

**Enterprise Risk Management:  
*Strategic Thinking in a Changing Risk Environment  
to Achieve Competitive Advantage***

**By Reid Adamson**

On the heels of the most severe economic downturn in generations, and with a sustained recovery in question, banks and other credit providers are faced with a delicate balancing act: how to restart the growth engine while balancing the risk profile of their portfolios. As they compete for new customers, lenders are finding that the recession has taken a widespread toll and that the number of credit-worthy borrowers has not returned to pre-recession levels. However when driven by management and boards of directors to restore market position and profitability, the solution too often is to compromise on deal structure and pricing. So what are banks and other financial services providers to do?

Capital structures are not designed to follow the peaks and valleys of volatile economies if the objective is long-term stability and growth for shareholders, customers and the markets served. Best in Class organizations understand that external factors such as economic events, competition and changing regulatory environments cannot be controlled. However, they also understand that the volatility of such external factors creates a level playing field. And, therein lies the opportunity for well-managed institutions to accept risks inherent in their businesses and strive to outperform competitors by managing those risks better.

***A Framework for Enterprise Risk Management that Creates Strategic Advantage***

What is an enterprise risk management (ERM) framework? Unlike accounting, regulatory, tax, and other well-defined governance structures that exist throughout financial institutions, there is not a single standard for an enterprise risk management framework. While basic risk management concepts may be straightforward and easily described, developing and implementing a data-driven framework that is measureable, manageable, utilized and understood across the organization is more challenging, and is a key success factor in deploying ERM. Of equal, if not greater, importance is gaining executive buy-in and support.

The process of managing risk before, during and after the life of the risk instrument, regardless of its nature (e.g., loans, securities, on/off balance sheet items, derivatives or operational risks) can create a strategic advantage. Institutions that take this comprehensive ERM approach can work to define the risk profile of the institution through a framework that connects seamlessly to the strategic planning process and extends through budgeting/forecasting, monitoring, product definition, risk-based pricing, asset/liability management and capital planning. In doing so, these institutions undertake transactions with the knowledge of risk impact to the organization and a clear understanding of where that transaction fits within the risk profile and level of exposure the institution has chosen to take.

***An Approach to the Development of an Effective Strategic Enterprise Risk Management Framework***

Early in the development of a strategic enterprise risk management framework, it is important for an organization to conduct a self-assessment to understand how current risk management practices have either succeeded or failed. By addressing a few insightful questions, this self-assessment should reveal how risk is viewed by the organization.

- Is the risk or potential risk something to be avoided or accepted and managed effectively?
- Is it everyone's job in the organization to manage risk, or is risk management reserved for a select few who reside outside of the organization's business line growth engines?
- Is risk viewed as identifying and avoiding certain hazards, or as helping to drive a well-defined business strategy?

A key part of the self-assessment process is to compare current practices against Best Practices to identify gaps in:

- Governance
- Management
- Risk-assessment processes
- Measurement tools
- Reporting tools
- Data management and technology
- Definitions of, and language around, risk
- Clarity of organizational roles and responsibilities with respect to risk

In much the same way that an organization self-assesses its Information Technology maturity by evaluating itself against identified characteristics, self-assessing an organization's risk maturity can follow a similar process as part of an enterprise risk management framework.

Moving beyond self-assessment and the evaluation of risk maturity, lenders need to examine the risks inherent to the organization -- often referred to as "risk events" -- within each key operating environment. Conducting such an examination can yield an inventory of risks for the organization that may then be assessed individually and categorically. This assessment phase requires a keen understanding of the organization's competitive positioning and tolerance for risk, as risk events are evaluated in both the context of organizational strategy and the control environment.

#### ***Implementation, Testing and Measuring are Key to Working Toward Desired Results***

Implementation is an important element to achieving the desired results of strategic enterprise risk management framework. It is also where breakdowns can frequently occur, particularly in the application of measurement tools. For example, the ability to quantify precisely the effectiveness of controls is difficult, but necessary to correlate control effectiveness with inherent risk to yield a reduction to a net or residual level. The challenge is to quantify both the risk and mitigating controls to achieve the quantifiable net measure of risk. Calculated net residual risk can be compared to the organization's risk tolerance level, which must also be quantified, to determine where outliers exist, indicating that the organization is operating outside of its risk strategy. Outliers can fall on either side of the desired risk appetite, indicating either that the organization is taking more risk than intended or conversely that the organization is taking less risk than desired under the enterprise risk strategy. A situation where less risk is being taken relative to enterprise goals may arise from multiple factors, such as:

- Overestimating the level of inherent or gross risk of the instrument or event

- Underestimating the effectiveness of controls and supporting business processes, or
- Adjusting the organization's level of risk tolerance due to changing external or internal factors

For example, attracting an individual or team with a higher level of expertise in their field might lead an organization to increase its risk tolerance for that business group and re-evaluate the effectiveness of the control environment.

The factors that influence risk tolerance, both qualitative and quantitative, are fluid and constantly changing. Therefore, practicing risk management is not only a matter of developing and implementing a framework, but also of understanding and being able to adjust continuously the levers that balance risks both at the individual risk level and cumulatively at the portfolio level.

Enabling the risk management framework can require deploying measurement tools on several levels. Cataloging and measuring individual risks is only a first step. On an enterprise level, measurement tools should work toward enabling risk severity to be categorized so that individual risks and portfolios of risk instruments may be put into the context of impact on the organization. Enterprise level measurement tools should contain quantifiable as well as qualitative measures such as monetary thresholds and degrees of shareholder impact, reputation risk or regulatory consequences.

Risk severity must then be evaluated in the context of probability that the risk will occur. Taken together, the suite of measurement tools incorporated into an enterprise risk management framework must operate effectively at both the micro (individual risk) and macro (enterprise) levels.

### ***Conclusion***

For banks and other credit providers, the decision to operate within an enterprise risk management framework is a commitment to change the way business is done, most noticeably by involving a greater number of people throughout the organization in consciously managing risk. A common misperception, particularly among business lines that have historically operated outside of an enterprise risk governance structure, is that practicing enterprise risk management is synonymous with discouraging risk taking. In fact, the associated business opportunities and profits can be the rewards of a well articulated risk strategy and sound risk management practices. When risk is understood, quantified and well-managed, the entire organization can benefit because the employee and management stakeholders all work toward common vested interests in creating shareholder value for the organization.

A commonly used, but pointedly accurate, cliché is that “risk management is a journey, not a destination.” This simply implies that neither the framework nor its application are static, that external factors affecting markets go through cycles and are in a constant state of flux, and that organizations are always changing themselves. Additionally, data management practices require ongoing review to improve the quality of information directed through measurement tools and thus the accuracy of the risk assessment. Finally, a well-tuned risk management framework will use a common risk vocabulary that is embraced by senior executives and is well-documented, communicated, understood and used across all levels of the organization.

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