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One eye on the rear-view mirror: A look at the challenges facing the risk function in Asia

There is generally broad agreement about the causes of the current financial crisis: lax lending standards, high consumer debt, increasing use of complex structured products and innovation outpacing capacity to manage risk amongst others, resulting in a global crisis of confidence and liquidity. Given that many of the causes of the financial crisis were rooted in the U.S. and Europe, it is not surprising that financial institutions in those markets have borne much of the pain — from the nationalization of Northern Rock in the U.K. to the collapse of Lehman Brothers in the U.S. to the U.K. and U.S. governments taking substantial equity stakes in major financial services firms, including AIG, Citigroup, the Lloyds Banking Group and Royal Bank of Scotland Group.

The Asia Pacific region's financial institutions and markets have not been immune to the current crisis. The rapid adjustment of historically high market values; diminished domestic consumption rates and a dramatic decline in export volumes have impacted profit prospects and growth opportunities. However, in stark contrast to their North American and European peers, regional financial institutions have fared better. In most instances, institutions have pursued conservative business models that have concentrated on providing credit to mainly larger, lower-risk companies; they have strong capital ratios and healthy deposit bases; and limited exposure to structured products and securitized assets. Their comparative standing has also benefited from the relatively unsophisticated consumer financial services markets in Asia and the lack of a secondary mortgage market. Regional and domestic players in Asia are looking to shore up their competitive advantage and enhance their existing business models by expanding customer-focused services and delivering further cost efficiencies.

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Predicting the impact of the crisis on financial institutions and markets and making pronouncements as to how the landscape will look going forward continues to prove difficult. What is evident is the changing role that governments and regulators will play and the unprecedented influence that they are having in shaping both institutions and markets. The overhaul of financial regulation and market practices is and will be a universal development, although it is likely to vary in terms of nature and implementation from one jurisdiction to another. Despite calls for greater interna-

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tional cooperation to prevent future problems of a similar scale and, from some quarters, the suggestion of the establishment of a global financial regulator, developments within risk management will continue to be localized. It is widely accepted that there has been greater awareness of operational risk pre-financial crisis and that attention will only be intensified in the current climate. In addition, market, credit and liquidity risk management are now moving to the top of the management agenda.

Spencer Stuart has been serving the financial services community in Asia Pacific for more than a decade, conducting a wide range of executive searches and talent studies. To deepen our knowledge of the talent implications facing the risk management community, we interviewed a range of business leaders and senior risk managers across the corporate and investment banking, asset and wealth management and securities sectors, to get their views and observations on the challenges that they face. Through the course of these discussions, we identified four consistent themes:

> **Continuing the evolution of risk management in the region**
> **Strengthening risk management culture throughout the organization**
> **Empowering the risk function**
> **Upgrading and investing in talent with established risk management credentials and/or business line experience**

Risk management moves center stage

The risk management function within the region has and continues to undergo dramatic change. There are a number of catalysts for this evolution, the least of which was the Asian financial crisis of 1997-98. Post-crisis reforms centered on implementing "best practice" standards, robust regulatory and infrastructure frameworks and greater coordination between regional and national regulators. There was a concerted effort to transform the risk function from one that had been akin to a compliance role, establishing and monitoring credit and market risk limits, to a more proactive and substantial function that incorporated operational risk.

Further developments have occurred in the last four years in the developed markets of Hong Kong, Singapore and Japan as well as the emerging markets of Korea, Indonesia, Thailand, Malaysia, China, India and the Philippines, as banks have been actively implementing changes in accordance with Basel II. Whilst the extent and speed of implementation has varied from one jurisdiction to another depending on the local banking systems preparedness, there is broad agreement with the principles of Basel II across the region. Furthermore, institutions have been responding to regulatory changes as regional markets have developed and matured. As investors have demanded more active investment strategies and corporations have required more sophisticated financing solutions, there has been a need to enhance risk management and credit procedures. With the region offering almost unstoppable growth, business models were adapted as securities firms increasingly invested their own capital in complex structured products and derivatives, resulting in the need to strengthen operational and liquidity risk in addition to credit and market risk.

Increasing cross-border opportunities, global standardization and the adoption of International Financial Reporting Standards (IFRS) have contributed to the changing profile of the risk management function. In the case of China, where a number of "mega" banks have been listed in recent years, they have benefited from the experience of their international investors and partners. Furthermore, as these institutions look to establish branches outside China, they are required to adapt and enhance their risk and corporate governance procedures to comply with markets in which they are present. It should be acknowledged that there have been considerable strides taken to change the risk management culture and to strengthen the function within domestic institutions in China and more broadly across the region. Whilst these continue, it should be noted that there remains considerable disparity in China between the "big four" and the vast majority of domestic financial institutions in terms of expertise, transparency and compliance with international standards.

As an interesting aside, whilst there continues to be a commitment to implementing international standards by domestic institutions and across emerging markets, the ability of Western institutions to advise on risk management and governance issues has been greatly diminished given the origins of the current financial crisis. The definition of "best practices" is currently in flux and the credibility of some of these best practices is being questioned in some quarters. Indeed, historic market volatility in Asia has led some to observe that, in some ways, risk management processes are, in fact, more stringent in this region than in other, more established financial centers.

As with the Asian financial crisis, today's global crisis has imparted a degree of urgency in further strengthening regulatory and supervisory oversight. As already noted, the current financial crisis was brought about by a variety of differing factors, including poor risk management decisions and a lack of capacity to manage risk effectively given developments in new products and financial instruments. As Western governments acquire substantial equity stakes in institutions, they will insist on an overhaul of best practices. The very public nature of their capital injections and guarantees has created an overwhelming public demand for strengthening of the regulatory environment, and financial institutions will be expected to demonstrate tangible improvements. Whilst much of this will be confined to U.S. and European markets, local regulators, notably those markets of Hong Kong and Singapore, where there has been a significant growth in structured products activity pre-crisis, are also expected to implement changes. The key in Asia will be to implement changes that strike a balance between reducing risk whilst allowing continued growth and opportunities within local markets.

A question of stature

If it is accepted that there is a need for financial institutions to develop strong risk management cultures that are centered on personal accountability, the internal commitment and perception of the risk management function needs to dramatically change. The current crisis, as with the Asian financial crisis before it, has highlighted the lack of visibility of the risk function at the board level, which has resulted in an important risk and control function in many instances. For a universal mindset change to take place within institutions, there has to be commitment throughout global, regional and local management levels. Furthermore, chief risk officers need to take on a more strategic and advisory role, influencing executive management decisions and being an integral part of the global, regional and local management teams. The CRO roles need to evolve from risk reporting to an influencing position.

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A recurring theme throughout our conversations has been the need to empower the risk and control function. This is achieved by maintaining an independent function that has clearly defined reporting responsibility and ultimate responsibility over decision making. It is also widely felt that there is a need to further integrate the risk management function with business lines and ensure that risk managers become more knowledgeable about the business in which they have oversight. Embedding risk managers on trading floors, involving them in product development and strategic business decisions not only strengthens the risk and control function, but also will help raise the level of awareness of risk. Furthermore, it will lead to risk mangers obtaining equal status with their business line counterparts. The risk and control function needs to be viewed as a strategic function that can enhance profit opportunities rather than being viewed as an obstacle impeding business growth opportunities. Indeed, strong risk credentials should be seen as a competitive differentiator.

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Internalization

The current financial crisis has identified the need to internalize and strengthen risk management practices across all financial institutions — including asset managers, securities firms, insurers, retail banks, consumer finance businesses and corporate banks. There have been many pronouncements around the role that rating agencies have played in the current mortgage crisis in the U.S. and the almost blind-faith that investors and financial institutions prescribed to those external rating agencies. In a regional context, the external use of auditors and consultants is widespread within domestic institutions, especially within those markets where there is a limited pool of established and experienced risk management professionals. Similarly, the crisis has sparked a debate around the reliance that is placed on quantitative models and the need to improve stress testing and scenario analysis. Evaluating market risk should be less focused on the mathematics and become more relevant to the changing market dynamics. Credit risk needs to be enhanced with improved data quality and stronger analytical rigor. Redemptions within the asset management community have highlighted the need to improve liquidity risk. It is also widely recognized that there needs to be a movement away from reward and compensation models that focus on short-term profits.

Implications for talent

As the Asia Pacific region has gained in strategic importance and offered strong revenue growth opportunities, there has been a move to upgrade in-region risk management capabilities. For the large part, international institutions have been able to rely on importing talent from their global networks. For domestic institutions, even within markets with well-regarded and well-established regulatory frameworks, this continues to be a significant challenge. In developing markets, the ability to attract, retain and develop individuals with strong risk management credentials has been a barrier to implementing robust and rigorous risk and control functions.

As risk, governance and operation models adapt to the new market environment, there is a continued need to upgrade and enhance the risk management talent in the region. Whilst we would expect to see the transfer of procedures, technology and professionals into the region continue, our discussions have emphasized the need to develop local talent. This is recognized as a long-term commitment demonstrated by the introduction, with the support of industry figures, of university courses aimed at producing future generations of graduates with a strong understanding of risk fundamentals. The risk function in Asia needs to become more proactive and move away from a purely implementation-focused role.

Neither the challenges ahead nor the solutions are easy. A majority of the individuals that we interviewed highlighted the need to incorporate individuals with strong business experience into the risk and control function. In order to attract business line professionals, there will need to be a convergence of stature, compensation and a clearly defined career path going forward. Given the widespread headcount reductions taking place across financial services, we are seeing an increasing number of "front-office" professionals moving into strategic business support functions, although there is a concern that these transitions may be short-lived once business levels return to normal. It is also acknowledged that this is easier to achieve at the more senior end of the career spectrum, although in some emerging markets, including China and Vietnam, there is an issue with the lack of senior talent within both the business line and risk function.

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In order to achieve a well-rounded and effective risk management function in the region, institutions will need to implement formal training both for existing risk managers and more broadly within the organization to raise awareness. In addition, technology and systems will need upgrading to improve data quality, efficiency and relevance. Both of these developments require additional and dedicated funding, which has been hard to secure in previous years and will surely be challenging in today's economic environment. Indeed, in some instances declining business levels have led to retrenchments within some regional credit departments. Where there are limitations on funding and investment, institutions are actively looking at how process implementation can be improved.

Despite the considerable attention that is being placed on the risk and control function, as of now, this has not translated into significant dedicated hiring initiatives. A number of institutions are upgrading internally and are expected to continue to do so. Others are making strategic and critical hires, although they remain in the minority. The reality of cost and headcount constraints in which many multinational organizations are currently operating are affecting the ability of local management to retool and reallocate resources to risk management functions. There is an expectation that this will change as business volumes pick up.

Conclusions

Measuring financial value is only the starting point for risk management. There are qualitative aspects to the function requiring the attention of senior business leaders, including: how the CRO interacts with and is able to influence the CFO, CMO and CEO; the positioning of risk management internally and the quality of risk professionals. In addition, risk management incorporates several elements which need to be integrated holistically at the enterprise level, such as market, credit, liquidity and operational risk on both assets and liabilities across different products, channels, customers and geographies. Successfully addressing these issues requires an internal cultural shift toward the recognition of risk by the business as a function operating with the same business goals in view and with a key role to play in achieving those goals. This change must be led by senior business figures. It will take individuals with strong leadership and influencing skills as well as considerable business acumen to lead the risk function through this shift and beyond. Attracting, developing and retaining these executives must be a key agenda item for CEOs and HR leaders, whatever the market conditions.

About the author

James Lawrence-Brown is a member of the firm's Financial Services Practice, specializing in the area of global banking and markets. He brings to his role more than a decade of success in senior-level executive search across the financial services industry and has particular expertise in the derivatives and structured products markets.

Based in Tokyo, Midori Katsumata is a core member of Spencer Stuart's global Financial Services Practice. With more than 20 years of industry experience, Midori brings valuable insight to the recruitment of senior functional executives and general management for financial services clients.

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Financial Services Practice Asia Pacific Consultants

Anjali Bansal
abansal@spencerstuart.com

Michael Bruce
mbruce@spencerstuart.com

Kerri Burgess
kburgess@spencerstuart.com

Fabrice Desmarescaux
fdesmarescaux@spencerstuart.com

Ko Fukuzawa
kfukuzawa@spencerstuart.com

Midori Katsumata
mkatsumata@spencerstuart.com

Hypatia Kingsley
hkingsley@spencerstuart.com

James Lawrence-Brown
jlawrencebrown@spencerstuart.com

Margaret Lee
mlee@spencerstuart.com

Malini Vaidya
mvaidya@spencerstuart.com

Toshikazu Yabuno
tyabuno@spencerstuart.com

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Financial Services Practice

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