Leveraging technology in an evolving risk management landscape

Banks continuously face a set of risks and governance responsibilities. Some are standing issues such as relentless monitoring and managing credit, market, and operational risks. Along with these issues, evolving themes of climate change and conduct risk deserve fresh attention. While these themes are not entirely new, they have become more prominent and pressing. Banks should be monitoring these themes and developing plans to factor them into their strategy and operations. While governments may be addressing these issues through regulation or policymaking, banks need to develop an agile approach to mitigate these issues.

Using technology for risk management

Artificial intelligence (AI) and Machine Learning (ML) are increasingly recognized across industries for their potential to transform business and address large and voluminous transactions. In risk management, AI and ML have also become synonymous with enhanced expectations of mitigating risks at reduced costs. This has been possible due to the technologies' ability to handle and analyse large volumes of unstructured data at faster speeds with considerably lower degrees of human intervention. The technology has also enabled banks and financial institutions to lower operational, regulatory, and compliance costs while simultaneously providing them with accurate credit decision-making capabilities.

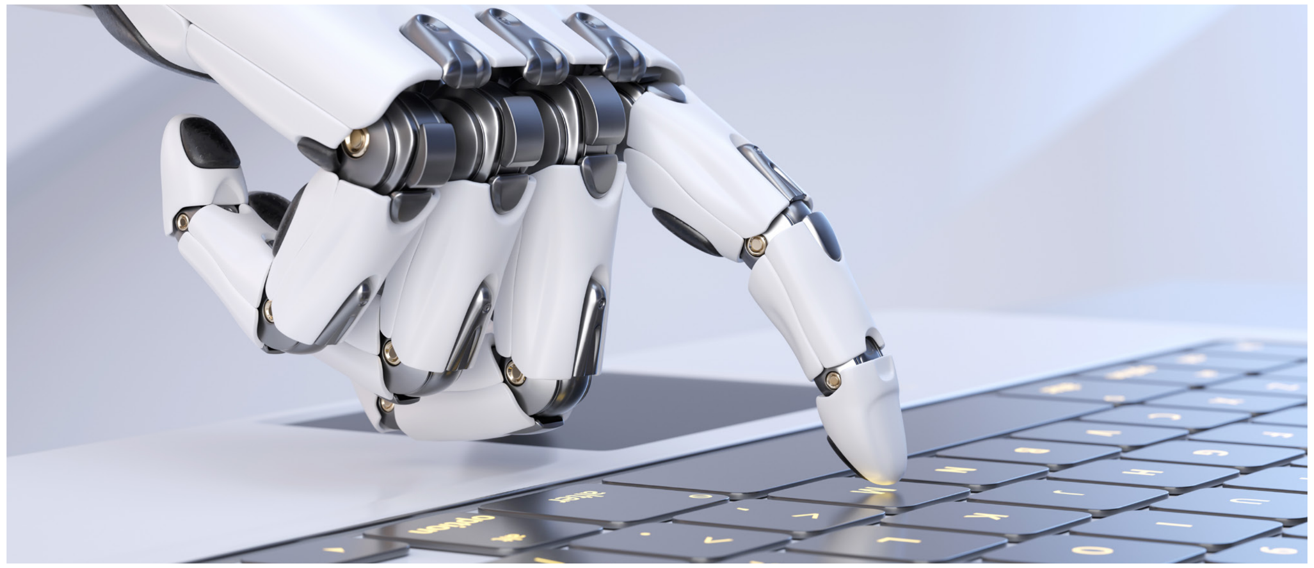
AI and ML powered risk management solutions can also be used for model risk management and stress testing, as required by global prudential regulators, and allow for superior forecasting accuracy, optimised variable selection process, and richer data segmentation.[40] This technology can be used by banks, for example for credit risk modelling, fraud detection and trader behavior in front office.

Evolving risk landscape

Climate risk

New risks to growth have emerged as the pandemic has evolved. In KPMG's CEO Outlook Saudi Arabia 2021, Saudi-based CEOs identified climate change as the top risk to growth.

Driven by the Paris Climate Accord and other factors, governments are outlining new corporate requirements tied to climate change. Regulators recognize that moving towards a low-carbon economy will create additional complexities for financial services firms. They are worried that banks are not ready for the types of prudential and conduct risks that could arise, both in terms of the direct risks from the physical impact of climate change on assets, and the transition risks inherent to a wholesale move towards a low-carbon economy. Nonetheless, governments will prioritise the effectiveness of environmental regulations in reaching climate change goals over the difficulties faced by banks.

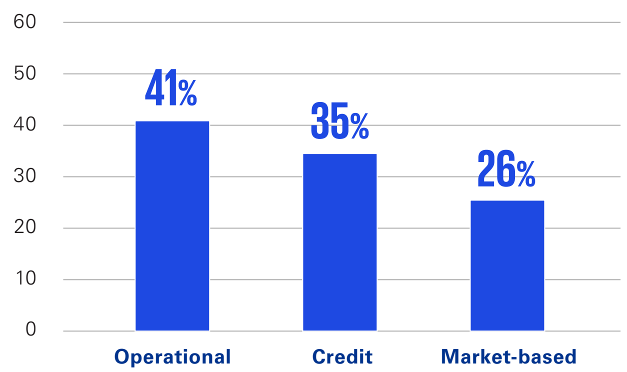


Which of the following risks pose the greatest threat to your bank's growth?[41]

1. Cybersecurity risk
2. Tax risk
3. Reputational risk
4. Reputational brand risk
5. Interest rate risk

Banks are also starting to feel pressure from their customers and from the public at large. Customers want to bank with a firm that reflects their views and beliefs. Younger generations, in particular, are said to be choosing their bank based on their ESG credentials. That said, in Saudi Arabia, most of the pressure to change is felt from investors and regulators. According to KPMG's 2021 CEO Outlook, 85% of surveyed CEOs in Saudi Arabia are feeling the most pressure for ESG reporting from regulators and institutional investors, rather than from customers.[42]

Climate change considerations can also affect calculations in risk management that extend beyond climate risk itself. In fact, climate change is a systemic risk for the entire banking and capital markets sector. According to a recent review by KPMG of annual reports in the financial sector, financial institutions identified their climate-related risks as per the figure below.[43]



Financial institutions are being confronted with operational and financial challenges related to:

- **Prioritization:** choosing which material risk exposures take precedence on the balance sheet, these risks involve asset valuations, changing consumer behavior, and new technologies.
- **Data:** identifying accurate and timely data to measure, monitor, and report on climate risk.
- **Alignment:** aligning climate-related public disclosures and commitments with the ability to develop and report accurate metrics against those commitments.

Conduct risk

Another risk to consider, which is also tied to mitigating the effects climate change, is conduct risk. It is broadly defined as any action of a financial institution or individual that leads to customer detriment, or has an adverse effect on market stability or effective competition. Banks and financial institutions that fail to bring conduct risk in line face regulatory action, fines, and reputational damage, which can harm business for years.

Understanding and addressing the drivers of conduct risk is essential in improving standards of behavior. While the starting point for this journey can vary, there are three core areas at the root of conduct risk:

- **Inherent factors:** characteristics intrinsic to financial markets and their participants, such as information asymmetries between firms and their clients or the financial capability of clients.
- **Structures and behaviors:** entrenched behaviors and conflicts of interests that could prevent markets from working as well as they could.
- **Environmental factors:** macro-economic developments that have the potential to impact financial markets and the long-term needs of consumers. Firms ineffectively responding to these pressures can lead to poor conduct outcomes.[44]

Operational risk - Basel accords

An imminent change to the risk landscape for banks is the January 2023 deadline for adherence to the Basel accords. Following a one-year deferral due to the

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Covid-19 pandemic, the Basel Committee aims to build upon the previous accords to strengthen risk management, regulation, supervision, and stability within the banking industry. Although this new accord presents changes to many of the regulated risks, the focus here is on operational risk management and on the impact of the new standardized approach for operational risk capital on banks.

Currently, banks can choose their approach to calculating operational capital, with the possibility of capital savings in return for higher investments in risk management. Under the new Basel accord, banks will have to use a revised standardized approach (SA) to calculate the minimum operational risk capital requirements. This approach will replace all three existing approaches for operational risk under Pillar 1.

As with all Basel Committee standards, the new SA applies to all internationally active banks on a consolidated basis, and national supervisors may also apply the framework to non-internationally active banks.

The new SA seeks to restore credibility in the calculation of risk weighted assets (RWAs) and to improve comparability of banks' capital ratios. It is therefore critical that banks maintain high quality operational risk teams, use processes such as risk modelling and scenario analysis to assist with business decision making and embed operational risk management mind sets into the business.

Implications and key challenges for banks

The implementation of the new SA framework will have potential impacts on the bank's data, systems and processes, business models, and capital.

- **Data, systems and processes:** Banks will have to ensure their internal loss data collection processes are sufficiently robust and cover the required ten-year history.

- **Business model and capital:** The definition of the Business Indicator Component (BIC) (as compared to gross income currently used for calculating the simpler Pillar 1 approaches) generates higher capital requirements for some business activities. Therefore, banks should analyze their different business lines to ensure they remain sustainable in all aspects (including profitability, customer expectations, capital usage, etc.).

Although the new framework is not in force until 2023, all banks should ensure they are incorporating the new approach into their capital planning process as well as in risk adjusted return measures at an early stage.

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