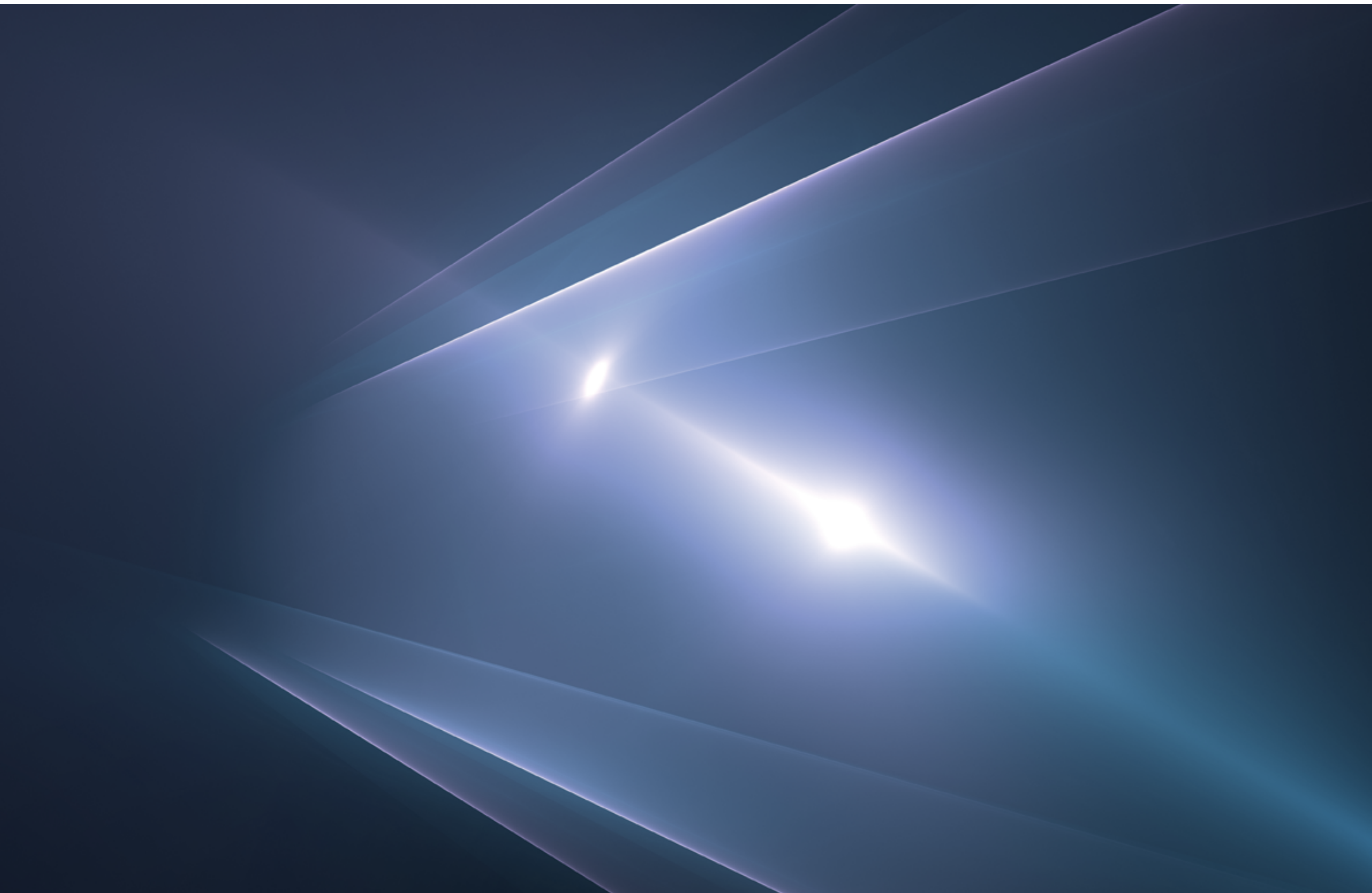
CAPCO

NON-FINANCIAL RISK:

AGILITY IN TIMES OF UNCERTAINTY



THE CURRENT LANDSCAPE

Financial regulators are increasingly demanding that boards of directors have a raised level of awareness of the non-financial risk[1] (NFR) their firms are facing, along with the effectiveness of the mitigating controls they have put in place. In the ever-changing highway of regulatory compliance, companies across all industries continue to face different emerging risks. The ongoing coronavirus pandemic has undoubtedly put more pressure on the risk frameworks and processes of financial services which will inevitably increase their exposure to emerging risks. In this paper, we'll be sharing our perspective on the importance of effectively managing the challenges related to NFR in these unprecedented times.

THE SCALE OF THE PROBLEM

NFR management (NFRM) is an integral part of running a profitable business. The scope of NFR is vast, and NFRs can arise from inadequate or failed internal processes, people, systems, or external events which can adversely affect a firm's daily business operations, profitability, customers and reputation. NFR can consist of other interrelated risk types[2] which can be difficult to identify, measure and manage in comparison to financial risks.

In recent times, NFR has caused significant losses for a number of financial institutions. A high-profile example of a $1.7 billion loss event due to failures of internal controls was Punjab National Bank[3]. According to the ORX global loss database, from 2013 to 2018, more than 80 major financial institutions suffered an average annual gross loss of €25.2 billion, averaging 60,600 reported loss events per annum.

Total gross loss of events reported per year between 2013 and 2018 (EUR billions)

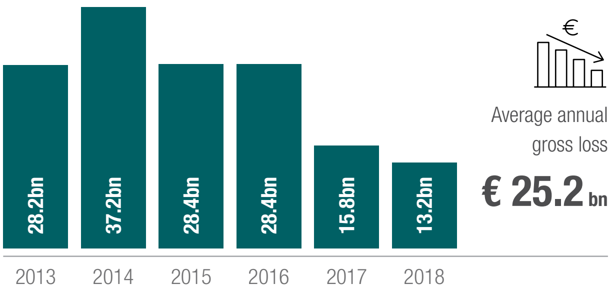


Figure 1: Source: ORX Annual Banking Loss Report

Total number of events reported per year between 2013 and 2018

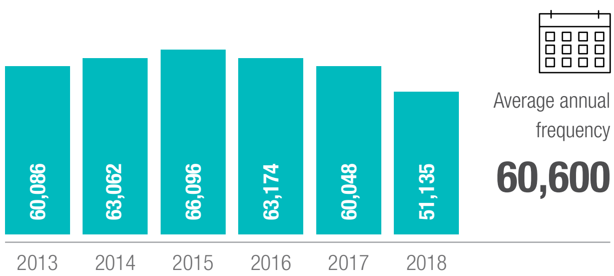


Figure 2: Source: ORX Annual Banking Loss Report

1. Also viewed as Operational risk
2. Operational risk, People risk, Conduct Risk, Cyber security risk, Financial reporting & tax risk, Regulatory risk, Legal risk, Model risk, Third Party risk, Reputational risk, Strategic risk
3. https://www.finextra.com/blogposting/15061/gem-of-a-fraud-a-classic-example-of-operational-risk

Across banking, which includes retail, private and commercial banking , this breaks down across business line and event type as follows:

Table 1: Total losses (€Billions) submitted in each business line and event type between 2013 and 2018

	Internal Fraud (IF)	External Fraud (EF)	Employment Practices & Workplace Safety (EPWS)	Clients, Products & Business Practices (CPBP)	Disasters & Public Safety (DPS)	Technology & Infrastructure Failure (TIF)	Execution, Delivery & Process Management (EDPM)	Totals
Retail Banking	€ 1.1	€ 6.7	€ 3.7	€ 28.0	€ 0.4	€ 0.6	€ 13.5	€ 54.0
Private Banking	€ 0.2	€ 0.2	€ 0.3	€ 2.7	€ 0.002	€ 0.024	€ 0.7	€ 4.2
Commercial Banking	€ 0.2	€ 4.8	€ 0.2	€ 13.0	€ 0.03	€ 0.3	€ 4.8	€ 23.4
Total Loss Events for Banking	5,120	101,846	39,154	51,276	2,859	2,641	69,783	272,679

The two key findings to highlight are:

1. **Technology & Infrastructure Failure (TIF)** displays lower numbers of loss events and only €0.3 billion in total losses which indicates that as companies invest more in technology to strengthen their security, the likelihood of losses with respect to TIF is typically low. On the contrary, cyber and information security risk continues to be a pervasive theme in the banking industry as the financial markets adapt to more disruptive technologies and sophisticated threats.

2. **Clients, Products & Business Practices (CPBP)** consists of the highest total losses (€43.7 billion) across business line, which is 54 percent of the overall total of losses for banking.[4] This unequivocally indicates that banks should give the most focus to this area of their business in order to manage their NFR losses effectively.

4. 75% of the totals in the aforementioned figures

WHAT ARE THE KEY CHALLENGES FOR BANKS?

Given the challenges firms are facing, rapid action is required to optimize the way NFR will be managed. Capco offers the following recommendations:

CHALLENGE THEME	CHALLENGES	RECOMMENDATIONS
1. **People**	**Business practices** – employee conduct resulting in inappropriate business practices. **Hiring practices** – improper recruitment practices which leads to ineffective workplace principles **Location strategies** – resource fragmentation across regions can lead to high levels of staff turnover in lower cost areas. **Dysfunctional functions** – challenges surrounding the identification of NFRs as companies often incorporate risk management within their IT, Compliance, and other functions.	• **Embed a strong risk culture** – A successful risk management approach and a strong risk culture goes hand in hand. Capco recommends all firms strengthen their risk culture. This means they should communicate adequate responses to risk sensitive activities and ensure compensation policies are adjusted according to the risk appetite and risk-taking conduct of employees. This sustainable risk-smart culture manifests at all levels and embeds appropriate benchmarks for risk activities, while encouraging employees to conduct themselves according to the firm-wide strategy and risk appetite. • **Improve staff retention** – Employees often venture away from companies that operate in ways which conflict with their principles when issues are not being addressed effectively. This is heightened if the problems correlate to reputational damage and the reduction of future employment opportunities with rival companies. To avoid, firms should review and monitor their recruitment and management practices to foster long term career fulfilment. • **Crystallize roles and responsibilities** – Holding people accountable for managing NFR is crucial to success. Capco advises that firms enact distinct role accountabilities to help streamline the risk management process which improves the management accountability of the firm's culture.

CHALLENGE THEME	CHALLENGES	RECOMMENDATIONS
2. **Policy, Legal & Regulatory compliance**	**Legal and regulatory compliance** – non-adherence to legal and regulatory mandate / guidelines which may lead to a breach. **Policy adherence** – lack of adoption of standard operational risk policies and limits.	• **Improve legal and regulatory compliance** – There is a general consensus that the major NFRM challenge is the escalating cost of compliance. Failure to adhere to financing laws is pushing regulators to step up their enforcement. Recent compliance failings in Australia has led to a major bank facing potential financial crime fines[5]. Capco believes that legal and regulatory compliance is an irrefutable part of obtaining better performance in an ever-changing market. Firms should have an open and transparent approach with regulators and timely disclosure of misconduct findings. Firms should be diligent in their contractual arrangements which are deal related and invest in KYC capabilities which can de-risk transactions linked to the potential breaches. • **Compliance testing** – In addition to the above, Capco recommends the realignment of business lines and ensuring processes are adequately mapped and understood. This should enable firms to perform adequate testing to ensure people are adhering to policies and procedures.
3. **Technology**	**Disjointed systems** – over time, companies become manual and legacy systems become no longer fit for purpose, due to over engineered solutions and metrics or reporting which no longer add value. **Infrastructure scalability** – architectural shortcomings limits the ability to expand the architecture to support growth. **Security** – lack of protection of proprietary information and assets.	• **Automation** – Many firms can use automated software solutions to help get things done faster, more cheaply and more accurately. Capco recommends all firms invest in automation and robotics technologies to reduce on-going legacy system costs and meet evolving regulatory demands predictably and cost-effectively. • **Fintech** – Fintechs and these vendors will change the way they can provide clients with cutting edge solutions to compete with the digital disruptors, who would gladly take advantage of any bank's inability to provide customers with the latest digital technology-enabled experience. • **Scenario modelling** – Firms should leverage scenario modelling and benefits simulations to gain meaningful insights in order to provide better decision-making when assessing the likely outcomes for embedding new security systems and processes.

5. https://www.ft.com/content/46ea37f5-1e75-466c-bc93-ce31ae8c8301

CHALLENGE THEME	CHALLENGES	RECOMMENDATIONS
4. **Data & Reporting**	**Financial integrity** – inaccurate reporting, metrics and financial data **Information retrieval** – accessing NFRs requires a wider variety of sources – i.e. KRIs, reportable incidents, trigger events, risk maps, risk, and control profiles, risk & control assessments, etc.	• **Enhance reporting capabilities** – Firms that want streamlined strategies for managing NFR should leverage valuable features such as control diagrams, scorecards, supervisory management information (MI) and role-based dashboards. This offers transparency of risk management processes which can support more timely and efficient identification of potential risk events. • **Data & analytics** – The changes to the financial markets is pushing the need to govern, control and ensure quality of data. Capco provides several offerings which help clients harness the power of data through a range of data tools, techniques, and frameworks to accelerate their clients' data journey. This will ensure banks meet the growing need to engage customers more effectively, bring products to market quicker, reduce risk across business lines and transform operations.
5. **Risk & Controls**	**Pressures on the risk framework** – banks have seen increased trading volumes due to the COVID-19 pandemic and these volumes significantly impact manual processes, which creates volume sensitivity for complex products and therefore a higher likelihood of control failures.	• **Manage key risk exposures** – Capco urges firms to focus on quickly identifying, measuring, monitoring, and controlling inherent risk exposures to evaluate risk controls based on inherent risk while managing the residual risk through mitigating controls. Firms should prioritise testing measures to ensure people are adhering to the procedures. • **Reduce operating costs** – The costs of operational failures continue to mount as changes to the market bring new regulation, technology and ways of working. Mitigating losses should be a top priority for firms today. Capco recommends firms reduce their loss events by anticipating possible risk events using more effective controls monitoring tools, machine learning solutions and artificial intelligence. We offer these services to our clients to enable them to develop a streamlined framework, improve efficiency and strengthen loss mitigation practices in relation to transaction monitoring.

ADAPTING TO A NEW WORLD OF RISK

> *Risk comes from not knowing what you're doing* [6]
>
> – Warren Buffett

We are observing an unprecedented scale of uncertainty across the financial industry because of COVID-19. We see top banks striving to reduce costs and shifting their focus to operational efficiency as a response to this pandemic. The authorities do not only expect these banks to display agility under uncertainty, but also to support new initiatives to rapidly adapt their processes – which may have been in place for years – in order to facilitate new measures designed to stabilize the economy.[7] Lessons learnt from the past can help these banks foster preparation and responsiveness in their approach to strategic decision-making, which could determine their fate in the face of potential future recessions. In order to thrive in such times, companies must understand their vulnerabilities, invest in capabilities to protect themselves, while leveraging technology and data to support agile decision-making during times of uncertainty.

6. https://www.cnbc.com/2017/05/01/7-insights-from-legendary-investor-warren-buffett.html
7. https://www.hsbc.com/media/media-releases/2020/hsbc-holdings-plc-annual-results-2019

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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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