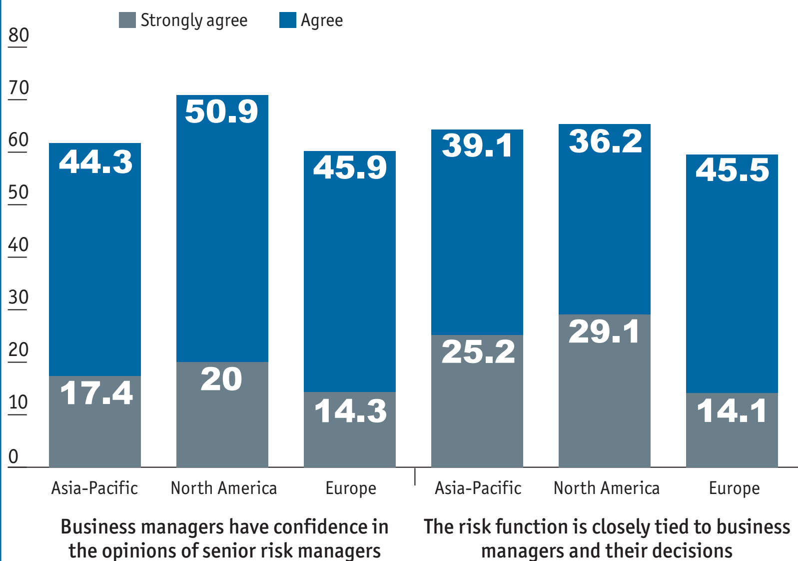
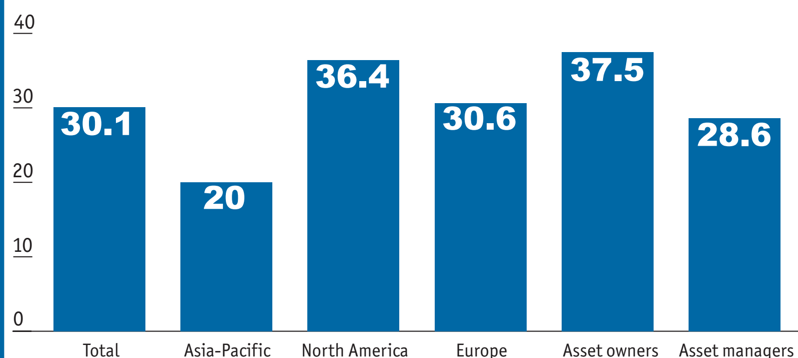
Figure 7



have confidence in their risk managers' opinions. This rises to 71% in the US, where a fifth of institutions say they strongly agree with this statement. But just 60% of European institutions say they have confidence in risk managers and just 14% strongly agree they have confidence. Confidence in risk managers in the Asia-Pacific region lies in the middle of these two extremes (Figure 7).

Figure 8



A similar pattern is seen when institutions are asked how closely the risk function is tied to business managers and their decisions. It is relatively high in North America at 67%, as low as 60% in Europe, while Asia lies in the middle again at 64%. This suggests that US institutions have responded more rapidly and more fully to investors' demands to embed risk into the organisation. Europe seems to have been slower to react, keeping the risk function at arm's length.

Respondents at European institutions are also least confident that business managers understand the role of risk managers. Only just over half, 52%, think this is the case compared to 76% in North America and 60% in Asia.

Questions arise over the quality of internal risk information—especially in Asia

The survey suggests relevant and timely information on risk is not always getting into the right hands. Only 30% of survey respondents rate the information they receive from internal sources about risks that relate to their job as very good, a figure that falls to just 20% in Asia (Figure 8). This may reflect the fact that Asian markets are less mature and have faced comparatively less regulatory scrutiny in recent years than those in North America and Europe, which could mean relevant information is less easily obtained. By contrast, a larger proportion of employees at institutions headquartered in North America, 36%, rate the quality of the risk information they receive as very good. This presumably reflects the increased demands of regulators and investors, as lessons are learned in the wake of the financial crisis—and also the level of investment in risk-management technology designed to enhance and integrate risk reporting.

The quality of internal information on risk is ranked as very good by 38% of people working for asset owners, while just 29% of respondents from asset managers rate it as very good. In

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general, this could reflect the fact that asset managers tend to be bigger, more complex organisations, whereas asset owners often have fewer moving parts—and perhaps a correspondingly more focused dissemination of internal information on risk.

Operational and regulatory risks are not always adequately identified and explained

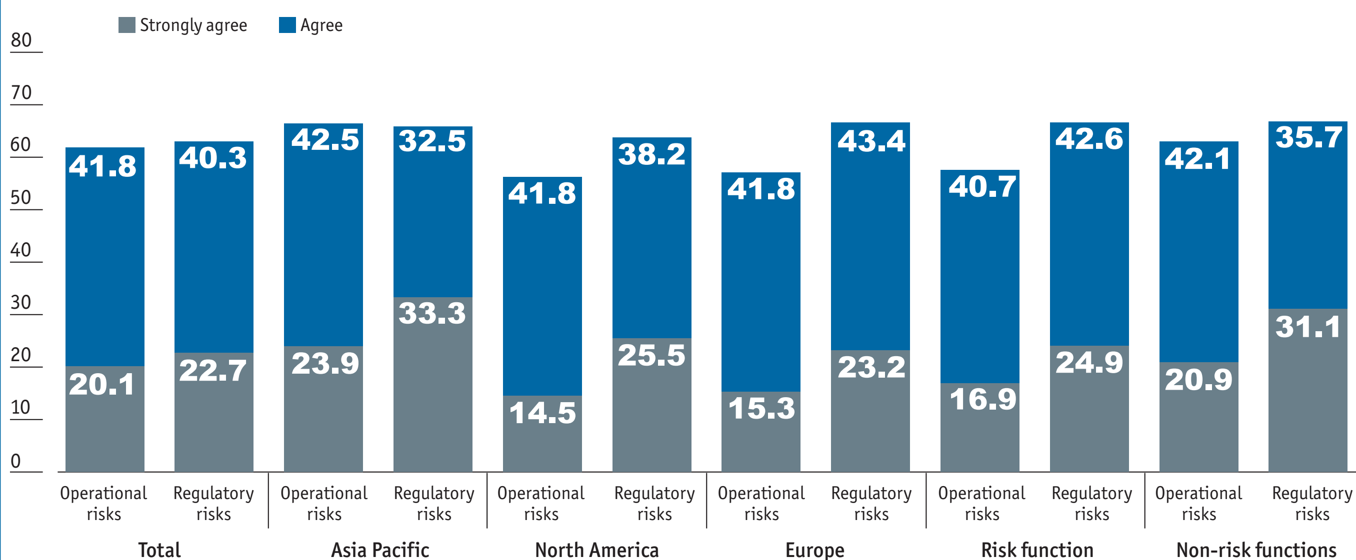
Less than two-thirds of respondents, just 62%, agree that operational risks are clearly identified and explained by the risk function, and just one in five strongly agrees that this is the case. This falls to as low as 56% in North America and 57% in Europe (Figure 9). It is just 58% among risk managers themselves, which suggests they may feel excluded from operational risk issues and unable to get their message across. It may indicate that the remit of the risk function is fairly narrow and does not extend to broader business issues.

Among all respondents, just over two-thirds, 67%, agree that regulatory risks are clearly identified and explained, and just 29% strongly agree. In each of the geographies, and among executives in both risk and non-risk functions, more agree that regulatory risks are well explained than those who are happy with their organisation's information on operational risk. This suggests that institutions are more focused on regulatory risk than on operational issues—in line with the priorities identified above. It also reflects a possible gap between strategic risk mitigation, often related to regulatory changes, and tactical preparedness for operational risk events that requires a deep understanding of an organisation's systems and processes. As regulators are putting increasing emphasis on embedding risk frameworks within investment institutions, it could indicate a need for more thorough risk awareness and communication across such organisations around operational risk.

Figure 9

Clarity of risk information

(% respondents saying risk is clearly explained)



Source: Economist Intelligence Unit survey

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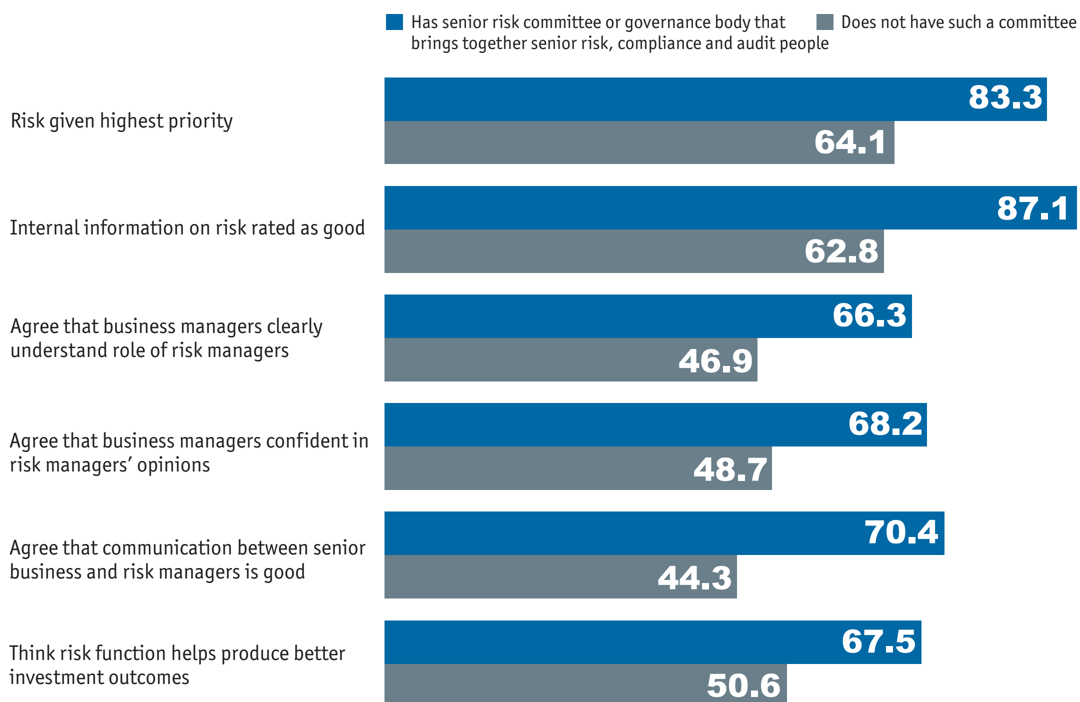
Risk committees provide the bedrock for more cohesive risk frameworks

The survey suggests that the presence of a senior risk committee or a governance body that brings together senior risk, compliance and audit people is linked with:

- a more risk-aware organisation;
- better quality of risk information;
- fewer misunderstandings between risk and business functions;
- better co-ordination between risk, compliance and audit.

For instance, 83% of respondents at firms with risk committees say risk is now the highest priority for their organisation, compared with just 64% of those without a risk committee. Meanwhile, the quality of risk information received is higher at organisations that have a senior risk committee. Some 87% of institutions with a senior risk committee rank internal information on major risks as good or very good, compared to just 63% of those without such a committee.

Importantly, organisations with a senior risk committee have less confusion about the role of the risk function and fewer differences and misunderstandings between the risk function and the business. Two-thirds of respondents at institutions with such a committee think that business managers have a clear understanding of the role of risk managers, compared to 47% in those without such a committee. Some 68% of those with a committee think business managers at their organisations have confidence in the opinions of senior risk managers, compared to less than half who maintain that view in organisations without such a committee. And for those institutions with a committee, 70% think the risk function communicates well, while this falls to just 44% in those without (Figure 10). In



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other words, the more formalised the processes, the better the communication.

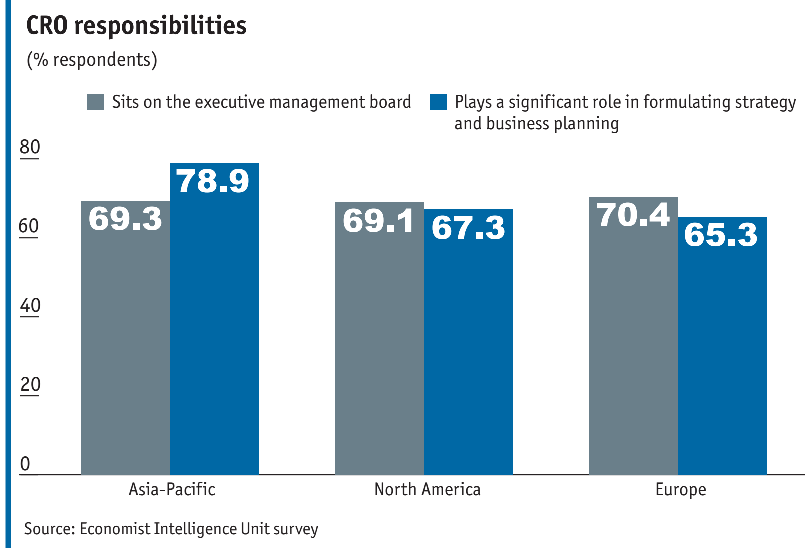
Furthermore, institutions with a senior risk committee or a governance body that brings together senior risk, compliance and audit people are twice as likely to have their CROs on the executive management board (80% versus 40%). Also, CROs are much more likely to play a significant role in strategy and business planning (78% versus 51%). Finally, the co-ordination between the risk, compliance and internal audit functions is far higher in organisations with a senior risk committee (rated as “excellent” or “fairly good” by 91% of respondents) compared to those without such a committee (71%).

It is also worth noting that those respondents who agree that “the risk function helps produce better investment outcomes” are more likely to have a senior risk committee (78% vs 64%). By the same token, 68% of those with a risk committee agree that “the risk function helps produce better investment outcomes” compared to 51% of those without such a committee.

CROs have gained a seat at the chief executive’s table and are playing a major role in strategy and business planning...

Some 69% of institutional investors have a CRO that attends executive board meetings, meaning risk issues are represented in key decision-making at the majority of such organisations. At the same time, though, nearly a quarter of CROs do not attend such meetings. In these cases, it is likely to be more difficult for them to report risks to the business at the most senior levels. In addition, a fifth of CROs do not play a role in business planning and formulating business strategy. This may be an oversight at those institutions. CROs have valuable risk information at their fingertips and can prevent the adoption of strategies that could weaken the business, and

Figure 11



Source: Economist Intelligence Unit survey

also help to identify areas where it could achieve higher returns for the risk taken.

The involvement of the CRO in high-level strategy is important to the interconnection of risk and investment outcomes. The survey suggests that it is more likely that risk management will lead to better investment outcomes when the CRO sits on the executive management board: 74% of those who agree that “the risk function helps produce better investment outcomes” say that their CRO is on this board, while just 60% of those who are neutral or disagree with this statement have CROs on the board.

By geography, it is notable that in Asian organisations, the CRO is as likely to be represented on the executive management board as elsewhere, but he or she is more likely to play a significant role in formulating strategy and business planning (Figure 11).

...but executive board members often lack the incentive to protect their firms against the downside

Risk objectives are not always supported by incentives. While at 88% of all investment

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organisations executive board members have some sort of risk target, at less than half of them (46%) are they financially rewarded for meeting risk targets or objectives. Some 40% of institutions offer no financial reward whatsoever for meeting risk targets or objectives. The implication is that executive board members at these groups are not incentivised effectively to insure their organisations against negative or calamitous events.

Incentives for other functions vary, but in all cases targets are more likely to be applied than incentives. The rate of reward varies by region: investment professionals in North America are more likely to be incentivised than elsewhere, with 76% of them financially rewarded for meeting risk targets or objectives compared with 61% in Europe. Asia, once again, is in the middle at 70%. However, Asia is ahead in terms of rewarding compliance/risk professionals for meeting risk targets. Nearly two-thirds (65%) have such rewards, compared to 51% in North America and 54% in Europe (Figure 12).

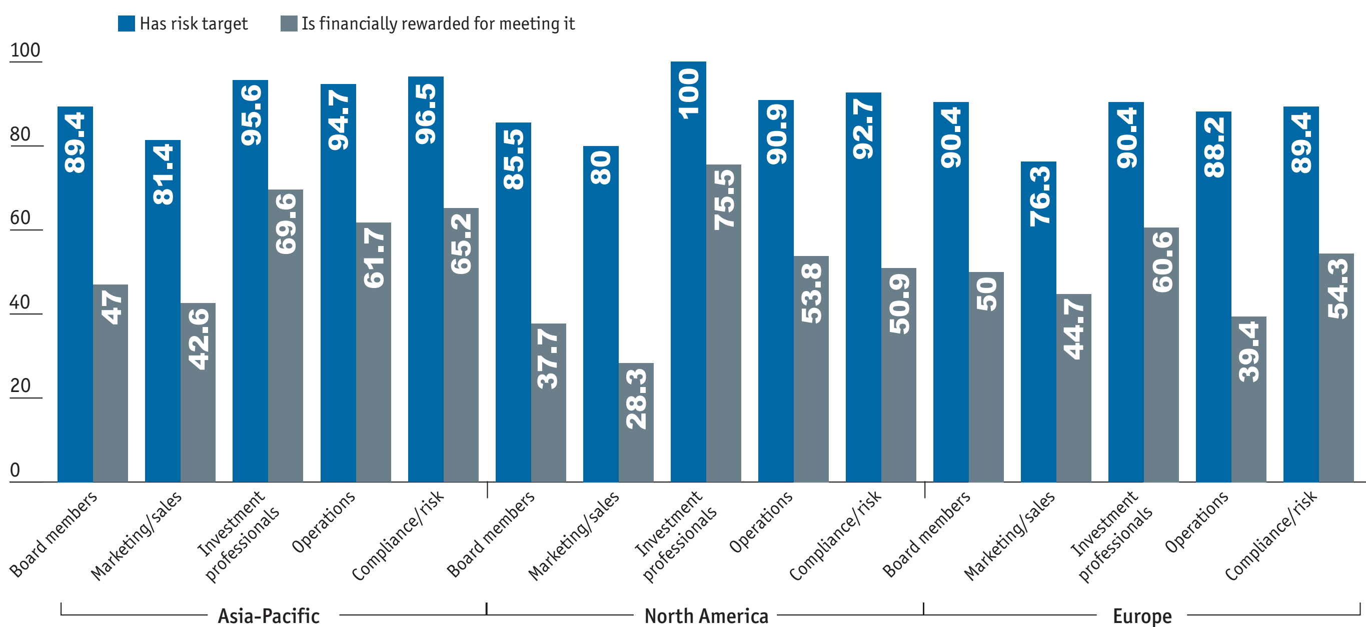
Importantly, it also appears to be the case that risk targets and rewards for meeting them are more often applied to investment professionals and the risk function than other functions, such as marketing and sales. Though understandable from an operational perspective, it may be evidence that more attention needs to be paid to fine-tuning risk awareness and mitigation throughout the organisation, and to incentivising all employees to meet risk targets.

Finally, those institutions that associate risk with better investment outcomes are more likely to reward any function for meeting its risk objective or target (Figure 13). This suggests a link between risk, investment performance and financial incentives to meet risk targets (though again, it does not necessarily prove a direct causative relationship).

Figure 12

Risk (targets) and reward

(% respondents)



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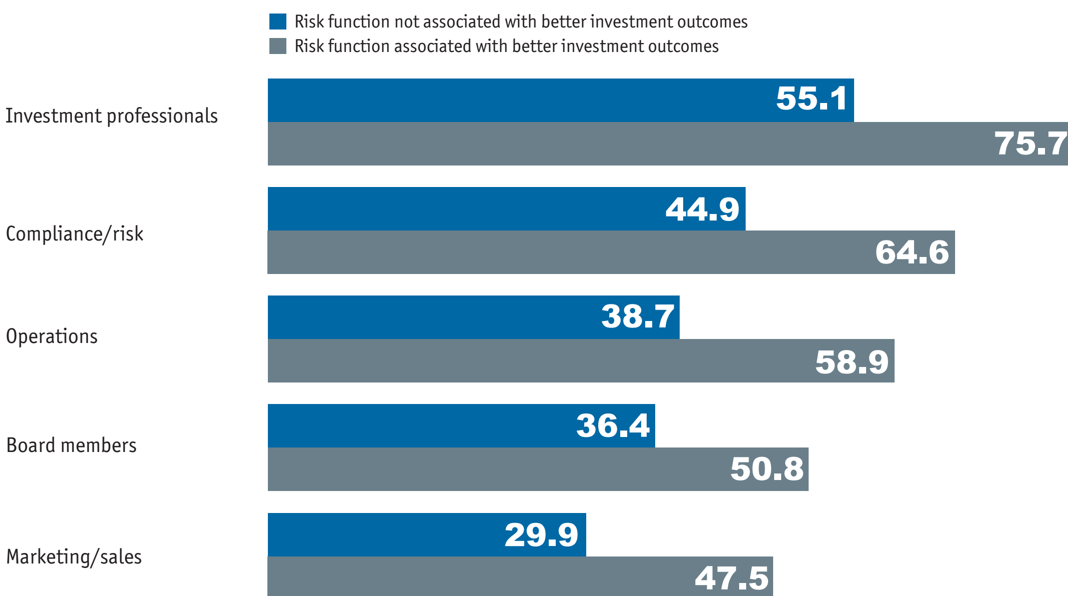
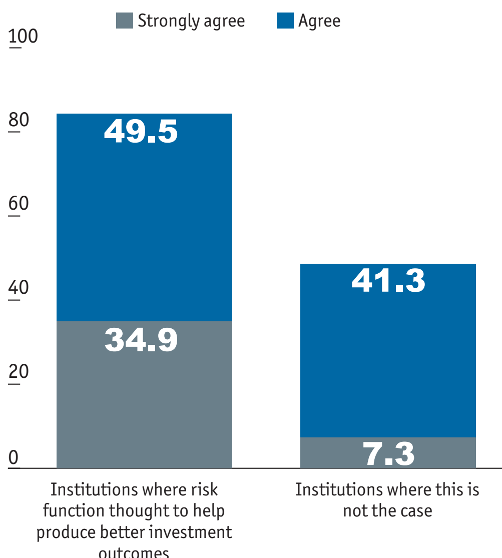


Regular dialogue between the front office and the risk function is associated with better investment outcomes

Those institutions that think their risk function produces better investment outcomes are also those where there is more likely to be regular dialogue between the risk function and the front office about the selection of assets and other investment matters (including counterparty risk). Some 84% of those that agree that the risk function helps produce better investment outcomes say such dialogue occurs regularly, while this is true of only 49% of those that do not think the risk function produces better investment outcomes (Figure 14).

Moreover, about 35% of those that agree the risk function helps produce better investment results strongly agree that dialogue takes place—where this is true of only 7% of their counterparts that do not associate the risk function with better



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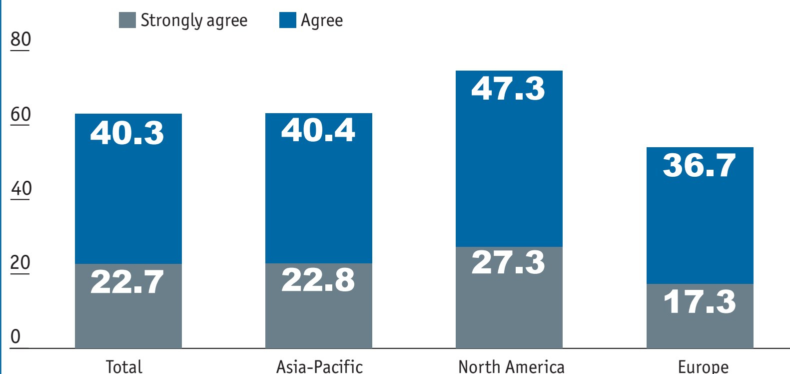
investment results. Significantly, the "better investment outcomes" group are also more likely to think that operational and regulatory risks are clearly explained—a key concern, as Figure 9 above shows. This suggests regular dialogue with the risk function is important to gaining understanding of more qualitative risk categories such as operational and regulatory risk, and that there might be a link between this understanding and better investment outcomes (though causation cannot be proved).

Figure 15

Risk-aware benefit?

The risk function helps produce better investment outcomes

(% respondents)



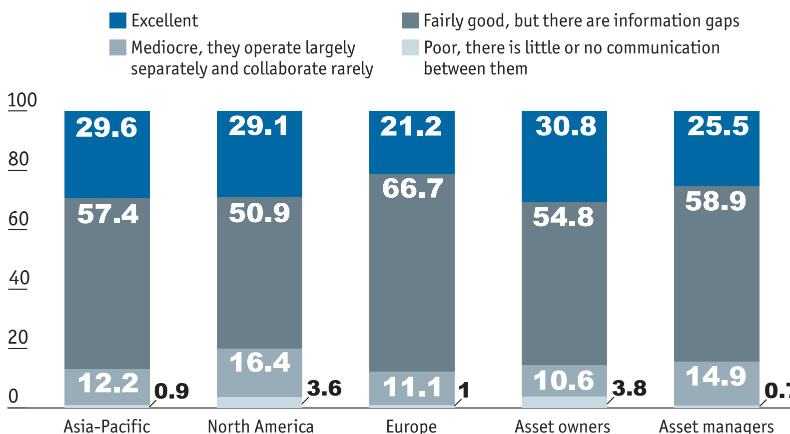
Source: Economist Intelligence Unit survey

Figure 16

Joining the dots

Co-ordination between risk, compliance and internal audit functions

(% respondents)



Source: Economist Intelligence Unit survey

Globally, 71% of respondents agree that there is regular dialogue between risk and front-office functions about the selection of assets and other investment matters (including counterparty risk), and around one-quarter strongly agree that this is the case. However, this is true of only two-thirds of institutions in Europe. Following the correlation posited above, it is therefore unsurprising that only 55% of investment institutions in Europe associate the risk function with better investment outcomes, compared to 63% in Asia and 75% in North America (Figure 15).

Risk, compliance and internal audit functions are starting to join the dots

Co-ordination between risk, compliance and internal audit at investment institutions is considered fairly good overall, and excellent in just over a quarter of cases. It still early for these activities at many organisations and some employees are still defining and refining their own roles, so it is understandable that co-ordination is not yet seamless. However, once again, Europe is lagging: just 21% of European institutions describe co-ordination between these functions as "excellent", compared with 29% in North America and 30% in Asia (Figure 16). Split by type of organisation, the survey shows there is marginally better co-ordination between these functions at asset owners compared with asset managers.

Reporting risky practices can be a risk in itself

Only half (52%) of employees in investment organisations can report concerns about colleagues' practices through formal processes without fear. This falls below 50% in both Asia and North America (Figure 17).

Nearly a third of institutions (30%) say there are no formal processes for reporting risky practices and 13% say there is some career risk involved

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Figure 17

Reporting risky practices

To what extent can employees feel comfortable bringing colleagues' poor risk practices to the attention of senior staff?

(% respondents)

Source: Economist Intelligence Unit survey

if concerns are escalated. At 20% of North American institutions, employees are risking their careers by voicing concerns. This is high compared with other regions and represents a clear disincentive for employees to escalate practices that are not in keeping with stated risk policies and objectives.

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Conclusion

There is no doubt that risk awareness at investment institutions has improved beyond recognition since the pre-financial crisis era. This survey shows that slowly but surely, through a variety of means, institutions are also starting to inculcate enterprise-wide risk awareness, with the aim of reassuring investors and regulators. Complex risk-management machines have swung into action in an effort to improve risk governance, processes and practices. However, in many cases, these machines require further adjustment to ensure they fulfil their purpose.

This research suggests that at many institutions, the flow of data to and from the risk function can be unreliable, and important information does not always reach the right people. Risk professionals encounter obstacles in communicating their role to the business and, at the same time, the business often does not fully understand the role of the risk function, often viewing it as just a means to meet regulatory requirements. This creates a communication gap, with the result that risk awareness may not be embedded throughout the organisation.

If this suggests that the risk function is not doing its job well that would be too simple an explanation, since responsibility for understanding risk must be shared across all functions. Frequently, at the heart of the problem is a lack of dialogue or integration between the risk function and the business. When this is the case, trust tends to break down. In institutions with better dialogue between the functions, however, there tend to be better investment outcomes. Better outcomes are also seen at institutions where there is a senior risk committee and where the CRO has a seat on the executive management board. Such measures create clarity around governance structures and the role of risk officers, enhancing dialogue and reporting between the business and the risk function. This helps close the communication gap, delivering better investment outcomes and ultimately building an enterprise-wide culture of risk-awareness.

To sum up, a great shift of emphasis has taken place, and investment institutions deserve recognition for this response to the calamities of recent years. A shift in mindset and communication across investment institutions is now required to raise firm-wide risk-awareness even further, ensuring the enterprise as a whole can fulfil its responsibilities towards its shareholders, clients and regulators.

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