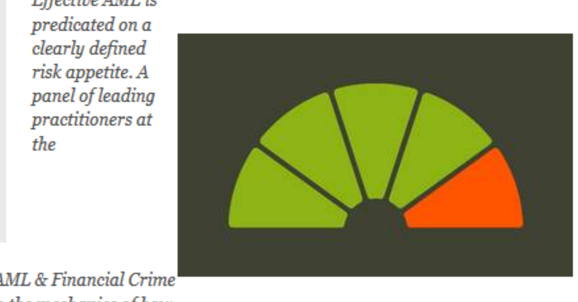
Risk appetite – a question of definition

Effective AML is predicated on a clearly defined risk appetite. A panel of leading practitioners at the ACAMSmoneylaundering.com AML & Financial Crime Conference in Miami delved into the mechanics of how to assess risk and then communicate it. ***Timon Molloy*** *reports.*



Justina Rousseau, a risk manager with Wells Fargo Bank and the session moderator, opened by asking for key challenges. "Well, three years ago there wasn't a clear effort to define risk appetite," Steven Beattie, Global AML Services Leader, EY, observed. "Sure, there were risk assessments for AML and other financial crimes but to have an articulated statement – 'what is my risk appetite; how do I view risk; and how are things going to impact my reputation?' – I'd say that's more of a recent, evolving practice." Some firms call it 'risk tolerance' - the expression of the risk they are prepared to take for a class of client, product, business activity or geography; increasingly, this formal statement is a regulatory expectation. "But there's not a lot of clear guidance out there on how to think through what that will read like," said Beattie, which is challenging, since, once written, the firm will be held to account against it.

Explicit and workable

Firms have been working with a risk appetite "in one form or another for many years but not necessarily reflected that", noted William Langford, immediate past Global Head of Compliance Architecture and Strategy at Citi. A major test, he said, lies in how to make a high-level statement very specific and applicable on the ground.

"Yes, operationalising your risk appetite is the challenge," Robert Curry, Chief AML Officer, US Bank agreed. The angle will differ according to where one sits "in the house", he said: there will be an enterprise perspective, then business and segment-line views. At a more granular level, there will be due diligence decisions on which initiatives to accept and reject, and if, and how, to set prohibited, restricted and tiered high risk categories. The calculus must be balanced, said Curry, against the firm's regulatory risk appetite "from the audit and federal regulatory sides of the house".

Multi-levered

"It's the multi-disciplinary approach [that's important]; it's not just about the compliance risk; there are other risks to take into account," Brion (sic) Nazzaro, Chief Compliance Officer, WorldRemit, affirmed.

Other risk disciplines that can be leveraged in formulating the institution's AML risk appetite include, said Curry, reputational, operational and legal, as well as, on the market side, counterparty risk management: "You have to make sure those different risk disciplines are all in line."

Over the past couple of years, Langford said that he'd been looking at how the disciplines come together. At Citi he'd spent a lot of time thinking about "whether some of the ways in which Risk presents and measures and sets their own limits has application more broadly in Compliance and in AML." He believed that there was scope to begin to draw on measurement practices in operational and traditional credit and market risk; the "analogy is pretty tight" in areas like KYC (know your customer) and monitoring. Production is an example where output can be tracked as a performance control, providing a "decent indication" of conformance to risk appetite. He predicted there would be a closer marriage of Risk and Compliance in the next couple of years.

Driving back to financial risk-reward, a delegate queried whether an institution would factor control charges into their analysis: "If we get into this line of business we can make $20m a quarter but it will cost us $1m to balance the risk. Is profit/loss, risk versus profit part of your risk appetite?" Langford was clear: "Without question, if the cost of controls is going to outweigh any net profit you're going to generate, you won't do it." It was his understanding, however, that currently the regulators don't believe institutions are accurately pricing risk.

Reputational risk is the principal component, the delegate asserted. "You might have a high profit and low cost, but the reputational risk isn't worth it." He cited the example of a "'gentlemen's club' in New York City, a gentlemen's club in Miami and one in LA. You might know the owner, the licence, the business - $25m profit a quarter, $100,000 a quarter to run, which you can make up in fees for deposits – but as soon as it hits the newspapers that XYZ Bank accepted deposits from the club, the reputational risk negates everything."

Single customer view – not yet

"Reputational risk is amorphous, difficult to identify and to manage. It's [also] more difficult to recover once you've lost it," Beattie remarked. Definition will vary significantly according to firms' experiences. Although additional valuable information on clients may be gained from reviewing their profiles for operational, market, liquidity, credit and reputational risk, these were not feeding directly into assessment of AML risk, he said: "Right now, they're still very separate in this state... I'm not seeing some broad and holistic governance risk management framework." The discussion presupposed that firms understood their cost of compliance for a given relationship, which, in turn, called for a single customer view across the enterprise: that challenge was, he said, enormously complex and the response, via steps towards definition of risk appetite, only "embryonic".

Proactive collaboration

The firms that had made progress in establishing some kind of risk appetite were those which had "set up the structure, the organisational construct". Expecting a framework to emerge naturally would only disappoint. "You don't have relationship managers sitting around hoping to figure out how to manage this risk, right? Their job is to be out there trying to grow the business." Where Beattie had seen the approach tried, operations people, relationship managers, perhaps the CEO of the business and someone from Compliance had come together. (In a three lines of defence model – business, the first line, then compliance and audit – any thought that the risk appetite can be set without input from the business is to invite trouble, said Beattie.) Armed with quantitative and qualitative information they would sit round the table and work through the issues: "Do I retain? Do I exit? Is it a product I want to be in?"

"That's exactly what we've done," said Langford. Op-risk, credit and market risk and Compliance had all met at the behest of the board, who wanted a better picture: "And nothing heightens the senses like [the prospect of] a board meeting." The forum created traction in starting AML and Compliance to think if there might be scope to adopt techniques and metrics used elsewhere.

Working through existing risk committees worked best for Nazzaro. "The product and service committee, in particular, can be very helpful," he said, with insertion of a formal mechanism for review of risk by reference to some metric before a new launch, with follow-up to gauge the predictive power of the a priori assessment. An explicit approach also helps to counter any surprise when it comes to reviewing exposure in established, especially favoured, clients.

Surely, whoever has responsibility for the brand should have a seat at the risk table, a delegate suggested. "We might feel great about the risk appetite in Compliance. The point is it's irrelevant if it's not the business's risk appetite, right?" Langford preferred not marketing but that business leaders should be involved. "They're the ones who, ultimately, will suffer the P&L loss if people say 'I cannot believe that Bank XYZ will bank the gentlemen's clubs'."

The only way is up

Once the risk appetite is conceptualised the difficulty is to translate it into behavioural changes, Langford said. "Typically, it's not on the control side: there are things we do to measure it and stay within it. It's all about the advice and guidance to the business, which is out prospecting or discovering new business or getting rid of existing business that they find too risky."

Effective promulgation of the risk appetite starts with "socialisation", that is, from the bottom of the organisation up, rather than top-down, said Curry. AML Compliance may have to step back and look hard at its policies, which have been in place five or seven years, and ask whether they are still relevant: "It's about socialising that and discussing those changes with your various business lines, with the chief risk officers of those business lines." From there, the topic can be taken to the operational risk committee and then to the executive risk committee.

Rewarding structure

One of the most positive aspects of the formalised approach to risk tolerance is the "prospective advice to the business", said Langford, which cuts down on the rate of deal refusals on compliance grounds. "Have the fight when it's not dollars and cents on the line... It's a lot easier when it's generic, when they're talking about it, than it is to say [no] to a business person who's lined them up and already spent the money on the new Lexus." Compliance ought to take a leading role in promoting the need to spell out the risk appetite, he added, since it will have a unique perspective on the potential regulatory impact of onboarding the wrong clients or products and operating in geographies outside the scope of the firm's controls. The business will continue to own the risk but Compliance should "provide some strong advocacy and informed build-out".

Second and third lines

Compliance staff who understand new products – "often more complex than they appear on paper" – are essential, said Curry, for meaningful evaluation; it's no good expecting this of individuals who are normally siloed in transaction monitoring or KYC. He has an enterprise compliance function to "kick around" the analysis, as a final check on whether it's rich enough before he looks at it.

The third line of defence will want to know how the risk appetite was assembled, how it operates and how its effectiveness is measured. "It's a critical role, they play," said Langford. Audit also need to be challenging the underlying assumptions, said Nazzaro – "you looked at the customer but you didn't look at the activity. There are so many risks, you can't look at them all". Compliance need to be ready with an explanation of why they may not have looked at some elements. The most appropriate response, he suggested, is "We re-evaluated all the time". The third line will also be involved in other initiatives, beyond just client-centric concerns, that bear on the risk appetite, stressed Beattie, like new product approval processes, joint ventures and acquisitions.

Dynamic ranking

Once the risk appetite is set, appropriate criteria need to be specified down to business line and even product level to arrive at the right customer risk ranking. "We've seen many different models," said Beattie, which will take in customer-specific information, the industry they're in, relevant geography, products, usual transaction activity: "It really is multi-dimensional risk consideration. We use tiered risk scoring based on those different attributes." But, however risk is defined at one point in time, if may be different three months hence, he added, and the organisation has to stay on top of the dynamics. The process is simplified where strict prohibitions and restrictions exist since they can save on having to collect some (or all in the case of rejection) risk attributes. Core category business is straightforward as well – nothing exotic. Resource will be more concentrated in the remaining area of "specialised business", said Beattie; "that's where thinking and the debate and the scoring really comes in".

"I agree with that," said Langford. He viewed the granular customer risk rating, which forms part of the customer due diligence, as "almost evidence of adherence to your risk appetite as opposed to the setting of your risk appetite". As the business prospects, it will need to know into which cluster a customer falls that isn't so finely striated that it gets lost in distinctions of high, medium high, medium risk. "For me, this is a critical distinction between this type of exercise and a more granular risk rating for KYC purposes," he said.

Although individual customer risk rankings are dynamic, the aim is to test risk ranking model outcomes against initial assumptions and across business lines, Curry noted, which means trying to keep those models "synched up" in terms of approach. "You don't want to have to go back and change your risk ranking model three months after you've put it out."

The complexity of risk decision-making is illustrated by the case of correspondent banking. Among many factors there will be several that are key, Langford said, any one of which alone will not tip the scale but enough together will. "I might say that it's okay to go into market X, I can live with market X but if I'm there I may not live with anything except central banks. I may not take any indigenous bank; it has to be a branch of an international bank."

Operational factors

Turning to operational challenges, Beattie highlighted culture, the need for advocacy from the top for roll-out of risk appetite implementation, for support for the tough decisions it will mean on business that the firm will not/no longer do. As well as inherent risk data on clients, which might not be expected to change too often – which might include ownership structure – thought has to be given to controls over, for example, volume and activity; if this increases or changes suddenly, a formerly benign customer can present very differently.

Review of the risk appetite cannot be approximated by client review, that is, by revisiting KYC, Langford observed: "Have a strategic process to think about risk appetite – where we are and what are we doing – broken down as granular[ly] as you need it to be, based upon the type of bank that you are, but to my mind it's important to distinguish between the two."

If an institution believes that it knows who all its clients are based on NAICS (North American Industry Classification System) codes, chances are it will have data quality issues, said Beattie, as they will not properly describe large, complex or even medium-sized organisations. "How can I say I'm going to have a relationship with X amount of my portfolio to match my risk if I really don't know if, say, I've uniquely identified all my NBFIs [Non-bank financial institutions]?" Large-scale NAICS remediation would mean effectively giving up compliance. Instead, Beattie says some firms have used proxy information to try to identify by account characteristic and activity.

"Transaction, typically, is key," said Curry. Investment in transaction, behavioural pattern analysis is needed to ensure client reviews, to be conducted impartially, are triggered. The line of business risk also needs to be reviewed, he noted, taking account of leadership, commitment from the top, training, policies and procedures, their transaction analysis and customer risk rating approaches.

The third line of defence and regulators will want to see evidence of the risk appetite framework but to date Beattie has not witnessed a quantitative approach by many firms: "It's more solid business judgement... That said, it's heavy with metrics and reporting: you've got everything from client acceptance and review boards to risk and reputational committees." There are committees "by region, by business by sub-business" and concomitant reporting.

Langford concurred: "You don't typically find robust processes in place that are labelled 'risk appetite' or 'risk tolerance' right now." Organisations do, though, already have multiple structures operating to handle risk and the task is to "start putting our arms around those and show how they come together or where they do not come together at all" in order to embark on creation of a multi-year strategy. "Is it just a bunch of documentation? No, it's how that whole programme comes together," said Curry, "It's how it comes to life, how it's operationalised throughout the whole organisation." In putting a "sceptical lens" on implementation, the gaps will be evident, which can then be addressed as the programme evolves in subsequent years.

Control your appetite

The launch point for measuring success of risk appetite management will be the organisation's existing metric pack, said Langford. Compliance tends to struggle with recording outcomes as opposed to outputs, he noted, but the good news is that a review of parameters already tracked will indicate if the firm is working within its risk tolerance. "If you are up to date on your KYC reviews and they are passing QA [quality assurance] that will give you some evidence that you are staying within your risk appetite by customer types and high risk customers and prohibited customers." Similarly, the firm can gain some assurance if it does not have a problem with late-filed SARs, and the disclosures pass QA, ie, their content and source accords with the risk and monitoring of the type(s) of business undertaken. More difficult, said Langford, is to understand the points at which prospects that never reach the reputational risk committee are rejected: it means working more closely with the business to determine how early in the process financial crime risk is raised. "That's where I think we should all be spending a bit more time," he opined.

One criterion, said Curry, is how often customers who fall outwith the firm's risk appetite are identified, which can be followed over time. If there is marked incidence in some business lines, Compliance may decide to target extra training in response. "I also look at how well we keep up with our re-reviews, not only of customers but of the risk appetite," said Curry, which may draw attention to any bottlenecks in the process.

"Greater transparency in the organisation and more of the right discussions," would be one measure of success, said Beattie, the corollary of "fewer individuals going rogue and making decisions on clients and products or whatever it may be". Faster decisions would be another metric, he said: too often, AML Compliance can become caught up in protracted debate with relationship managers for lack of protocols on how the decision-making process will work. Another index of success, Beattie posited, is how often controls are changed or relationships exited in consequence of the risk processes.

No one throat to choke

Looking to whom in the organisation should take final responsibility for the risk appetite piece, Langford was firm that "[A]t the end of the day, the business owns the risk" but "I see it as hand-in-hand. I don't think the business should be expected on its own to set its own compliance risk appetite but I don't think Compliance on its own should set it and say to the business, let's go."

"There's no one throat to choke on this," said Beattie. "It depends what level you function at." If the aim is to roll out a global policy across lines of business with risk statements and tolerances it has to be done at a C level, led by a CCO (chief compliance officer), and will then translate into different permutations for firms according to how they operate in their respective sectors and geographies, he observed.

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