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Mitigating financial services risk with component business modelling (CBM)

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Holding money. Protecting it. Investing it. Using it to make even more money. What's *not* risky about that?

At its most fundamental level, banking is all about managing risk, and doing it well isn't an option. It's a necessity – the cost of staying in the game. Innovative financial institutions are joining in the fight to reduce that cost, however, and component business modeling (CBM) is fast becoming a weapon of choice.

Choice doesn't enter the discussion, though, when it comes to the regulatory aspects of risk management. Banks – large and small, local and global – are expected to comply with the increasingly stringent demands of industry and legislative initiatives such as Basel II, Sarbanes-Oxley, the USA PATRIOT Act and International Financial Reporting Standards – all of which can combine to confound even the most well-run bank's attempts to stay on the black side of profit margins.

It costs money to implement anti-money laundering programs, set up procedures to protect against fraud and guarantee compliance with trading rules. And in a business environment that features lackluster interest rates, rising overhead and swarming competitors who used to be satisfied just being department stores and supermarkets, additional expenditures serve only to narrow already thinning margins.

Getting holistic

Risk management and compliance may be non-negotiable, but fortunately banks have a choice in the way they go about meeting those requirements. They can address them independently and separately, creating stovepipe projects, or they can take a more holistic approach and try to integrate risk management programs on an enterprisewide basis to achieve economies of scale.

There are similarities, after all, in risk and compliance issues requiring bank attention, which means synergies might be uncovered in the strategic application of programs to address those issues. Fraud prevention and anti-money laundering procedures, for instance, involve similar architectures for monitoring transactions, identifying patterns and creating alerts. The use of data warehousing technology also can be similar in terms of system design. Models may differ, but the implementation of common architectures can help lower operational costs.

The best-case scenario, however, involves banks actually taking advantage of regulatory mandates to put in place risk management systems whose scope and power can be leveraged to improve business and shareholder value by increasing revenue, market share and profits. CBM is one way forward-looking financial institutions are analyzing where in their organizations risk management and regulatory compliance requirements can be consolidated and exploited to squeeze more out of the whole than might be suggested initially by the sum of the parts.

CBM helps a bank connect its organizational processes with its business strategy and appropriate technological solutions, facilitating fact-based decisions about the most effective methods for managing change. Deconstructing a bank's business operations into components – similar activities that utilize the same data – puts into clear focus the tendencies a bank may have to collaborate or not collaborate across product lines, functions and geographies. At the same time, componentization points the way toward eliminating redundancies, closing gaps, and improving efficiency and resilience.

Key CBM activities can include:

- Defining discrete components in terms of business processes, organization, operations and supporting technology.
- Linking the consumption of resources with revenue generation and competitive performance.
- Analyzing underlying competencies to identify discrepancies between the way business processes are and the way they could be.
- Highlighting system and application gaps, duplicate processes and overextensions.
- Identifying collaborative patterns to help transform business performance.
- Ultimately producing a plan to repurpose existing facilities and develop new processes, organizational structures and systems.

Tipping the scale

As banks begin to restructure themselves into component-based businesses, they often are able to leverage the potential of an on demand IT environment, combining seamless connectivity and efficiencies with the advantages of specialization and scale found in a fully networked business. In the specific area of risk and compliance, CBM can help banks:

- Identify ways to remain compliant and restructure with less effort, risk and cost.
- Highlight "hot spots" for immediate attention.
- Solve problems innovatively, such as through global sourcing of noncore tasks and processes.

In essence, CBM offers a top-down view of risk and compliance elements, and it begins by helping to answer some fundamental questions about how to appropriately and cost-effectively isolate risk- and compliance-related activities. Are there units within the bank that are specifically in charge of risk and compliance? If so, a bank may decide to focus chiefly on those organizations. Should the entire bank be assessed, or just the wholesale side of the house? Should the examination be limited to individual units, or extended to the group level? CBM helps first to define the questions and then to uncover the corresponding answers.

Inside the area of regulatory compliance, for instance, CBM may lead to the identification of risk management, control, governance, monitoring and external reporting components within the larger, overall function. Using that information, a bank can help ensure that the right business processes are addressed and build an adaptive, cost-effective system to quickly respond to continuing regulatory changes.

At the same time, separating a bank's business processes into individual components can help identify high-revenue, low-cost activities that offer the potential for fast returns. It may be advantageous, for instance, for a financial institution to focus on external fraud first and internal security later. CBM often makes it abundantly clear where a bank's priorities lie and points the way to quick wins.

Lastly, banks can utilize CBM to uncover and address problems in innovative, cost-efficient ways. Citibank, for instance, has applied some of the financial controls and risk management models of its corporate bank to its consumer business, updating its global risk reporting database three times a day to give it the capacity to make hair-trigger decisions.[1] Another global banking business, facing the prospect of an international loss database that needed to capture data at a granular organisational level, used CBM techniques to consider establishing its own infrastructure to handle the job. It quickly discovered that, over a three-year period, it could outsource the service and cut costs by nearly 80 percent.[2]

The bottom line is that many banks are meeting the challenge of regulatory compliance and risk management by using CBM to enhance existing system infrastructures, automate appropriate procedures and build in more resilience. By implementing a single, integrated variable-cost IT solution that goes beyond compliance to meet many requirements, banks can optimize revenues through the reduction of fraud and bad debt; cut costs by streamlining collection, delinquency and recovery processes; and use risk-based pricing to improve credit assessment. It also makes sense to leverage risk management investments to improve customer relationship management, especially by utilizing existing databases and analytical engines to uncover additional customer opportunities.

There's no doubt about it. Banking is a risky business and always will be. But using CBM to restructure processes around cost-effective, enterprisewide technological solutions can help significantly reduce losses and optimize compliance. Central to the effectiveness of that strategy is a mindset that treats risk management and compliance expenditures not just as a cost, but as an investment with the potential to significantly increase a bank's risk … of success.

[1]Company Web sites; BankTech; IBM Institute for Business Value.

[2]IBM client engagement.