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Quality in – Quality out: Sophisticated Product Risk Management Can Sustain Your Business

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After the financial crisis regulators around the globe issued numerous new rules to protect investors. Main reason was to ensure that characteristics and risks of financial products are transparent and unambiguously communicated to clients by financial institutions. The risk of investing in a certain financial product (product risk) is usually calculated based on its market, credit and liquidity risk. While underestimating product risk can entail compliance issues, at the same time an overly risk-averse assessment of product risk can lead to a limited product offering and lost business opportunities. TALOS exhibits valuable experience in analysing, scoping and implementing such risk rating solutions for banks.

Product Risk Solutions Within the Investment Suitability Process

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Nowadays, banks in almost any developed market are obliged by various regulatory requirements (e.g. MiFID II, FIDLEG, PRIIPs) to adhere to a structured advisory process which includes advanced investment suitability checks. In principle, a client's risk rating is mapped against the risk of a single financial product or the client´s overall portfolio risk. In other words, the client's ability and willingness to take risk is compared to the risk of the desired financial product/portfolio. A typical investment suitability check encompasses at least three steps:

1) **Knowledge and Experience:** Does the client have sufficient knowledge and experience of a product or product class?

2) **Product Risk vs. Client Risk:** Does the product risk level correspond to the risk level the client is willing and able to take?

3) **Portfolio Risk vs. Client Risk Budget[1]:** Is the overall portfolio risk in line with the client's risk budget?

In the following we focus on 2). To assess Product Risk vs. Client Risk banks may choose from three options to implement a solution.

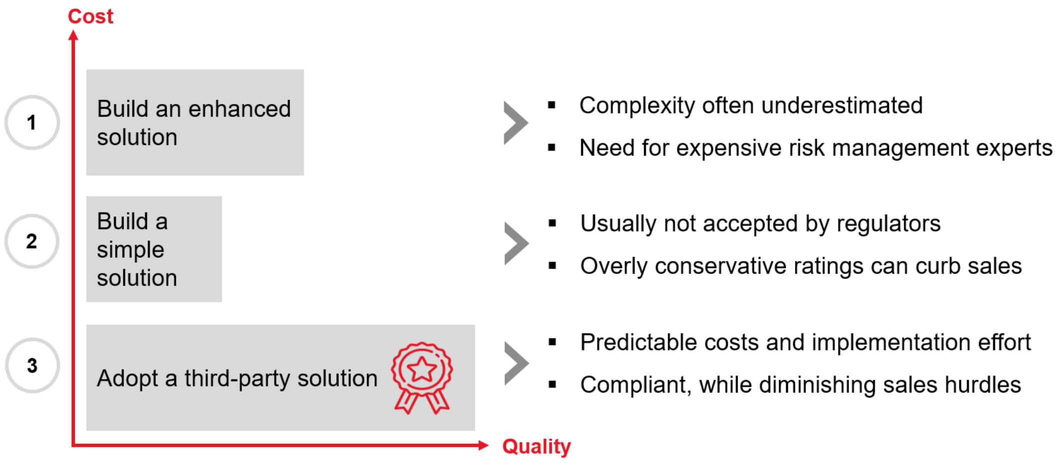

Figure 1: Three different approaches for implementing product risk solutions.

[1] A client's risk budget defines how much risk a client tolerates with respect to his overall portfolio. This is often determined with a conditional value at risk (cVAR) - the client's tolerance to suffer a certain loss over a specific time period in his portfolio.

1. **Build an enhanced solution** - Building own, enhanced solutions is in most cases costly and often complex. It requires a large amount of structured data (e.g. volatility figures, credit ratings etc.) and product risk models for a wide range of investment products. Expensive licences need to be purchased from financial product data provider and respective interfaces need to be developed. In order to structure and maintain the massive amount of product data, data management resources and data warehouse capacities are usually needed. The product risk models that are based on the structured data must be developed and maintained by a dedicated team of expensive risk management experts.

2. **Build a simple solution** - It is very tempting to implement simple solutions for product risk ratings that are not able to differentiate and measure the adequate risk - especially when structured products and derivatives are involved. Rating any complex financial products by default as highly risky is simple and cheap, but in turn the product can no longer be offered to clients who only tolerate low risk products. As a result, the approach may curb sales/revenues because higher ratings lead to more mismatches with clients' risk ratings. On top, regulators in the Asian markets like the Hong-Kong Monetary Authority (HKMA) maintain rigorous rules for risk ratings and do not accept simplified risk rating solutions.

3. **Adopt a third-party solution** - Sophisticated product risk rating solutions can better differentiate investment risk for two main reasons. First, they make use of more data than a typical bank can usually access. Second, they calculate risk based on advanced algorithms and elaborated models. Costs for selecting an external vendor can often be netted as no internal expert teams are needed. Regulators often delay final specifications of implementation rules. Specialized and agile providers can better handle such last-minute adjustments. Furthermore, they can include complex requirements from different regulators across various jurisdictions due to their holistic market overview. In the sense of a true and fair view, cons as for example the selection process, dependency and some loss of flexibility may be brought up, yet according to our experience the pros definitely outweigh.

An educated decision requires a thorough analysis of internal processes, key figures on order flows as well as market screening for suitable providers. TALOS looks back at more than a decade of projects around regulatory transformation and supply management. We apply a 3-step approach for analysing a client´s environment, proposing options based on individual facts and a pragmatic approach to drive a transformation.

1) **Analysis:** Analyse advisory processes, product shelfs and order flows based on a structured questionnaire. Leverage research to screen the market for providers and platforms.

2) **Proposal:** Provide a proposal based on findings identified and drive the decision-making process. This may also include a request for proposal for suitable providers and a proof of concept.

3) **Transformation:** Drive transformation front-to-back by implementing the new software solution, optimizing processes involved and managing stakeholders, including training and hand-over.

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Case Study – Implementation of a Product Risk Solution at a Global Bank

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Initial Situation

A global bank's wealth management division was challenged by local regulators due to inaccurate and occasionally non-existent declaration of product risk when giving investment advice. The applied product risk rating approach was unable to differentiate between product groups and asset classes. Also risk classifications were inappropriately reflected in the investment suitability assessment tools. In addition, for newly issued financial instruments no risk rating was available at time of issuance, hence respective advised ad-hoc trades could not be performed.

TALOS Approach

During the initial client analysis phase, all impacted products, order flows, stakeholders, as well as IT-applications involved in the advisory process were identified and specific regulatory provisions analysed. Since the bank's global product risk rating framework was very sophisticated, state of the art and sold as a white-labelled product risk solution to other banks, the analysis showed that rolling out the existing internal solution to the affected division was the most efficient approach. The internal solution had already been approved by various regulators and had also been applied in other major locations. Thus, a dedicated market research was dispensed with.

During the proposal phase, a proof of concept was carried out based on the existing product risk rating framework, including all major stakeholders from involved departments and considering numerous specific IT-applications in the regional wealth management division. As the local regulatory authority had very strict requirements on product risks, the global risk rating framework had to be amended specifically to meet the expectations stated by local regulators.

At the transformation stage, the new product risk rating framework was implemented consistently across all relevant IT- applications used by relationship managers to give investment advice. In addition, TALOS acted as subject matter expert for the design of a risk platform for local product experts, integrated into the global risk application. Purpose of this additional application was to enable instantaneous manual product risk calculation and publication by local staff. The risk calculation logic for structured products was implemented directly in the local trading software in order to provide instant risk ratings for ad-hoc trades. In order to ensure a smooth transition, training on investment risk calculation was provided to local product experts and a target operating model for regional risk support teams was defined and deployed.

Client Benefit

The new product risk rating framework implemented in the regional wealth management division makes sure that the investment product risk communicated to clients is assessed correctly and in line with all regulatory requirements. The new standard is considered as best practice by the market and the client even considers offering the solution to other financial institutions. The fully integrated digital solution offers instant manual risk rating calculation and supports advised ad-hoc trades for structured as well as fixed income products. In a nutshell, the new product risk solution ensures compliance with local regulatory requirements, helps the client to expand its product offering to low-risk clients, and at the same time reduces costs and time-to-market for newly issued financial instruments.

If you want to learn more about our experience and the options of managing product risk, please contact us.

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Who we are

TALOS is continuously striving to shape new standards in management consulting. As a specialized consulting boutique of Swiss origin, we are serving the European financial services industry from our local offices in Zurich and Luxembourg.

Founded by experienced management consultants in 2008, we have grown since then to a renowned consulting company with a complementary service offering across various disciplines.

With our tailored hands-on approach, we accompany our clients in mastering the fundamental challenges the industry is facing.

We are a trusted partner for our clients helping them to increase their organizational effectiveness and operational efficiency.

We strive to be recognized as one of the leading management consulting boutiques for the European financial services industry.

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