Building and Refining Enterprise Risk Management Programs, Part 2

A well-defined Enterprise Risk Management ("ERM") program provides the tools, methodologies and infrastructure to identify current and emerging risks, develop a complete risk appetite program, respond to loss incidents and near misses, and assemble a reporting package that aggregates key risk information across the enterprise into a unified and coherent view.

In case you missed it, read Part 1 about building a better ERM program.

FTI Consulting has developed an ERM Advisory Model, structured around three key topics, that outlines an approach to building, assessing and refining ERM programs: Risk Governance & Compliance, Risk Strategy, and Risk Transformation. The goal is to provide the right menu of services to produce a highly tailored assessment of any company's ERM program and a logical roadmap forward to establishing a new program or achieving a more impactful program.

Risk Governance & Compliance

Risk Governance describes the formal management framework that ensures appropriate oversight of all risk-taking activities. It is an integrated set of policies, procedures, controls, and reporting. That framework must promote independent, informed, and empowered management bodies such that:

- All members of senior management remain aware of all identified material risks across the entity and are making informed risk vs. return decisions;
- The Board has appropriate expertise to credibly challenge policy and actions taken by management;
- The company's strategic and financial planning are fully harmonized with the risk appetite of each business unit and the overall company as appropriate; and
- Capital is allocated to businesses in an efficient manner reflecting a detailed, sophisticated, and current understanding of the full range of risks to which each business is vulnerable.

Senior bodies provide oversight to change management programs to develop and refine risk management capabilities aligned with the above objectives and to maximize the impact change programs will have in mitigating risks facing the entity.

Risk Governance goes beyond defining senior oversight — it sets out the roles and responsibilities for risk managers operating throughout the organization, with controls in place to ensure escalation and information sharing where appropriate.

Getting the three-lines-of-defense model (*i.e.*, frontline risk managers, enterprise-level Chief Risk Officer, and internal audit) right is an essential part of the Risk Governance model. While ERM resides in the second line, risk managers embedded in the business in the first line contribute critical information. Activities and accountability points continue to evolve across the first and second line as needs change and examiner expectations continue to advance the supervisory goal of fostering a more muscular first line.

A critical task of senior risk officers is to demonstrate that risk management capabilities are compliant with supervisory expectations. The remit of the Compliance function is often thought of in terms of business compliance with key laws and regulations such as Fair Lending and BSA/AML. A distinct second role of the Compliance function, however, focuses on the risk management functions themselves, and the extent to which those capabilities meet examiner requirements and expectations. Almost all institutions work to get out in front of business compliance, but a surprising number are content to underinvest in risk management functional capabilities until criticized by examiners. Leading institutions view the entire compliance space in total, often coordinated by ERM, which assesses all forms of regulatory compliance in risk identification exercises.

Risk Strategy

Risk managers cannot simply be risk-averse — the Risk function's role is not to be an obstacle to the revenue-generating functions from performing their roles that naturally result in risk exposures being created. Rather, the Risk function, and the ERM group in particular, performs several key functions in the pursuit of optimal risk-adjusted performance, including:

- Identifying, assessing, and controlling the risks created by the organization's range of activities, including risks introduced by third-party relationships.
- Calibrating risk appetite and limits to achieve commercially viable outcomes that give the business room to operate and compete while protecting the firm's capital and reputation.
- Identifying the key severe, but plausible, scenarios that would be most adversely impactful to the overall organization, and plan/mitigate accordingly.
- Identifying the range of quantitative modeling in use throughout the organization, and assessing the degree to which model risk has been identified and managed . In particular, inputs to models that are unsupported management assumptions must be subject to particularly rigorous independent review and challenge, as this vulnerability was at the heart of modeling failures in the Global Financial Crisis of 2008-09 and again in the current 2023 regional banking episode.
- Aggregating and presenting the larger "picture of risk" by business unit and at the entity-wide level to the Treasury department to better achieve optimal capital allocation, which steers business units to demand fair compensation for bearing their relative degree of risk.

Individual senior managers often say they have a detailed understanding of the risks in their purview but suspect material risks could be lurking elsewhere in the organization that have not been adequately identified and assessed. They wonder if certain plausible scenarios that might seem manageable to their unit could be very damaging to the overall organization. An effective ERM program addresses these questions and gives broader senior management teams both better information and reassurance that the most relevant severe but plausible adverse scenarios to the overall organization are anticipated and mitigated where possible.

Financial Planning & Analysis ("FP&A") teams endeavor to bake in a detailed understanding of the risks facing business units and the enterprise. However, after a complete Risk Identification exercise reveals rich risk inventories and risk appetite statements are designed and calibrated for each business unit, we find the FP&A process gains immeasurably from the range of new structured and easily integratable information provided by these ERM resources. Capital planning programs undertaken by Treasury similarly benefit from ERM results, even in smaller organizations.

Risk Transformation

At both financial institutions and corporates, risk management functions have been both growing in headcount and evolving in terms of range of capabilities. How transformation programs are formulated, planned and budgeted, however, is often prone to bias factors such as availability, attribution, or confirmation biases,[1] or simply cruder political favoritism. Once a broader Enterprise Risk function is in place that fully identifies and prioritizes the range of risks borne by the entity, as well as fostering consensus on the new and emerging risks facing the organization, risk change programs can more accurately and efficiently address the right problems first.

Many organizations operate change programs at a departmental level without a Target Operating Model ("TOM") for how risk management will be carried out across the broader enterprise, leading to inefficiencies and duplicative effort, and in some cases failed projects due to the inability to develop critical linkages between functions. Typically the CRO has the responsibility to assess whether change/transformation programs underway align to strategic imperatives and are likely to result in optimal cost-efficient outcomes. Consultants can assist CROs by helping to identify key scenarios that could undermine projects and develop better contingency planning as needed.

Interim planning is also often inadequate while change programs are underway. Indeed, many large bank failures, the 2023 cases included, happened while known issues were being addressed (in retrospect far too slowly). A lack of strategic interim planning can lead to adverse and even catastrophic outcomes. Using outside experts to help identify an interim strategy until transformation projects are complete can be a prudent step that best protects the organization.

ERM is for Everyone

While Financial Institutions tend to have longer histories in building risk management programs, non-financial corporations can also reap many benefits from this comprehensive and integrated approach to ERM. Building a program requires not only risk expertise but also specific industry experts who can collaboratively develop the framework, policies and procedures that are both tailored to industry-specific requirements and are right-sized for the organization.

1 Daniel Kahneman and Amos Tversky, Judgment under Uncertainty: Heuristics and Biases, 1974. http://links.jstor.org/sici?sici=0036-8075%2819740927%293%3A185%3A4157%3C1124%3AJUUHAB%3E2.0.CO%3B2-M

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