WHITE PAPER

Managing the Risk of Regulatory Change: Four Tires, Three Drivers and a Sophisticated Engine

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In the past year, the industry continued to experience unprecedented fines, examination pressure, heightened expectations from the regulators coupled with cyber-attacks and uncertain consumer confidence. How does an organization not only survive, but also prosper in this environment? With an effective change management system grounded in a strong collaborative relationship between operational and compliance risk management.

Regulatory and operational risks continue to be at the top of industry surveys as challenges for organizations and cited as failures by regulators. The complexity and number of regulatory changes creates additional significant operational risk, while at the same time many organizations continue to report that a lack of internal resources hinders their progress; and studies highlight that people are the greatest challenge to implementing change.

With all aspects of an organization's processes seemingly impacted by uncontrollable aspects, how should one manage the daily operations and the regulatory wave that never ends?

Breaking the process into parts

Any regulatory change management program can be broken into four parts: Identification, Assessment, Controls Enhancement, and Control Monitoring.

Identification: First, you need to identify all of the regulations to which you are obligated across all of the jurisdictions where you do business. This may mean different state requirements, or banking vs. securities, but for more and more firms it means adopting a global view. The identification process consists of scanning the horizon and creating a regulatory library—the entire universe of all possible regulations or standards.

Assessment: Once you have the universe, you then need to assess the impact. This entails mapping the regulatory library to operational processes throughout the organization. What of that library is applicable, to whom is it applicable and in what fashion? In this stage, you record the inherent impact and likelihood that the risks will occur in its mapped operational process.

Controls Enhancement: Now that you know the universe that each business process has to manage, you need to work with the business to identify how they are going to meet the requirements—the controls. The business should design controls in a way that compliments their business. The regulators expect the controls will be inventoried in a centralized location which will allow for proper oversight and enterprise-wide analysis to better understand where one key control may mitigate multiple risks across the organization.

Control Monitoring: Ongoing monitoring is necessary to ensure the controls can be sustained and properly mitigate the risk to an acceptable tolerance. Once controls are inventoried then they can be applied to the inherent risk and the residual risk recorded.

Regulatory risk: the potential of financial loss or regulatory censure due to inability to respond appropriately to changing laws, regulations and codes of conduct. Regulatory risk is one way in which operational risk can arise.

Operational risk: the risk of loss resulting from inadequate or failed internal processes, people and systems or external events. These risks are not revenue driven but are integral parts to whether an institution is successful at keeping customer loyalty and sustaining financial growth.

Who's on First?

Once you have created the universe and assessed the risks and controls, you are now ready to manage the performance of that structure through the three lines of defense.

While there is some difference in the OCC and Basel II definitions of the three lines of defense, generally the three lines work together as follows:

The **First Line** has the job to do the right thing. They make sure that the daily processes are in place and that controls are functioning as expected. They monitor the performance of the controls to ensure everything is done according to standards and losses are not incurred.

The **Second Line** defines the right thing. They are scanning the horizon, keeping the database of relevant requirements and ensuring the information is effectively communicated. The Second Line independently monitors business controls to ensure compliance with the stated standards.

The **Third Line** provides independent review of both the First and Second lines. How well is the First Line performing against the guidance provided by the Second Line; and how well is the Second Line providing proper governance and oversight? While the Third Line will obtain information from the First and Second lines, they will create an independent assessment of the risks to the business and how well the processes and controls are mitigating the risks.

The three lines of defense working in harmony is good business sense. The First Line knows a lot about the business and a little about regulations, while the Second Line knows a lot about the regulatory environment and a little about the business. Then the Third Line looks at the operation as a whole to confirm the organization's stated objectives are being met in accordance with the agreed upon standards.

When compliance is looked at through this lens it is easy to see how compliance risk management fits into the Basel II operational risk framework. Philippa Girling describes the risk framework in her recent book *Operational Risk Framework: A Complete Guide to a Successful Operational Risk Framework* (Wiley, October 2013). The risk management framework is supported by two pillars: Governance and Risk Appetite. Good governance ensures that risks that are outside of the firm's appetite are appropriately escalated and mitigated. Culture

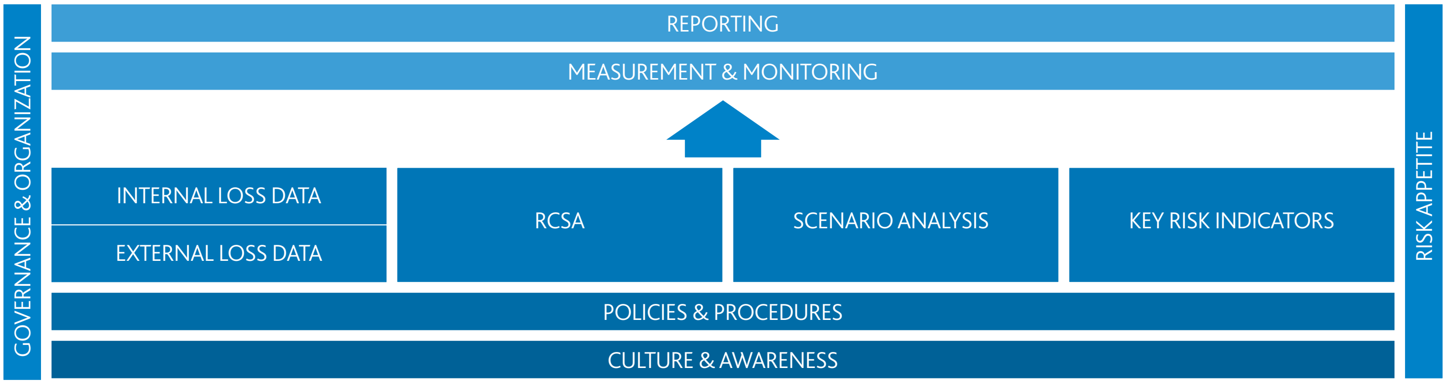

Figure 1: An effective risk management framework (from Operational Risk Management, Girling (2013))

and awareness form the bedrock of good risk management and are key to the successful management of regulatory or compliance risk. Policies and procedures provide the "how to" structure and then the real work commences. The work of risk management includes learning from past mistakes (Loss Data), assessing current risk (RCSA and Scenario Analysis) and monitoring changes in risk levels (KRIs). This structure is continually monitored and measured and the results reported upward to drive risk informed business decisions.

The Key to Staying on Track

Now the structure is defined, documented, built and the wheels of success are turning, only to run into a wave of regulatory change. Some might say, "There is so much I don't even know where to start." Stay flexible. Organizations that foster a top down culture of risk management will absorb change easier. Many companies that suffer needlessly when regulations change are those that cannot easily accommodate that change within their operational or management structure.

The purpose of the operational risk framework is to identify dangers and help the business to navigate around them so they can achieve their strategy. Being proactive is important in the identification stage. If a new regulation is on the horizon, don't wait to see how it will play out. Absorb the change into your governance structure and step through the risks that arise and changes that will need to occur.

Proactive organizations will often involve their regulator in the process. They will obtain feedback on the implementation plan and even implement the regulatory changes before the "go live" date, giving them plenty of time to analyze and adjust before the mandated effective date. Projecting the possible impact will let you know ahead of time how it will affect staffing, systems, processes, customers, revenue and income. Unmitigated risk implies a worst-case scenario and being prepared for the worst will help navigate the unknown and potentially stormy waters of change.

Industry experts predict this volatile regulatory environment will continue for the next several years. Organizations have shown, in light of the weak economic environment, this is not a problem they can afford or are willing to throw bodies at to handle in a "manual" manner. Everyone is being asked to do more with less. Therefore, forward looking approaches that incorporate sustainable and scalable technology solutions will allow proactive firms to rise to the top with competitive advantages.

Technology is used to create the discipline you expect—having one source of truth from regulatory change notification to proving compliance provides transparency to regulators and executive management as to the effectiveness of the program.

Reading the Tea Leaves

There must be a continuous, preemptive and systematic process to managing the regulatory change management process cohesively and consistently across the enterprise. Unfortunately, the range and complexity of new regulations, the inability of regulators to provide succinct instructions for compliance, and outdated processes for managing the impact of regulatory change, have made it very difficult to "read the tea leaves" and identify the potential impact of regulatory changes. We continue to see regulators aggressively scrutinize organizations' abilities to answer these three primary questions of compliance:

Question #1	Question #2	Question #3
What are the laws and regulations you are beholden to across all the business lines and jurisdictions in which you operate?	Are you confident you are adhering to all of these obligations in an appropriate manner?	Can you prove adherence to a third party (i.e. regulators, customers, investors, and board members)?

While seemingly simple, even for smaller organizations, these questions can be exceedingly difficult to answer. We see the most successful financial services organizations address these questions through a cohesive regulatory change management process.

End-to-End Regulatory Change Management	Compliance Process Controls	Compliance Testing and Reporting
A regulatory library contextualized to the specific business and product lines, ongoing regulatory change feeds and automated workflow management to ensure all new and amended rules are captured and implemented effectively within the impacted lines of business	Risk assessments, control testing, risk scoring, key performance and risk indicators, and issue tracking integration	Reporting and dashboards, demonstrated continuity of control, integrated story for three lines of defense

You can get a sense of how complex the process can be if you think about the same questions from a personal perspective. When you left your house this morning did you know all of the laws and regulations that pertained to you as defined by your city, county, state and country? If stopped and questioned, could you actually provide proof of your compliance with any one of them? As ridiculous as this example seems, this is exactly the expectation that today's regulators are placing on organizations in financial services.

Now think of spending just 30 – 60 minutes a day focused on regulatory change and then multiply that by the number of people impacted in your organization, the costs of this time can easily add up to millions of dollars that your organization is losing due to inefficiencies in gathering and operationalizing the information. This isn't a brand new problem. Ever since the origins of the internet, you can access a deluge of information easily and quickly, but finding information that is reliable, accurate and actually applies to your business can be challenging.

ACQUIRING CONTENT

ANALYZING THE IMPACT

DISTRIBUTION TO THE BUSINESS

MONITORING & SUPPORTING PROGRESS

VERIFICATION

REPORTING

In order to do this effectively you need an intelligent regulatory change management process. A process becomes intelligent when the content is actionable and the process breeds accountability and transparency.

Getting to an Intelligent Process

Identification: Authoritative source content should be acquired on as real time as practical basis for your firm. For smaller organizations, this is a daily or weekly consolidated email alert that contains the subjects in the jurisdictions related to your business. For larger or more complex firms, this is an automated data feed. In both cases, compare the supplier's inventory of rules and ability to provide you what you need. There is enough change to worry about without the extra headache of getting bombarded with information that is not relevant. In order to eliminate the inefficiencies and redundancies involved in the process, each regulatory change should be classified according to a consistent taxonomy. By classifying the appropriate industry focus, jurisdiction, regulator, impacted regulation, and other information you set the ground for automating your regulatory change process.

Assessment: A solution should promote your taxonomy, the common language used in your organization by all three lines of defense and within each business unit. This common taxonomy is a foundational requirement in order to properly define and assess processes, risks and controls. With this common structure it is easier to analyze the impact of the change across interrelated processes, businesses, and the product and customer lifecycle. The solution should provide the flexibility to designate multiple impact points throughout the institution.

Having this information in a format that is easily consumed by your change management platform allows it to quickly be routed to the right individual in a way that facilitates immediate insight and action.

Routing information is either done manually or via triage rules. The manual review or triage rules first filter for what is irrelevant. When something is irrelevant, mark it as such and forget about it. You want to make sure that the right people in your organization are receiving only the information they need, and, after determining that a change has no impact, are able to quickly move on to more relevant tasks.

Once the irrelevant information is filtered out, the relevant information is quickly distributed to the business based on your defined rules mapping. Rules mapping is a critical construction stage of the regulatory change management program. This map becomes the one source of truth for which regulatory changes make it through the filter and to whom they are routed to for review and assessment—facilitating accountability.

The relevant information that gets assessed and assigned out for action must be prioritized and tracked to mitigate risk to the business. The solution should provide a common workflow that delivers real-time accountability and transparency across the affected business processes.

Control Enhancement and Monitoring: In today's world, particularly if you are managing this via spreadsheets and Word documents, this process often ends up looking like a bowl of spaghetti. Changes come in the door via multiple mediums; individual lines of business take action to implement updates to the processes, create new controls and produce reports to prove it was all done. A manual process may be possible for a small organization or in an environment where changes are infrequent. However, the inefficiencies, lack of true accountability and transparency are adversely highlighted when it comes time to prove your compliance to a board committee, an examiner or other third parties. It can take a lot of time to pull together a cohesive view and there is inevitable risk that inaccuracies make their way into your manual reporting process.

A common taxonomy, workflow and system of record will allow the organization to deal more effectively with change, quickly understand the implications of the change and assess and mitigate risks across the institution. Referring back to the operational risk framework, the—Governance, Culture and Awareness, Policy and Procedures, and Risk Appetite—blocks are big and purposely located as a reminder that the framework within which the process works is fundamental to the stability of the program.

The Light at the End of the Tunnel

As overwhelming as implementing a robust regulatory change management process seems, the long term benefits outweigh the immediate cost. A culture of risk management driven by strong operational and compliance risk management qualities allows the organization to have a living program which is proven by its daily activities and not just by the paper it is written on. To stay ahead of regulatory change and enforcement actions organizations must absorb changes, hug the curve and keep moving forward on the road to success.

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