Turning a Solid Risk Management Framework into a Competitive Advantage:

How Increasing Resiliency and Adaptability Can Help Differentiate Your Bank

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IN SPORTS, PEOPLE – FANS AND COACHES ALIKE – TALK ABOUT HOW DEFENSE WINS BALL GAMES. DEFENSE PROTECTS YOUR HOUSE.

At many banking institutions, risk management teams are considered the heart of the company's defense. They fill in the X's and O's helping organizations follow the rules of the sport, mitigate risks and fix things when they go wrong, especially if the referee – in this case, we're talking major federal supervisory agencies – throws a flag.

But if that's the only way you look at these functions, you're shortchanging how risk teams can play powerful offense. Put to work strategically and integrated smartly into every business decision, risk management can help score big points with your customers as you launch new products and services or find yourself needing to adapt quickly to externally driven changes.

"In today's banking environment, developing an enterprise culture that embraces risk management is essential to effectively playing both ends of the field."

Getting across the goal line in building an effective risk management culture has never been a more important strategy for banks.

Bringing a Risk Management Culture to Life

Unfortunately, too many organizations still box off risk management in a corner, thinking those teams only need to handle the often-burdensome work of meeting regulatory requirements and expectations. Without question, that remains a major responsibility, but the mindset with which your bank approaches these roles can differentiate your business in a market that has never been tighter.

When you recast the role and ownership of your risk management as a strategic pillar in your future growth and direction, you'll find that adhering to best operational practices – on everything from regulatory adherence to product and service adjustments – minimizes risk and actually propels your company forward.

Put simply, better risk integration will help you nimbly steer around potholes in your path and avoid annoying backtracking to fix early-stage problems.

ALIGNING WITH CHANGING TIMES

The year 2020 was unlike any other, with significant ups and downs in every facet of our economy, and direct impacts on financial institutions. Faced with significant revenue hits due to interest rates at prolonged record-low levels at the beginning of 2021, banks are pushing through new products and forging digital transformations to drive greater engagement and meet customers where they are.

The pandemic and its safer-at-home government guidance initially sent employees out of the office to work from kitchen tables and basements. Did your organization respond to this new normal with robust attention to risk management to keep customer information secure? If they weren't able to soundly close all the gaps as they pivoted in that unprecedented moment, have they gone back to ensure today's operations fully comply and are adequately controlled to mitigate the risks? And as they start to think about

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recalling workers to brick-and-mortar locations, how will they incorporate lessons learned during the pandemic to advance their go-forward risk approach?

While striking the right balance on risk management has always been a challenge for banks, the Great Recession of 2008-09 upped the ante with the level of federal scrutiny and expectations on banks.[1] A decade ago, there was intense focus on regulatory and financial risk. In addition to continued focus in the regulatory and financial risk space, more recently regulators and organizations have begun placing greater emphasis on nonfinancial risk, including operational, strategic and reputational risk, which, of course, can also lead to financial impacts.

GETTING IT RIGHT MATTERS

In today's environment, risk management failures come with greater fines and costs – from reputation to reparations – and the scope of regulatory focus[2] only continues to widen. In an early case, the Biden Administration within its first week signaled that we should expect a renewed focus on oversight and the Consumer Financial Protection Bureau director has pledged an aggressive approach to supervision and enforcement.[3] And COVID-19 just might end up spotlighting all the cracks that financial institutions are still struggling with.

All of that adds up to the unprecedented need for banks to have a robust risk management framework, reinforced by employee engagement, for how they identify, manage and respond to risk across business lines and functions. Too often, organizations try to reinvent the wheel every time they face an opportunity or demand – either internally or externally – that requires process change, historically because the various teams, in an effort to drive success, kept their frame of reference limited to their specific function. They spend too much time in rework and starting over, when established risk processes and policies could help them be more nimble and agile in navigating change.

A THOUGHTFUL, INTEGRATED AND ENTERPRISE-WIDE APPROACH, AS WE OUTLINE BELOW, WILL GET YOU MOVING IN THE RIGHT DIRECTION – BUILDING A SUSTAINABLE RISK MANAGEMENT CULTURE.

Driving a Risk-Aware Culture Starts – but Doesn't End – at the Top

The attitude and actions of your most senior leaders establish your organization's approach to effective and successful risk management. Setting the tone, those leaders draw that proverbial line in the sand and establish staunch expectations for your bank – and your people – in managing risk. That extends to adhering to firm ground rules for how you operate day in and day out, whether responding to internal business initiatives or external regulatory requirements. If those at the top aren't essentially shouting from a megaphone that embracing risk management fortifies everything you do, then you're starting at a disadvantage, like going into a game with not enough players.

Remember, however, that risk management is a team sport, with your leaders serving as coaches to draw out the best of each employee.

Driving understanding around the specific role everyone plays on that field can't be understated, as well as those in support roles, such as your trainers, equipment managers and even your grounds crew. The more alignment you gain toward the goal, the greater – and easier – you can claim victory.

RISK MANAGEMENT CULTURE NURTURES COLLABORATION

Building an inimitable risk management culture means creating open channels where your people work collaboratively, have transparency into related roles and maintain appropriate independence that allows them to complete key tasks effectively and stave off risk. In nurturing a new way of life for your organization and driving alignment on goals, you want to set up holistic guardrails to keep risk management top of mind and drive shared accountability.

When you have a well-defined and well-deployed risk management framework, you are delivering efficiency to your organization. When a change is needed, your framework and supporting components guide consistency in how you approach risk-based decision-making (which regulators watch for), and you have proven and specific parameters to help you get from Point A to Point B without adding risk, whether for routine changes or unexpected twists and turns.

Your framework should incorporate several key elements:

- **GOVERNANCE:** Think of the risk management framework as your institutional playbook – your ultimate governance document. Start with how you are going to govern your risk. What is the bank's risk strategy? What is the role of the board and management? What committees are going to make up your governance structure, and what is the decision-making authority, approval and escalation process across those bodies? In addition to your overarching institutional playbook, there will be many other governing documents – committee charters, policies, procedures – related to how your enterprise prepares for and reacts to any kind of risk. Of course, those governance elements and documents should be well-vetted and discussed before initially approved, but you also need to continue to review and update these guidelines in light of evolving business and regulatory environments.

  To add substantial value to your organization, your governance documents should address:

- ***ONGOING MONITORING AND REPORTING:*** *You need robust systems in place to regularly and consistently track how your processes are performing, so you can gauge that business as usual is chugging right along. That reporting also becomes your benchmark for what normal should be when things go awry. Build in specific and well-defined process reporting and guidelines for identifying risks.*

- ***ISSUE IDENTIFICATION:*** *Make sure everyone across your organization is playing by the same rules. Establish parameters around what ingredients – such as the number of customers impacted or bottom line losses – will push an issue another rung up the severity ladder. Keep in mind other factors, such as how long it remains open or the number of due date extensions, might change an issue's risk rating over time.*

- ***ESCALATION:*** *Know how you're going to respond to an issue before it happens, and know what will trigger an escalation. For instance, a low-rated risk or issue might only warrant detailed remediation, tracking and awareness within the line of business. A medium-rated risk or issue, however, might need to be reported and tracked in more detail at the line of business risk committee level. And a high-rated risk or issue is likely something that would need to be brought to the attention of your Board of Directors and subcommittees. Although we're only scratching the surface here, you need to dig deep to have defined escalation strategies in place to know the right actions to take at the right time.*

- ***REMEDIATION:*** *Of course, you want to solve the problem – and quickly – but you need a roadmap for how to drill down to find and fix the right root cause. Act too fast or focus on the wrong thing, and you could find yourself back to square one after investing a lot of time, money and energy on something not contributing to the issue. Also think through and document validation parameters for remediation activities.*

- **OPERATING MODEL:** These are the nuts and bolts of who plays for which team and what position each person plays. It is critical to distinguish the roles and responsibilities each player has for identifying, assessing, mitigating and monitoring risk that is – and this is a key point – generated by the core activities in its business. Take the time to ensure each first-, second- and third-line role clearly understands its expected contribution, and your organization will be positioned to act quicker and move through a smoother change-management process – and handoffs of risk.

To ensure we're on the same page, the first line represents your revenue-generating groups, such as retail bank, commercial banking and wealth management, along with functional areas, including finance, human resources and marketing, for example. **Because these are the teams also generating risk in the day-to-day business, they need to own, identify and control that risk, something that first lines are struggling with in today's evolving risk-playing field.** As a sign they haven't quite figured out what they should be doing, we oftentimes hear of second-line players being recruited to the first line to bring in risk experience and run those second-string initiatives in parallel, but not in tandem, with the business processes. Based on our experience, this is a sure way to raise a flag with the regulators, who want to see that the business knows how to develop its own effective controls and understands its early role in managing risk.

The second line provides independent oversight to the first line, putting together the basic game rules to help keep you moving toward the goal line. **Consider this as your slate of coaches, with specialties in everything from strength to quarterbacking, who are providing oversight, educating teams on policies and putting guardrails in place.** They will challenge the first line if they see it headed down the wrong path or not appropriately managing risk. Keeping a level of independence, they don't get into the action, but they are asking effective questions, mapping out direction, and helping the first line develop talent to move from junior varsity to varsity status. They are empowering the first line with what it needs to make game-time decisions to hold the line on risk.

Finally, your third line is completely detached, as this group – namely, your internal audit team – is charged with providing objective assessments and validation that you're operating safely, soundly and at prescribed risk levels. **Stepping in as unbiased referees, they review game plays and make the call, assessing first- and second-line documentation like sideline video for frame-by-frame insight to get the exact action.** Their biggest risk is blurring the line of independence by cozying up too much to the other lines as they establish their protocols and policies or remediate their issues: They need to fight to protect their objectivity to call a game fairly.

- **STANDARD FRAMEWORK, DEFINITIONS AND TAXONOMIES:** Across the enterprise, your people need to speak the same language and approach risk ratings consistently. By making an upfront investment across business lines and functional areas to calibrate these elements, you build confidence that your bank gives thoughtful attention to categorize risks into the right buckets. Extend that standardization as you establish assessment scales and definitions of different kinds of risks and risk events. This will ease risk aggregation and risk reporting, ensuring that you are able to provide a holistic view of risk in a meaningful and actionable manner.

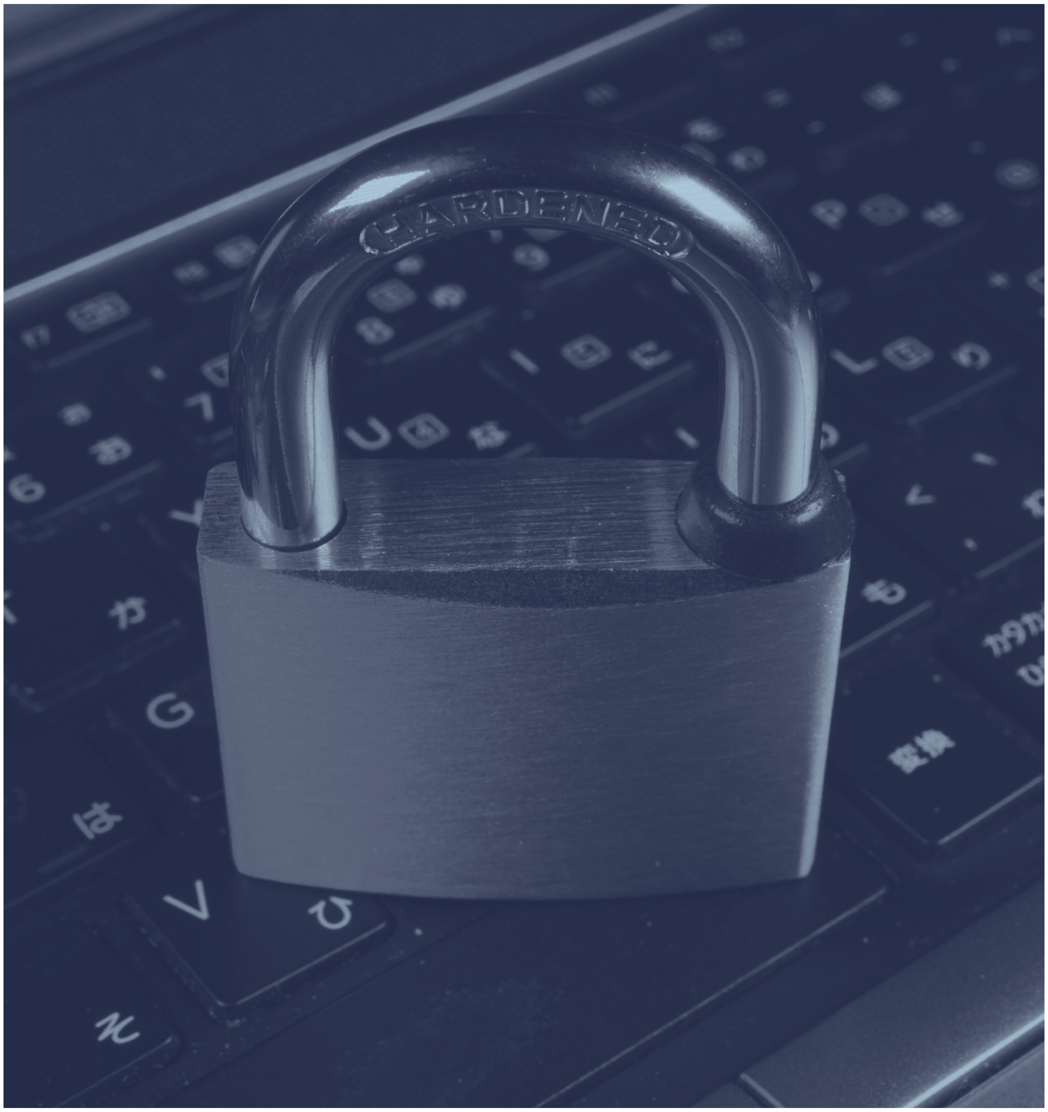
  Your common methodology for assigning risks translates into trust in your reporting, as your leaders and, ultimately, board members, understand that you've aligned on the highest ratings for those risks with the greatest magnitude of impact. Put another way, an area where you might have the highest risk of something going wrong isn't necessarily the risk that could have the biggest consequence.

- **RISK APPETITE:** In simplest terms, how much risk is your organization willing to take to achieve strategic objectives in doing business, knowing the potential impacts it will have on your customers, bottom line and reputation? In general, your leaders should re-engage and re-establish this risk appetite each year, but monumental events such as the pandemic can prompt more frequent reviews, allowing you to adjust to contemporary conditions. Be sure to develop and launch key risk indicators (KRIs) to quickly gauge how your bank is performing against your designated acceptable risk levels.

Exceeding your risk capacity – which is the most risk you can safely bear in the course of daily business, while your appetite represents your tolerance – could have dramatic impacts, such as requiring you to raise more capital if deposits are trending downward. Consider establishing two boundaries, an inner and outer marker, that generate two trigger points to raise the flag on a live risk, so you can take appropriate action aimed at getting your bank back in its comfort zone. The inner trigger is a warning that additional review and action might be required to bring it back within tolerance, while the other serves as a red alert, potentially requiring escalation or more formal remediation – as you already defined in establishing your governance model. Adhere to the rules you set for your organization.

ONE CAVEAT: Don't set your governance documents aside and never consult them again. Business strategies and regulations change, and your staff turns over; if you're not minding the store, those two potential pitfalls could easily take you off track. You'll want to routinely review to align with new facts, provide refresher training and keep your eyes open on how regulations might have an impact.

A risk management framework isn't a one-size-fits-all approach. What works for a major national bank, say, doesn't match what a regional bank needs. In other words, the robustness of your model should be commensurate with your bank's unique profile. Your goal is to introduce sustainability and best practices in how you identify, manage and address risk, while avoiding common pitfalls along the way.



Risk-Aware Culture Positions Your Bank for the Next Step of Success

With increasing regulatory pressure coming in the year ahead, developing a robust risk management culture no longer is a "nice to have" within your organization: It's a "need to have." Those banks that recognize and nurture what should become a core tangent of their overall corporate culture will be those best-positioned for success in the always-evolving financial services industry.

Getting there is a journey, and, as expected, you'll need to call some timeouts to rethink your strategy on how to get your entire team aligned on that end goal. Fortunately, we gathered our expertise and experiences in an accompanying playbook, Making Risk Management a Way of Life: How to build a risk-aware culture that enhances your business. Requesting your copy is no more difficult than calling “heads or tails” during the coin flip before the big game. But the clock will start ticking soon, so you want to plot out your step-by-step drive down the field.

WHEN THE FINAL BUZZER SOUNDS OR THE CLOCK RUNS OUT, YOUR BANK WILL STAND TALL – RESPECTED AND TRUSTED BY REGULATORS, CUSTOMERS AND STAKEHOLDERS. IN OTHER WORDS, YOU’RE A CHAMPION.

About the Author

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Cara is a Principal with Spinnaker Consulting Group. With significant experience in the risk and control area within the financial services industry, Cara has a passion for the various facets of enterprise risk management and an uncanny ability to zero in on problems to solve underlying issues.

In her 20 years as an executive with some of the largest banks in the US, Cara gained valuable experience in the areas of retail banking, underwriting, loan operations (origination, processing, closing, and servicing), operational risk management, credit risk management, conduct risk management, regulatory compliance, consulting, and international compliance. During this time, she led a variety of teams responsible for ensuring effective first and second line of defense risk identification, assessment, control, mitigation, monitoring, reporting, and oversight.

Cara has a Master of Business Administration from Case Western Reserve University and a Bachelor of Business Administration from University of Georgia. As a devoted UGA alumna and college football fan, Cara collects pictures of Uga, the bulldog.

Notes

[1] Lazette, M. (2017, December 18). Recession Retrospective. Cleveland Federal Reserve. (https://www.clevelandfed.org/newsroom-and-events/multimedia-storytelling/recession-retrospective.aspx#retrospective)

[2] Office of the Comptroller of the Currency (2020, October 1). OCC Releases Bank Supervision Operating Plan for Fiscal Year 2021. (https://www.occ.gov/news-issuances/news-releases/2020/nr-occ-2020-130.html)

[3] Ueijo, D. (2021, January 28). The Bureau is taking much-needed action to protect consumers, particularly the most economically vulnerable. (https://www.consumerfinance.gov/about-us/blog/the-bureau-is-taking-much-needed-action-to-protect-consumers-particularly-the-most-economically-vulnerable/)