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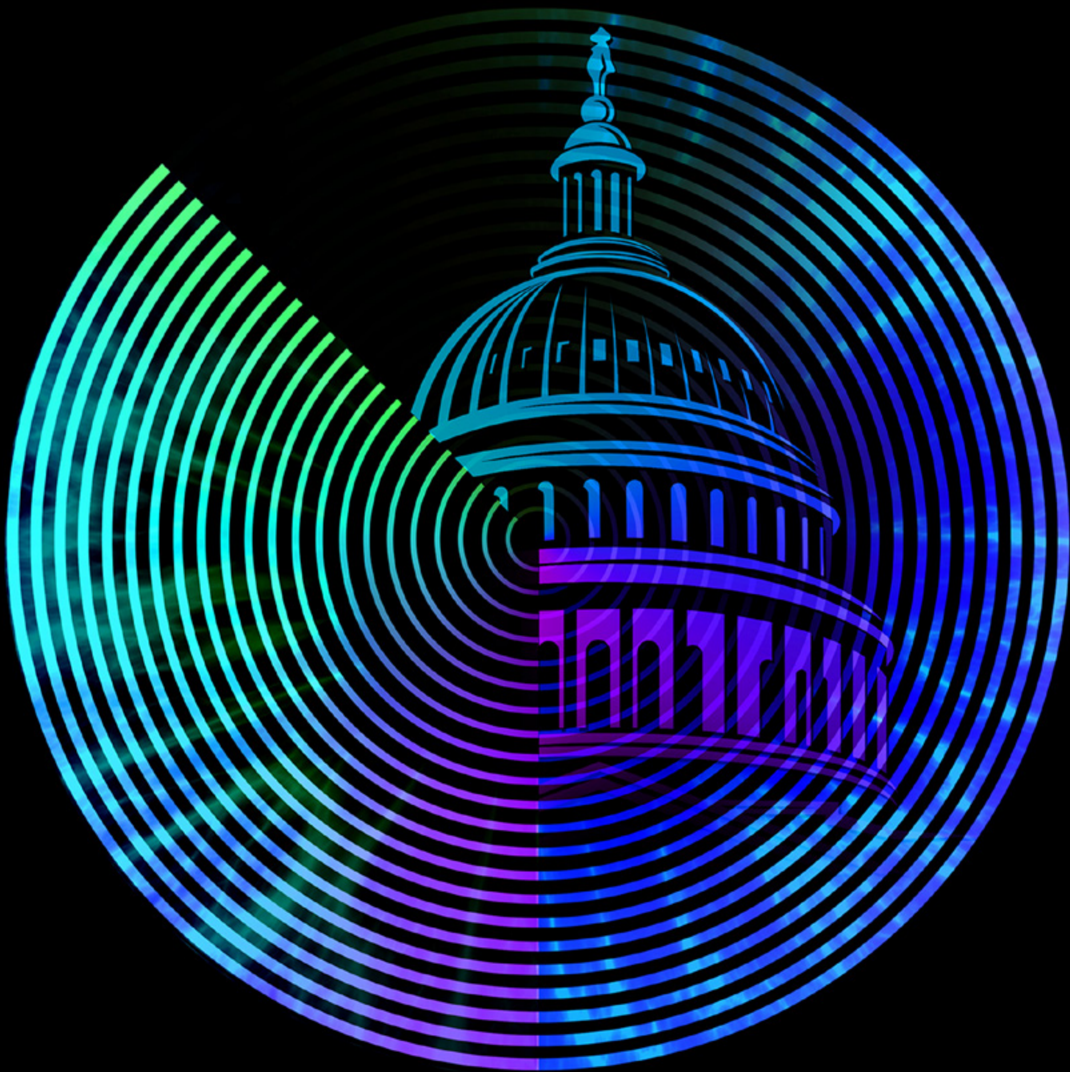


Transforming compliance risk metrics

February 2023

Developing actionable insights to proactively measure compliance risk

Many financial services institutions are redesigning their existing set of compliance risk metrics to measure their risk and control environment more effectively.

Overview

Compliance risk is a key component of financial services institutions' nonfinancial risk frameworks. Over the past few years, many financial services institutions have made significant investments in their risk and control programs to develop robust compliance risk management programs. However, measuring the effectiveness of these compliance programs has been challenging due to a variety of factors, including:

- ***Heightened regulatory expectations across jurisdictions:*** There continues to be heightened regulatory expectations on the designing, measuring, and monitoring of compliance programs, their effectiveness and other related emerging risks. As part of these expectations, many firms are reevaluating their compliance risk metrics framework to assess coverage of their regulatory obligations and demonstrate effective risk management through these metrics.

- ***Limited leading indicators:*** Traditionally, metrics have focused on lagging indicators of compliance risk that do not enable proactive risk mitigation decisions. Many firms are now actively looking to improve their library of leading (forward-looking) indicators as part of overhauling their metrics framework.

- ***Excessive reliance on subjective assessments of risk:*** The subjectivity of risk assessments leads to inconsistent measurement of risks across various business and functional areas of the firm. This is further exacerbated by ineffective or poorly designed thresholds to measure heightened risk exposure of material compliance risk breaches.

Components of metrics framework design

While each firm may be in a different phase of their metrics redesign journey, there are a few key components to consider:

- ***Engaging a cross-section of stakeholders:*** Many firms think of compliance metrics as the primary responsibility of the compliance function. However, designing and operationalizing these metrics also requires active participation from first-line stakeholders, technology teams, and other second-line stakeholders.

- ***Redefining the metrics framework:*** An enhanced metrics inventory is at the core of a compliance risk management framework. The metrics inventory should focus on the key risk areas for the firm, have clearly defined ownership for each metric along with well-defined breach thresholds.

- ***Tech-enabled operationalization:*** Engaging technology teams throughout the process helps facilitate clear communication around the operationalization of the metrics. Technology-enabled dashboards and reporting helps management have a better view of the risk profile and make more informed and data-driven decisions.

- ***Sustainability of design:*** As the risk and control environment is dynamic and continues to evolve, it is imperative that the metrics framework keeps pace with these enhancements. There should be a documented process to make periodic updates to the framework based on material changes to the risk and regulatory environment.

Building an enhanced metrics inventory

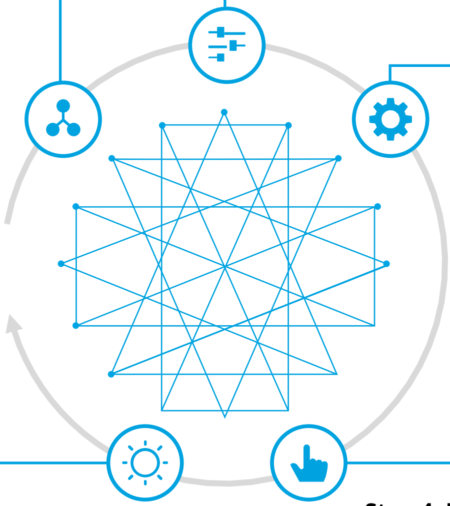
Once a firm is committed to improving its compliance risk metrics, there should be a well-defined and repeatable metrics design process.

Step 1: Metric composition across levels
The alignment of compliance risk metrics to a firm's risk taxonomy along with business and function hierarchy is an important step in building a proper foundation for a compliance risk metrics inventory. This alignment can help drive top-down and horizontal consistency in measuring risk. Further, metrics are typically developed across multiple levels, including:

- **Enterprise or program level:** Top-level metrics that are used to enable senior management to have a holistic view of certain key risks that are common across the firm.
- **Risk category:** Metrics aligned to various risk categories under the broader compliance risk taxonomy used by the firm.
- **Business or function:** Metrics used to measure risk that is specific to a group, s uch as retail banking, insurance, real estate, investment banking, finance, legal, and so forth.

Step 2: Predictive metrics
Identifying the early warning signs of compliance risk is key to reducing known risks, making informed decisions, and identifying new and/or emerging risks.

Developing leading metrics can produce more accurate risk measurement that helps reduce regulatory risk exposure and creates a more holistic view of measuring and identify trends. Leading metrics are increasingly seen as more important across the industry.



Step 3: Firm-specific factors
Firms should consider firm-specific risk factors such as regulatory actions, high-risk activities, and internal issues when building an enhanced metrics inventory. Based on the size and complexity of a firm's operations, there are several factors that should be taken into consideration (e.g., sanctions and high-risk industries and jurisdictions).

Step 4: Industry-leading practices
Metrics should also be informed by leading industry practices. This involves comparing key risk themes, metric coverage, and thresholds to peer institutions. Given that regulatory guidance has largely been principles-based, alignment to how peers are defining specific risk measurement rules is a helpful exercise for most financial services institutions. Firms will typically prioritize the highest risk laws and regulations to inform a risk-based approach.

Step 5: Thresholds
Thresholds are typically defined at the enterprise level and cascaded down to the lower-level businesses (top-down). Once a metric is defined, historical metric data is gathered and used to calibrate a threshold (i.e., peak, trough, and average values). These values are considered in relation to the risk appetite and management's discretion.

External benchmarking exercises also provide inputs to acceptable thresholds. Thresholds are typically calibrated on an annual basis; however, certain events (i.e., risk appetite breaches or an increase in residual risk indicated by the Risk Control Self-Assessment (RCSA) process) could trigger more frequent threshold calibrations.

Many firms have started their journey to evolve the compliance risk metrics framework. While most firms will benefit from alignment with practices used by their peers, the risk framework requires a significant amount of customization based on firm-specific risk and control factors. Despite those differences, there are key components and leading practices for risk metric identification that should be applied universally. During operationalization, design principles should be consistently adopted across the firm to enable standardization across reporting.

A strong metrics framework can help inform management about the effectiveness of various other compliance programs and processes. This could include informing the compliance risk assessments, identifying areas for additional monitoring and testing, and better understanding the firm's alignment to its compliance risk appetite.

A self-assessment of current capabilities can help firms understand and plan their next steps to an enhanced risk metrics framework.

Contact us

For more information about how Deloitte can help your firm redefine the compliance risk metrics framework, please visit www.deloitte.com or contact:

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