Federal Financial Analytics, Inc.

Reputational, Strategic, and Compliance Risk Analytics: Board/Senior Management Adherence to FRB Capital-Plan Requirements

Federal Financial Analytics, Inc.
September, 2013

On August 19, the Federal Reserve Board issued its supervisory expectations for capital planning at large bank holding companies (BHCs). 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. Importantly, the Federal Reserve has for the first time expressly mandated that satisfactory capital plans must include rigorous, forward looking analytics addressing each BHC's reputational, strategic, and compliance risk (including possible legal risk). As this requirement breaks new ground for most BHCs in an area of acute concern to CEOs and the board, we here outline the Federal Reserve's new best practices and how BHCs can quickly comply with them so dividends and other capital distributions can proceed as desired in 2014. A proven best practice 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 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.

The Federal Reserve Supervisory Statement:

Importantly, the FRB now 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").

1121 Fourteenth Street, N.W.
Washington, DC 20005
www.fedfin.com

PHONE 202.589.0880
FAX 202.589.0423
E-Mail: info@fedfin.com

> Examples of these other risks include reputational risk, strategic risk, and compliance risk.[1]

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.[2] 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, 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.[3]

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.

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, planned management overlays must be supported by prospective action commitments, not general assertions about the BHC's willingness to act "if needed" under stress.

Best Practice:

The following is an outline of steps FedFin has found result in effective governance of reputational, strategic, and compliance risk. Our practice has principally focused on these to promote best-practice strategic planning and this proven methodology is ideally suited to comply also with the FRB's new supervisory statement. Key steps include:

- Working with designated senior management, FedFin prepares a list of business lines and/or products material to reputational, strategic, and compliance risk. FedFin review

---

[1] FRB, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice*, Page 6 (Aug. 2013), *available at*: http://www.federalreserve.gov/bankinforeg/bcreg20130819a1.pdf.
[2] Ibid, Page 17.
[3] Ibid, Page 17.

is based on our knowledge of the external environment to ensure that additional business lines/products are included if they are material to capital/earnings and may be subject to material risk, leading to a final list based on internal models and our expert judgment.

- 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 and what actions, if any, are planned to mitigate risk. FedFin expands this list as necessary with additional external stress factors, including fat-tail risks, and surveys management to determine what, if any, response has been identified to items omitted from the initial internal list.

- 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. Missing risk mitigations are identified by FedFin for senior management review in advance of completion of the risk analytical landscape.

- 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.

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 inform the board and senior management in a rigorous, disciplined way about emerging reputational, strategic, and compliance risks on an enterprise-wide basis. The complexity of these risks and their seemingly “political” nature have long obscured the bottom-line impact of these risks absent appropriate mitigation They demonstrate 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.

- 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 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.

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.

© 2013 Federal Financial Analytics, Inc. All Rights Reserved.