Whitepaper on risk scoring in the financial services industry

Five reasons why Financial Services organisations need to be scoring their risk

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In March 2021 the Basel Committee on Banking Supervision (BCBS), an international committee formed to develop standards for banking regulation, made revisions to its Principles for the Sound Management of Operational Risk.

The Principles were first introduced in 2003 and were revised in 2011 to incorporate the many lessons learnt from the global Financial Crisis of 2007-2009.

A review of the Basel Principles in 2014 identified that several had not been adequately implemented and that further guidance would be needed on these.

Significantly, these included risk identification and assessment tools, such as risk and control self-assessments (RCSAs) and key risk indicators.

Enter the 2021 Principles which state that, "Sound risk management allows the bank to better understand and mitigate its risk profile. Risk management encompasses identifying risks to the bank [and] **measuring** and **assessing** exposures to those risks (where possible)..."

Now a spotlight has been shone on the importance of being able to recognise and **quantify** the extent of risk for financial services organisations globally.

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What is quantification of risk?

Quantification of risk is a process to evaluate the amount of risk within an organisation.

It is being able to calculate the degree of potential dangers and threats and gauge the impact that these could potentially be having on the organisation. It also provides a reference point so organisations can track changes and progress over time.

Only once you evaluate risks into a **measurable quantity** can you make decisions on what to do with the risks as part of your risk control strategy.

The objective of quantification is also to establish a way of arranging the risks in order of importance. In most projects there will not be enough time or money to take action against every risk that is identified.

Non-Financial Risk (NFR) becoming increasingly regulated

For financial services, financial risk management, and the quantifying of financial risk, has been well catered for over the past few years using a variety of sophisticated risk models and technology.

Financial institutions plan and prepare for these types of risks, such as credit risk and liquidity risk. However, **operational risks** are those which are not covered by these traditional financial risk management processes, and include cyber risk, conduct risk, privacy risk or external unknown risks, such as a global pandemic.

It also, notably, includes **compliance risk** (which, some might argue, is easier to control and manage than a global pandemic.) Compliance risk is an organisation's exposure to legal and financial penalties for failing to adhere to a rule, regulation, law, code of conduct or standards of practice.

Financial services are increasingly regulated which is resulting in growing pressure on them to better manage and quantify their NFR.

One vast source of non-financial risk is unstructured data. This type of information makes up around 80% of an organisation's data estate. Every email sent, Word document created, or recorded telephone call saved, makes up the ever-growing mountain of unstructured information.

The 2018 General Data Protection Regulation (GDPR) is just one new regulation which has affected business operations greatly, shaping how financial institutions have had to ensure privacy as a strategy and propelling data management and privacy into the boardroom.

This trend of growing privacy-related regulations is believed to be at its starting point and for those organisations that operate across multiple jurisdictions, the complexities associated with managing these obligations is only likely to become more of a significant burden over time.

What are the risks within unstuctured data?

Traditionally, financial institutions have shied away from analysing unstructured data, for many perceived reasons which include:

- **The unstructured information is spread across, and siloed in too many disparate sources**
- **It is complicated to analyse**
- **It is costly to analyse**
- **Storage is cheap so there is a tendency to 'keep everything forever'**

But risks within unstructured data are prevalent. Take payment card information, for instance. Raw PCI information may have been extracted from structured systems to be utilised in spreadsheets and reports, to facilitate users doing their day-to-day jobs. [In fact, across the many organisations hivera has worked with, we are yet to find somewhere that this hasn't been a significant risk.]

The raw information within structured sources is secure and encrypted so even if the system is breached, it is highly unlikely you will lose this data. The challenge with the information which has been copied into spreadsheets and reports is that is it not encrypted or controlled in the same manner.

Organisations know the risk exists, but they don't know where it is, what to do about it, or business priorities have traditionally been centred on customers and commercial benefit.

Or even worse, unstructured data has been disregarded, because once you know it exists, you have to solve it. Much like the trip hazard for the Health & Safety Officer.

Why should organisations score the risk within unstructured data?

Now that organisations know that unstructured data risk exists and they need to do something about it, the question remains, "why quantify it?" Why do organisations need a scoring metric?

There are five significant reasons why scoring risk will aid organisations extensively.

I. To easily and simply understand the extent and impact of the risk
If you cannot quantify the risks, you cannot prioritise and solve them. Without looking at the entirety of data (including the 80% of unstructured information), it is impossible to understand the current state of play in your organisation. Giving organisations the ability to measure risk lets them appreciate where they are on a scale and gives them the understanding if, and where, they need to take action of the back of it.

It also lets the information specialists in organisations easily provide detail to management and the board that the risk is present and a threat – or the 'evidence bag' to showcase the risk and get business buy-in, so to speak.

We all use metrics to make it simple to understand complicated information, such as our business KPIs, and visualising risk as something as simple as a number makes it easy to determine where you need to improve, or if you are doing the right thing.

Risk scoring is akin to the Richter Scale of compliance, a simple visualisation of the impact the risks are having, critical for forecasting the effect of damage.

2. To benchmark risk to see how you compare with industry standards and regulations
While risk scoring lets you visualise the level of risk, it is important to understand this in context. Being able to see a risk score against industry standards is an uncomplicated way to determine how you compare to your competitors and where you need to be in terms of the regulations with which you are required to meet.

If a risk score determines that, by comparison, other organisations are managing customer and card data more effectively, a risk score is the empirical measurement of where you are versus where you need to be.

3. To decide what to do with the risk and where to prioritise
Once you quantify risk, you can proactively manage it and put in place measures to remove it. Risk management is based around four actions – avoid, mitigate, transfer and accept- but without being able to visualise your risk, it is difficult to know which of these actions to prioritise.

The goal of any risk management is to reduce the risk exposure, so that will require knowing where to remediate dangers. Risk scoring, therefore, provides the basis and understanding for actionable intent.

4. To be able to see risk control trends over time
Once risk control measures are in place, organisations need to be able to see how the measures are affecting risk exposure. It goes without saying a goal for organisations is to see every risk on a downward trend, and this can be tracked over time. Visualising an improving risk score offers a simple way to establish that the organisation is managing risk effectively. A continued reduction can also aid organisations to manage how they ruminate their capital adequacy requirements as less risk can aid understanding of how much capital is required in relation to current liabilities.

5. To be able to demonstrate compliance
In an increasing regulated environment, it is important to show that you are striving towards compliance. An improving risk score is the indication, both internally and externally, that measures are working. Like the aforementioned 'evidence bag', an improving risk score signifies that the risk management approach, strategy and implementation is, and continues to be, effective organisation-wide.

"With the new BCBS guidelines, never has measuring the extent of risk been such an important part of data management. The regulators themselves are on a steep learning curve and we know the output of that is going to land on organisations. If you're not starting to think about KRIs, what you are doing about them and how you even identify what they are, you are on the back foot already, because the regulator is leapfrogging organisations in this respect."

Darren Baldwin, Financial Services Lead, hivera

About the hivera risk score

Quantifying risk is critically important when assessing the threats, challenges and regulations faced daily.

hivera is an industry-leading risk scoring solution that defines the gold standard for data governance and risk quantification within unstructured data for financial services firms.

Using a unique three-tier risk matrix to identify low, medium and high data risk points, hivera maps these accurate insights against information governance policy, regulatory requirements and organisational appetite for risk. These factors, combined, create a risk score metric that is bespoke to your organisation.

Our Team

hivera is a dedicated RegTech platform specifically for the Financial Services sector. With hivera, financial organisations can bring visibility to the regulatory risk in their unstructured data, automate their information governance strategy to regulatory standards, and demonstrate quantifiable regulatory compliance to auditors.

To speak to a member of our team about how a risk score could be implemented as part of your risk management strategy, contact us today via the below methods:

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