The future of strategic risk management in financial services

Risk Advisory

The future of strategic risk management in financial services

The financial services industry is currently in a period of heightened change and uncertainty. Changing regulatory expectations and increasing geopolitical risk are shaping the external environment, while growing competition among banks, non-banks, and financial technology firms (FinTechs) is reshaping the competitive field.

As pressures mount on traditional sources of profitability, financial institutions are increasingly searching for new avenues for growth—developing more customer-centric service strategies and entering into "digital banking" through partnerships or ventures with FinTechs.

While failing to innovate in this environment may place financial institutions at a competitive disadvantage, doing so without aligning business strategies with sound risk management practices may also heighten strategic risks[i].

Strategic risks are the risks that threaten to disrupt the assumptions at the core of a financial institution's strategy.

Regulators' expectations on strategic risk
Recognizing the growing impact of strategic risks on financial institutions, regulators now expect institutions to have formalized processes to assess strategic risks.

"Their boards of directors and senior management, who bear the responsibility to set strategy and develop and maintain risk management practices, must not only address current difficulties, but must also establish a framework for the inevitable uncertainty that lies ahead. Notably, the ongoing fundamental transformation in financial services offers great potential opportunities for those institutions able to integrate strategy and risk management successfully, and I will argue that survival will hinge upon such an integration in what I will call a 'strategic risk management framework'."[ii]

—US Federal Reserve Governor Randall Kroszner

Steering risk management into the future

The business environment is evolving, and risk management needs to evolve along with it. In addition to infusing strategy and risk management, Deloitte has identified three other levers that can be used to modernize risk management for changes in the business:

People. For risk management functions, taking on ownership of strategic risks will require new organizational constructs, competencies, experiences, and business relationships. Institutions will need to empower chief risk officers (CROs) to have accountability for strategic risk management and establish "owners" of specific strategic risks such as geopolitical, economic, and FinTech risks. Management of strategic risks will require the ability to apply a risk lens to areas such as product development, sales, and culture. This will be a departure for many institutions, where risk management has traditionally focused on financial and regulatory risks. Some organizations have found it useful to bring in individuals from the business either on a rotational or permanent basis, as well as training up existing risk professionals in new methodologies for assessing strategic risk.

Three lines of defense. Under the three lines of defense model employed by most financial institutions, business units own and manage their risks; the risk management function provides independent oversight and challenge; and internal audit reviews the effectiveness of the risk and control framework. Even if the three lines of defense model is conceptually sound, many institutions have faced practical challenges in implementation resulting in the risk management function effectively playing both first and second lines of defense roles. Embracing a strategic risk approach, including embedding risk into the strategic planning process and utilizing strategic risk tools, allows the risk management function to play a true second line of defense role—providing effective challenge to critical business decisions in order to enhance decision-making and to enable growth.

Technology. The latest technologies—such as cognitive analytics, machine learning, natural language processing, and big data—have the potential to fundamentally transform risk management. From a strategic risk management perspective, organizations can use these technologies to continuously monitor changes in the environment to determine which could be truly disruptive; and embed these technologies into enhanced tools such as horizon scanning and scenario planning simulation to drive higher levels of sophistication in managing risk.

For further discussion of Deloitte's point of view of the issues affecting risk management functions, and the opportunity to enhance these functions, see: The future of risk in financial services report[i].

Increased focus on strategic risk

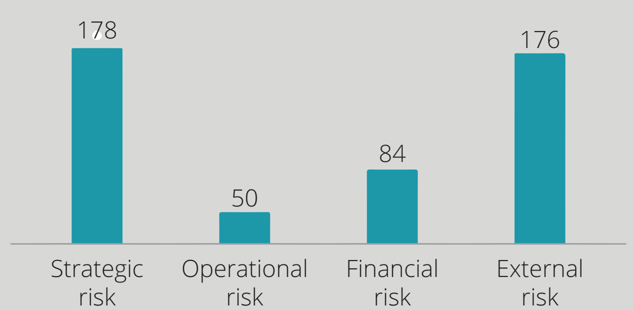
Although risk management functions understand the importance of managing strategic risks, many have not historically engaged in this area. Part of the reason is because regulatory focus has traditionally been on financial risks, including credit, market, and liquidity risk—risks that can be more easily quantified.

But the future of risk will require an increased focus on strategic risk. Regulators are increasing their focus on non-financial risks, including strategic, operational, and compliance risk[iii]. And for good reason.

A comprehensive, Deloitte analysis covering a ten-year period consistently identified strategic risks to be the number one cause of losses in company value (see sidebar). Another recent study published in the Harvard Business Review found that strategic risks proved to be the most damaging type of risk companies faced[iv]. The analysis found that 86% of significant market capitalization declines in the past decade were caused by strategic risks—with operational risks (9%), legal and compliance risks (3%), and financial reporting risks (2%) trailing significantly behind.

Deloitte's comprehensive "Value Killers" analysis identified strategic risks as the number one cause of dramatic losses in company value[v]. The comprehensive analysis studied the 1,000 largest global companies in the decade between 2003 to 2012, analyzing companies that suffered share-price declines of more than 20 percent in a one-month period relative to the MSCI Global 1000 index.

Frequency of risk events across 100 public companies with largest value drops.



These studies highlight the need for risk functions to help financial institutions identify and manage strategic risks. Indeed, the future of risk will require risk functions to devote more focus to managing strategic risks, as the external and competitive environments become more volatile and uncertain, and internal operating models become more technologically-driven.

Defining strategic risks

What are strategic risks? Unlike operational and compliance risks, strategic risks are not inherently undesirable. There can also be an upside to taking these risks. The aim of managing strategic risks is not necessarily prevention, but also anticipation and understanding. Understanding strategic risks helps leaders to know how they should respond, for example, either by tweaking the current strategy, increasing investment, enhancing internal capabilities, or sometimes, even changing direction completely.

It can be helpful to think of strategic risks in three categories:

- Strategic positioning risks: Are we going in the right direction? How should we position ourselves for the future? Are we well-positioned to create value and meet customer needs for the foreseeable future? Are we focused on the right markets?
- Strategic execution risks: Do we have the right talent, capabilities, and infrastructure to execute on our chosen strategy for the future? Have we hired the right people, put in place the right technology, or chosen the right alliance partners to achieve our strategic goals?
- Strategic consequence risks: Could our strategic choices result in new risks or result in unintended consequences for the financial institution? Will our strategic choices create inappropriate incentives or create new risks for us (e.g., conduct, reputation risks)?

For additional information, see sidebar: steering risk management into the future

Managing strategic risks

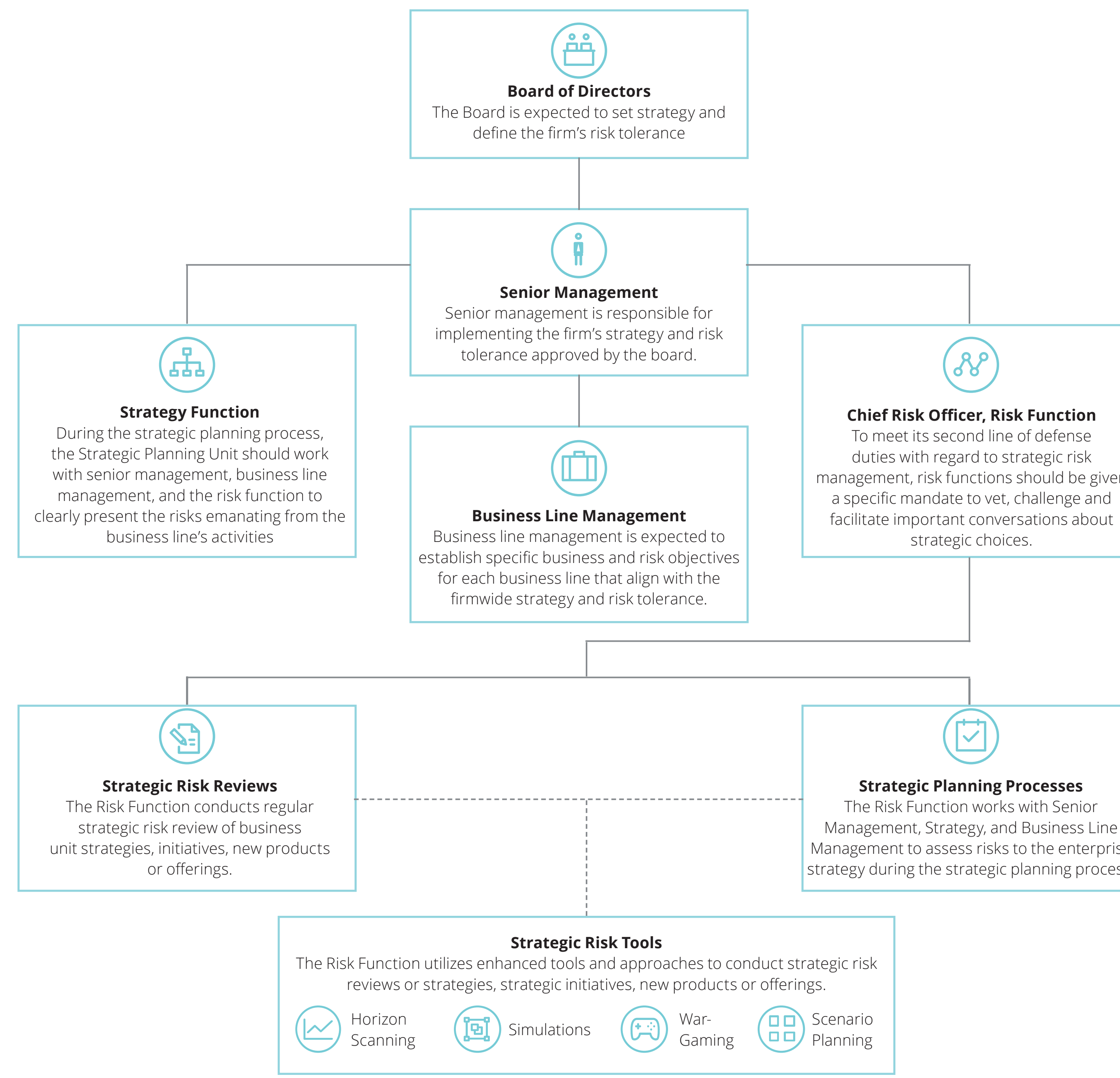
For a variety of reasons, managing strategic risk is considerably more difficult for financial institutions than managing some of the more traditional financial risks. According to Deloitte's annual Global Risk Management Survey[vi], almost all respondents considered their institutions to be extremely or very effective in managing traditional financial risks such as market (92 percent), credit (89 percent), asset and liability (87 percent), and liquidity (87 percent). In contrast, only 46 percent of the respondents said the same about strategic risk.

To start effectively managing strategic risks, financial institutions need to establish governance and ownership for strategic risk management; better integrate the stakeholders responsible for strategy and risk management; put in place risk review processes that allow for independent oversight and challenge of strategies, which are linked to risk appetite setting; train risk leaders in forward-looking risk management approaches; and put in place frameworks to assess risk impacts on key business variables.

Governance and ownership of strategic risk management

Recent Federal Reserve proposals suggest specific guidance for governance and ownership of strategic risk management[vii]. The board is expected to set strategy and define the firm's risk tolerance. Senior management is responsible for implementing the firm's strategy and risk tolerance approved by the board, including ensuring the firm's infrastructure, staffing, and resources are sufficient to carry out the firm's strategy.

Strategic Risk Governance and Organization Operating Model



Business line management is expected to establish specific business and risk objectives for each business line that align with the firmwide strategy and risk tolerance. During the strategic planning process, the strategic planning unit should work with senior management, business line management, and the risk function to clearly present the risks emanating from the business line's activities. Business line management should be able to explain how those risks are managed and align with the firm's risk tolerance.

To meet its second line of defense duties with regard to strategic risk management, risk functions should be given a specific mandate to vet, challenge and facilitate important conversations about strategic choices. For example, the CRO should report concerns to the board's risk committee if the firm does not have sufficient risk management capacity to enter into a proposed merger or new product line and promote the taking of appropriate actions, as warranted. The CRO should recommend constraints on risk-taking and enhancements to risk management practices to senior management and the board.
Alignment between these important stakeholders—the board, senior management, business line management, strategy and risk—is required for effective strategic risk management. Institutions are more effective at anticipating change and achieving the right outcomes if they consider strategy and risk management together rather than as two separate mindsets and functions. Applying a risk lens to areas such as product development and sales is particularly important, as the focus of regulatory supervision shifts to non-financial risks, including assessing an institution's culture, and how it ensures that its customers get fair and transparent outcomes.

This will be a departure for many institutions, where risk management has traditionally focused on financial risks. Change will not happen overnight—taking on ownership of strategic risks will require new mindsets, competencies, and business relationships that risk management teams will need to grow and build over time.

Strategic risk processes and tools
Specifically designed processes and tools targeted at strategic risks have shown to be effective methods of bringing much needed clarity to an often complex area.

Strategic planning process and risk appetite setting
For most financial institutions, a fundamental first step is to integrate a strategic risk review process into the annual strategic planning processes. During the strategic planning process, the strategic planning group and risk function should be well integrated to ensure a risk-oriented approach to planning is conducted. Based on the strategic priorities developed through the planning process, institutions should be deliberate about setting their risk appetite levels against key risk types (credit, market, strategic, operational, and compliance), as well as against key business areas.

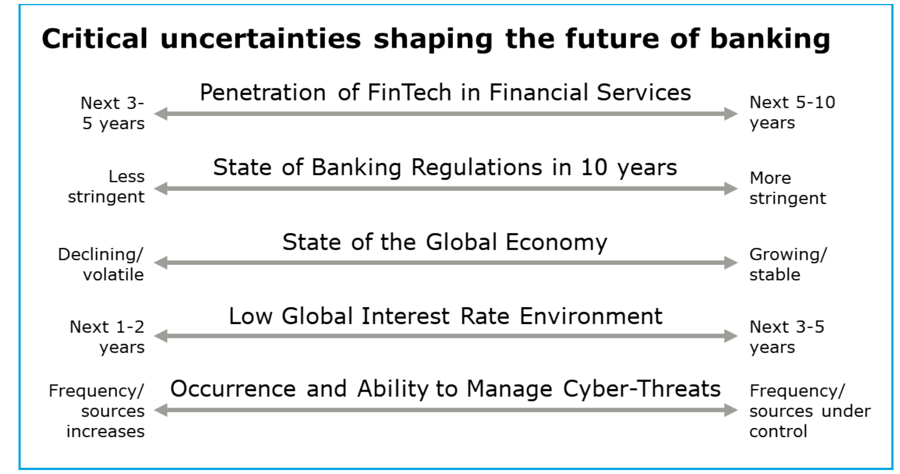
Similarly, at the business unit level, institutions should also establish formalized, regular processes for identifying, assessing and reviewing strategic risks and assessing risk appetite levels. For example, the business unit should evaluate how it cascades the risk appetite down to risk limits for different business areas to manage their risks and how and how it monitors those risk limits.

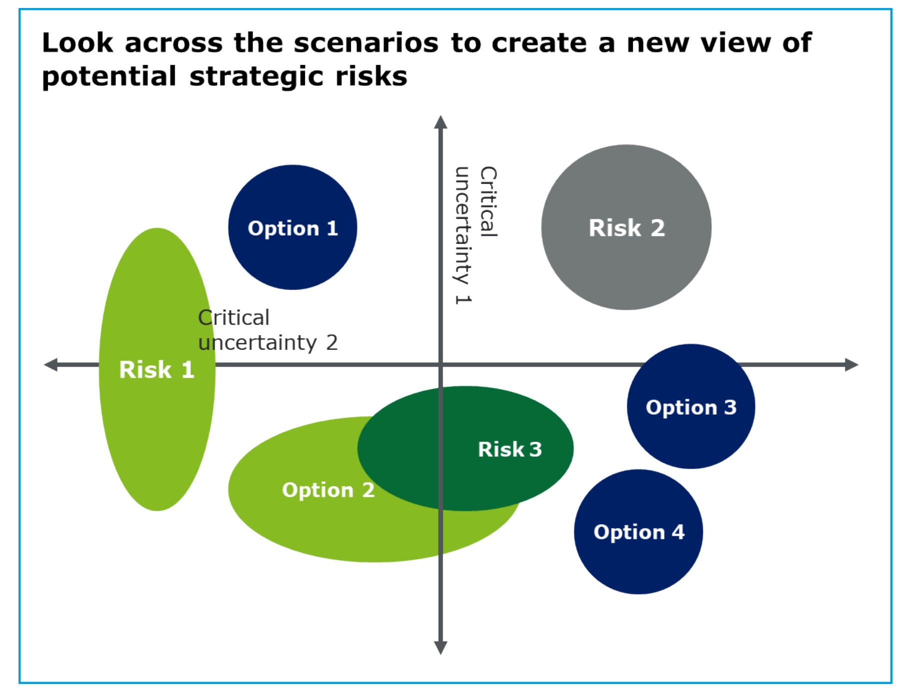
Scenario planning
Scenario planning can help financial institutions see a set of both risks and opportunities more broadly, to identify alternative scenarios that might challenge their current strategic assumptions, and to spot potential sources of risk that may not surface in other ways.

Scenario planning provides an approach to rigorously confront and explore the uncertainties shaping an institution's business environment. Leading financial institutions understand the importance of "leaning in" to uncertainty, cultivating an ability to see and interpret change before it becomes a strategic risk, and adapting their strategies to find new ways to create value.

Financial institutions may particularly find value in scenario planning, as they face significant sources of uncertainty, including the rise of FinTech and the changing regulatory landscape. Scenario planning can provide a useful means to organize thinking around these critical uncertainties, providing a way to explore plausible futures, identify risks and opportunities, and determine strategic choices.

The future of strategic risk management in financial services





Case study: Regional bank uses scenario planning to surface strategic risks and opportunities from changing digital landscape
A regional bank used scenario planning to understand strategic risks and implications of the changing digital landscape on their strategy. In particular, they wanted to understand how they should be thinking about using technology to interface with their customers, the strategic choices they would need to take to be successful given these changes, and the risks they would need to mitigate as they evolved their platform. The scenario planning exercise brought together stakeholders from across the organization, including the c-suite, business unit leaders, strategy, and risk. The exercise surfaced both opportunities and risks for the organization—including recognizing several points where it could be disintermediated, in particular, in how they interfaced with customers. The exercise also helped the risk function understand how the risk profile of the organization would evolve in the coming years, and as a result, the risk organization was prompted to increase investments and controls in data privacy, data management, cybersecurity, and brand and reputation management.

Case study: Global Investment Bank utilizes simulation exercise to tests its ability to execute a coordinated response to a major global counterparty and liquidity crisis

A global investment bank utilized a simulation exercise to test its ability to execute a coordinated response to a major global counterparty and liquidity crisis. The bank wanted to test its ability to satisfy regulatory requirements and the needs of counterparties in a real-time, crisis-simulated situation. The simulation took place over a 48-hour period with stakeholders from across the organization playing their divisional roles—from treasury, operations, data management, public relations, and the c-suite. Subject matter specialists were brought in to play the roles of regulators and counterparties. The exercise tested the capacity of the organization to aggregate exposures within four hours, as well as to plan out the sequence of critical tasks and decision-making responsibilities required to manage a crisis over a 48-hour period. The simulation exercise resulted in:

- A better understanding of the bank's ability to manage client related asset management movements and crisis communications in the event of a counterparty failure;
- Improved standardization of process and reporting template for exposure to better understand its aggregated risk exposure; and
- Development of a crisis management playbook.

War-gaming and Simulation

War-gaming provides a tool for improving decision-making under uncertainty, by providing opportunities to surface competitive dynamics; rehearse, refine and test strategies in a realistic environment. For example, war-gaming and simulation can help organizations think through strategic questions such as: *How will our competitors react if we launch our strategy? What would happen to our market position if we launched this product? What is the likely response from our employees given our culture and incentives? What infrastructure and data do we have—or need to have—to successfully pull off this strategy?*

Like Scenario Planning, War-gaming provides a means to think outside of conventional mental models to discover threats and opportunities of strategic choices and allows leaders to see the potential second—and third—order effects of their decisions. War-gaming is va versatile tool for institutions who can use it to help prepare for a range of issues, including preparing for everything from cyber breaches, to testing a financial institutions ability to execute a coordinated crisis response to a major global counterparty and liquidity crisis.

Conclusion

Risk management in financial institutions has been shaped over the past decade, largely in response to regulations that emerged from the global financial crisis. But as the nature of the financial industry changes over the next decade, so too will risk management need to evolve.

Leading financial institutions are broadening the role of risk management, from solely a function to maintain regulatory compliance to a function mandated to help the business make better decisions and take smarter risks.

To get started on this important journey, financial institutions can take the following steps.

- **Drive coordination across stakeholders responsible for strategic risk management.** Enable more coordination between those responsible for strategy—the board for setting it, senior management for implementing it and the strategic planning function for assisting them—and stakeholders responsible for risk management.
- **Assign a senior executive to be accountable for strategic risk management.** Empower the CRO to have specific accountability for strategic risk management and provide the risk function with a specific mandate to vet, challenge and facilitate important conversations about strategic choices.
- **Assign strategic risk owners within the business.** Establish "owners" of specific strategic risks such as geopolitical, economic, and FinTech risks, who are responsible for monitoring and managing these risks areas.
- **Train risk leaders in forward-looking risk management approaches.** Expand the risk manager's toolbox to include approaches well-suited to looking externally and into emerging risk areas—tools such as such as scenario planning and war-gaming and simulation.
- **Establish strategic risk review processes.** Integrate strategic risk review processes into the annual strategic planning process and for significant strategic initiatives/investments, such as a new product development/launches, geographic or channel/service expansion, and M&A pursuits.
- **Link strategic/business decisions to risk metrics that matter.** Establish risk metrics and rating criteria that matter to the business.

Strategic risk management is the next frontier of risk management, one that will generate a more intelligent conversation about the risks that are sometimes imposed on financial institutions and the opportunities for business growth. Armed with the right tools, leaders can accelerate how quickly they discover such risks and fit them into their ongoing strategy and decision-making processes. Financial institutions that do will see how managing strategic risk—and the ability to name it, track it, and deal with it—can turn into an important strategic advantage going forward.

Contacts

Edward Hida
Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
ehida@deloitte.com

Keri Calagna
Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
kcalagna@deloitte.com

Michele Crish
Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
mcrish@deloitte.com

Endnotes

[i] For a discussion of the new environment for risk management, please see Deloitte's report, ***The future of risk in financial services,*** https://www2.deloitte.com/global/en/pages/financial-services/articles/gx-future-risk-in-financial-services.html

[ii] ***Speech by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the Risk Management Association Annual Risk Management Conference, Baltimore, Maryland, 10/20/2008.***

[iii] For additional information on developing a non-financial risk management program, please see Deloitte's report: T***he Future of Non-Financial Risk in financial services: Building an effective Non-Financial Risk management program,*** https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Risk/gx-ra-future-non-financial-risk.pdf

[iv] ***How to Live with Risks,*** Harvard Business Review, July-August 2015 edition.

[v] For additional information on Deloitte's comprehensive "value killers" analysis, please see Deloitte's report: ***The Value Killers Revisited: A risk management study,*** https://www2.deloitte.com/global/en/pages/risk/articles/the-value-killers-revisited.html

[vi] Global risk management survey, 11th edition, www.deloitte.com/insights/globalrisksurvey

[vii] For additional information, see: ***Proposed Guidance on Supervisory Expectation for Boards of Directors,*** Federal Reserve System, 08/09/2017.

Deloitte.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), its global network of member firms and their related entities. DTTL (also referred to as “Deloitte Global”) and each of its member firms are legally separate and independent entities. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte is a leading global provider of audit and assurance, consulting, financial advisory, risk advisory, tax and related services. Our network of member firms in more than 150 countries and territories serves four out of five Fortune Global 500®companies. Learn how Deloitte’s approximately 264,000 people make an impact that matters at www.deloitte.com.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms or their related entities (collectively, the “Deloitte network”) is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2019. For information, contact Deloitte Touche Tohmatsu Limited.

Created by Core Creative Services RITM0351159