

An Investigation into Non-Financial Risk Management

Collective Thought: Buy and Sell Side
COO Roundtables and Debates,
New York, March 16 and 17, 2022

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Attendees

36 COOs and executives from the office of the COO from 29 banks and asset managers. The first face-to-face New York round tables for the International COO Community (ICOOC) since February 2020.

Executive Summary

The subject of non-financial risk (NFR) is high on the COO agenda, as the industry exits one crisis (the pandemic) and enters another (the Russia-Ukraine conflict). Whilst very different in nature and impact, both fall within NFR, where an organisational and industry commitment to horizon scanning would have had the industry better prepared for both. The conclusion of both evenings was that whilst bankers and asset managers had largely shown themselves in a positive light in their response to the unique challenges presented by the pandemic and were prepared through previous experience for the sanctions imposed on Russia, not enough time is spent on emerging risk identification. It was broadly acknowledged that time dedicated to this task is notional, 2 to 3%, or as one COO noted 'passing thoughts in the shower'.

Aligned to this acknowledgement, preparedness in crisis management, and in developing a mindset that is trained for crisis as opposed to managing business as usual, was seen as an area of investment that would be a valued contribution to an organisation's operational resilience.

Present at the debates was Control Risks, a global crisis management consultancy that has worked closely with Armstrong Wolfe since the outbreak of the pandemic. Ammi Small, Principal - Crisis and Security Consulting at Control Risks, outlined in response that such training would deliver a crisis management leadership framework, supported by procedures and protocols, enabling an organisation to more effectively manage and limit the impact of a crisis from its outset. "Knowing your position, your principle responsibilities, who deals with what and who to call, would enable a smooth transition into crisis management mode," commented a COO Americas for Banking and Markets. "Something we have not done to date, relying more on instinct and the managerial chain of command to expedite a response, which has its place but also its limitations."

It is a fair point to make that how best to manage NFR in an increasingly integrated and complex world is a point of debate as opposed to contention. As NFR challenges are largely non-proprietary in nature, and with the design and execution of NFR to support and direct risk decisions an emerging point of industry-wide deliberation, it offers an opportunity for cross-industry collaboration. The discussion is presently centred on defining the NFR taxonomy and the organisational realignment in moving NFR from a decentralised, judgement-based assessment to a centralised data, judgement and holistic based evaluation.

NFR Debate Takeaways:

- Inconsistent understanding of NFR
- Ineffective handling of overlapping risks
- Ineffective resource allocation and use of business time
- Multiple overlapping communications
- Limited and arguably ineffectual horizon scanning

These conclusions were considered worthy of deep-dive consideration, with NFR being added to the iCOOC 2022 working groups:

iCOOC Non- Financial Risk Working Group 2022 - 2023

Attendee:

- Global Head of Business Controls and/or non-financial risk

Objective:

- The Commercial Case for Investment in NFR (Commercial Differentiation and Franchise Protection)

Areas of Investigation:

- Non- Financial Risk Management
 - Framework and Taxonomy
 - Management and Governance
 - Technology Solutions and Data Management
- TTX (Tabletop Exercises)
 - Managed Simulations/ Scenarios

Objectives and Milestones:



Defining Non-Financial Risk

During the last ten years, NFR has increased in significance and complexity, and consequently the need to understand and manage its potential consequences. Specifically, NFR is all the risks which are not covered by traditional financial risk management. This negative definition resembles the initial definition of operational risk, where it depends on the company whether they use the term operational risk

synchronously with enterprise risk and NFR. Conversely, NFR is a broad term that is usually defined by exclusion, that is, any risks other than the traditional financial risks of market, credit, and liquidity.

Organisational Impact

If we accept the latter, then operational and enterprise risk are component parts of NFR. Some companies have accepted this deduction, with both risk functions being consumed and rolled into NFR, positioned in 1st line and reporting to the COO or directly to the CEO but not the CRO.

In such cases this has seen the broadening and deepening of the 1st line business control officer's mandate. Many in this position noted, whilst not arguing against this functional evolution, that their activities are already fully utilised in dealing with the today, not having the time or resources to dedicate to a more expansive mandate, let alone adding resource to commit to horizon scanning. Therefore, in most cases the established operating model remains a de-centralised approach to NFR management, with judgement being its primary assessment tool. In such cases NFR is partnered with operational risk management, supported by enterprise risk and emerging risk assessment undertaken by compliance. Any change will require a mind-shift in the c-suite and a risk awareness cultural shift throughout the organisation.

This opinion holds true for NFR and the multiple disciplines that fall under its umbrella, which include operational, compliance, ethics and conduct, information technology and cyber, business continuity, fraud, money laundering, third party, and legal risks. These disciplines organisationally often, and still do, operate in silos. However, with increased complexity and volumes of NFR events, the silo approach has resulted in both ineffectiveness and inefficiency. Therefore, it is clear there are opportunities to improve the management of NFR and associated costs by rethinking the approach to NFR within banking and asset management.

Most organisations have numerous specialist teams dedicated to the management of various NFRs, often with overlapping responsibilities and different lines of ownership and management, where these silos observations often run untested and in isolation through to the CEO's office. This approach of organising the various teams to manage NFR in isolation exposes institutions to both ineffectiveness and inefficiency in NFR management and ensures the impact and value that could be made on decision making is inadequate.

"If a holistic and centralised approach to integrating judgement and data was established, allowing translation of this information, this single source would have authority, it would become the de facto voice of truth."

- Head of Strategic Risk Organisational Design, Global Asset Manager

To test our hypothesis, we asked an established global head of NFR a few relatable questions:

- **Q** - How do you define the difference between enterprise risk management and NFR?
A - Financial risk is market, credit, and liquidity. All other risks are NFR.
- **Q** - Is enterprise risk management positioned as 2nd line and checking NFR 1st line? cf. 1st line business controls and compliance
A - We don't have enterprise risk management. 2nd line is organised by risk type (e.g., resilience, compliance, etc)
- **Q** - Is operational risk consumed by NFR and its previous activities integrated into the NFR taxonomy?
A - Yes, operational risk is part of resilience risk, which is part of NFR.
- **Q** - Do you consider NFR a function that is tasked to both detect and predict? This by taking an internal/backward view with controls and surveillance and an outward/forward view with geo-political risk translation, regulation, behavioural analytics for example?
A - NFR is about risk management. One important tool to manage NFR is controls. However, there should be other options, including doing things differently or limiting activity.
- **Q** - Do you envisage NFR end state/TOM to be a centralised repository of NFR data (under a NFR head reporting to the [1st line] COO or CEO), where this data can be more effectively translated, alongside and married to judgment-based assessments?
A - Data can and will help but we will remain reliant on the judgement of people who understand the business.
- **Q** - Is the feasibility of a NFR market-wide information utility a viable/desired end game?
A - There may be a role for this (e.g., loss data, risk, and control taxonomies)

The NFR Taxonomy

NFR management is an essential element of the strategic management of any organisation and should be embedded in the ongoing activities of the business. Central to this is the assessment of significant NFRs and the implementation of suitable risk responses. Risk responses include:

- Acceptance or tolerance of a risk
- Avoidance or termination of a risk
- Risk transfer or sharing via insurance, a joint venture or other arrangement
- Reduction or mitigation of risk via internal control procedures or other risk prevention activities

Allowing for its importance it is surprising that no industry benchmark exists for NFR and there is no recognised NFR taxonomy for companies to reference. As noted, NFR remains a broad term that is defined through exclusion, that is, any risks other than the traditional financial risks of market, credit, and liquidity. Furthermore, enterprise risk management is defined as the process of identifying and addressing methodically the potential events that represent risks to the achievement of strategic objectives, or to opportunities to gain competitive advantage, but is limited in scope and does not capture the NFR universe.

Other important enterprise risk concepts include the risk philosophy or risk strategy, risk culture and risk appetite. These are expressions of the attitude to risk in the organisation, and of the amount of risk that the organisation is willing to take. These are important elements of NFR governance responsibility, with risk being made up of three main parts:

- **1 - Impacts and consequences:** This is the “effect” on objectives
- **2 - Causes:** These are the root causes of the risk, often identified through asking the question, why? Continuing until the answer is “it just is” or the answer is “outside of your influence”.
- **3 - Events:** These are things that occur between the causes and the impacts.

NFR causes at the highest level typically come back to four main causes:

- **1 - People**
- **2 - Inadequate process**
- **3 - Systems**
- **4 - External events**

The NFR management process consists of three parts:

- **1 - Risk assessment and analysis**
- **2 - Risk evaluation**
- **3 - Risk treatment**

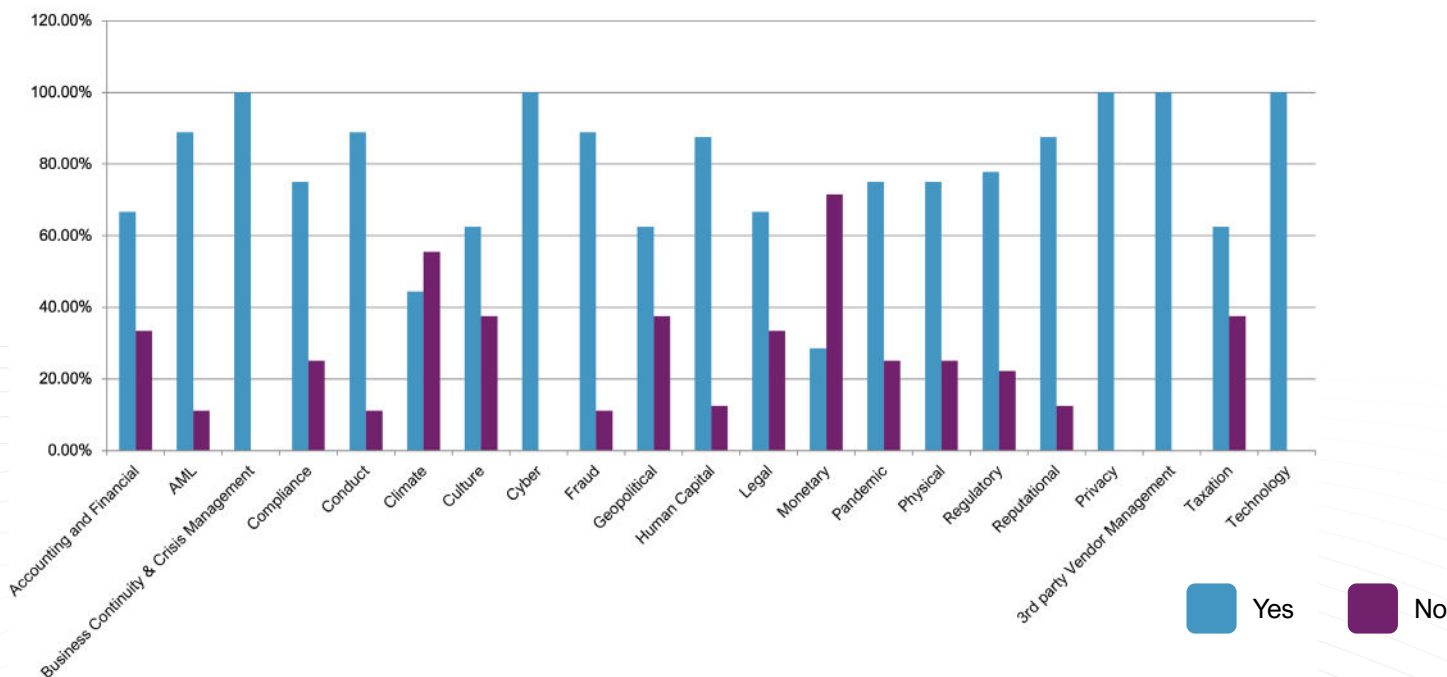
These principles are well set and understood, but to be applied with greatest effect require the NFR taxonomy to be determined. There are several guiding principles that financial institutions should be aware of when defining a common taxonomy, which include:

- Risk types are mutually exclusive and collectively exhaustive
- Risk definitions are comprehensive in scope
- Risk taxonomy is simple and intuitive for end-users
- Risk taxonomy considers risks that the institution may be subject to, today and tomorrow
- Risk categories can be tied back to specific laws, rules, and regulations

This is more challenging within NFR, one COO stating “It is the possibility of the unknown that makes defining a NFR taxonomy challenging. We arguably understand the majority of NFR categories, although we cannot predict how they will manifest themselves. Horizon scanning will help us take anticipatory actions. Playbooks can be useful, although my experience is most are cast aside when an event happens. Simulations and scenario testing (tabletop exercises) are of equal value, as they develop a crisis management mindset as well as prepare for a defined event. Developing a NFR crisis management framework, aligned to horizon scanning and applied to a NFR taxonomy, with the data and judgement gathered and translated centrally appears a lofty aspiration. Another added “But one worthy of pursuing and perhaps better served working together than in isolation.”

At both evenings, the below 21 NFR classifications were tabled for debate. The expansive and unlimited nature in which each category could be dissected and scrutinised showed clearly the need to focus on interpretation and preparedness to meet the myriad of established and unforeseen NFR.

Are the Following Presently Categorized as an NFR at Your Organization?



COO Feedback

“I wanted to extend sincere thanks for including me in the event this week. It was great to connect with peers and the discussion was fantastic. I truly appreciated the opportunity to participate.”

- Global Head of Controls, Canadian IB

“Thanks very much for dinner and drinks on Wednesday evening. It was great to finally see you face-to-face! Great evening and very engaged roundtable – miss those interactions and look forward to many more. I am good on participation in the strategic risk working group and the proposed simulation exercise.”

- Head of Enterprise Risk, US Asset Manager

“Great to see you on Thursday. Thank you for dinner and the chance to network. Happy to engage on a Taiwan tabletop exercise.”

- Global COO, Global Asset Management company

“Just wanted to send a note of thanks for the dinner last week. As I mentioned during the takeaway’s conversation – it was very refreshing to be able to hear from other COOs and realize that we’re all dealing with the same universal problems and discussing innovative ways to address them.”

- Global COO Markets, Canadian IB

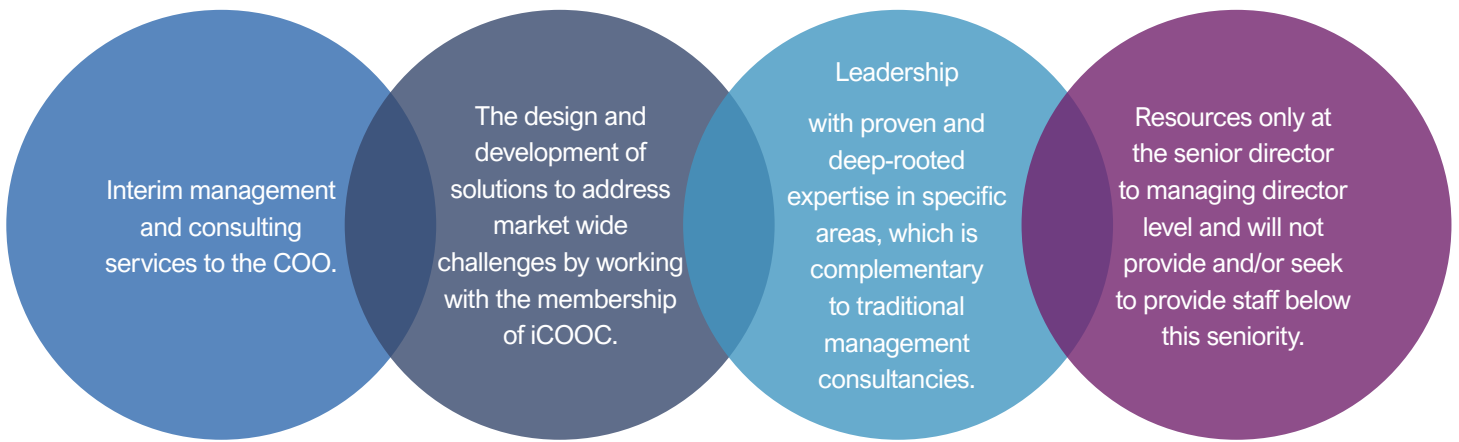
“Thank you again for a great evening and fantastic discussion! I am very interested in a follow-on chat with a few folks from this evening - would you mind sending me the names/emails to reconnect – very useful.”

- Americas GBM COO, French IB

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