Libor
the risk lesson

Making Enterprise Risk Management a Reality

Many firms claim to have enterprise risk management frameworks, yet many have had problems with implementation and project effectiveness. In this article we consider the barriers to the implementation of an effective framework, some of the challenges and some of the solutions that should be considered.

Why Enterprise Risk Management Frameworks Fail to Deliver

1. Lack of Senior Management Support

It is hard for Boards and senior managers to actively engage in this process. Many start with good intentions which result in the acquisition of an experienced and potentially effective team. However the Board members themselves have a range of responsibilities many of which fall within their normal levels of knowledge and experience. On the basis that you do not "buy a dog and bark yourself" they increasingly rely on the appointed experts and slowly disengage from the process.

Their lack of knowledge of the area results in their ceasing to conduct the level of review of key elements of the programme that is required which is increasingly perceived as their having limited interest in the ultimate success of the project. Developing an Enterprise Risk Management Framework is a major change project and requires maintenance of momentum and the availability of critical resources. In the absence of evidential key management support it can be hard to identify this as a key project receiving the necessary level of support required for its success from the business.

Of course some Boards do include the necessary skills, but these are not always evident in all firms. The failure to appoint particularly non-executive directors who have real knowledge and experience of risk management has certainly exacerbated this problem. Training for Boards and senior managers combined with the appointment of additional non-executive directors with risk management skills would certainly start the process. Regular reporting on the project from the Board to the business would also assist in ensuring momentum is maintained.

2. The Risk Management Team are Seen as Outsiders

Many of the staff recruited to staff the risk management function will come from outside of the organisation with knowledge of risk management techniques applied in their previous firms. They could be seen as a regulatory imposition by the business that fails to appreciate their value or their role.

Some of the teams are themselves the cause of the problem. They seek to show that they are the experts in the field operating with the business on a "needs to know" basis. They resort to jargon as a form of protection and to attempt to garner respect and develop a mystique. This only serves to exacerbate what is seen as a "them or us" approach.

Some of these teams will have combined experience of one or more approaches. Enterprise
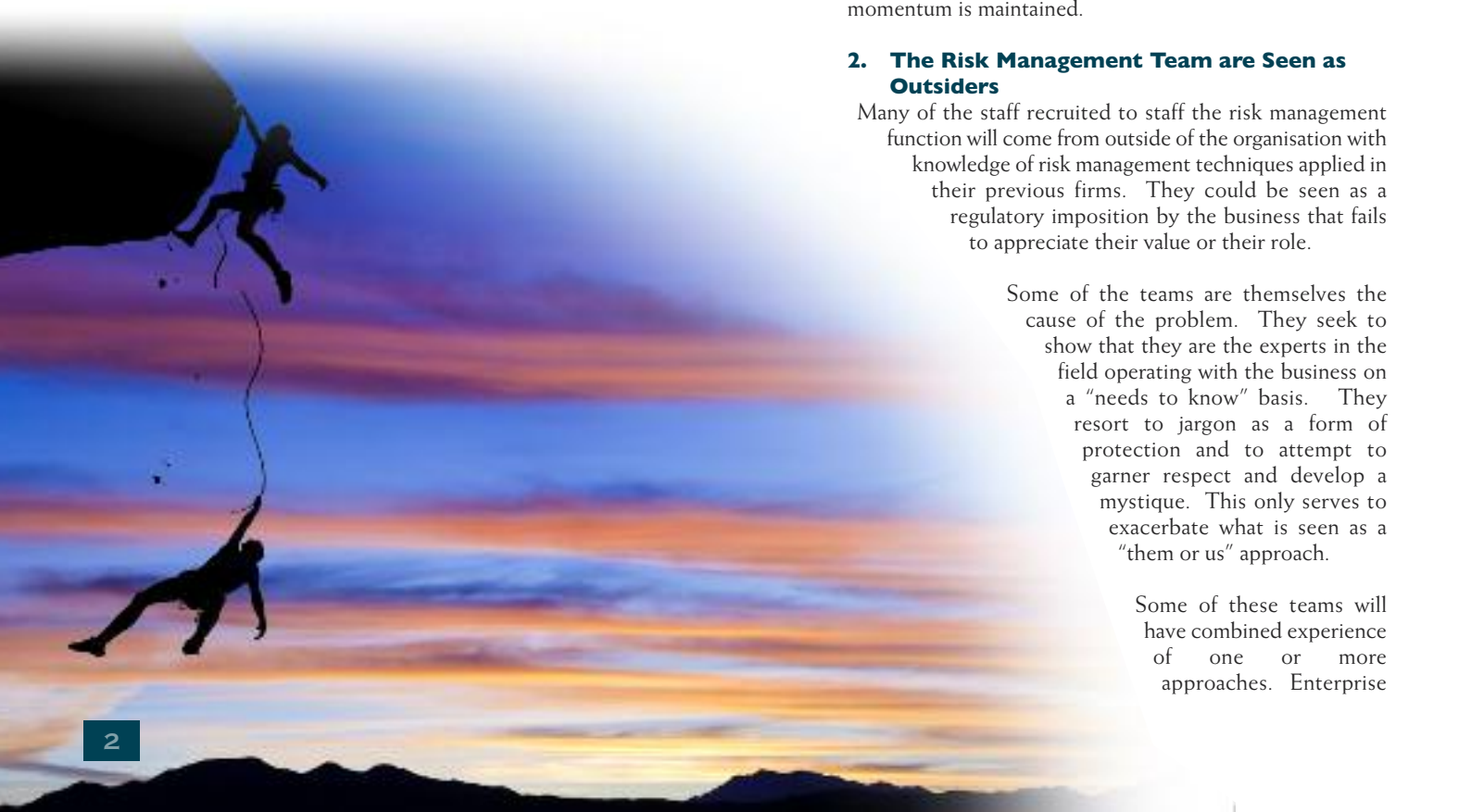
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Risk Management is not new, yet many of the techniques we are currently implementing are often perceived as being new when this is not the case. However the expert hired from outside may bring their previous approaches to your firm when they are not suitable. They could be over complex, more expensive than necessary or totally inappropriate for your type of business. Of course unless the senior management have some form of awareness of what they are looking for then how could they identify that an approach was inappropriate?

To counter this we would expect the Risk Management team to include a number of staff who have been with the firm for a period of time and bring knowledge of "how we do things around here" to the team. This needs to be supplemented by regular reviews of the project by knowledgeable experienced external experts to ensure the project is not going off track.

3. Systems are Acquired to solve a Data Problem

I am sure that we have all seen this issue in practice. A firm knows it has a paucity of data so believes incorrectly that a systems solution will solve the issue. It may be that the risk management team have familiarity and respect for systems that they have used before which are data hungry but potentially effective risk management systems.

The acquisition of such a system actually has the effect of delaying the firm dealing with their real issue which is the data availability. Often the data exists but either is not easily sourced or can only be sourced at an exorbitant or prohibitive cost. Having acquired what is then the wrong system to deal with the wrong problem; the risk management team are indelibly wed to its ultimate success. Rather than dealing with the data issue they seek to develop synthetic data solutions which nobody understands or believes. The outputs from such a system are likely to be at best inaccurate and at worst misleading.

To counter this, the initial project plan should identify the key data requirements and any barriers to an effective implementation. The software solutions identified as meeting the needs of the firm should be consistent with the actual needs of the firm and consistent with data availability. If there is a data issue this should be identified and dealt with first perhaps by using the services of one of the outsourced service providers.

4. Risk Management is seen as a Regulatory Construct

In some firms it appears that the only reason risk management is being implemented is due to pressure from the regulators. Whilst anything that ultimately results in a risk management framework being completely implemented must be welcomed, risk management is a not a regulatory requirement. The business needs effective risk management regardless of the regulatory requirements.

The problem is often caused by the way that the project and its development are communicated to the Business. If the regulatory stick is used to liberally then the entire project is seen as being really a compliance issue and the Business

essentially disengages, leaving everything to the risk management professionals to deal with. You hear comments such as "Risk is management by the Risk Management function" or "We only do that because we are told to" without any of the values of the project being clear.

This should have been avoided and communication is at the heart of the matter. In all communications both from the senior management and from the risk management team should emphasise values and drivers, making the programme part of the way we do business as opposed to an imposition. If you have to rely on regulation to make the programme tick then you have probably lost the argument and will find barriers to meeting the use test.

5. Failing the Use Test

Even the regulations include the need for risk management data to be used by the Business. Essentially an enterprise risk management framework has the objective of ensuring that risk assessment and evaluation are included throughout the firm, from the Chairman to the Doorman. Of course not everyone requires the same risk management data nor are they able to make use of it in the same way. Much of this is about education so that the business has a better idea of what it should need as opposed to what it currently gets. It is also about constructive challenge by helpful risk management professionals that are patently adding value.

If modelling is too complex the ability of the business to understand and appreciate the outcomes could be impaired, limiting its usability. If the risk management function move from facilitation mode to taking direct responsibility without values being clear then the likelihood of the data being used is small. Of course effective risk management is not just about calculation; rather it is a state of mind. What is needed is for all staff to consider risks and risk mitigation as they are conducting their roles without confusing risk reward relationships.

6. Undue Complexity

All risk management units will need to undertake some form of risk modelling, using some elements of complex mathematical techniques. However in some teams this appears to be all that they do – what they are forgetting to do is risk management. To get senior management and Business buy in the risk professionals will need to translate the mathematics into a form that is understandable to the people that need to use it. In other words avoid equations if your audience cannot understand equations!

There is an intellectual challenge for risk management professionals to make complex ideas simple and to seek simple as opposed to elegantly esoteric solutions where these exist. If the output is unlikely to be completely accurate or is intended to operate on average or over pools then there could be simpler attribute based solutions which could be applied.

It is also important for both senior management and the Business to be willing to state clearly that they do not understand the modelling. If they do not have the right level of knowledge then they will not know the limitations of the

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technique or the assumptions that have been made. Without this knowledge the data could be dangerous for them to use. Adequate challenge in the Risk Management Committee should resolve this issue.

7. The Wrong People on the Risk Management Committee

Who should attend the Risk Management Committee? If it is the risk team headed by the Chief Risk Officer then it is an internal departmental committee and not really a true Risk Committee. If it is only the Board then the meeting could end up replicating discussions that should (and are) conducted at the Board. Neither feels appropriate.

Since Enterprise Risk Management is a Business concern it is the business that should be represented and dealing with the issues, facilitated by Risk Management. This would suggest that business units should be represented with the C Suite only taking responsibility where the business would not otherwise be represented. The Chief Risk Officer is then the secretary to the committee as opposed to the Chairman of the Committee. The Risk department do not own risk. They neither enter into transactions nor develop business. Their role is to ensure that the business manages to do this effectively. It is when this role is not clearly understood that so many problems occur.

8. Inconsistent Modelling

At its heart Enterprise Risk Management needs consistent modelling across the business. This needs to be conducted in each of the silos of risk that currently exist. If there is a clear risk vision as to what the framework is intended to achieve then this helps. Developing a single risk taxonomy with each risk terms defined only once in a language that mere mortals could understand would obviously help. Implementing thorough risk appetite modelling together with a risk acceptance policy dealing with the correlation of risks and cascading this to the level of the control would also be of benefit.

Within the risk silos (credit, counterparty credit, market, liquidity, operational, reputational and strategic) there is a need for tactical and strategic risk solutions. The tactical involves the business to achieve the modelling that they require for their own purposes. This may not be completely identical for all risk types although consistency where appropriate would be an advantage.

They also need to consider strategic enterprise risk management which requires that the total output from the framework is actually additive. This again is about vision and understanding that tactical and strategic risk management may use the same data as input but could actually be difficult. While some level of differentiation is appropriate for tactical risk management, this cannot be applied to strategic risk management.

In Conclusion

So there are a range of issues which cause the programme to fail to achieve its objectives. Some of these are risk management's fault while others are due to over exuberant expectations or a lack of knowledge. Each can be addressed with care and thought. An effective Enterprise Risk Management Framework enables a firm to better understand and price the risks it is taking improving profitability and reducing earnings volatility. Surely that is a worthwhile objective for any firm!!!

For comments and feedback
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