Rewiring RISK MANAGEMENT in BANKS amid THE COVID-19 PANDEMIC

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Abstract

The 2008 financial crisis shook the banking and financial services sector and triggered a tsunami of regulations aimed at ensuring the resilience and stability of the banking system. The prevailing COVID-19 pandemic, however, has shocked the sector in a different way. Globally, economies are still coming to terms with the widespread impact that the pandemic has unleashed in terms of lockdowns, economic slowdown, job losses and potential bankruptcies. The COVID-19 pandemic will sorely test the enhanced risk management and capital adequacy frameworks adopted post the 2008 crisis, especially given that no scenario analysis would have considered an event of this nature and scale.

The COVID-19 crisis is likely to highlight systemic weaknesses that will need to be addressed. This white paper examines key risk management areas that banks will need to focus on in the short-, medium- and long-term. It also discusses changes to risk management methodologies, processes and systems to address the impact.
Evaluating the Impact on Risk Management

In the wake of the COVID-19 pandemic, regulators have instituted new liquidity lines to ensure sufficient cash availability in the banking system and prevent adverse impact to the lending capability of banks. The European Banking Authority (EBA) has announced that EU-wide stress testing will be postponed.\(^1\) Despite the relief measures from regulators and governments, we expect the banking system to undergo fundamental changes in response to the weaknesses highlighted by the COVID-19 crisis.

Risk management becomes especially important during times of crisis to retain customer trust and ensure the stability of the financial system. In our view, assessing the short-, medium- and long-term impact on different areas (see Figure 1), and defining a strategic response focusing on changes to risk management methodologies, processes and systems is key.

Despite elaborate relief measures already in place, the COVID-19 crisis is likely to bring to light several weaknesses in the global banking system.

Building operational resilience in the short to medium term is fundamental to ensuring the seamless delivery of essential banking services during a crisis like the COVID-19 pandemic. Regulators in some geographies have already recommended that banks must focus on building operational resilience. We expect regulatory bodies across geographies to eventually come up with a similar requirement. Building operational resilience goes beyond the operational risk and business continuity frameworks that banks already have. It requires:

- Identifying business services, which if disrupted could harm consumer and market integrity
- Setting tolerance limits for the disruption
- Testing resilience through various extreme but plausible scenarios
- Building capabilities and communication plans to recover from the stress scenario as effectively as possible
Building Agile Enterprise Stress Testing and Scenario Analysis Capabilities

Stress testing, scenario analysis, and what-if analysis are crucial to understanding and preparing for a crisis. However, the existing stress tests and scenario analyses have not been able to safeguard banks from COVID-19 shocks. This can be attributed to inadequacy of scenarios and lack of agile stress testing capabilities – these must be addressed in the short to medium term.

Inadequacy of scenarios

Banks run scenarios based on historical financial market events like the Black Monday of 1987 or the 2008 financial meltdown. The forward-looking scenarios typically relate to economic slowdowns and geo-political tensions such as the US-China trade war and the war in the Middle East. Consequently, these scenarios are limited in scope from the geographical impact perspective and are executed when risk events are already on the horizon. In retrospect, the SARS outbreak in 2003 can be viewed as a dry run to the COVID-19 pandemic but very few banks, if any, would have extrapolated or included it in their scenario analysis. This points to the need to augment the scenarios by making them broader in scope and evaluating them for contagion effects.

Absence of agile enterprise-wide stress testing capabilities

The Comprehensive Capital Analysis and Review (CCAR) regulation in the US requires enterprise stress testing covering multiple risks such as credit, market, counterparty and so on. However, the time required to execute the tests runs into weeks and months. Moreover, in most banks, internal enterprise-wide stress testing is not the norm – individual risk departments perform internal stress tests risk area-wise and submit the results separately for different risk types.

In our view, banks must make the following changes to their stress testing capabilities:

• Assess processes, systems and infrastructure used for running what-if scenarios and create plans for the changes required to achieve intraday computation and reporting capabilities.

• Expand the repository of scenarios by including extreme but plausible scenarios to widen the scope of stress tests. Using natural language processing (NLP) models to capture news of interest across the globe will help banks identify scenarios that are plausible but have not been considered, besides providing early warnings of impending crises. Experts within a bank can assess if the event can potentially evolve into a global crisis requiring scenario analysis; for example, extrapolating the SARS outbreak that was largely confined to South-East Asia would likely have given pointers to bankers on better managing the prevailing crisis.

• Evaluate internal models to determine their efficacy in capturing all the risk factors, analyze the validity of assumptions, check data sufficiency, scrutinize the methodology used to verify if the models are understating the risk, and take remedial action as required.

In most banks, agile enterprise-wide internal stress testing is not prevalent – this will have to change.

Given the prevailing situation, the short- to medium-term focus will be on reducing costs and increasing efficiency. Specific risk use cases that can be resolved using robotic process automation (RPA), machine learning (ML), NLP, and cognitive RPA to augment risk officers in performing effectively will be in the spotlight. Such automation initiatives backed by intelligent technologies will in turn help banks in building operational resilience. Cloud adoption too will get a push because of its ability to render operational flexibility through ease in scaling operations, and reduce costs associated with maintaining in-premise hardware. However, before embarking on cloud migration for a wide set of risk management applications, banks must perform a cost-benefit analysis to quantify actual dollar saves.
During a crisis such as the COVID-19 pandemic, capital and liquidity become scarce. It becomes very important to deploy capital to the most productive business lines. The returns must be in line with the risk taken. The reliability and accuracy of metrics such as risk adjusted return on capital (RAROC) are crucial to capital deployment decisions of the management. Reliable metrics require alignment between the risk and finance functions from a business outcome perspective rather than merely ensuring technology alignment between risk and finance IT teams. Banks that lack an active risk and finance alignment program should initiate one while banks that have already taken steps in this direction must ensure that the program is driven by broader business outcomes instead of just cost optimization and IT systems rationalization goals.
Once the COVID-19 dust settles, there will be increased clamor and consensus to move toward sustainable banking factoring in environmental, social and governance (ESG) aspects. This will give impetus to green financing and green investment. From a risk management perspective, banks will need to quantify financial risk due to climate change. Climate risk assessment has become a part of the regulatory agenda. In fact, some regulators are recommending scenario analysis and quantifying risk measures for the banking book and trading book to assess climate risk from three different scenarios. It is but a matter of time before all regulators mandate it in some form. In our view, banks must define a holistic roadmap for performing stress tests and scenario analyses that considers all the different factors and quantifies the financial risk. This in turn will help banks in proactively managing climate risk and preparing for future crises.
What Lies Ahead

It is extremely difficult to predict how the pandemic will play out over the next few weeks or months. Given each new crisis is different from previous ones, banks must prepare themselves to manage risks emanating from COVID-19 and other such Black Swan events by expanding their risk assessment capabilities. We believe that such capabilities will soon become the norm and banks that do not act fast in building them will be at a competitive disadvantage and risk being left behind by their peers.
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