Strategic risk management in banking

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The banking industry is currently in a period of heightened change and uncertainty. The competitive environment continues to evolve, with growing competition among banks, non-banks, and financial technology firms (FinTechs). At the same time, the ongoing low-growth, low-interest rate economic environment is putting pressure on traditional sources of profitability.

Banks are increasingly searching for new avenues for growth—developing new and innovative retail products, seeking yield through alternative investment vehicles, and implementing new sales and marketing strategies to increase volume. While failing to innovate in this environment may place banks at a competitive disadvantage, doing so without aligning business strategies with sound risk management practices may also heighten strategic risks.

Although risk management functions understand the importance of managing strategic risks, they have not traditionally had the mandate and resources to properly engage in this area—for understandable reasons. Despite the desire of risk leaders to be more forward-looking and proactive, over the last several years new regulations and enforcement actions have required them to place much of their time and energy into compliance and remediation activities.

However, over the next few years, leaders who continue to ignore the act of properly considering strategic risks could place their institutions in peril. A recent study published in the Harvard Business Review found that strategic risks proved to be the most damaging type of risk companies faced. The analysis found that 86 percent of significant market capitalization declines in the past decade were caused by strategic risks—with operational risks (nine percent), legal and compliance risks (three percent), financial reporting risks (two percent) trailing significantly behind.

**New regulatory approaches**

Regulators have been pushing institutions to formalize capital-planning and stress-testing processes for many years to help ensure their ability to weather future events. These efforts have arguably made institutions more resilient, and efforts to integrate these processes into day-to-day operations should in theory be influencing key decisions and business strategies.

However, many analysts have argued that deficient strategic risk management practices continue to contribute to problems at institutions—from lack of alignment between strategic choices and risk appetite, to the lack of systems to adequately challenge strategic choices for risks.

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It is clear though, that both banks and regulators recognize that financial services is changing and that new approaches to managing risk—approaches that are more forward-looking—are needed. Regulators are themselves exploring new ways of approaching the changed financial services environment. Some regulators, for example, have started experimental initiatives to explore how they can work with technology companies by creating a “regulatory sandbox.” They have also been exploring how they can apply new technologies to improve the efficiency of regulation (commonly known as “RegTech”).

For institutions, there is of course a strong case to better demonstrate that they have integrated strategic thinking and risk awareness for more informed, value-based decision making. Banking regulators in the U.S. and globally are starting to make the management of strategic risks an important issue and enforcement priority. Speaking on strategic risk management, the U.S. Federal Reserve Governor Randall Kroszner has said: “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.”

Similarly in the U.K., the Prudential Regulatory Authority (PRA) stated that regulators will: “[Seek] to assess whether, on the balance of risks, there are vulnerabilities in firms’ business models, capital and liquidity positions, governance, risk management and controls that cast into doubt their future financial soundness... [and] consider whether and how the wider external macroeconomic and business context may affect the execution of a firm’s business model in a variety of different scenarios.”

A traditional regulatory or compliance approach may soon prove to be insufficient. These comments suggest that regulators expect institutions to have an embedded approach to managing strategic risks. Additionally, as regulators tighten standards in areas such as culture and conduct, they will expect institutions to have formalized processes to assess risks to the business model stemming from technology and other changes in the external environment, and that it has the appropriate structures in place to systematically assess risks to its strategic choices.

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Defining Strategic Risks
What then are strategic risks? In short, they are the risks that threaten to disrupt the assumptions at the core of an institution’s strategy—risks from changes that threaten to overturn the initial set of strategic assumptions and conditions.

But 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.

When strategic risks are fully understood, they help leaders assess which opportunities will give them the most long-term value, and which are no longer worth pursuing. We find that it can be helpful to think of strategic risks in terms of these three categories:

• **Strategic positioning risks**: Is the organization going in the right direction? Do the strategic objectives make sense and are they achievable? Are we well-positioned to create value and meet consumer needs for the foreseeable future?

• **Strategic execution risks**: Do we have the right talent, capabilities, and infrastructure to execute on our chosen strategy? Have we hired the right people, put in place the right technology, and hedged our risks appropriately?

• **Strategic consequence risks**: Could the strategic choices result in new risks or result in unintended consequences for the institution? Will our strategic choices create inappropriate incentives or create new risks for us (e.g., conduct, reputation risks)?

Thinking in these three categories can help risk leaders frame and bring clarity to the often clouded growth and strategy discussions.

Managing Strategic Risks
Effectively managing strategic risks requires financial institutions to: better integrate the stakeholders responsible for strategy and risk management; put in place processes that allow for independent reviews of strategies for strategic risks; train risk leaders in forward-looking risk management tools and approaches; and frameworks to understand how change and uncertainty will impact key business attributes. To help approach these challenges, the remainder of this article will explore some of the structures, processes, and tools that institutions have at their disposal.
Key pillars of an effective strategic risk program

- Greater integration of Risk Management with strategy and the business...
  to help the enterprise take smarter risks
- Enhanced tools and methodologies...
  to identify strategic and emerging risks
- Understand the impacts of change and uncertainty...
  to the strategy, business, product or offering

- Strategic Planning Process
- Scenario Planning
- Revenue
- Assets
- Assumptions
- Assumptions Testing
- Trend Analysis
- Strategic Risk Reviews
- War-gaming
- Patterns of Disruption
Institutions are more effective at anticipating change and achieving the right outcomes if they don’t consider strategy and risk management as separate and parallel mindsets.

**Strategic Risk Ownership – The Role of the Chief Risk Officer (CRO)**

Once a strategy is set, institutions will need to develop a view on whether it continues to head in the right direction, and whether it has put the talent and capabilities in place to meet the strategic objectives. These are an institution’s strategic positioning and strategic execution risks. But who is responsible for managing these risks?

Given the strategic nature of these questions, it should be no surprise that stakeholders expect an institution’s board and CEO to have significant responsibilities for overseeing and managing strategic risks. For example, in their “Principles for Enhancing Corporate Governance,” the Basel Committee specifies that the board should “approve and monitor the overall business strategy of the bank, taking into account the bank’s long-term financial interests, its exposure to risk, and its ability to manage risk effectively.”

In our experience, institutions that have been able to effectively manage strategic risk take it a step further. They empower their CRO to share responsibility for strategic risk management. In this way, the risk function is given a specific mandate to vet, challenge and facilitate important conversations about strategic choices and risks. This is not meant to create an adversarial relationship between risk teams and the business, but rather to help the business to take smarter risks.

Institutions are more effective at anticipating change and achieving the right outcomes if they don’t consider strategy and risk management as separate and parallel mindsets. Applying a risk lens to areas such as product development and sales is particularly important, as the focus of regulatory supervision shifts to assessing an institution’s culture, and how they ensure that its consumers get fair and transparent outcomes.

In our experience, this will be a departure for many institutions, where risk management has traditionally focused on financial, operational, and compliance 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.

Institutions are experimenting with different governance and organizational models. For some institutions, an easier path to starting this journey may be alternatives such as creating a strategic risk “working group” or center of excellence that is co-owned by the CRO and Chief Strategy Officer (CSO), which includes cross-functional personnel from teams such as risk, strategy, technology, and innovation.

Option 1

Risk driven Strategic Risk Management Group
Strategic Risk Management Group (SRMG) owned by the Chief Risk Officer, led by the risk management group

Option 2

Strategic Risk Management Center of Excellence
Strategic Risk Management Center of Excellence (CoE), co-owned by the Chief Risk Officer and Chief Strategy Officer, and including representatives from strategy, risk, innovation, technology, product development, data, and customer experience

Strategic Risk Governance & Organizational Model (Illustrative)
Some Strategic Risk Processes and Tools
In addition to greater ownership of strategic risks, 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. Once an institution is familiar with these established methods, they could be applied at both an enterprise and at a more tactical level, to business-unit level strategies and initiatives.

Strategic Risk Review Processes
For most institutions, a fundamental first step is integrating a strategic risk review process into the annual strategic planning processes. This means conducting an independent, specific review of the enterprise strategy with an aim to answer the following questions: Is the institution heading in the right direction (strategic positioning risks)? Does the institution have the right talent and capabilities needed to execute its chosen strategy (strategic execution risk)? Could the chosen strategy create unintended consequences or new risks for the institution (strategic consequence risks)?

Similarly, at the business unit level, institutions should also establish formalized, regular processes for identifying, assessing, and reviewing strategic risks. For example, institutions may require strategic initiatives or capital investments over a certain dollar amount to undergo a strategic risk review.

Importantly, these processes should always involve members of the management teams, and not be conducted by risk management teams in isolation.

Conducting strategic risk reviews jointly and in concert with strategic planning processes will improve management’s decision-making process by enforcing a disciplined approach to considering the continued relevance of set strategies, and the effect of uncertainty.

Trend Analysis
The problem for most business leaders is often not a lack of information, but the inability to distinguish signals from the noise. Executives are bombarded every day with claims of imminent disruption: blockchain; FinTech startups; changing customer behaviors. Without a means to evaluate the impact of identified trends, they are just buzzwords. Institutions can take a “watch and see” approach, but in our experience, successful institutions have systems in place to identify signals of change, evaluate the potential impact of trends on their business, and determine when a trend has gathered enough momentum to require action.

For example, should the institution “ride the wave” of the trend, and if so, should it partner, acquire, or form an alliance with a newly formed technology startup? Or should it avoid making costly investments, because the trend is a “flash in the pan”? What will be the magnitude and effect on the players in the market if so? These questions are not easily answered without experience in applying a systematic, analytical strategic risk lens.
The model below describes how a trend follows different trajectories to evolve into a disruptive force and the various factors/forces at play.

<table>
<thead>
<tr>
<th>Forces/factors at play</th>
<th>Flash in the pan</th>
<th>Gathering momentum</th>
<th>Gathering scale</th>
<th>True disruptor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Displaces leading incumbents</td>
<td>Minimum/No</td>
<td>At a slow but steady pace</td>
<td>Niche; needs mass adoption</td>
<td>Loss of market/share for incumbents</td>
</tr>
<tr>
<td>Expands market (beyond the substitution effect)</td>
<td>Minimum/Temporary effect</td>
<td>Limited; aggregates products, segments</td>
<td>Limited; substitutes existing products</td>
<td>Yes; creates new market participants</td>
</tr>
<tr>
<td>Exceeds customer value expectations (meets latent needs)</td>
<td>Yes; Solution may be point-in-time</td>
<td>Yes; delivers options, efficiency</td>
<td>Yes; creates optionality, novelty</td>
<td>Yes; meets expressed and unmet needs</td>
</tr>
<tr>
<td>Creates an ecosystem/platform (low dependence on govt. subsidies; enables collaboration)</td>
<td>Minimum/No; scale is not achieved</td>
<td>Limited; success and pace depends on subsidized pricing</td>
<td>Yes; economies of scale Achieved through multi-stakeholder participation</td>
<td>Achieved through multi-stakeholder participation</td>
</tr>
<tr>
<td>Exploits macro-economic/social trends (tailored, modular solutions)</td>
<td>Yes; Solution may be point-in-time</td>
<td>Yes; addresses emerging, identified needs</td>
<td>Yes; addresses emerging, identified needs</td>
<td>Yes; tailored solution to meet evolving needs</td>
</tr>
</tbody>
</table>

Illustrative
Scenario planning

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

Fundamentally, scenario planning provides an approach to rigorously confront and explore the uncertainties shaping an institution’s business environment. For many institutions, this can be an important but difficult process, as very often when institutions face uncertainty they take a “head in the sand” approach. Unsure of how to think through the uncertainty and complexity taking place around them, many organizations go into a state of denial or paralysis. Leading institutions, however, learn to “lean in” to uncertainty. They cultivate an ability to see and interpret change before it becomes a strategic risk, and adapt 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 (and other critical) uncertainties, providing a way to explore plausible futures, identify risks and opportunities, and determine strategic choices.

Critical uncertainties shaping the future of banking (illustrative)

- **Regulation of FinTech**
  - Next 3-5 years ↔ Next 5-10 years

- **State of Banking Regulations in 10 years**
  - More stringent ↔ Self-regulating approach

- **State of the Global Economy**
  - Declining/Volatile ↔ Growing/Stable

- **Low Global Interest Rate Environment**
  - Next 1-2 years ↔ Next 3-5 years

- **Occurrence and Ability to Manage Cyber-Threats**
  - Frequency/Sources increases ↔ Frequency/Sources under control

- **Emerging Markets Competitors**
  - Remain Regional Players ↔ Compete with Universal Banks

Look across the scenarios to create a new view of potential strategic risks

Critical uncertainty 1

Critical uncertainty 2

Option 1

Option 2

Option 3

Option 4

Risk 1

Risk 2

Risk 3
Assumptions Testing
The greatest source of risk to a strategy is often the assumptions underlying it. Making choices and assumptions about the state of the world or market is inherent in the strategy-setting process, but conditions will eventually change, potentially dislodging an initial set of assumptions. Developing the institutional skill to challenge assumptions is an important part of the strategic risk toolkit.

The assumptions testing process begins with making all assumptions explicit and understood, then challenging them against external forces. This allows the institution to establish indicators/triggers that can be monitored over time to alert the business when assumptions may be changing.

Surprisingly, in our experience, this is a process that is often more difficult than most would expect. Implicit assumptions are often so deeply ingrained, both in the way people see the world and in their business models, that many assumptions go unrecognized. However, it’s generally preferable to challenge your own assumptions rather than to wait until they’ve been invalidated by external competitors or events.

Assumptions testing should also be utilized at both the enterprise and business unit levels. At the enterprise level, the board and executive team regularly assesses the viability of its strategy as well as vulnerabilities to its business model. This should foster questions not only about its risk appetite and capital adequacy levels, but also whether it has the right supporting operational model. For the business units, assumptions testing might occur before strategies or new products and offerings are rolled out. What is the expected growth of the customer segment we are targeting given new technologies like robo-advisers? Have we made the right assumptions about how much customers would be willing to pay for features like a virtual assistant to help them answer bank account questions? Is improving the user interface worth the investment?

Understand the Patterns of Disruption
In their recent article, Patterns of disruption: Anticipating disruptive strategies in a world of unicorns, black swans, and exponentials, leading researchers from Deloitte US Center for the Edge have identified nine patterns of disruption to help executives consider how they can start asking the right questions about their business.6

These nine patterns highlight ways forward-thinking institutions have created new value by adopting new, disruptive approaches. For example, by “connecting peers” or by “turning products into platforms,” institutions have been able to gain market share, or in some cases, even change the landscape of an entire market. While these patterns can’t describe every possible challenge an institution will encounter, they help leaders frame and make sense of the changing dynamics many institutions are experiencing. Armed with this understanding, banking executives can start to ask the right questions about their business—questions about which components of their traditional business are vulnerable to change and how to incorporate new approaches to create value.

Leading institutions learn to “lean in” to uncertainty. They cultivate an ability to see and interpret change before it becomes a strategic risk, and adapt their strategies to find new ways to create value.

Nine patterns of disruption

The nine patterns of disruption represent disruptive strategies and approaches that can be used (and are currently being used) to disrupt various markets. They provide incumbents with a framework to consider both threats to their existing strategies/business models and approaches they can leverage to become the disruptor.

- **Expand marketplace reach**
  Connecting fragmented buyers and sellers—whenever, wherever

- **Unlock adjacent assets**
  Cultivating opportunities on the edge

- **Turn products into platforms**
  Providing a foundation for others to build upon

- **Connect peers**
  Fostering direct, peer-to-peer connections

- **Distribute product development**
  Mobilizing many to create one

- **Unbundle products and services**
  Giving you just what you want, nothing more

- **Shorten the value chain**
  Transforming fewer inputs into greater value outputs

- **Align price with use**
  Reducing upfront barriers to use

- **Converge products**
  Making $1 + 1 > 2$
The nine patterns highlight ways forward-thinking institutions have created new value by adopting new, disruptive approaches.

### Relevant patterns of disruption for banking (illustrative)

**Expand marketplace reach**
Connecting fragmented buyers and sellers—wherever, whenever

**Turn products into platforms**
Providing a foundation for others to build on

**Connect peers**
Fostering direct, peer-to-peer connections

### Business | Key characteristics/vulnerabilities
--- | ---
**Trade finance**
- Model has changed because of risk and compliance issues
- Profit comes from client knowledge sufficient to assess and price counterparty risk
- This information is opaque and incumbents are slow to assimilate new information for counterparty risk analysis

**Security lending**
- Opaque, bilateral business
- Need to move to more democratized electronic and peer-to-peer
- Incumbents looking to move out “non-core” activities to utility providers (e.g., counterparty credit or corporate actions)

**Foreign exchange**
- Slowly moving to more electronic platforms
- Odd-lot, or large round-lot-trades have a lot of friction and thus profit
- Buyers want transparency and best execution
- Incumbents can partner or buy third parties to use or kill new capabilities
War-gaming

War-gaming provides a tool for improving decision-making under uncertainty, by providing opportunities to surface competitive dynamics, as well as to rehearse, refine, and test strategies in a realistic environment. For example, war-gaming and simulations 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 data do we have—or need to have—to successfully pull off this strategy?

Like Scenario Planning and Assumption Testing, 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 a 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 bank’s ability to execute a coordinated crisis response to a major global counterparty and liquidity crisis.
Assessing impacts of change and uncertainty on the business
Managing strategic risks requires executives to understand how external trends, business model innovation, new approaches used by competitors, and internally-generated strategies or products could threaten an organization’s historical sources of competitive advantage.7

In particular, it is important for organizations to qualitatively and quantitatively assess the impact of changes on three key variables: revenues, assets, and assumptions.

- **Revenue:** How will external changes or new approaches affect existing sources of revenue?
- **Assets:** How do external changes or new approaches render our existing assets and investments? Do they make them less valuable or obsolete?
- **Assumptions:** How do changing external trends or new approaches affect the long-standing assumptions we’ve made about our strategy, business model, or marketplace?

Conclusion
Risk management in banking has been transformed and shaped over the past decade, largely in response to regulations that emerged from the global financial crisis. But as the nature of banking changes over the next decade, so too will risk management need to evolve. Leading financial services organizations are rethinking and 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.

Strategic risk is the next frontier of risk management, one that will generate a more nuanced conversation about the risks that are sometimes imposed on companies and opportunities for new businesses. 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. Those that do are going to see how strategic risk—and the ability to name it, track it, and deal with it—can turn into an important organizational resource going forward.  

7. Ibid.