10 Steps to Enterprise Risk Management

Comprehensive Approach Reveals the Big Picture

The Risk Management Landscape

Risk management is a hot topic in today's banking industry with the OCC, FDIC and other regulators issuing specific guidance for bank directors on risk management. Enterprise risk management (ERM) is often touted as the most effective management approach. While most financial institutions have many of the essential elements of ERM in place, many with less than $1 billion in assets do not have a cohesive ERM program in place. A comprehensive approach can help achieve that objective.

How We Got Here

For most of the 20th century, risk management regulation focused heavily on credit risk, with little attention devoted to operational risk. The savings and loan crisis, the growing importance of the Bank Secrecy Act (BSA), 9/11, the advent of the USA PATRIOT Act and other historic developments changed the risk management picture. Asset-liability committees (ALCO), a refined CAMELS rating system and new consumer protection requirements also became part of the risk management mix.

This gradual recognition of the many factors that comprise a bank's risk profile, and the piecemeal evolution of the examination procedures that resulted, virtually assured the creation of separate risk management silos, particularly within smaller financial institutions. These silos make it difficult for directors and senior management to see and understand the total risk picture.

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The Value of ERM

A comprehensive approach to risk management is important for two reasons. First, risk is cumulative. A bank that exhibits one or two weaknesses in its financial metrics–even critically important metrics–is likely to survive if the problems are diagnosed and addressed early. A bank with three or four significant weaknesses also can be saved, but considerable time and effort may be required. Banks with multiple significant weaknesses have often passed the point of no return. As such, it is important to understand the cumulative effect of weaknesses within a bank's financial metrics and the exponential influence on the risk of bank failure.

Second, ERM is important because it helps management comprehend the true potential threat to the organization. Until now, the siloed approach has worked reasonably well, in part because most banking crises were caused by one or two variables (for example, weak underwriting and an economic downturn). Today, however, the risk war is being fought on many fronts and is complex. ERM practices make it possible to see the big picture.

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The 10-Step Program

To help financial institutions improve their risk management processes and techniques, Fiserv has identified 10 steps that provide a good framework for an ERM program.

Step One: Just Do It

The hardest part of developing an ERM program is recognizing it is needed and taking the first steps.

ERM is a big challenge, and your first attempt will not be perfect. During planning, the risk landscape will likely shift, but through iteration and refinement, you can move closer to your goal. The process of creating an ERM program is valuable in itself, as you will learn much about your financial institution and the interrelatedness of elements within the organization. The knowledge you gain in the first attempt will make it easier to refine the process moving forward.

Document your efforts in your board minutes and share them with examiners and auditors. These third parties are often willing to provide constructive feedback, as they have a vested interest in your success.

Step Two: Secure a Champion

Your board of directors is accountable to shareholders, the FDIC and the SEC (if public) for the adequacy of risk management procedures and controls and, ultimately, for the competence of management. This makes the chairperson of your board audit committee or ERM committee a logical champion of your ERM efforts, followed closely by the chair of the board and other board members. If these individuals understand that the ERM program is designed to help them discharge their duties and protect them from personal financial risk, you will likely obtain top-level buy-in and see a trickle-down effect through senior management as the organization comes to understand and embrace management's duty to help its directors.

Talk with the audit committee and ERM chairperson and explain where you are going and why. Get their endorsement, remembering that they also have a vested personal interest in your success.

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Step Three: Merge Silos

Processes that exist in a siloed risk management environment often work well. For example, credit risk, interest rate/liquidity/ALCO and compliance/BSA committee structures and measurements are, in most cases, well thought out and mature. If those risk committees and subcommittees are functioning as intended and get consistently high marks from regulators and outside auditors, fundamental changes are likely not needed.

What the subcommittees may need, however, is help understanding that they are one part of the big picture. This is where considerable tact and diplomacy are needed; if the effort is seen as a turf battle, it can trigger resistance. A board-level champion can help subcommittee heads understand that they are an important part of a larger whole, and that the ERM committee has jurisdiction in setting the bank-wide aggregate level of acceptable risk.

Step Four: Weight Risks

Certain areas of risk have the potential to seriously harm your financial institution; others are less critical. For example, while some compliance regulations involve a serious reputational risk and the potential for significant sanctions and monetary penalties, others verge on being best practice recommendations.

When assembling the ERM framework, create a logical mechanism for assigning relative weights to each area of risk and to selected components within those areas. The weighting scheme should take the relative consequences of a failure into account. Risk weighting presents an important opportunity to engage the board ERM committee in the risk management oversight process.

"In today's environment where the most dangerous risks are around the corner, risk management is everyone's responsibility."

Step Five: Create Dashboard

When various committees present one piece of the risk management puzzle at a time to board members and senior managers, it is difficult to "connect the dots." A risk management dashboard that contains all major risk elements can eliminate confusion and provide a clearer picture. A risk management dashboard:

- Is a high-level summary supported by drill-down detail
- Should be updated on a regular schedule and whenever significant events occur
- Does not need to be complex

One recommendation is to use your existing ERM or management reporting system for this purpose so the dashboard is simply an extension of existing best practice reporting. Using a single tool to highlight areas of concern or meaningful change to the board each month is likely to satisfy management's obligation to keep the board informed.

Step Six: Understand Risk and Reward

Bankers are paid to measure, quantify and intentionally incur risks to earn a return for their shareholders. Total return is maximized at the theoretical point where the incremental cost of additional risk is exactly equal to the incremental reward of taking that risk. They are not paid to avoid risks altogether. As such, each risk management unit should understand the basic risk-versus-reward proposition and the related mathematics.

Not all risks are created equal. Some risks are worth taking because the reward is greater than the likelihood (and consequences) of failure. Other risks are not worth taking, and still others should not even be considered (for example, when the risk is a bet-the-farm proposition, is illegal or immoral).

Step Seven: Set Limits

How much risk is deemed appropriate will vary from bank to bank and from board to board. The limit a board ERM committee sets depends on many variables, including the capital strength and earning power of the bank, as well as the experience and capacity of the management team. Banks that are strong in all CAMELS areas can afford to take on higher levels of risk (assuming the risk/reward tradeoff is positive) than those that are average or below average in one or more areas.

The board ERM committee should work with management to establish limits to risk taking. Management should first recommend boundaries–supported by reasonable data and arguments–for the bank's risk appetite. Although management's role is to advise and inform the board, the ultimate decision should rest with the board of directors.

Step Eight: Understand Cumulative Nature of Risk

A bank is more likely to fail if the number and magnitude of its shortcomings increases and the cumulative weight of the weaknesses causes regulators to conclude that the public would be safer if the bank ceases to exist. This is an important concept to understand. In setting risk limits, the ERM board should set limits for individual risk metrics and limit the cumulative shortfall.

For example, suppose the ERM board sets an action threshold score of 3.0 and a minimum threshold score of 2.5 for each of eight metrics, which would equate to an aggregate action score of 24.0 and aggregate minimum of 20.0. The action threshold is the level at which management would be required to submit a corrective plan to the ERM board to raise the score above 3.5 and to begin taking action to implement the plan. Recognizing the cumulative nature of risk, the ERM board might choose to set slightly higher limits of 27.0 and 24.0, respectively. In that case, a financial institution that scored 3.2 across the board (25.6 total) would still fail to meet the cumulative threshold. Management would then file and implement a plan for raising the aggregate score, presumably by addressing the most serious weaknesses. In this scenario, the ERM board is taking a global view of risk and avoiding the potential consequences of a siloed manager underestimating potential problems.

Step Nine: Make It Easy

In the areas of setting limits and risk weighting, management should make it as easy as possible for board members to comprehend and actively participate in the process.

Board members are generally astute, busy business people who serve as bank directors in addition to their primary professions. The level of banking knowledge each board member has will vary, which is why it is important to keep presentations simple.

- Use graphics to illustrate a point
- Reduce complex regulations down to their core
- Utilize analogies to explain cause-and-effect relationships
- Use business language rather than banking language

Additionally, management should not try to tackle all risk weighting and risk limits questions at once. If possible, the ERM framework should be implemented over several months. Present two or three small, well-written, well-supported and easy-to-understand recommendations each month to the board. Distribute these far enough in advance so they can be reviewed, summarized, presented and adopted at regular meetings.

Step 10: Refine, Refine, Refine

The implementation of an ERM program is an ongoing process that should be woven into the fabric of the bank. New risks emerge every day, and your process must be flexible enough to identify, quantify and incorporate these risks. The chief risk officer and others in senior management should devote time to researching emerging risks, imagining worst case scenarios and creating stress tests to understand the implications of critical failures.

A Top-to-Bottom Effort

With the risks to your financial institution constantly increasing, it's important that a clear understanding of ERM practices becomes part of your organizational culture. Global awareness of the process and a deep understanding of the board's focus on effective risk management are critical to obtaining the buy-in of the entire organization. In today's environment where the most dangerous risks are around the corner, risk management is everyone's responsibility.

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Fiserv, Inc.
255 Fiserv Drive
Brookfield, WI 53045

800-872-7882
262-879-5322
getsolutions@fiserv.com
www.fiserv.com

411-16-30900-COL 07/16