# The World Has Changed: How You Should Assess Your Risk Appetite

JULY 2021


**AUTHORS:**

**Joe Sergienko**
617.925.4091
jsergienko@thinkbrg.com

**Joshua Romano**
202.559.2180
jromano@thinkbrg.com


INTELLIGENCE THAT WORKS

BRG

# Introduction

In the last twelve to twenty-four months, an increase in innovation has led financial institutions to new, exciting business ventures—including cryptocurrency, financial technology ( fintech), sports and casino gambling, and cannabis—that present potentially lucrative sources of revenue. However, although these opportunities may allow financial institutions to increase their profitability quickly through new products, services, and offerings, each endeavor brings risks and challenges that most banks have not experienced previously.

Consider for a moment how these innovations align against the Office of the Comptroller of the Currency's eight categories of risk. These new areas increase a financial institution's overall risk exposure (see table 1):

**Table 1. Innovations vs. Key Risks**

| | | Risk Type | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| # | Innovation | Credit | Interest Rate | Liquidity | Price | Operational | Compliance | Strategic | Reputation |
| 1 | Cryptocurrency | X | X | X | X | X | X | X | X |
| 2 | Fintechs | X | X | X | X | X | X | X | X |
| 3 | Sports and Casino Gambling | | | X | | X | X | X | X |
| 4 | Cannabis | X | | X | | X | X | X | X |

To complicate matters, these businesses are relatively new, so historical performance and risk data is largely unavailable. This minimizes banks' abilities to determine how these strategic initiatives align with their willingness to accept risk. As each of these businesses continues to grow and the pandemic appears to be winding down, there has never been a more appropriate time for financial institutions to modify the way in which they think about and manage their risk appetite.

## Refining Your Approach to Identifying and Measuring Risk Appetite

Banks typically define and monitor their risk appetite based on the level of risk they are willing to accept in pursuit of their strategic objectives, often using historical data and experience to quantify the definition of risk appetite measures. However, the pandemic has shown us that the past can by no means predict the future, and banks need to be more forward-looking, beginning with refinement of their risk appetite statements, thresholds, and key risk types. For example, when you consider the sudden demand for cash from consumers and businesses and the volatility of the market caused by the uncertainties of the pandemic, financial institutions have a new appreciation for how they should think about what could trigger a liquidity risk exposure and how they should manage liquidity risk.

While the industry has never been more competitive in terms of attracting new and retaining existing customers, banks must keep in mind how new strategic undertakings align with their acceptance of risk-taking activities. Truly understanding the implications of exploring in these areas is not only an expectation of banks from a regulatory perspective, but also crucial in terms of successfully carrying out activities in one or more of these (and other) new businesses. This includes recognizing the impact on both existing and new risks, such as conduct risk, that a bank otherwise may not have considered a major risk type.

*It is important for banks to right-size their refined risk appetite such that it reflects how aggressive or conservative they are willing to be in pursuit of these businesses*

Last, it is important for banks to right-size their refined risk appetite such that it reflects how aggressive or conservative they are willing to be in pursuit of these businesses. By doing so, banks are better positioned to determine the steps necessary to achieve their strategic objectives and the pace at which those steps can and should be carried out. When you pair the challenges noted above with the complexities of these new opportunities, determining what level of risk is acceptable is critical to successfully achieving these new goals.

## New Business Ventures: Benefits vs. Risks

Each new business mentioned above presents unique challenges that financial institutions must consider as they contemplate if and how they will partake in one or more of the opportunities. The table below provides an overview and some benefits and risks that coincide with each business type:

| Table 2. Benefits and Risks for Innovation | | | | |
|---|---|---|---|---|
| # | Innovation | Overview | Benefits | Major Risks |
| 1 | Cryptocurrency | Virtual currency/digital assets are perhaps the most intriguing new offering that financial institutions are continuing to explore. Cryptocurrency provides customers with benefits and opportunities to become wealthy much more quickly than traditional banking products and services. | The business of cryptocurrency banking is a great way to attract new customers to bank with your institution. In a world that is increasingly driven by technology, this offering is at the banking forefront of technological advances, with the potential for quick, large payouts in a volatile market. | Most experts in the financial services industry would consider this the riskiest, most complex item on this list. As such, the Basel Committee for Banking Supervision (BCBS) recently published a consultative paper[1] entitled Prudential treatment of cryptoasset exposures, which states the following with regard to risks in this space: "Certain cryptoassets have exhibited a high degree of volatility, and could present risks for banks as exposures increase, including liquidity risk; credit risk; market risk; operational risk (including fraud and cyber risks); money laundering / terrorist financing risk; and legal and reputation risks." |
| 2a | Fintechs (partners) | Financial institutions are increasingly partnering with fintech companies to offer new products and services to customers. | Through fintech partnerships, financial institutions are better positioned to provide their customers with offerings that otherwise would be unavailable or take years to develop. | Both types of relationships with fintechs expose financial institutions to significantly greater third-party and operational risks. Other various risk exposures also increase depending on the types of offerings and services the fintech specializes in. |
| 2b | Fintechs (service providers) | In addition to partnering with fintechs to benefit their customers, financial institutions also hire fintechs as service providers focused on process efficiencies and technological advances. | Fintechs often provide services at a cheaper price and at a faster pace than if a bank were to try and perform the service on its own. | |
| 3 | Sports and Casino Gambling | Mobile sports and casino gambling applications continue to become legal in states across the country. As such, financial institutions must decide if they will permit digital gambling transactions. | This growing business gives financial institutions an opportunity to partner with various applications that both satisfy a new customer need and provide a new stream of transaction fees. | Supporting this new business by allowing digital gambling transactions on their network exposes financial institutions to new Bank Secrecy Act (BSA)/anti-money laundering (AML) risks, as well as regulatory compliance risk as federal agencies continue to evolve the ways in which activities related to this business are regulated. |
| 4 | Cannabis | Earlier this year, the US House of Representatives passed the SAFE Banking Act of 2021[2] which "generally prohibits a federal banking regulator from penalizing a depository institution for providing banking services to a legitimate cannabis-related business." | A business once considered a criminal activity now gives financial institutions the option to provide banking. | Similar to the sports and casino gambling business, the cannabis business exposes financial institutions to new BSA/AML and regulatory compliance risks. Additionally, given the cannabis business's heavy reliance on cash-run operations, it can expose financial institutions to liquidity risk. |

1 Basel Committee on Banking Supervision, *Prudential treatment of cryptoasset exposures*, consultative document (June 2021), available at: https://www.bis.org/bcbs/publ/d519.pdf
2 Congress.gov, H.R.1996 - SAFE Banking Act of 2021 (April 19, 2021), available at: https://www.congress.gov/bill/117th-congress/house-bill/1996

## Conclusion

Regardless of a financial institution deciding to offer one or more of these services, the financial services industry is as competitive as it has ever been, and banks are constantly exploring new opportunities to contend in the marketplace. While these exciting opportunities have the potential to be very rewarding in both the short and long terms, it is critical that financial institutions first evaluate what impact engaging in one or more of these business activities could have on their risk profiles.

The pandemic has caused challenging circumstances since early 2020; banks should take those difficult experiences and use them to their advantage, particularly with regard to how they think about managing their risks. Traditional banking products and services are no longer adequate to be competitive in the marketplace; neither is the traditional approach to managing risk based on historical experiences.

## How BRG Can Help

BRG's Financial Institution Advisory practice is composed of risk and compliance subject-matter experts who are prepared to support banks in this space in a variety of ways, including:

- Enhance/refine and quantify risk appetite statements and measures
- Develop forward-looking risk appetite metrics
- Evaluate potential impact of prospective business on bank's major risk categories
- Perform gap assessment of bank's current practices against regulatory requirements of prospective business
- Produce regulatory requirement inventory of prospective business
- Provide advisory services on benefits versus risks of prospective business
- Establish and implement a product risk-assessment process
- Develop and document a product approval process


## About BRG

Berkeley Research Group, LLC (BRG) is a global consulting firm that helps leading organizations advance in three key areas: disputes and investigations, corporate finance, and performance improvement and advisory. Headquartered in California with offices around the world, we are an integrated group of experts, industry leaders, academics, data scientists, and professionals working beyond borders and disciplines. We harness our collective expertise to deliver the inspired insights and practical strategies our clients need to stay ahead of what's next. Visit thinkbrg.com for more information.

**THINKBRG.COM**