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Enterprise risk management: A financial services survival kit

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As storied firms collapse and alleged investment fraud exacts billions in losses, it's easy to wonder, "Where was the risk management?" Across the financial services industry, many existing risk management systems did not reflect the risk of new and complex instruments and relied too heavily on improper ratings.



These shortcomings were compounded by management's inattention to risk and regulators' purported lack of understanding of complex derivatives. In some of these situations, risk was indeed recognized, but there was no forum or supportive culture for staff to voice misgivings. Unheeded warnings and unquestioned momentum undermined existing risk mitigation efforts, leading to a perfect financial storm.

Yet some institutions with strong risk management programs have been able to keep their heads above water. What's more, firms with a history of management engagement in the risk management process have not only survived in the current economic environment but, in many cases, are thriving. With a new administration and major changes to the industry's regulatory framework pending, now is the time for financial services firms to rethink their approach to enterprise risk management (ERM). Firms that

emphasize ERM will be better prepared to endure the continuing market volatility and react effectively to increased regulatory, compliance, credit and operational risk.

What is ERM and what can it do for you?

Risk is integral to doing business; in fact, businesses must take risks to succeed. However, the increasing complexity of financial instruments, rising transaction volumes and the huge scale of funds under management heighten risk for the financial services industry. Risks arise due to a variety of interrelated factors — market and economic trends, political and regulatory factors, reliance on complex technology, and the interconnected and global nature of today's financial markets — but often, they are addressed in a vacuum. One team may examine financial risk models, while a separate group manages operational and IT risk, with neither one necessarily comparing notes.

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With its holistic approach, ERM has been viewed as the gold standard of risk management methodologies, helping institutions identify, analyze, manage and monitor risk comprehensively. ERM focuses on the strategic analysis of risk throughout a financial institution, cutting across business units and departments, and taking into account end-to-end processes.

“By focusing on an enterprise-wide risk in a coordinated fashion, institutions are better equipped to prioritize the top risk drivers and are less likely to be distracted by risks that are less important to their strategy,” says Mark Beasley, director of the ERM Initiative at North Carolina State University. This comprehensive approach to risk oversight enables an institution to align its risk appetite with its overall business strategy, deciding how much uncertainty is acceptable and how much could actually add value.

How to start

With the current challenges facing the financial industry, it's easy to dismiss any new process as unnecessary overhead. Yet measures undertaken to comply with regulations like the Sarbanes-Oxley Act largely overlap with ERM. Financial services firms are already deeply involved in discrete risk management programs to comply with the requirements from the SEC and the Financial Industry Regulatory Authority, as well as from state and federal regulators. Expanding the risk universe to include strategic, reputation and operations risk also can add value by making decision-making less dependent on financial factors alone.

When building an ERM process, an institution should:

- Understand its strategic objectives, operations, control environment and inherent risk: What could keep the company from achieving its business objectives? What opportunities will help it achieve its objectives? In what ways might the institution be too conservative about certain risk areas?
- Define the risk universe and risk language, e.g., risk appetite, risk tolerance and risk response (accept, avoid, share, mitigate). Common terms will help categorize risk and in turn, determine actions to address it.
- Develop questions to gauge the current state of risk awareness (i.e., significance, likelihood and impact) through interviews, common risk attributes and industry knowledge. How cognizant is management of the inherent risks of certain types of instruments marketed and traded by various desks? How aware are supervisors, traders and sales personnel of new regulatory requirements? How are broader trends in the market and economy affecting each of the businesses in a diversified banking and securities organization?
- Conduct facilitated sessions to define the risk appetite, finalize the risk categories and rank the top 15 risks.
- Assign risk owners and create an action plan.

Make ERM more effective

If your institution has already set ERM in motion but hasn't seen any benefits, there are numerous ways to make your system more effective. For ERM to work, the board and senior management must work to establish a culture of risk awareness. A supportive ERM culture helps establish a transparent environment where people are willing to express their concerns without fear of retribution. This is not possible without the CEO's active and visible support.

Steps to ERM improvement:

- Integrate strategic planning processes and risk assessment activities and consider risk variations across strategic goals. For example, how does the institution manage credit risk? Does the firm use a cross-functional team to relate credit risk to market volatility, risk-based margin availability, hard-to-value assets, etc.?
- Develop practical risk response action plans and regularly report progress to the board.
- Reward risk ownership and establish effective risk management action plans.
- Risk is not static. Commit resources to periodically refresh the risk universe and risk priorities. Remember that ERM is an ongoing process; it is not a project with an end date.
- Don't overcommit and underdeliver — implement ERM in manageable stages. Establish an executive risk oversight group that regularly reports key risk management information to the board of directors.

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Understandably, financial services firms are pressed for time and resources and are hesitant to focus any attention on non-revenue-producing functions. For many of these firms, ERM can seem to be an overwhelming and far-reaching initiative, one they don't think they have the bandwidth to support.

"The biggest ERM failure in organizations is the fear of starting toward an enterprise-wide approach to risk oversight," says Beasley. "It's hard for business leaders to argue against being more risk aware; however, many are intimidated to begin. The key is to start and to keep it simple, allowing it to evolve over time."

The dos of ERM

- Follow a framework like COSO's *Enterprise Risk Management – Integrated Framework* to keep from getting lost in the details. Take advantage of ERM thought leadership already available to you.
- Engage existing risk management groups within the organization, including the chief risk officer, chief compliance officer and internal audit director. Consider naming a risk champion who understands ERM's importance and can coordinate efforts across the institution's boundaries and the overlapping roles of the executives.

- Anticipate the impact of an extended economic slowdown and broad regulatory changes on the risk profile of your firm. Review other external factors.
- Evaluate current, not just historical, data.

The don'ts of ERM

- Don't underestimate the impact of the institution's existing culture. Ignoring ingrained perspectives and habits can undermine efforts for change.
- Don't undersell ERM as business risk assessment. It's a big-picture way of looking not only at your business, but your industry and the market at large.
- Don't employ ERM as a defensive measure. Knee-jerk reactions to risk do little to advance long-term strategy.

Ultimately, the goal of ERM is not to eliminate risk but to help preserve and enhance value. ERM does this by arming institutions with comprehensive information, and better risk information leads to better decision-making. In a global economy in which events in a seemingly isolated sector can trigger a domino effect, institutions must take a proactive and comprehensive approach to managing risk. ERM provides an institution with the opportunity to be an example, not another cautionary tale. •

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