Reputational, Strategic, and Compliance Risk Analytics:

Board/Senior Management Adherence to FRB Capital-Plan Requirements

Federal Financial Analytics

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Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W.
Washington, D.C. 20005

On March 26, 2014, the Federal Reserve Board completed its review of the capital plans of the largest banking organizations operating in the U.S., rejecting five plans based principally on determinations that boards of directors and senior management had inadequate qualitative analytics and implementation. Failure is a franchise-level challenge, as well as a public reproof of the board and management that leads to significant internal upheaval. Through both its official statements and, now, its sanction of several major banks, the FRB has made clear that quantitative capital planning – that is, meeting targets down to the requisite basis point – is only one criterion and, indeed, a less important one on which capital distributions will be allowed. Qualitative capital planning is in many ways far more challenging than quantitative planning precisely because there is no clear score on which expectations of success can be based. In this paper, Federal Financial Analytics, Inc. describes key elements of successful qualitative capital planning.

Action Items:

- Quarterly matrices should be constructed of strategic, reputational, and compliance risks/opportunities in material business lines and at the top-tier entity, looking ahead for at least nine quarters.
- Regulatory and policy risk/opportunity drivers, as well as relevant legal risks, should be factored into matrices on both a current and prospective basis.
- Identified risks and opportunities should be analyzed for likely capital, earnings, liquidity, and related impact under base, adverse, and seriously-adverse scenarios. These scenarios should incorporate potential regulatory and policy outcomes as well as other relevant drivers.
- Upon identification of risks and opportunities, mitigations either in place or at hand should be identified and incorporated into the strategy or reflected in revised planning to demonstrate that mitigation is not just contemplated, but also under way.
- Expert judgment should ensure that risk matrices are complete, risk assessments are objective, and all mitigants have been identified and are likely to prove robust. Mitigants may arise from legal, risk-management, and government-relations actions not ordinarily understood as earnings drivers, demonstrating the bottom-line impact of qualitative analytics within the banking organization.
- From these analytics, senior management and the board make informed, forward-looking decisions that meet regulatory criteria for effective qualitative capital planning and risk governance, as well as ensure important emerging risks and opportunities have been identified to avoid undue risk or capture first-mover advantage.

The FRB said when the March 26 results were announced[1] that the 2014 stress test will be even more demanding than the prior review. Further, these tests are inextricably linked to the

[1] Stephanie Armour, *Bank Risk Management Scrutinized*, Wall Street Journal, April 1, 2014, *available at* http://online.wsj.com/news/articles/SB10001424052702304157204579475843730526038.

recovery planning required in "living wills" – resolution plans that, if not also qualitatively satisfactory to the FRB and FDIC, can lead to demands for divestiture, restructuring, and other franchise realignment. The Office of the Comptroller of the Currency has also proposed heightened expectations for qualitative risk management that will require forward-looking strategic, reputational, compliance, and legal-risk planning by national bank boards and senior management.[2] In short, effective qualitative capital and risk-management planning is a critical strategic challenge for large insured depository institutions and their parent organizations.

The Federal Reserve Supervisory Statement:

On August 19, 2013, the Federal Reserve Board issued its supervisory expectations for capital planning at large bank holding companies (BHCs).[3] The statement makes it clear that BHCs and other firms subject to Federal Reserve stress tests will need quickly and, for the most part, dramatically to improve practice to ensure that capital distributions can proceed as desired in 2014. As noted, these issues proved very challenging as the tests proceeded into 2014.

Importantly, the Federal Reserve for the first time expressly mandates that satisfactory capital plans must include rigorous, forward looking analytics addressing each BHC's reputational, strategic, and compliance risk (including possible legal risk).

Specifically, the FRB stipulates that:

Given the scope of operations at and the associated breadth of risks facing large, complex BHCs—including the risk of losses from exposures and of reduced revenue generation—they are often exposed to risks, other than credit or market risk, that are either difficult to quantify or not directly attributable to any of the specific integrated firm-wide scenarios that are evaluated as part of the BHC's scenario-based stress testing ("other risks"). Examples of these other risks include reputational risk, strategic risk, and compliance risk.[4]

After detailing these added risks, the FRB stipulates how each is to be incorporated into satisfactory capital plans. Critical to meeting this requirement is providing the board with scenarios that stress core assumptions and reflect independent risk assessments supported by expert judgment, with the supervisory statement making clear that a best practice is the use of internal models supported by expert judgment.[5] The FRB further states that:

> The information provided to the board should include sufficient details on scenarios used for the BHC's internal capital planning so that the board can evaluate the appropriateness of the scenarios, given the current economic outlook and the BHC's current risk profile,

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[2] OCC, *Proposed Rules and Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches*, 77 Fed. Reg. 4282 (Jan 27, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-01-27/pdf/2014-00639.pdf.
[3] FRB, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (Aug. 5, 2013), *available at* http://www.federalreserve.gov/bankinforeg/bcreg20130819a1.pdf.
[4] Ibid, Page 6.
[5] Ibid, Page 17.

business activities, and strategic direction. The information should also include a discussion of key limitations, assumptions, and uncertainties within the capital planning process, so that the board is fully informed of any weaknesses in the process and can effectively challenge reported results.[6]

Importantly, the FRB also makes it clear that the results of risk analytics for reputational, strategic and compliance risk need not necessarily lead to higher capital – indeed, the statement stipulates that simply adding a percentage of additional capital as a buffer above minimums is a poor practice likely to be sanctioned by the FRB. Capital may be a required response, but so too could be reduced revenue scenarios, higher loss expectations, and/or a management "overlay" that adjusts expectations in a targeted fashion.

Effective Qualitative Capital-Plan Risk Analytics

A proven best practice in this arena is preparation of disciplined matrices presented quarterly to the board on reputational, strategic, and compliance risks, as well as on mitigations underway to anticipate enterprise-wide and business-unit risk. Since these risks are largely qualitative, mitigation efforts through risk-management, compliance, legal, and government-relations operations are often seen only as cost centers. However, these matrices demonstrate the bottom-line value-added of risk mitigation in these sectors and thus create incentives for improved risk management the FRB and OCC are likely to endorse.

The following is an outline of steps FedFin has found result in effective governance of reputational, strategic, and compliance risk. Our practice has developed these to promote best practice strategic planning, with this methodology also well-suited to support board governance under the FRB's new supervisory statement and the OCC's heightened expectations. Key steps include:

- Working with designated senior management, FedFin prepares a list of business lines and/or products material to identify reputational, strategic, and compliance risk. FedFin target identification is based on our knowledge of the external environment to ensure that business lines/products are included if they are material to capital/earnings at the company and may be subject to material risk, leading to a final list based on expert judgment and internal models, insight, and forward-looking planning, especially with regard to M&A.
- Based on this list, FedFin surveys management (legal, government relations, compliance, risk management, corporate planning) to determine which reputational, strategic, and compliance risks are projected for the next nine quarters or other specified period and what actions, if any, are planned to mitigate risk.
- The internal and FedFin lists of risks and mitigants are then collated into a presentation for senior management. Possible risk mitigations omitted from internal plans are identified by FedFin for senior management review in advance of completion of the risk analytical landscape.

[6] Ibid, Page 17.

- A final matrix is then prepared of key business lines/products, anticipated risk (baseline, adverse, and seriously adverse) and planned actions and/or those already under way.
- The risk analytical landscape is presented to the board on a quarterly basis. All relevant material leading to the landscape, board deliberations, and resulting actions are retained by the BHC, with FedFin also preparing a report to management on its conclusions at the end of each quarterly risk assessment and resulting board decision(s).
- For each quarterly board report, ongoing work reviews the prior matrix, adds new risks (if any), catalogs mitigations as results are in hand, and provides management with a report on any outstanding issues unresolved since the prior report that may be of material concern. A new landscape matrix is then prepared for the board with additional qualitative reporting and follow-up documentation.
- Upon announcement by the Federal Reserve of the stress-test parameters, qualitative findings germane to the time period and Board-specified scenarios are correlated to ensure that capital planning within the stress-test framework demonstrates adherence to the FRB's requirements related to risk analytics and supports proposed capital distributions.

Results:

These matrices have the following value-added:

- They protect the BHC from falling short of FRB expectations related to risks often not well quantified in existing models, reducing the risk of failing the stress tests and absorbing the hit to market capitalization and other costs that then ensue.
- They anticipate OCC demands in the new heightened-expectation framework under which the board is to ensure that the national bank is operating in a risk-mitigation framework compatible with safety and soundness at the insured depository, while also providing bank and parent boards a cross-check on any possible divergent business goals and risk/capital forecast.
- They inform the board and senior management in a rigorous, disciplined way about emerging reputational, strategic, and compliance risks on an enterprise-wide and material business-line basis. The complexities of these risks and their seemingly "political" nature have long obscured the bottom-line impact of these risks absent appropriate mitigation. The process demonstrates the value-added of work done by risk management, compliance, legal and government relations that are often viewed solely as cost centers.
- They support forward-looking calculation of legal risk, essential to effective calculation of reserves highlighted by the FRB as a critical concern in the 2013 statement and a major problem area in the subsequent stress-test results.
- They are a vital early warning to the board and senior management of emerging risks that, even if not yet evident in new rule or law, are gathering momentum and may well change the national bank and BHC's established business practices.
- They provide the analytics necessary to garner first-mover advantage in advance of rules or other policy factors that redefine core business lines.

FedFin's practice demonstrates that this management overlay is often the best approach to risk analytics for reputational and strategic risk because management can take actions such as adding internal controls, exiting products, executing first-mover plans, and taking similar strategic action. Importantly, management overlays must be supported by prospective action commitments, not general assertions about the bank's willingness to act "if needed" under stress.

Over the past twenty-eight years, Federal Financial Analytics, Inc. has advised boards of directors on these risks, presenting the type of expert judgment of internal assessments that have long been best practice and now must be adopted by all covered firms. We thus provide key insights and required implementation action in this summary document. It is informed not only by our longstanding practice in this area, but also the objective advice we provide to global regulators, central banks, and governmental agencies. A list of clients which have consented to the release of their names may be found on our website, www.fedfin.com. Recent speeches and Congressional testimony by firm principals, as well as our in-depth studies, may also be found on the site.

To find out more, please call Arezou Rafikian at 202-589-0880 or e-mail her at arafikian@fedfin.com