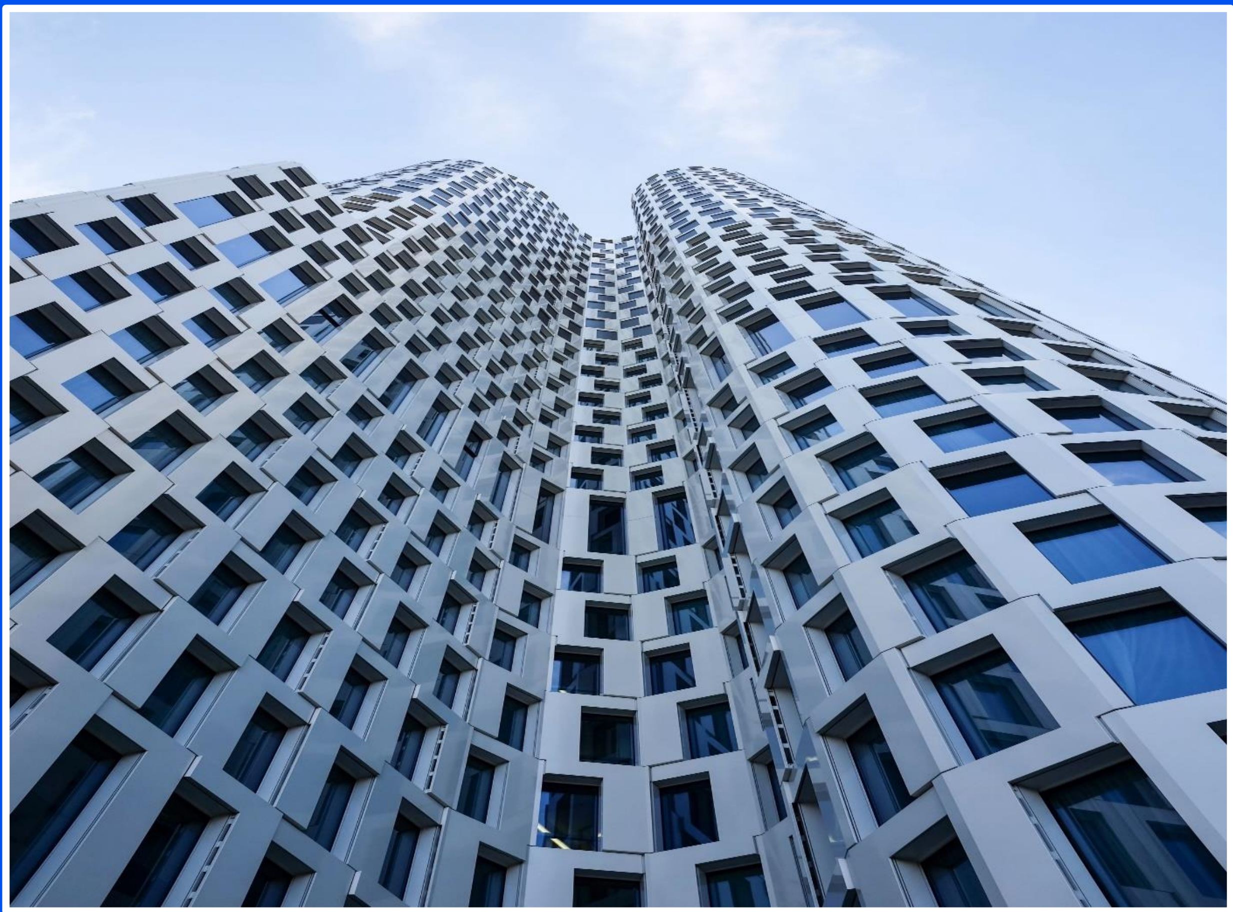
European Risk Management Council

Risk Landscape Review

March 2023



- Not Easily Quantifiable Risks
- UK and APAC Risk Sentiment Index

DEAR READER,

I am delighted to present the Q1 2023 edition of the Risk Landscape Review, which includes two articles.

The first article is dedicated to the analysis of not-easily-quantifiable risks. In recent times, such risks, including geopolitical risk, have increased and caused substantial disturbances in markets and businesses. In the article, Peter Neville Lewis MIRM, Director of the Risk Coalition Research Company, focuses on the fundamental nature of these risks and discusses what should be done to better manage them.

The second article is a summary of the Risk Sentiment Index (RSI) for the UK and APAC, an expert-driven forward-looking index that reflects the expectations of experts about the risk landscape of the financial sector in the next 12 months. The results of the survey in the UK and APAC that we recently conducted suggest that Chief Risk Officers and other risk decision-makers expect some positive changes in the risk landscape.

My huge thanks to all contributors and survey respondents. Enjoy the reading.

Yours sincerely,

Dr Evgueni Ivantsov

Chairman of European Risk Management Council

Table of Contents

Why Not Easily Quantifiable Risks cannot be assessed by using standard risk management systems

By Peter Neville Lewis MIRM, Director Risk Coalition Research Company

The risk landscape has changed dramatically in the last 12-18 months. Business has become more complicated and complex. Businesses and auditors have believed for too long that most risks are quantifiable, measurable and controllable. This is no longer true, especially with the emergence of NEQ risks. The interconnectivity of risk and strategic objectives requires the adoption of a more sophisticated approach to operational risk and resilience as organisations now find themselves dealing more and more with NEQ (Not Easily Quantifiable) risks.

These can comprise geopolitical, geo-economic, ESG, AI ethics, cyber manipulation, deep supply chain etc issues, all of which may also involve additional moral decision making in determining the best course of action. The following few examples make the point.

Investing in green solar panels meets Environmental concerns but if the manufacture of say 50% of a key component (polysilicon) takes place under forced labour conditions in Xinjiang (NW China) how does this square with Social requirements? Similarly, the raw minerals for EV batteries are often sourced by mining methods which involve human rights abuse.

RTZ lost its CEO because they failed to take account of the moral outcry which followed the blowing up of a sacred Aboriginal site in the pursuit of mineral wealth. Their shares have suffered too.

Exponential changes, growing frequency and increasing velocity of risks, regulations, globalisation, distributed operations, technology, data aggregation and geo-economic forces are impacting every business in new ways. Staying on top of, and making sense of, all this is a significant challenge for boards, executives and their professional advisers for the foreseeable future.

The combined effect of all the above factors demands a fresh mindset towards risk governance, one which is more holistic and nuanced, drawing on all aspects of risk foresight, oversight, controls and governance. Relying on a disassociated collection of legacy risk management processes and often silo-ised functions is not the best way to address NEQ risks. The linkage and transfer of these risks across business units requires 360-degree contextual awareness of risk management processes in order to fully address uncertainties and the likeliness of achieving strategic objectives. Synchronised risk intelligence and continuous dialogue are a more effective approach, especially as decisions can involve moral conundrums – what is the right thing to do? The answers to these are rarely to be found in spreadsheets, data or management information.

So what are the core pillars for assessing and handling NEQ risks not just to prevent or limit harm to the business model but also, critically, to determine and develop new opportunities in a fluctuating business environment.

1. Resilience:

New reporting mandates now make this an imperative discipline. It is the ability to recover from a risk event and minimise the impact on the business. And then from lessons learned to take a fresh breath, go again and develop new business thinking. The French have a good expression “reculer pour mieux sauter” – to take a step back in order to jump better. (Think of an Olympic high jumper).

2. Agility:

A critical mindset with constant attention to multiple scenarios. It involves horizon scanning, blue sky thinking and preparing the business for likely and unlikely threats, as well as equally for new possibilities. Organisations must be ready for swift responses to new events. Agility and resilience are two sides of the same coin and each can drive the other. Both are essential components of risk management best practice where NEQ risks are involved.

3. Integration and Integrity:

With a growing focus on ESG related risks this comparatively new factor needs to be embedded into all management skills. Many elements of ESG fall into the NEQ category. ESG is also about the integrity of the business – how it communicates its purpose, values, ethics and commitments to the environment, society and the highest business standards for all its stakeholders. All the key risk linked functions of a business must co-ordinate to prove the widest insights into handling NEQ risks with integrity.

4. Reputation:

Doing the right thing and taking difficult decisions. Media scrutiny plus heightened public awareness and interest means that decisions and actions taken may be challenged not only by regulators but by independent investigators and legal professionals. A robust, carefully calibrated and principles-based risk process should underpin responses to NEQ risks standards to avoid possible reputational harm.

5. Culture:

The Board and its executive team should ensure, as their absolute priority, that every member of the organisation should fulfil their roles and designated duties to the highest possible standards. However, NEQ risks will challenge traditional approaches to risk assessment and will require a culture of openness and support at all levels - a holistic process of more collaborative thinking. Escalation of complex issues, where data and previous experiences may be lacking, should be encouraged so that a wider examination of the threats and opportunities can be carried out.

Twenty first century business operates in a world of complex and complicated uncertainties where even a relatively minor event can cascade into becoming a significant issue impacting several parts of a business which may not be obviously connected. Siloed approaches to risk management (eg a poorly implemented 3 Lines system with weak 1st Line accountability and reporting) which do not connect functions and systems, can lead to incomplete understanding of the bigger picture.

There is in the end no perfect solution to managing NEQ risks but by blending foresight, oversight, insight and (where there are lessons learned from previous events) hindsight, from different parts of the business, organisations have a better chance of holistic, more balanced analysis to improve decision making and risk taking. Process should never get in the way of dialogue.

Risk Sentiment Index: Q1 2023 Update

From Pessimism to Optimism: The Recent Shift to a More Positive Mood

The European Risk Management Council has updated its Risk Sentiment Index (RSI) with fresh data collected for Q1 2023 from the UK and APAC. Chief Risk Officers and other senior risk executives from banks provided their views on future trends for seven types of risk, including credit, market, liquidity, operational, cyber & IT, conduct, and regulatory risks. Using the survey results, the Council aggregated the data into a forward-looking index that reflects expectations about the changing risk landscape of the UK financial services sector in the next 12 months. Numerically, the RSI reflects the adjusted percentage of respondents who believe that the risk will increase in the next 12 months.

UK Risk Sentiment Index

- The aggregated RSI for seven risk types decreased from **0.5 in Q4 2022 to 0.41 in Q1 2023** which reflects a change of the survey respondents' mood to more optimistic (Figure 1). After the year of a very high RSI, the quarterly measure dropped well below a long-term average of 0.47 and returned to the level where RSI was before Russian's invasion of Ukraine in Q1 2022.

- The change of the mood to more positive is demonstrated by a shift in the vote distribution among main categories (Figure 2). A percentage of respondents who expect that risk will significantly increase in the next 12 months dropped sharply from 29% in Q4 2022 to 17% in Q1 2023. At the same time, a percentage of respondents who expect no change in risk increased to 26%, the highest level in the past year (in Q4 2022, it was 22%). This shift in the vote distribution indicates that respondents don't expect a high volatility for UK financial services in the next 12 months.

- Among individual risk types, the quarter-to-quarter change is characterised by a decreased those risks that previously had been identified by respondents as "hot" risks. RSI for credit, market, liquidity and cyber risks dropped substantially. RSIs for operational, conduct and regulatory risks increased but this increase was from a relatively low base (Figure 3).

- In spite a substantial reduction in Q1 2023, credit risk and cyber risk remain the areas of the prime concern where respondents expect an increase of these risk in the next 12 months (Figure 4). RSI for cyber risk is currently at 0.6 and is the highest among all seven risk types. RSI for credit risk is at 0.54 and this is below a long-term average of 0.64 (Figure 5).

Figure 1. UK RSI trend: Q4 2018 – Q1 2023

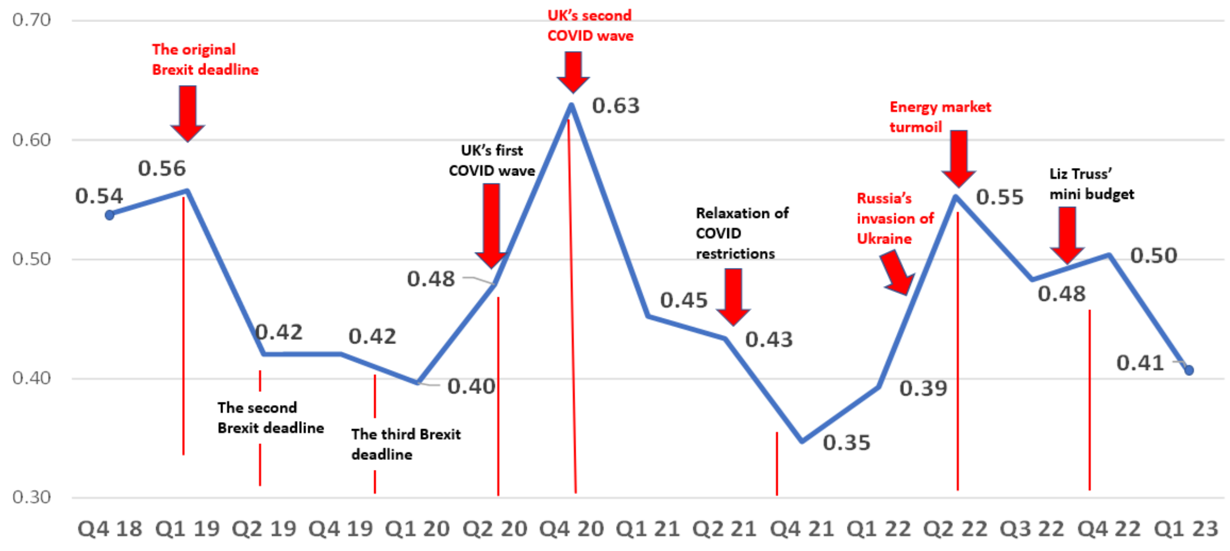


Figure 2. Distribution of respondents' votes

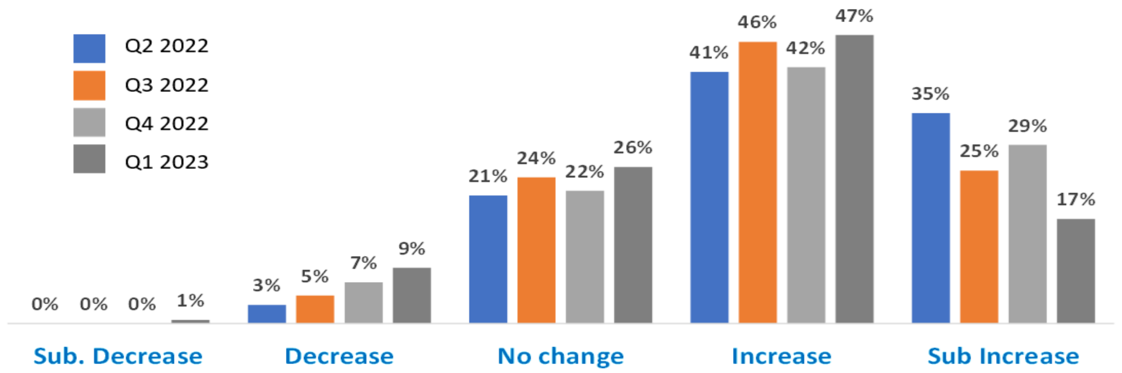


Figure 3. Recent RSI trends for individual risk types

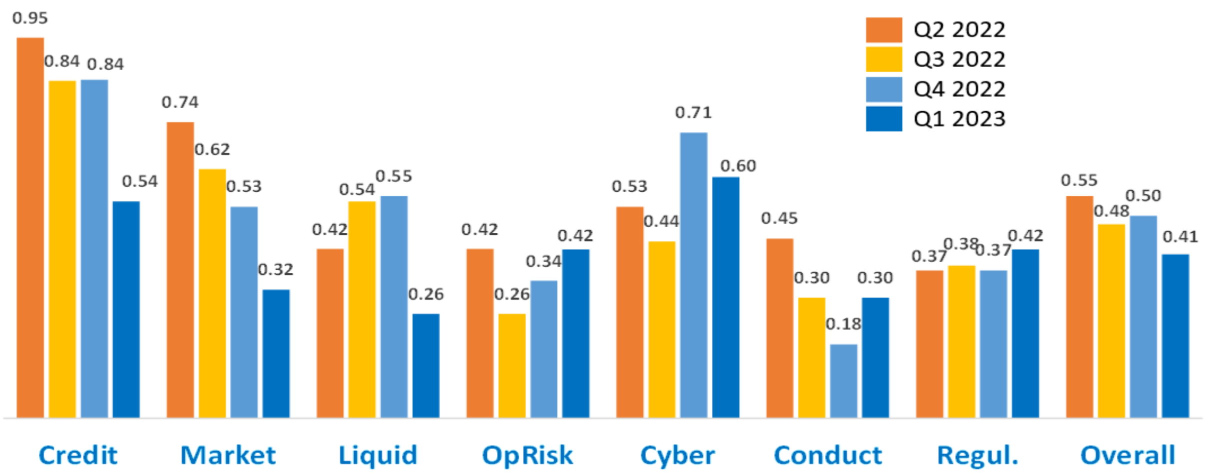


Figure 4. Comparison of RSIs for different risk types in Q1 2023

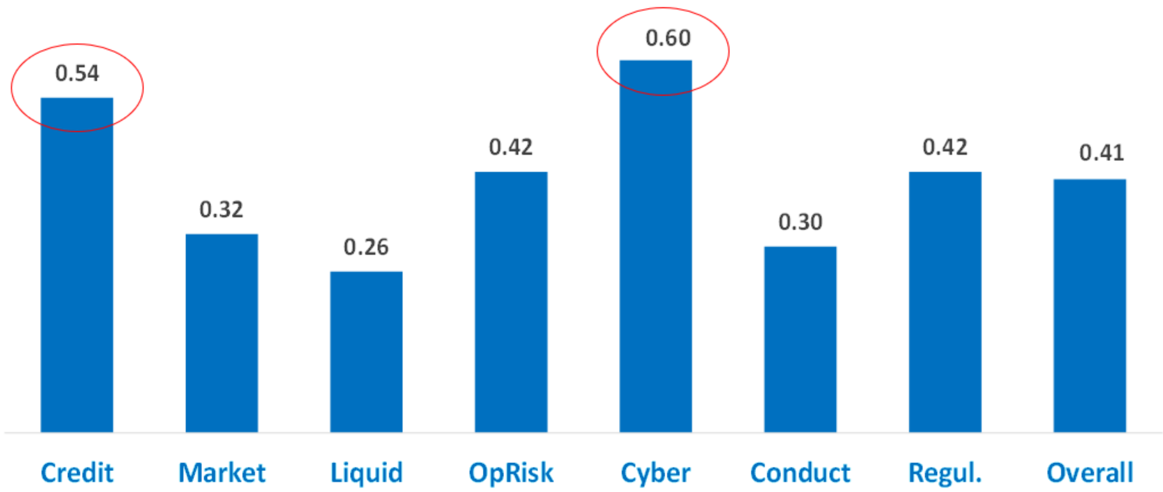
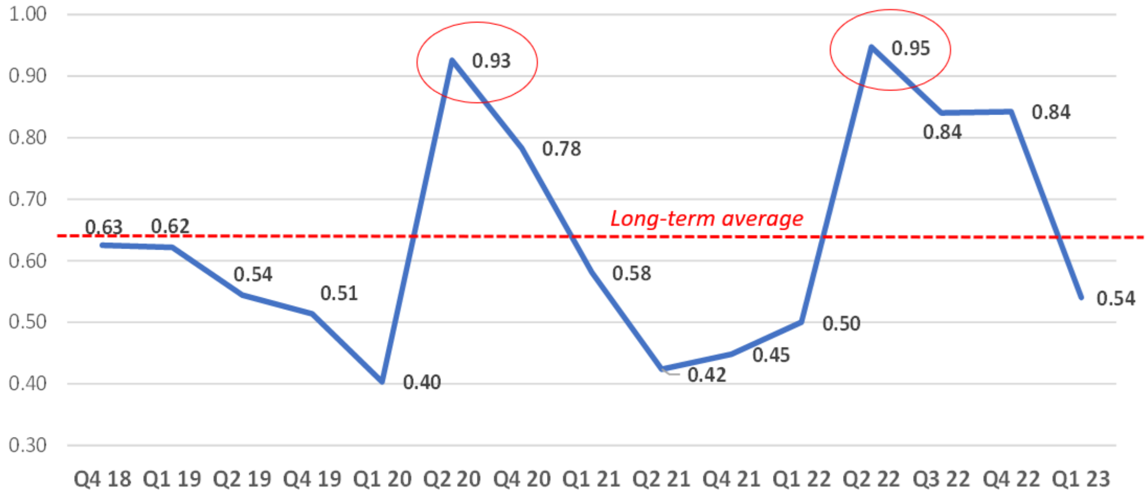


Figure 5. UK RSI: Credit Risk Trend Q4 2018 – Q1 2023



APAC Risk Sentiment Index

- The aggregated RSI for seven risk types decreased from 0.56 in Q2 2022 to 0.52 in Q1 2023, which reflects a shift from more pessimistic to more optimistic expectations among APAC respondents (Figure 6). The global market recovery from the shock after Putin's invasion of Ukraine and the lifting of most COVID restrictions in the APAC region played a positive role in this shift. Interestingly, the current level of aggregated RSI is the same as it was in Q4 2018 when the first RSI measurement was taken.

- The Q1 2023 survey revealed a minor positive shift in the distribution of votes. Compared to the previous survey, the share of respondents who expect a substantial increase in risk in the next 12 months reduced slightly from 33% to 27%. At the same time, the percentage of respondents who believe that risks will not change stayed almost the same at 17% vs 18% in the previous survey (Figure 7).

- The picture for the individual risk types in APAC is similar to what we observe for the UK (above). Q1 2023 results show a reduction of RSIs for financial risks (credit, market, and liquidity) and cyber & IT risks. At the same time, RSIs for operational risk, conduct, and regulatory risks went up (Figure 8).

- In Q1 2023, according to respondents, the top "pressure area" for the next 12 months will be credit risk, and cyber & IT risk also remains a serious concern (RSI of 0.63 and 0.61 respectively) (Figure 9). On the opposite side of the spectrum, there is conduct risk. While the RSI for conduct risk almost doubled compared to the previous measurement, it is still at the lowest level among all risk types.

Figure 6. APAC RSI trend: Q4 2018 – Q1 2023

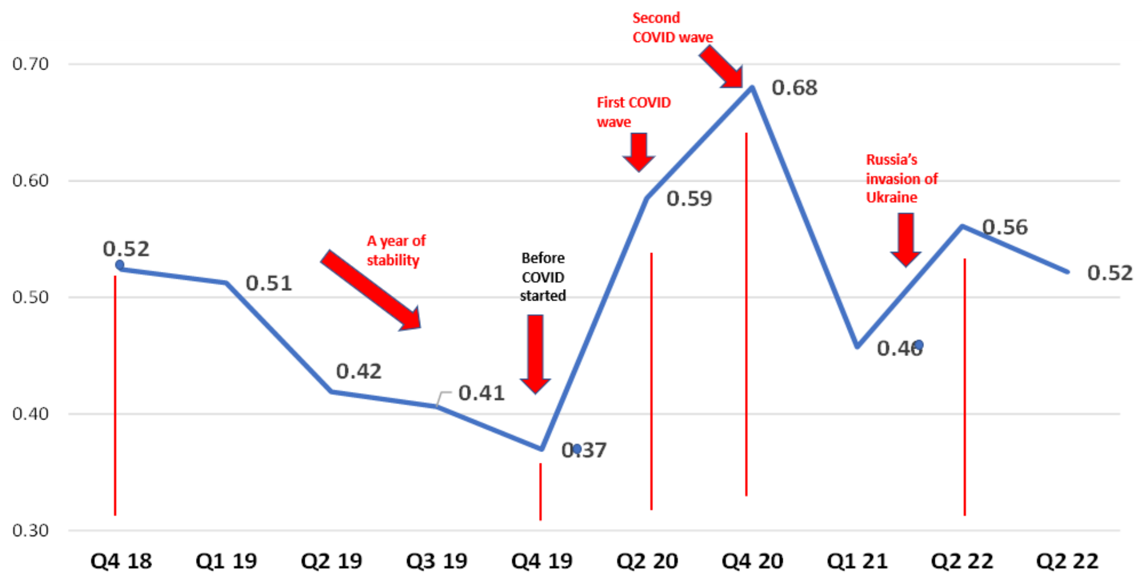


Figure 7. Distribution of respondents' votes

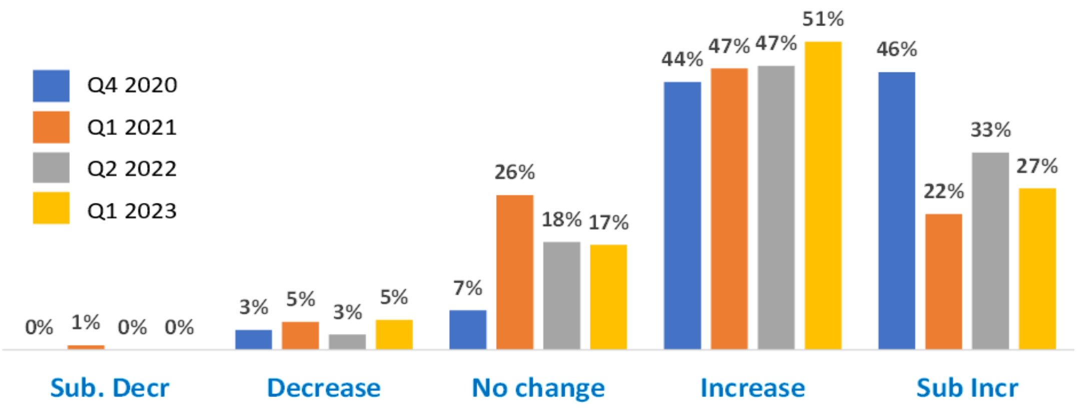


Figure 8. APAC RSI trends for individual risk types

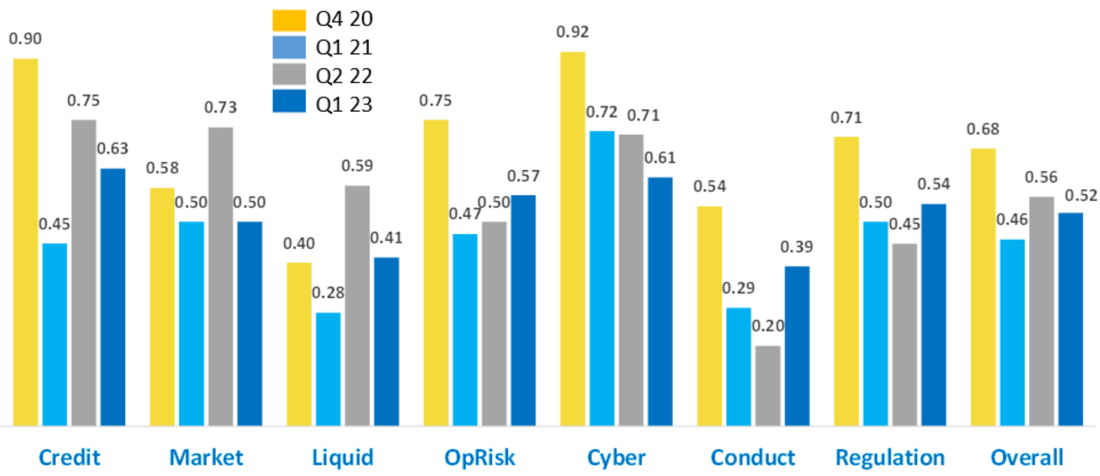


Figure 9. Comparison of APAC RSIs for different risk types in Q1 2023