Creating a Culture of Risk Management

Financial Service organizations must initiate a top-down transformation to spread risk management visibility and accountability throughout the enterprise

A Position Paper by Wolters Kluwer Financial Services

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Introduction

After the rash of corporate and accounting scandals leading up to the Sarbanes-Oxley Act in 2002, a "Culture of Compliance" emerged to foster ethical behavior and decision-making. The culture of compliance goes beyond having good policies and procedures, a dedicated compliance staff, sufficient compliance resources or electronic exception reports. It articulates a sense of responsibility for compliance at every level of the organization.

In the risk-averse environment following the latest financial crisis, we believe there is a strong case for replicating this successful paradigm shift to create an enterprise-wide risk management culture. In a risk management culture, accountability for risk permeates the enterprise from the boardroom to the front line—instilling employees with the tools to identify, manage and mitigate risk.

In a poorly controlled organization without an institutionalized culture, employees will tend to do the wrong thing even in the face of good policies. In a well-controlled organization with an institutionalized culture, employees will do the right thing even in the face of unclear policies. Financial service organizations that establish a strong culture of risk management will foster risk-informed decision-making that ensures long-term viability.

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Why Push for Change?

The typical scenario in financial service organizations today involves silos of risk management. Individual business lines, products and geographies have their own analytics and reporting, with limited visibility into the impact of their risks across the enterprise. From the executive management perspective, there is no global view of risk. The situation is made worse when the business lines that create risk are not held responsible or accountable for managing their risk.

In this scenario even a cautious, risk-averse organization is put in jeopardy when one line of business takes risks without a full appreciation of the potential impact on the enterprise. The unscrupulous or ill-advised actions of that one unit can incur enforcement actions, monetary fines and reputational losses that affect the entire organization.

When business unit risks are not factored into the organization-wide risk assessment, it is impossible to effectively control those risks. The struggle to capture risks for every risk discipline across all lines of business exasperates the situation. Often, risk assessment efforts by the individual disciplines (compliance, operations, information technology, audit, etc.) are perceived as being a waste of time and/or adversarial by the business entities charged with completing their paperwork. The overlapping processes become redundant and burdensome, resulting in the assessments not being taken seriously.

In many cases, manual collection and collation of risk data exacerbates the problem, because the process is time-consuming and error-prone. Some institutions still distribute multiple spreadsheets or check-box questionnaires to gather information. By the time that information is returned to the responsible risk discipline, the data is often at least one quarter behind, precluding real-time or proactive risk control. In these cases, risk managers spend more time shuffling paperwork than assessing and mitigating risk.

Regulatory agencies have expressed concern about how these issues affect the ability of financial service organizations to effectively control risk. Regulators agree that instilling an enterprise-wide risk management culture is the key to establishing more responsible risk management practices in the financial sector. Going forward, it is the expectation among regulators that financial service organizations will proactively pursue this course of action.

Defining the Risk Management Culture

Enterprise Risk Management (ERM) is a proactive, institution-wide program where policies, procedures, processes and technology are used to measure, monitor and manage risk. A well-managed ERM program provides the critical insight that fuels strategic decision-making and prioritization of opportunities. A culture of risk management is characterized by the pervasive view of ERM as a day-to-day part of doing business.

Instead of treating risk management as a separate discipline, the risk culture elevates this function to a position that overarches individual business units, geographic locations and risk disciplines. Responsibility and accountability for risk management permeates the entire organization. Employees who create the risks understand that it is their job to identify the risks they face. In fact, everyone in the organization is encouraged to identify risks without fear of repercussions. And everyone recognizes that the goal is not to eliminate risk but to control it.

In this culture, a centralized and integrated approach to risk assessment enables individual business units to score and monitor inherent and residual risks by both impact and likelihood in a way that is consistent across the enterprise. In order to draw reasonable conclusions from this information, the ERM framework and methodology provide consistent reporting using common terminology and key risk indicators. There is a library of risks and controls, with a history of issues tracking and resolution that puts the assessed risks into context.

The ERM program ensures that everyone understands the exact nature of the risks being taken, as well as the controls that are in place to mitigate any adverse impacts. Decisions in a risk management culture are based on a 360-degree view of risk at all levels—from the C-level suite to the business process users. Executives look at past, present and future trends based on what has worked before, controls that are effective today, and the likelihood of the risk occurring in the future. Then, resources are allocated accordingly.

How to Create an ERM Framework

If a culture of risk management sounds unlike anything happening in your organization today, you are not alone. But the regulatory mandate is clear: Financial service organizations are expected to undertake this paradigm shift now. The process must begin at the top—changing the attitude of the Board of Directors and getting the support of executive management. Executive management will define the risk appetite—or the amount of risk an institution is comfortable accepting in order to do business—and shape the strategy for putting an ERM program in place. The senior management team and business units then set the policies and procedures that clearly articulate the expectations for managing risk.

The ERM program should have the flexibility to allow each risk discipline to monitor the items that are important to it, but within a common framework. This common framework will allow risk identification, measurement and management both within a risk discipline and across the enterprise.

However, this top-down approach is simply not enough. The risk culture needs to permeate throughout the organization and be used in day-to-day decision-making. That means establishing a risk management program that involves every employee. Provide them with the knowledge and tools they need to meet the organization's expectations. Risk management accountability should be incorporated in employee job descriptions and compensation plans. Make expectations clear, evaluate risk management during performance reviews, and execute performance-based incentives and penalties.

The risk culture should put mechanisms in place that empower employees to raise issues and talk about what action to take. Every employee and new hire should receive training on risk management definitions, thresholds, policies and procedures. Training should be reinforced by testing for understanding of—and adherence to—these risk policies and procedures. The ERM program should not only assess the impact and likelihood of risks but also evaluate the degree to which risk policies and procedures are being followed and the effectiveness and efficiency of these policies and procedures. Then, information learned during the evaluation process should be used to continually improve the ERM program.

Just as controls are put in place to mitigate risk, employee communications should be instituted to raise awareness and reinforce risk-aware behavior. By taking these steps, organizations can begin to operationalize and institutionalize risk-sharing down to the front-line employees.

Success Factors in the Paradigm Shift

As the culture of compliance has taken hold in financial institutions, the view of compliance has changed from reactive to proactive, and from adversarial to supportive. This same shift in perspective must occur for a culture of risk management to become ingrained in financial service organizations.

For a culture of risk management to take hold, there must be a pervasive philosophy communicated from the top down and embraced enterprise-wide. Every employee must understand the organization's risk tolerance (or risk appetite) and where the "edges of the envelope" are for each business line, product and geographic unit. Those on the front lines must buy into the definition, and operate at or near the edge without crossing the line.

Lines of business that have a track record of reacting to risk rather than anticipating and controlling it must change their attitude about risk management. To take a more holistic approach and fully understand the risk landscape in their organizations, they must work cooperatively and collaboratively with the functions that manage risk: compliance, risk management, IT/information security, etc. The risk culture must elevate these risk officers to the role of business partners rather than adversaries and inquisitors.

Finally, for a risk culture to succeed, the organization must adopt appropriate technology for improved transparency and control. A single enterprise risk engine for monitoring and managing risks can provide a centralized, integrated approach that alleviates many of today's issues. Employees who are armed with the right tools and empowered to report risk will become more proactive in "doing the right thing." The right technology provides accurate and timely data so that the organization can strategically allocate limited resources to high-risk areas.

Conclusion

There is clear evidence that a culture of risk management changes the way employees think about their responsibilities and, ultimately, influences enterprise-wide performance. When everyone in the organization becomes a participant in the risk management program, then they understand the risks and support the controls that are in place.

Financial services firms with a strong risk culture supported by enterprise-wide data and analytics had relatively stronger performance during the most recent financial crisis, according to a new report by Oliver Wyman and the *RMA Journal*.[1] Wyman reports, "[L]eading organizations had made an early investment in a risk appetite supported by senior management, and used their 'risk culture' to communicate risk appetite in a way that ensures it becomes part of day-to-day decision-making throughout the organization."[2]

A strong risk management culture will enable innovation in the business lines without exposing the organization to the kinds of risks that resulted in the most recent financial crisis. The result will be more intelligent risk-taking, more effectively focused execution against opportunities, and fewer catastrophic failures and loss events. Investors will notice. Regulators will notice. Customers will notice. Investing in sound business practices leads to a healthier bottom line, a solid reputation and a strong competitive position in the financial services market.

[1] Wyman, Oliver. "Institutions Need to Better Understand Their Risk Appetite," The RMA Journal, March 2010. (http://www.oliverywyman.com/cn/risk_appetite.htm)

[2] Wyman, Oliver. "Institutionalizing Risk Appetite Remains a Challenge for Banks," Press Release, February 4, 2010. (http://www.oliverwyman.com/ow/pdf_files/FINAL_PRESS_RELEASE_RMA_OW_Risk_Appetite_Survey_02_04_10.pdf)

Role of Technology in Risk Management Culture

Having an on-demand, 360-degree view of data is critical to enterprise risk management. Technology not only aggregates risk assessment data for analysis and insight, but also automates risk discipline workflows so that processes are synchronized and standardized. An ERM solution provides a common framework for identifying, measuring and monitoring risk across the organization. In a risk culture, ERM tools:

- Enable employees to raise issues/identify risks for discussion, and report on monitoring and performance of controls.
- Provide visibility into past assessments, issue resolution and historical trends, so managers can accurately assess the likelihood of an event and its potential impact.
- Streamline the assessment process and standardize terminology, scoring and weighting systems.
- Eliminate redundancies among risk disciplines, enabling business lines to describe risks in similar ways.
- Centralize the library of information, regulations, policies and procedures for a single source of truth.
- Create 360-degree views of risk at all levels—enterprise, operational and risk discipline.
- Foster intelligent decision-making with accurate, timely and relevant risk data

ARC Logics for Financial Services is an ERM solution configured with risk management, workflows, controls, and policies and procedures specific to the U.S. financial services regulatory and risk environment. This modular platform enables even the largest, most diverse organizations to measure, monitor and manage compliance and operational risk across multiple lines of business and geographies.

To learn more about how *ARC* Logics can help your organization create an enterprise-wide risk management culture, call Wolters Kluwer Financial Services at 1.800.261.3111 or visit WoltersKluwerFS.com/*ARC*Logics today.

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