

# Risk Management: An Overview of Practices

By Edward Hida

Risk management is often viewed as a way to prepare for the negative, but it can also be a way to generate positive business results for an institution. Managing risk effectively can help a board or institution make better, more informed decisions about the relative risk associated with business units, geographies, service lines, products, and customers—ultimately creating value and helping stimulate growth.

Deloitte & Touche LLP recently published the fifth edition of its *Global Risk Management Survey: Accelerating Risk Management Practices*, an overview of risk management and related governance issues at major financial services firms globally. Deloitte & Touche also performed a review of risk management governance and oversight activities at 20 of the largest banking companies in the U.S. to supplement this.

Financial institutions have become leaders in the development of cutting-edge risk management approaches. While there is inherently a different fit for every organization, institutions from all industries can take practical guidance from the findings to better enhance the performance of their own risk management practices. A close look at risk exposure is particularly useful in dynamic industries with changing technologies, fierce competition, or heavy regulation.

## Board-Level Responsibility

Due to the growing variety of risks—coupled with the possibility of a huge negative impact that these risks may have on a company's finances and reputation—risk management has become a high-priority item for financial insti-

tutions. And boards of directors are taking notice. At 70 percent of the institutions participating in the survey, the board has ultimate responsibility for the governance and oversight of that function. This level of responsibility is up significantly from 59 percent in a similar survey in 2004.

At most of the top banks, boards of directors consider risk management to be a key element of their overall governance, with more than three quarters taking a “somewhat” or “very” active role. Half of the boards studied in the review have a separate risk committee or equivalent. The development of a separate board risk committee reflects financial institutions' deep focus on risk monitoring and management at all levels. Of the remainder, two have a combined audit and risk committee, and the rest of the institutions entrust the responsibility for risk management to their audit committees.

A number of institutions within the financial services arena have made great strides in implementing risk management practices. Below are a few examples of how boards of directors have tailored their individual approaches to risk management:

- More than one large financial institution has established a risk or risk policy committee, responsible for reviewing benchmarks for financial risk exposures; receiving and reviewing reports from senior management about the steps it has taken to monitor and control such exposures; reviewing capital allocation; and reviewing reports of significant topics prepared by internal risk oversight functional groups.
- One global financial institution has integrated its audit and risk management committee. That committee is responsible for such items as the integrity of the corporation's financial statements and financial reporting process; policy standards and guidelines for risk assessment and risk management; compliance with legal and regulatory constraints; and oversight for the independent auditor relationship.

**Director Summary:** This article highlights and draws insight from the risk management practices at financial institutions and discusses some of the new trends shaping risk oversight and governance at the board level.



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- One financial institution addresses risk management in its audit committee charter and discusses with management the results of the examination activities of the corporate audit and credit review staffs. Part of this discussion includes policies regarding risk assessment and risk management, with the goal of assuring directors that matters of consequence identified during the examination are satisfactorily addressed by management.

Risk management is becoming more universally recognized each year, and institutions are increasingly building in top-level board oversight for risk management. Ten years ago, a large corporation probably would not have had a specific board committee for risk management oversight. Now an increasing number of financial institutions with complex risk exposures have moved in that direction, and still others may examine whether they too ought to do so in the future.

### **The Chief Risk Officer**

According to the Deloitte & Touche survey, the position of Chief Risk Officer (CRO) at financial institutions is becoming more widely adopted. At present, 84 percent of the institutions have a CRO, up from 81 percent in 2004 and 65 percent in 2002. What does the CRO do? The survey shows that risk quantification is one of the major responsibilities, undertaken at 85 percent of the institutions. Other duties assumed by about four out of every five CROs are weighing risk exposures versus limits; overseeing and participating on risk committees; and defining and categorizing quantitative financial risks.

The most effective CROs, moreover, are demonstrably part of the senior management team, and they interact often with senior management and their boards of directors. Forty-two percent of CROs surveyed report directly to the CEO, while 37 percent report directly to the board of directors—an indication that financial institutions are taking risk seriously and have placed a great amount of responsibility in the hands of the CRO. Additionally, at more than eight out of ten of the financial institutions

surveyed, the CRO meets at least quarterly with the board: 44 percent on a quarterly basis, 33 percent monthly, and 9 percent meet at least weekly. The CRO's relationship with the chief executive is even closer, with 40 percent meeting at least weekly and another 8 percent meeting daily.

Companies considering the appointment of a CRO could take a page from the book of the financial institutions: Frequent exchange of information with the board of directors and the CEO is essential if the person holding this position is to be able to do the job right.

### **Enterprise Risk Management**

Enterprise risk management (ERM) in financial services builds on the long tradition of effectively managing specific risks, such as credit risk and market risk, which have been well addressed for years. The challenge for ERM is to develop and implement a holistic, organization-wide, and standardized risk management processes for the organization, so that it has an integrated view of the risks ahead. The Deloitte & Touche survey found that while only 35 percent of financial institutions had an ERM program in place, 32 percent said they were currently implementing one, and another 18 percent said they had plans to do so.

With ERM the management of diverse types of risk is integrated with a consistent overall framework and vision—rather than based on isolated or fragmented efforts which do not yield a view of overall institutional impact or of inter-relationships between risks. When this integrated approach to risk management is used as the company's framework, there will be consistent reporting of relevant business and risk information to appropriate individuals at varied business units across the enterprise to make decisions on a common, risk-informed basis.

Of course, every ERM program has to be tailored to the requirements of the corporation, since there is no single approach advisable for everyone. A good way to begin is by listing objectives, followed by creating the framework designed to achieve those objectives. Companies can then go on to develop and implement ERM governance structures, such as a risk committee of the board of directors, a CRO position, and business-unit risk executives.

Rolling out the risk framework to business units, consolidating risk exposure across the organization, and building risk management approaches into everyday business decision making and strategic planning are no easy tasks. Yet, three quarters of executives from companies with ERM programs said the total value exceeded the costs. ERM can bring substantial benefits to an organization, but it must have the full support of the board for it to be successful at any company.



## Types of Risk

An important step for a company seeking to improve its risk management activities or to embark on an ERM program is a risk assessment. Boards and senior management need to be aware of all of the potential risks the company faces—along with how their organization measures, monitors, and mitigates those risks. Some of the key risks facing institutions include:

- **Credit Risk.** Credit risk is being monitored by many more tools—and many more sophisticated techniques—than ever before. As information evolves and decision-making tools continue to improve, there is a greater need for more granular analyses of risk and return. For instance, risk profiles by products and by geographic regions might be studied so as to enhance risk adjusted pricing and credit allowance capabilities.
- **Market Risk.** At companies that have large market risk exposures and correspondingly utilize best practices, the analysis of market risk has evolved to incorporate sophisticated analytics. Nevertheless, stress testing, which takes account of certain low-frequency events like large moves in market prices, volatility, and leverage, should be used more extensively.
- **Operational Risk.** Operational risk, and especially the process of measuring this kind of risk, is generally considered to be in its infancy. The tools that are most often used to measure and monitor operational risk are risk and control self-assessment techniques, key risk indicators, an internal loss event database and analyses, and risk mapping. Ultimately, though, more rigorous operational risk management will certainly become a commonly accepted and practiced capability.
- **Valuation Risk.** The proliferation of illiquid investment instruments with inherent complexity—including derivatives, private equity investments, collateralized debt obligations, and mortgage-backed securities—has a significant effect on valuation risk. Among the risk management and control techniques for this category of risk are valuation policies and procedures, independent price verification, model validation, and a model oversight and governance structure.
- **Extended Enterprise Risk.** Extended enterprise risk refers to the introduction of a third-party provider, often a company located overseas, into the equation. The intrinsic complications of managing operations across borders, resulting from different legal systems, regulatory policies, and local cultures, means that a substantial amount of work remains to be done in order to have consistency in a corporate risk management program.
- **Strategic Risk.** Strategic risk is the risk of a loss arising from a poor strategic business decision. These are the

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risks that an organization will not be able to make its financial and business objectives due to its ability to manage its business, products, markets, and customers. Some leading companies are beginning to integrate their strategic planning and ERM processes so that they can apply the elements of their risk framework directly to their business plans.

- **Reputational Risk.** Reputational risk is the risk of damage to an organization through loss of its reputation or standing in the business community, which may have impact upon its customers, suppliers, regulators, investors or other stakeholders. Often reputational risk is considered a consequential risk due to the fact that other risk events may first occur, sometimes in spectacular fashion, to trigger a reputational risk event.

Understanding and addressing the various risk types and potential implications relevant for an institution can better position the board of directors to add significant value in its oversight and governance role to an organization. Risk management cannot be ignored or overlooked by a board of directors—it must be a major consideration, with its risk management or audit committee playing the lead role.

In sum, there's little doubt that risk management will assume greater visibility at companies during the years ahead. But the effectiveness and performance of risk management programs must be improved if the concept is to be taken to new levels. It is incumbent upon boards of directors to ensure that these programs are formalized at the highest levels of the organization, with constant oversight by both senior management and the board itself. ■

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