Simply Stated, What is Enterprise Risk Management All About?

ABOUT THE AUTHORS:

Jack R. Salvetti is the President of S.R. Snodgrass, an expert accounting and consulting firm specializing in services to financial institutions. His unique combination of consulting experience and CPA background helps institutions understand and define their business to facilitate the development of plans that deliver measurable results.

Nancy D. Schell is a Senior Vice President with S.R. Snodgrass, A.C. Nancy is the Director of the firm's Financial Services Consulting Group specializing in the areas of Strategic Planning, Enterprise Risk Management, Organizational Design, Profit Enhancement and Process Improvement.

S.R. Snodgrass, A.C., Certified Public Accountants and Consultants
Phone: 800.580.7738
Web site: www.srsnodgrass.com

Circulate through a crowded room full of bankers and the talk will likely be about Enterprise Risk Management. Often the conversations go something like:

"So what exactly is Enterprise Risk Management anyway?"

"How is ERM any different from what we are already doing with managing risk?"

"Is this just the latest regulatory fad – and when will it pass?"

The truth is ERM is not a new concept. Bankers have always been managing risk – the very nature of banking is the effective management of risk. Ask different consultants about ERM and you may receive vastly different concepts and approaches to ERM. Each service provider defines and shapes ERM to match the products and services it sells. Even the regulators who are requiring the adoption of ERM processes do not provide much clarity.

Fortunately, there is a framework that can help. The Federal Reserve Bank of Cleveland has been the most proactive in attempting to define ERM and has developed a useful information source. That framework identifies 12 broad principles of focus that are further broken out into 47 specific elements. While only a guideline, the FED project is a valuable resource for better understanding the concept, developing an ERM process, and sorting through the confusion.

STRATEGY AND RISK APPETITE

The first of the 12 FED principles describes Strategy and Risk Appetite: "Strategic planning processes make risk a core consideration in setting corporate strategies and objectives. A firm's risk appetite clearly articulates the level and types of risk that it will pursue considering the firm's risk capacity, strategy, objectives, operating environment and return goals."

This short statement encompasses the magnitude of ERM, which connects risk management with strategy, operational excellence, and the vital link between risk and reward.

There can be no doubt that all banks have many risk management processes throughout the organization that are essential to managing the long-term and day-to-day performance as a safe and successful company. Viewed as spokes in a wheel, these processes are organized and connected into a consistent risk framework that properly aligns those management practices with the business strategy. The hub of the wheel, to which these risk processes are connected, is the ERM methodology. A common misperception is that ERM is *just* about measuring and managing risk. While one objective is to enhance the effectiveness of the risk management process, that is only part of what ERM should accomplish.

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ERM should also support the *leadership* of the risk and reward dynamic throughout the organization. The risk tolerances must be compared with financial return expectations to dial in the appropriate nature and levels of risk-taking. This extended view of risk and reward provides the rim of the wheel and completes the circle that is intended by the architects of authentic Enterprise Risk Management.

The ERM framework is intended to enhance risk management practices, achieve performance objectives, and improve decision-making throughout the organization. This process may be supported by various management tools, but they should not become the focus. ERM is not about a software platform or operational control review or the production of a glossy report generated from a data dump. Building the framework requires a series of system-wide discussions on goals and methods around four basic questions:

- What are the desired financial reward objectives;
- What is the organization's appetite for the types and levels of risk-taking in pursuit of these financial rewards;
- What is the measurement of the actual assessed level of risk-taking at this particular time; and
- What actions are required to bring the assessed level of risks in line with the agreed upon risk appetite?

The result will be a common language and methodology for effectively leading and managing risk and reward throughout the organization, yielding better decision-making and improved financial performance.

THE ERM FRAMEWORK IS INTENDED TO ENHANCE RISK MANAGEMENT PRACTICES, ACHIEVE PERFORMANCE OBJECTIVES, AND IMPROVE DECISION-MAKING THROUGHOUT THE ORGANIZATION. THIS PROCESS MAY BE SUPPORTED BY VARIOUS MANAGEMENT TOOLS, BUT THEY SHOULD NOT BECOME THE FOCUS. ERM IS NOT ABOUT A SOFTWARE PLATFORM OR OPERATIONAL CONTROL REVIEW OR THE PRODUCTION OF A GLOSSY REPORT GENERATED FROM A DATA DUMP.