Non-Financial Risk and the role of Finance

Non-financial risks, such as operational, reputational and strategic risks, have become increasingly important elements of a bank's risk landcape in recent years. The growing importance of non-financial risks, or 'NFRs', poses particular challenges for a bank's finance function, the team traditionally relied upon by senior management, the board, and other stakeholders to understand how risks affect the bottom line.

With increasing focus and activity by regulators to quantify, measure and monitor Non-Financial Risk, it is more important than ever that finance functions step up.

Essential to a bank's ability to understand any financial risk, and often relied upon to lead and manage the bank's response to financial risk, what role, exactly, should the finance function have in the identification, management and mitigation of non-financial risks?

The answer may surprise you….. basically the same as the function has regarding 'traditional' financial risks.

Financial Risk vs. Non-Financial Risk

Financial risks arise from the balance sheet, and a bank's response to them – including risks the institution is willing to accept – are readily expressed in the same way. This is familiar and comfortable ground for a bank, as well as the finance team. After all, banks make money by deciding which financial risks are acceptable, which are not, and how much risk to take.

Non-financial risks, by contrast, can come from anywhere. Media coverage of poor conduct ignites an inquiry, regulation, a class-action lawsuit. Government efforts to promote ESG heighten shareholder concerns about greenwashing. Non-state actors in regions with no connections to business activity leads to a critical cyber exposure, pushing back other priorities.

Measuring and Monitoring NFR

KPMG industry research[1] indicates that the better NFR is measured and monitored using an integrated approach, the better NFR is managed. The finance function's role in shaping how NFR is quantified – how it is 'made real' for senior management, the board and other stakeholders – cannot be overstated.

All NFR is quantifiable – in other words, its impact can be measured – in financial terms. Litigation risk requires provisioning. Cyber risk management and mitigation is a matter of capital investment and operating budget. Third party risks must be quantified and set against improvements in operating margin and efficiency ratio. These vital steps remain firmly in the finance function's domain, as is the case with traditional financial risk.

Regulators want NFR measured too

KPMG studies[2] note that regulators expect NFR management to comprise a growing share of risk management frameworks – and expect banks to do better at managing such risk. Authorities are also devoting more of their own focus and attention to the systemic risk presented by NFR.

By way of example, in its 2023 Financial Stability Report[3] Non-Financial Risks comprised 2 of the top 5 salient risks to the US financial system in a survey conducted by the Federal Reserve Board of Governors.

In Canada, the Office of the Superintendent of Financial Institutions (OSFI) Annual Risk Outlook for 2023[4] outlined what OSFI sees as the most significant risks facing Canada's financial system in the upcoming year. Of nine risks identified, four were NFRs.

[1] https://kpmg.com/de/en/home/insights/2023/05/biggest-non-financial-risks-for-banks.html
[2] https://kpmg.com/de/en/home/services/industries-and-markets/financial-services/non-financial-risks.html
[3] https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf
[4] https://www.osfi-bsif.gc.ca/Documents/WET5/ARO/eng/2023/aro.html

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Non-Financial risk measurement: why is it so hard?

With this increasing focus and activity by regulators to quantify, measure and monitor Non-Financial Risk, it is more important than ever that Finance functions step up. However, just as NFR arises from unexpected - even unique - sources, the barriers and obstacles to Finance functions engaging more effectively on NFR matters can be uniquely challenging. There is a simple, yet frustrating, reason for this.

The measures and mechanisms designed by the institution or by regulatory authorities to manage, mitigate or supervise NFR actually get in the way of the Finance function's ability to quantify them. The steps and frameworks designed by well-meaning risk managers, implemented with great care and at great cost to the organization, may be the biggest obstacle to understanding and engaging with NFR the way we do with traditional risks in a financial institution.

Exploring how NFR management practices complicate financial measurement may help Finance functions understand this challenge.

Operational risk muddlement

Anyone who has read the generally accepted definition of Operational Risk[5] has probably wondered why authorities didn't just say "Other" and leave it at that. Glib as that sounds, this spectacularly unhelpful concept had (and still has) profound implications on the ability of financial institutions to meaningfully track, let alone quantify, non-financial risk. Most NFR fits under the dreadful umbrella term of Operational Risk, and to this day institutions and regulators alike struggle to turn its vast scope into useful metrics and measures.

Risk managers have spent more than a decade creating frameworks and methodologies to break down Operational Risk into more specific concepts, the better to manage and measure exposures. The results are usually called operational risk taxonomies – a very structured-sounding outcome. The reality is different; too frequently, operational risk taxonomies remain ever-changing lists of concepts and categories riddled with sub-categories differently applied to different areas of the institution's operations, depending on the nature, scope – and above all, the perception – of what the institution actually does.

Are the outcomes more or less useful?

With the implementation of BCBS 239[6] risk managers and authorities have begun to apply these categories, concepts and frameworks to risk-weighted assets and capital in a somewhat consistent manner. That process is far from complete and with different regulators using subtly different interpretation of these concepts in their capital requirements, yet another layer of variability has been added to an already complex approach. To a Finance function seeking to quantify and characterize the financial impact of non-financial risks, that approach can easily become additional challenges, for instance:

- By 'breaking up' a risk event (e.g. a cyber security incident) into sub-events aligned with the multilayered operational risk taxonomy and its capital implications, it becomes harder to understand the realities of an event response and its financial costs.
- Operational risk management processes designed to aggregate risk impacts for capital purposes are used by risk managers, not business managers. The Finance function may find itself caught between first and second line understanding of non-financial risk.

Protracted and expensive approaches to NFR management have real impacts upon executives' ability to understand and relate such risks to the financial risks their institutions take. Finding ways to make NFR truly quantifiable and relatable to financial risk – while minimizing the complexity of operational risk management practices – will remain a challenge for finance functions in the foreseeable future. Steps that Finance can consider to minimize these challenges include:

- Developing an understanding of organization's ORM practices – to better understand where the chances of misalignment or confusion are likely to occur.
- Building their own lines of communication to departments that deal with NFR regularly – and not just the functions tasked with measuring or reporting it.

Both ORM and Finance are part of managing NFR, and ultimately it will fall to Finance to understand, and communicate, the effect of this growing risk focus on the institution's financial position.

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[5] https://www.bis.org/basel_framework/chapter/OPE/10.htm?inforce=20220101&published=20191215
[6] https://www.bis.org/publ/bcbs239.htm

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