Enterprise Risk Management: Pivotal to Surviving and Thriving in a Year of Uncertainty

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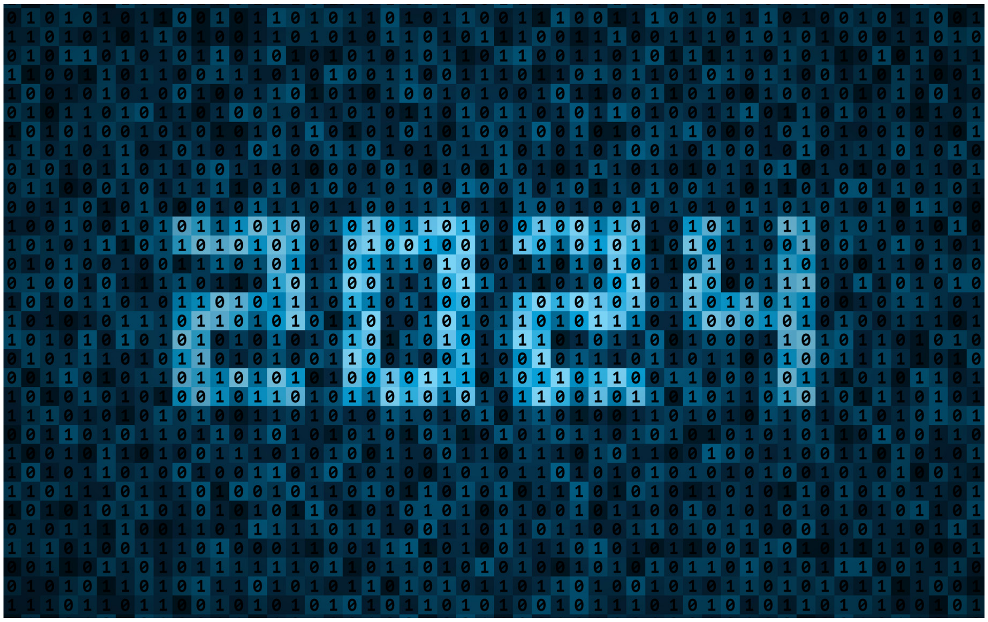

Bank management and risk leaders faced daunting prospects navigating 2023 as two years of increasing interest rates and inflation caught up with them. The resulting liquidity, capital and credit stresses were further compounded by heightened regulatory expectations across the financial services landscape. In 2024, they worry that the lagging effects of 2023 could carry over with increasing credit risk and other threats to earnings. Meanwhile, the economic environment was expected to remain volatile, giving rise to more and unpredictable business risks.

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All of this means that CROs and their teams now need to prepare for multiple scenarios within a reinforced enterprise risk management (ERM) strategy. We expect 2024 to be a year that separates winners from losers, where strong risk management can be a deciding factor. Those banks that are well-fortified against risks and regulatory issues will be in the best position to seek strategic growth opportunities as a new period of industry consolidation emerges.

Risk Surged in 2023

Today's higher interest rates can make loans more profitable for lenders, but they can also be bad for financial services businesses as they drive inflation, deter borrowers, increase the cost of funding deposits, make borrowing more expensive, and impair investment security portfolio.

Pressures such as these ultimately led to high-profile bank failures in the first half of 2023. These failures, in turn, created additional stress as many depositors fled regional and smaller banks to the perceived safety of bigger banks. They also caused regulators to refocus and tighten their oversight of matters such as liquidity and capital management.

By mid-year, credit risks were rising in consumer lending, especially with increased delinquencies in credit cards and auto loans. Many observers considered these developments to be a precursor to growing risk in residential mortgage lending, as well. Moreover, the commercial real estate (CRE) market was already showing weakness due to issues such as low post-pandemic occupancy rates in office buildings and rising funding costs, particularly in maturing credits.

Risk Uncertainty in 2024

With interest rates now expected to plateau near year-end 2023 levels, opinions remain mixed about whether the coming year will bring a soft or hard landing, with all the recessionary implications of the latter riding on the outcome. Meanwhile, other new stresses are already apparent, including:

- Many of regulators' new guidelines, proposals, and final rules in the wake of the bank failures of 2023 are likely taking effect in 2024 in areas covering capital, liquidity, corporate governance, and CRA (to mention a few).
- Many CRE loans are coming due in 2024 and need to be re-underwritten amid considerably different market conditions, raising the risk of default.
- Lagging interest rate impacts such as higher deposit costs and lower borrowing power are posing a growing threat to net interest margins (NIM).

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A theme running through these and other risks in 2024 is uncertainty. Take the question of whether or not there will be a recession, great or small. If the answer proves to be yes, and a recession leads to rising unemployment, the fallout could raise both consumer and commercial credit risks as both groups struggle in a shrinking economy.

Amid such market stress, banks with weaker financial and risk profiles could well face a difficult choice, possibly needing to shrink, consider selling, or face regulatory enforcement. The corollary is that stronger companies with robust ERM programs will have more opportunities to grow and pursue acquisitions.

How to Manage Risk through Uncertainty in 2024

Risk professionals, bank executives, and boards of directors will need to focus on five risk management essentials this year:

1. Credit Risk Management

Banks need to be very proactive with credit risk reviews at the individual loan and portfolio levels; credit portfolio analysis (including data analytics, risk modeling, and stress testing across the entire credit book to identify gaps and other issues); and proactive individual credit risk management to address identified issues by restructuring, loan workout, or sale. Problems can be exacerbated in these areas by banks' current difficulties hiring skilled loan review and workout staff.

2. Liquidity and Interest Rate Risk Management

Risk officers need to enhance their models, policies, and processes for liquidity and interest rate risk management to incorporate lessons learned from the bank failures of 2023. High interest rates, pressure on NIM, and a potential economic downcycle this year provide three strong motivations to stand prepared to meet short-term financial obligations under stress. A fourth is regulators' redoubled focus on liquidity. Modeling should be subjected to strong second-line challenge and stress testing; that also goes for contingency funding plans.

3. Capital Management

Related, but broader, is the mandate to closely manage capital relative to business strategies and risk profile. Here, too, models, policies, and processes need strengthening to ensure sufficient resources to absorb losses, maintain operations, and meet regulatory requirements—whether by diversifying assets, raising capital, or taking other steps to maintain financial stability and flexibility. Regulators are placing special emphasis on capital management planning and stress testing.

4. Enterprise Risk Management

Broadening even further, ERM needs to cover the spectrum of regulatory risks with more assiduous work on the identification, reporting, and rapid remediation of compliance issues by the risk management team in the second line of defense.

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2024 priorities enumerated in the Office of the Comptroller of the Currency's recent "Bank Supervision Operating Plan" range from some of the issues detailed above to consumer compliance, cybersecurity, financial crime, and climate-related financial risk, among others.

A good indicator of across-the-board elevation of regulatory risk is seen in the handling of matters requiring attention (MRAs). Regulators are issuing increasing numbers of MRAs for regulatory weaknesses and giving banks less time to address them. In 2024, deficiencies will have to be addressed promptly and fully—preferably after being self-identified. Otherwise, enforcement actions such as informal MOUs or formal consent orders could prevent a bank from pursuing strategic goals such as acquisitions.

5. Strategic Risk and Planning

With the stresses and failures of 2023 as prelude, 2024 should also be dedicated to strategic risk assessment and planning. This requires bank executives to take a hard look at the sum of their bank's credit portfolio, capital management, liquidity risk, and other focus areas above—and then consider the best future path. If the firm's overall financial and risk profile is strong, the answer could be growth through acquisition. If it's weak, the conclusion could be to retrench or sell. Either strategy requires strong risk management groundwork to succeed.

For example, a bank looking to grow through M&A should not only meet the highest industry and regulatory standards for its current size—but also prepare to meet best practices for its post-merger scale and scope. Regulators will expect this forward-leaning planning. For instance, a bank's posture under the Community Reinvestment Act or Bank Secrecy Act must be Satisfactory and lean toward Outstanding, or risk regulatory blockage of its merger proposal. This can happen—and recently has—leaving both banks involved in the deal devastated after lengthy, public planning.

Financial institutions need to prepare strategies for managing various scenarios through 2024.

The Takeaway

2023 has been a pressure cooker for bank risk professionals, and there's little release in the outlook for 2024. But much simply remains unpredictable in today's uncertain business environment, and so financial institutions need to prepare strategies for managing various scenarios through this cycle. And they need to remember that opportunity is often born of adversity. The stronger a bank's financial and risk profile, the better prepared it will be to grow and consider acquisition, in a year that could separate winners from losers in the financial services industry.

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- Financial Crimes in 2024: Expect More Threats, Oversight, and Technology for Good and Bad
- Banking and Capital Market Regulators' 2024 Agenda: Faster Settlements, More Centralized Clearing, Bigger Buffers

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