CAPCO

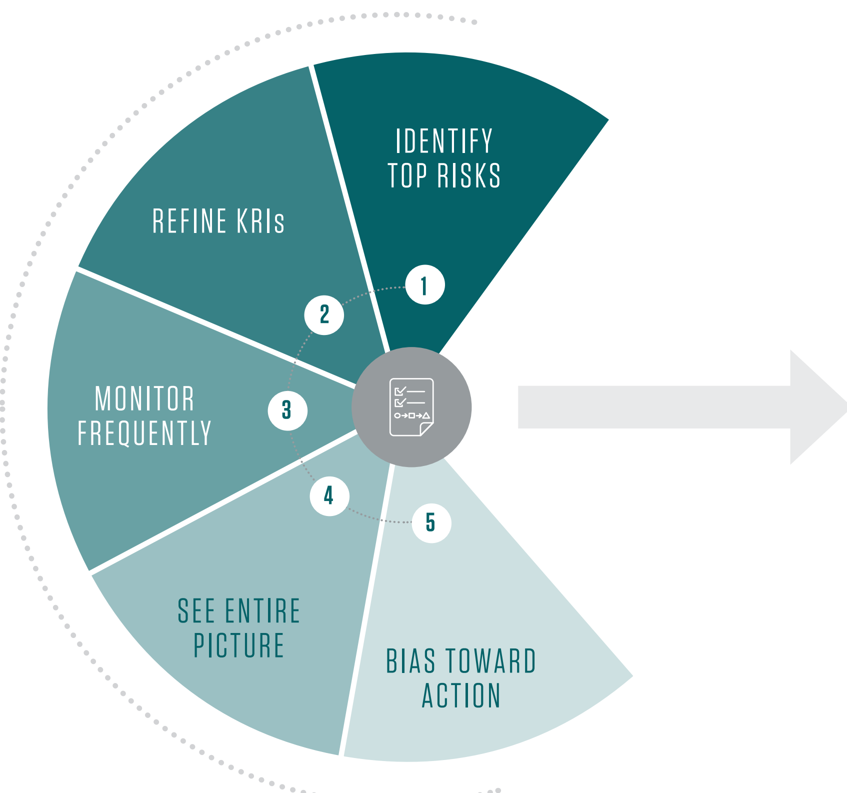
RISK COMMITTEE EFFECTIVENESS IN A TIME OF CRISIS

A CAPCO ENTERPRISE RISK MANAGEMENT (ERM) POINT OF VIEW (POV)

Some banks refer to business-as-usual with a shorthand, BAU. In the spring of 2020, we were jolted out of BAU, and we are in the process of determining what the new BAU will be. Aspects of our industry came to a grinding halt, and it still is not clear how or when some semblance of normalcy will return. At a high level, the risks to banks are clear. We have business customers who lost revenue, investor portfolios that lost value, and households who lost income.

We see uncertainty everywhere, which makes it challenging to look forward. But, looking forward is what we need to do.

Bank leaders manage uncertainty and risk every day. These leaders have processes, practices, and tools for managing risk. Now is an excellent time to use risk management tools and methods to forge a path forward. One place to start is with your risk committee. You can focus you risk committee on the future with these five steps:



BENEFITS

- Improved enterprise view
- More efficient use of executive time
- Fewer surprises
- Reduced disruption associated with managing risk

STEP 1: IDENTIFY YOUR KEY RISKS

Start by gathering internal and external information from around the bank to form as clear a picture as possible of the risks most critical to your bank resiliency or financial condition. Not all risks are created equal. We generally distinguish risks in three ways:

1) **Routine Risks** – generally low impact and commonly handled by individual business units

2) **Key Risks** – known scenarios that could materially impact the bank, typically requiring a cross-disciplinary response, and that the bank can mitigate using a series of key controls

3) **Emerging Risks** – these scenarios don't currently affect the business or require a mitigation response. However, the bank can observe changes to properties in such a way that these could become meaningful risks that the bank should be actively monitoring

The quicker your risk committee can identify your key risks, the better. If you knew your key risks before Q1 of 2020, now is an excellent time to revisit them. Keep in mind that some risk scenarios include a combination of routine, key, and emerging risks. Make sure you consider complex risk scenarios, along with simpler risk scenarios. Don't worry about the list being perfect. It is more important to get one drafted.

Think of risk identification as a group exercise with a goal of including more rather than fewer voices. Some risks are apparent to those closest to risk-taking activities. In other cases, those closest to a risk have one or more blind spots that make risk identification difficult. The best practice is to err on the side of gathering lots of perspectives. Once all perspectives are in, consider whether new information merits refining your list.

Clearly state each risk. If you don't have an existing definition of a risk, try starting with this traditional one. **A risk is a scenario that may lead to an adverse outcome.** Risk statements can be at a high level or a more granular level. When too granular, the risk may be routine and not key. When stated at too high a level, you may lose the ability to act on it. Consider actionable risk statements such as "remote employees underperform," "loan applicants provide fraudulent information," or "commercial loan delinquencies exceed worst-case models."

Everyone on your leadership team needs to agree on the difference between risks that can seriously damage or even kill the bank, versus cuts and scrapes. Once you identify key risks, use your risk assessment structure to evaluate whether suitable controls are in place to mitigate these risks to within acceptable tolerance levels.

Measures of success:

There are three measures of success for risk identification.

1. The risk identification process took into consideration all risk types. Your bank may want to use the lenses used in the Office of the Comptroller of the Currency (OCC) taxonomy that identifies eight risk types: credit, interest rate, liquidity, price/market, operational, compliance, reputation, and strategic. Your taxonomy might differ slightly from the OCC list

2. Each member of the risk committee knows the bank-wide key risks, along with the key risks in his or her area of responsibility

3. The bank's Risk Committee minutes indicate that bank leadership is in agreement on key risks.

STEP 2: REFINE YOUR KEY RISK INDICATORS (KRIs)

Key Risk Indicators (KRIs) are metrics used to monitor known key risks. To be a key risk indicator, the underlying risk is known to have a direct, material impact on the bank. Each metric is sensitive enough to capture change when it happens, and significant changes are worthy of executive attention. While most KRIs are quantitative, you can also monitor some risks with one or more qualitative measures.

Measures of success:

Perhaps the most important measure of success with KRIs is the “so what?” test. If a KRI moves significantly or unexpectedly and the risk committee is not motivated to act, the KRI didn’t pass the test. Refine or de-prioritize any KRIs that don’t pass this test. A well-designed risk dashboard provides the committee a view into the current status and trend for each KRI. Finding meaningful KRIs is far more important than having a large number of KRIs.

STEP 3: MONITOR FREQUENTLY

The bank maintains several risk monitoring activities designed to provide early warning should risk profiles change or events occur, which require the bank’s response. Monitoring activities need to adapt as circumstances change. In 2020, the bank needs to gather risk-related information considerably more often than it has previously. Monitor as frequently as possible, using spot and trend data to see a clear picture. In times of uncertainty, like today, committees need regular updates from those who are closest to where changes are occurring. The first line of defense functions are generally the teams closest to where changes are happening.

Look at your committee meeting schedule and make sure meeting frequency matches the rate of change. What was once a quarterly meeting may need to meet monthly, or a monthly meeting may need to be weekly. Let the need help drive the frequency.

Measures of success:

Monitoring processes are working when all committee members can say with confidence that they are aware of the bank’s risk profile and how it is changing. The question to ask yourself as a committee member is, “how would I know?” “How would I know if something meaningful changed?” When committee members can say with confidence how they would know, the monitoring process is working.

STEP 4: SEE THE WHOLE PICTURE – SHORT AND LONG TERM

In times of rapid change, the distinction between short- and long-term risks becomes more pronounced. You may overlook new risks and continue focusing on known risks. Or, the committee may put aside known risks to focus on the immediate challenge of addressing new risks. The reason risk committees exist is to see the entire spectrum of risks across the bank. Risk committees need to recognize risks that are rising in urgency (such as those related to COVID-19) without ignoring known risks that they expect to be present after the current emergency is lifted. Each committee member identifies how the bank's short- and long-term risks apply to their area of responsibility.

Measures of success:

The committee keeps its focus on short- and long-term risks, including the downstream impact of immediate decisions. Business unit forecasts, models, and assumptions are all aligned to the short, and long term risks the committee monitors.

STEP 5: BRING A BIAS TOWARD ACTION

Monitoring is of little value if the committee is made aware of risk issues, and their response is to admire the problem without acting. The committee's role is to act when needed. A disciplined practice of following up will result in issues that are addressed timely and resolved completely. Committee minutes are an excellent place to keep track of actions that are needed, as well as actions that were taken. For complicated or long-term risk issues, committees may need action plans. A written action plan helps the committee stay on top of who owns the issue, the steps needed to resolve the issue, and how close you are to calling the issue closed.

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Measures of success:

Committee minutes reveal a lot about committee effectiveness. Along with the minutes, look at the materials provided to the committee, including action plans and progress reports, for the story of this committee's effectiveness. The story that emerges may reveal a bias toward action or a picture of passivity.

PULLING IT ALL TOGETHER

You can help your risk committee use executive time effectively and avoid risk surprises with a focus on topics that matter the most to the future of the bank. Today that includes getting to the heart of what is changing and staying on top of key risks, both for the short term and the long term. Hone in on the data that allows the committee to make decisions about those risks. A focused agenda and well-designed risk dashboard go a long way toward paving the path to a new BAU.

ABOUT CAPCO ERM

Capco helps risk committees use their time effectively and address risks proactively. We can help your risk committee too.

Capco's Enterprise Risk Management team helps organizations build or enhance their enterprise risk management programs. Our consulting staff are seasoned industry professionals, representing former Risk and Compliance Officers, executives, and regulators. Our experience covers all areas of financial services, including strategic planning, operations, technology, and risk management.

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About Capco

Capco is a global business and technology consultancy dedicated to the financial services industry.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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