



AXON RISK ADVISORY
Powering Risk Management

MAKING DECISIONS AND MANAGING RISKS WITH CONFIDENCE IN THE NEW NORMAL

Lessons from the Covid-19 pandemic in the effective management of strategic risks

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"The biggest risk is not taking any risk. In a world that is changing really quickly, the only strategy that is guaranteed to fail is not taking risks."

- Mark Zuckerberg

Since the beginning of the Covid-19 pandemic, financial institutions have focused on responding to the initial areas of impact such as ensuring business continuity, meeting the urgent needs of customers and prioritising essential services and products. Pending a real solution to the crisis, such as a vaccine that works globally, banks and insurance companies have no choice but to look ahead and make decisions despite the high unpredictability of the situation.

The question is how to make decisions that will impact the future shape of the organisation with confidence in the current environment? What risk and control strategy can ensure the viability of the organisation in the medium term? How to maintain the confidence of customers, shareholders, and regulators?

In this article, we would explore some key actions to take to address these challenges:

- *Re-evaluate organisational vulnerabilities and reset the risk strategy*
- *Lead a risk-driven strategic and planning process*
- *Solidify the operational resilience framework and capabilities*
- *Strengthen the risk leadership capability and ensure the right behaviours and conduct*
- *Support and strengthen the role of the risk & compliance function*

Lessons from the pandemic in risk management

Clearly, this pandemic has been unprecedented and has posed a major challenge for many countries and businesses,

including financial institutions. Although contingency plans have allowed a basic level of service, the pandemic has also operationally impacted banks and insurance companies.

According to the latest survey by the Institute of Risk Management (IRM), changes in the ways of working, delays in projects and decisions as well as the distraction from delivery of the business objectives are cited as some of the main initial operational impacts¹ for organisations. However, pending an effective vaccine, some could argue that this is more the end of the beginning than the beginning of the end.

"A focus on the resilience of the organisation, the strength of the front-line risk leadership and the effectiveness of the risk management system can make a big difference in the survival of the business and the protection of customers and employees."

A powerful reminder of the basic principles of how to lead and manage enterprise risks (ERM) in a crisis, is to observe some of the initial lessons learned by governments in their response to the Covid-19 pandemic (table 1).

It is easy to look at the past and criticise what should have been done differently, but history repeats. A post-mortem assessment of some of the risk management weaknesses of firms that failed during the last financial crisis sadly leads to similar conclusions. The good news is that there is still time to re-learn quickly from mistakes and refocus the approach to respond to the current crisis.

Table 1: Preliminary lessons from the Covid-19 pandemic in risk and crisis management:

<i>Examples of initial government challenges in their response to Covid-19 ...</i>	<i>... Risk management principles, critical in managing a crisis</i>
<i>Lack of testing reduces the ability to understand the level of contagion and location of hot spots</i>	<i>Dynamic risk identification based on real-time indicators</i>
<i>Conflicting objectives within the government drive inconsistent decisions (e.g. timing of lockdowns)</i>	<i>Common risk strategy, focused governance and clear delineation of responsibilities</i>
<i>Lack of planning with hospital beds capacity collapses the health system</i>	<i>A coordinated approach to managing operational capacity, aided by risk tools like scenario analysis</i>
<i>Changes and distortions in the public message (e.g. use of masks) create confusion in the population</i>	<i>The 'tone from the top' and level risk leadership are strong and consistent</i>
<i>Collateral damage (e.g. economic or psychological impact) is not well considered in decisions</i>	<i>Key decisions supported by the advice of multidisciplinary teams and the risk function</i>

The new landscape of risks and opportunities

Few scenarios imagined the profound and lasting impact of the pandemic on the macroeconomic, social and business environment. Looking ahead to the 20/21 business plan, and beyond the financial impact (outside the scope of this document) on balance sheets and the bottom line, **organisations face a landscape of non-financial impacts that include:**

- A permanent change in customer behaviours and needs e.g. 10 - 25% of bank customers in Western Europe expect to visit fewer bank branches, even after the pandemicⁱⁱ
- Changes in the mindset of staff and new ways of working, including increased use of hybrid forms of work between home and office e.g. two-thirds of employees in the insurance sector are not keen on getting back to work in the officeⁱⁱⁱ
- New challenges in data protection and cybersecurity, given the increase of digital processes and information transmission in unprotected employee's home networks^{iv}
- A new map of critical suppliers and third-party outsourcers e.g. ^vnew dependencies with third parties

Strategic risk management in the new normal

This context justifies a period of reflection on how companies should evaluate uncertainty and how they assess and manage their enterprise-wide risks and opportunities. More than ever, a strategic approach to manage risks will be essential in protecting the organisation, guiding critical decisions, and generating tangible value to senior management and the Board.

Re-evaluate organisational vulnerabilities and reset the risk strategy

In this unprecedented situation, top management must seek to quickly establish a clear view of the new vulnerabilities for the firm and the impacts on the organisation's business model, value chain, and strategic risk profile.

This involves systematically reassessing organisational and enterprise risks (and risk dependencies) and resetting priorities and

the level of risk appetite, especially concerning non-operational risks and compliance. Areas, where to reassess the organisational risks and the relevant risk strategy in the new normal (and possible questions for discussion), include:

- *Our people and capabilities:* What is an acceptable level of info-security risks that allows flexibility for employees working remotely? How to protect critical employees and capabilities in areas of cyber/technology?
- *Our critical processes:* What are the critical processes that we must prioritise in the event of a new disruption? What are the contingency plans in case of failure of critical third-party suppliers?
- *Our key systems for the development of our activity:* What is our capacity to protect our critical systems and respond to the increase in cyber-attacks?

Boards also have a responsibility to understand the alignment of the business and risk strategy. They should play a critical role in questioning and challenging senior management teams (including the CEO, COO, CRO) on their approach to managing the organisation's risk profile in the current environment. This should include discussions about the workforce strategy, contingency plans, and operational resilience.

Lead a risk-driven strategic and planning process

Despite the push from regulators, with tools such as the ORSA or ICAAP¹ for insurers and banks respectively, many organisations still start the planning process with financial targets. Risk appetite and risk objectives tend to be more an output (or constraint) than an initial input or driver.

"More than ever, and given the level of uncertainty, the risk strategy and resilience priorities must be a primary (and perhaps most important) part of the strategic process during the 20/21 business plan."

¹ ORSA: Own Risk and Solvency Assessment; ICAAP: Internal Capital Adequacy Assessment Process

Being clear about the trade-off between risk management targets (e.g. control requirements for the protection for clients, employees and critical processes) and financial objectives (e.g. profit and growth) will be essential to achieve the long-term viability of the organisation. In this unique context, **senior management should re-evaluate its guidelines on how to carry out the 20/21 business plan and ensure a level of adequate collaboration between finance and risk.**

Solidify the operational resilience framework and capabilities

Even before the pandemic, regulators in Europe and the UK have prioritised new regulations to achieve a more integrated approach to operational risk management and build resilience. Beyond the regulatory demands, Covid-19 has brought to light the need to accelerate this process and drive more effective management of operational risks. Areas of consideration include:

- Focused governance on operational risks (e.g. a committee focused on non-financial risks), based on clear accountability for critical processes, fast-track communication and clear escalation of issues
- Pre-set risk tolerance levels (or action thresholds) for the main operational risks e.g. establish a tolerance for the interruption of each critical business service, including recovery time during severe but plausible scenarios
- Effective monitoring and ability to monitor these exposures in real-time
- Properly tested contingency plans to deal with major events.

Senior management should assess whether the organisation has the right project setup and investment budget in capabilities to achieve a level of operational resilience in line with regulators' expectations and the requirements of the new normal.

Strengthen the risk leadership capability and ensure the right behaviours and conduct

During the pandemic, anecdotally we have all seen how the actions of a country leader can endanger the population and lead to deaths. The same lesson applies to business, as senior management has a key role in taking risk management responsibilities and in giving a

consistent message about the right business behaviours and conduct during these times. In the current climate, we cannot deny the fact that some organisations in the financial sector (or areas of the company, or employees) may develop (intentionally or with negligence) conduct practices that are not appropriate (e.g. exclusion of certain most vulnerable groups, the inadequate reinterpretation of customer contracts, ineffective customer communications due to operational restrictions etc.). Regulators such as PRA, FCA and ESMA have already warned about these practices and the need^{vi} to treat customers with honesty and integrity.

"A culture open to accepting organisational vulnerabilities, honest in learning from its failures, and decisive in acting with new solutions, is critical in managing uncertainty and building resilience."

With this context, **senior management should assess how to monitor and promote the right conduct, risk leadership and behaviours as part of the performance assessment and reward structure.** It should also seek assurance of the adequacy of key touchpoints with customers, including its product governance, compliance with information disclosure guidelines as well as to conduct practices with regards to the suitability of advice and product sales.

Support and strengthen the role of the risk & compliance function

During these complex times, the risk & compliance function plays a critical role in assisting and guiding the first line of business. This includes not only helping in the areas listed above but also in maintaining the right level of engagement with regulators and translating new regulatory requirements. For example, regulators have called for increased vigilance against malicious and fraudulent activity, noting increases in online scams.

Still, the risk & compliance function has its challenges. Although the function has rapidly adapted to perform critical tasks in a virtual way, Covid-19 has only exposed the reliance on manual processes of many second-line teams in banks and insurance companies.

The new normal requires a re-evaluation of the effectiveness of the second line, their capabilities and the interaction the three lines of defence under different ways of working. It is perhaps time to accelerate investment innovation and new capabilities (including process automation and analytical capabilities) of the second line of defence function.

Final thoughts

Given the uncertain landscape, rebuilding confidence in the strategic decision process can enable the survival of the business and the protection of customers and employees. In this process, a focus on the organisation's resilience, the strength of the front-line risk leadership and the effectiveness of the risk management system can make the difference between failure and success.

How Axon Risk Advisory can help

Given the complexity of the situation, Axon Risk Advisory can provide an independent and expert perspective of the strategic regulatory & risk management challenges discussed in the document. Ultimately, this can provide an added level of confidence to stakeholders (including the Board and regulators) that the organisation is taking the right risk management approach in the new normal.

Axon Risk Advisory's services include:

- Expert assessment of the risk profile and risk strategy of your firm
- Independent risk review of your firm's 20/21 business plan and strategy
- Expert assessment and advice on how to strengthen your firm's risk management system to navigate the new business landscape (including a review of the operating model and capability of the risk function)
- Diagnostic and advice on how to build the required capability to meet increased regulatory expectation on operational resilience

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ⁱ Institute of Risk Management: "Covid-19 survey" (April 2020)

ⁱⁱ Mckinsey: "Reshaping retail banking for the new normal" (June 2020)

ⁱⁱⁱ Financial Times: "Hybrid working sets fresh challenge for collaboration tech" (July 2020)

^{iv} Marsh: "COVID-19: Cybersecurity Checklist for Remote Working" (July 2020)

^v Corporate Compliance Insights: "COVID-19 Puts Third-Party Risk Management Under a Microscope" (July 2020)

^{vi} European Securities and Markets Authority: "COVID-19: Reminder of firms' MiFID II conduct of business obligations in the context of increasing retail investor activity"