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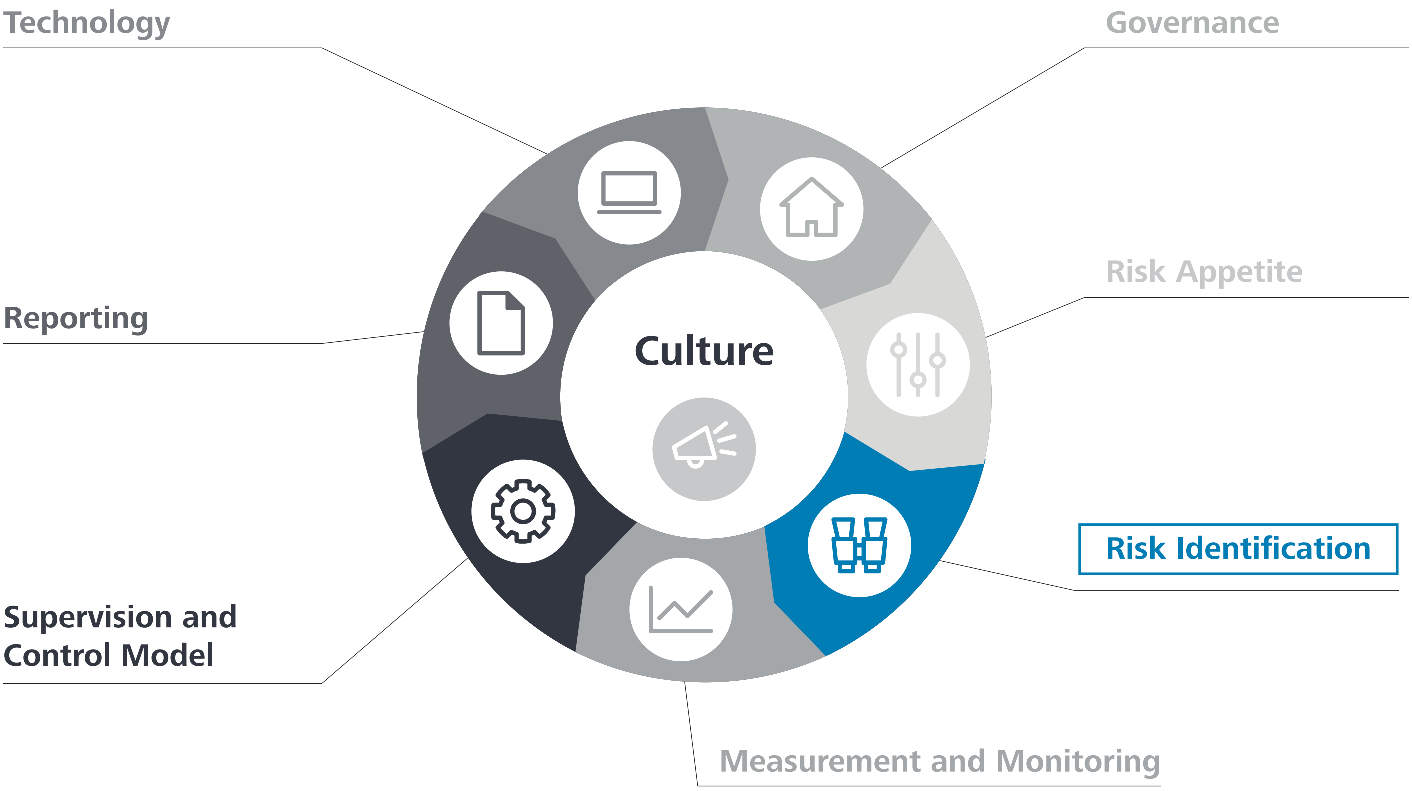
Non-Financial Risk Management Insights Series

Issue # 1 – Risk Taxonomy and Risk Identification

A thorough analysis of a bank’s risk profile that takes into consideration its business model and strategic direction is a fundamental prerequisite of an effective risk and control management framework; it necessitates a comprehensive risk taxonomy and a dynamic Risk Identification process.

We are pleased to welcome you to our Non-Financial Risk (NFR) Insights series. The series serves as a continuation of our original Point of View: The pressing case to design and implement a Non-Financial Risk Management Framework.[1] Each release will focus on one of the implementation categories:



[1] www.deloitte.com/de/nfr

Introduction

In the post-financial crisis era, most unexpected losses in financial institutions have emanated from non-financial risks. In general, risks have not been effectively controlled and in some cases, risks have not been identified, measured, or supported by models and capital. Institutions will therefore need to take a more holistic and systematic approach to identifying, assessing, and mitigating risks, including relatively new risk types and risks with increased focus (e.g., conduct-, cyber- and model-risk).

Identifying and managing all risks relevant to the organization, based on a strong risk taxonomy that comprehensively covers financial and non-financial risks is a prerequisite to implementing a sound risk management framework.

A comprehensive risk inventory developed through a consistent, dynamic and well-governed Risk Identification process can help inform and enhance capital adequacy, strategic planning, stress testing and other downstream risk management processes and capabilities.

Regulatory expectations

In Europe, Risk Identification is a key component of ICAAP and ILAAP; the Supervisory Board of the ECB has published specific expectations,[2] including:

- Institutions should implement a regular process for comprehensively identifying all material risks across legal entities, business lines, and exposures at least annually
- Institutions should define an internal risk taxonomy and maintain a complete risk inventory
- The Risk Inventory should incorporate an inherent risk assessment as well as a definition of materiality and involve the management body
- Material risks need to be considered in the ICAAP and ILAAP processes by allocating capital and liquidity respectively or by documenting a justification for not holding capital or liquidity to cover these risks

In addition to these requirements, many financial institutions supervised by the ECB have received guidance suggesting they should expand their non-financial risk frameworks and manage emerging risks more effectively.

In the United States, Risk Identification is a key component of CCAR stress-testing programs, and the Federal Reserve has published similar relevant expectations.[3]

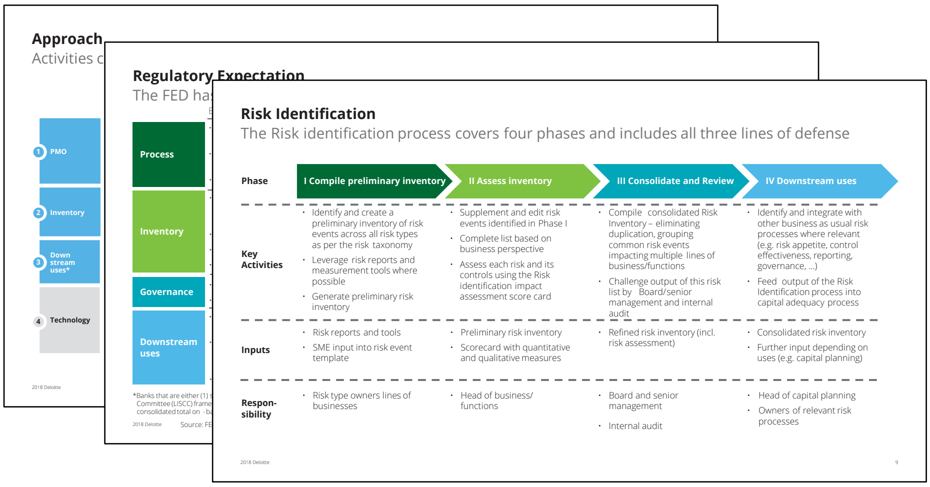
Challenges

It is particularly difficult to identify new and emerging material risks. It is in these cases that a dynamic Risk Identification process is most helpful and indeed necessary. The experience with operational risks is that banks' data capabilities can inhibit timely identification and mitigation of new and emerging risk types; similar challenges can be extrapolated to other non-financial risks.

Our approach

Deloitte´s Non-Financial Risk Management Framework provides guidelines for implementing a robust Risk Identification process, as well as a comprehensive risk taxonomy informed by extensive experience of risk identification exercises across a wide range of banks (cf. Fig. 1).

Fig. 1 – Deloitte has developed a set of tools and frameworks to help implement an effective and dynamic Risk Identification process



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[2] Cf.: ECB Supervisory Board, Multi-year plan on SSM Guides on ICAAP and ILAAP; February. 2017.
[3] Cf.: FED SR Letter 15-18, FED SR Letter 15-19 and FED Docket No. OP- 1594.

A key aspect of a successful Risk Identification implementation is compiling risk events consistently across the institution, and for all risk types along the risk taxonomy, into a structured inventory to establish a comprehensive view of all risk events, including hard-to-quantify risks (e.g., strategic risk events). For this purpose, Deloitte has developed a tool-kit for compiling and evaluating risks through a systematic assessment process.

Furthermore, our Risk Identification approach and tools can be linked to an organization-wide risk assessment, for which it is essential to consider quantitative (e.g., P&L impact) and qualitative factors and effectiveness of controls. Our experience shows that the involvement of all three lines of defense and senior management is necessary in order to ensure an adequate review, while simultaneously raising awareness in the organization.

In general, risk practitioners will need to work more closely with business line representatives to leverage insights gained from a holistic Risk Identification approach and to strengthen downstream capabilities, such as strategic planning, stress testing, and capital adequacy.

Maturity model and prevailing practices

We have observed differing degrees in sophistication about Risk Identification; most firms are still at the "Lagging" and "Moderate" levels of maturity (cf. Fig. 2).

Conclusion

Our structured Risk Identification approach strengthens the monitoring, detection, and management of non-financial risks and is designed to establish a basis for an effective risk and control management framework. Enhancing risk management capabilities to address newer non-financial risks starting with a holistic Risk Identification process is a key component of what we envision will be a common practice in future risk management frameworks.[4]

The next release of the Non-Financial Risk Management Insight Series will focus on Risk Appetite.

Fig. 2 – Risk Identification maturity model (extract)

Leading	• Dynamic, inclusive, consistent and comprehensive risk identification process across the organisation • Integrated into an effective control framework and downstream risk management uses (e.g. capital planning, stress testing, risk appetite)
Advanced	• Risk identification process backed up by efficient IT solution and sound data infrastructure • Strong involvement of multiple stakeholders including all three lines of defense review by senior management and board
Moderate	• Set-up of risk identification process across the organization and along a comprehensive risk taxonomy • Risk assessment performed by individual functions or lines of business not always consistent
Lagging	• Individual risk identification processes across lines of business and functions not supplemented by any top down view • No aggregation of risks in an organization-wide risk identification

[4] For an in-depth discussion on "The Future of Risk" see https://www2.deloitte.com/global/en/pages/financial-services/articles/gx-future-risk-in-financial-services.html.

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