Implementing Risk Management in 2008: Current Canadian Status of Implementing Risk Management

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Why Enterprise Risk Management?

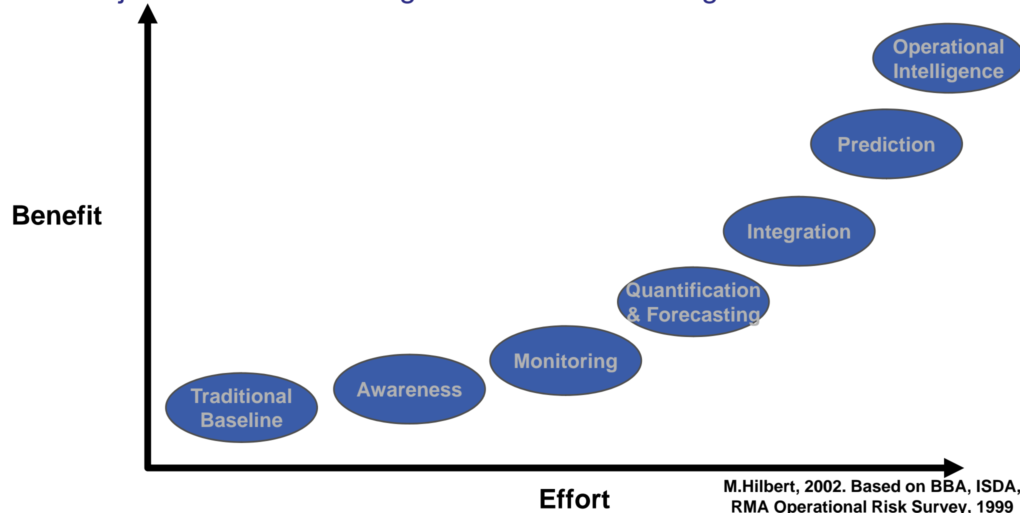
The market place will ultimately drive Enterprise Risk Management forward.

Enterprise Risk Management Drivers

- **Stakeholders, Rating Agencies & Regulators:**
  Areas where there is a high degree of public exposure/liability
  financial Institutions (OSFI, CDIC, etc), environmental legislation, etc
- **High Profile Failures & Disasters**
  Barings, Enron, 9/11 & the WTC
  Increased Reputational exposures (eg. Andersen)
- **Market Disclosure Requirements:**
  Increasing pressure for disclosures from investors and analysts
  Pressure from counter-parties – Climate Change/Carbon Emissions
- **Competitive Pressure & Improved Financial Performance:**
  Reduce earnings volatility
  Increase process effectiveness & efficiency

Organization should consider risk management as a spectrum. In deciding what level of maturity is appropriate they must consider a number of factors and the benefits increasing efforts will provide to the organization

Risk Managers with senior management, including the board, must decide what the ultimate objective for Risk Management is within the organization

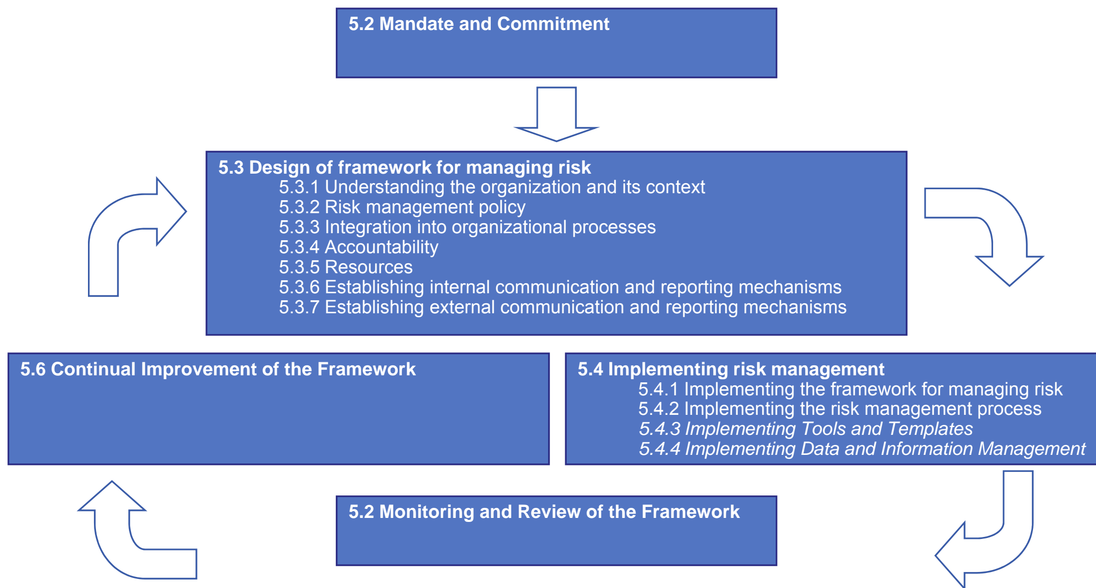


M.Hilbert, 2002. Based on BBA, ISDA, RMA Operational Risk Survey, 1999

The Risk Management Maturity Model

Traditional Baseline	Awareness	Monitoring	Quantification & Forecasting	Integration	Prediction	Operational Intelligence
▪ Reliance on Internal Audit ▪ Individual Mitigation Plans ▪ Reliance on "good" people/staff to make sure things are managed ▪ Internal Controls	▪ A risk governance structure is in place ▪ The organization has some definitions in place ▪ Risk management is re-enforced in policies and procedures	▪ A clear vision for ERM exists ▪ A balanced set of approaches are used (RCSA, event data, KRIs, etc) ▪ Dedicated staff exist to support risk management at all levels	▪ Risk is considered on a quantitative basis and risks forecasts are used to understand exposures ▪ Quantitative targets and measures are used	▪ Linked risk management processes across the firm ▪ Losses and indicators are correlated ▪ Integration with quality programs ▪ Risk assessment processes are integrated ▪ Integration inside and outside the firm	▪ Exposures and risks can de predicted based on operational metrics ▪ Event data captures both magnitude and frequency values ▪ Risk predictions drive process modification	▪ The use of ERM to realize business opportunity ▪ Risk Management is integrated with financial management performance management and operational effectiveness ▪ ERM is link with CRM and other major processes

Achieving effective Risk Management requires alignment across a number of dimensions inside and outside the organization



Pulling together the elements of a risk management framework can be a complicated undertaking.

M Hilbert 2008 Based on ISO 3100 Components of the Framework for Managing Risk, (ISO 2008)

Items 5.4.3 and 5.4.4. are not included in ISO 31000

Leading organizations are beginning to take a holistic approach to risk management to promote consistency of risk management across the enterprise. An holistic approach leads to better alignment of risk management processes and fewer surprises

- **Characteristics of Holistic Risk Management**

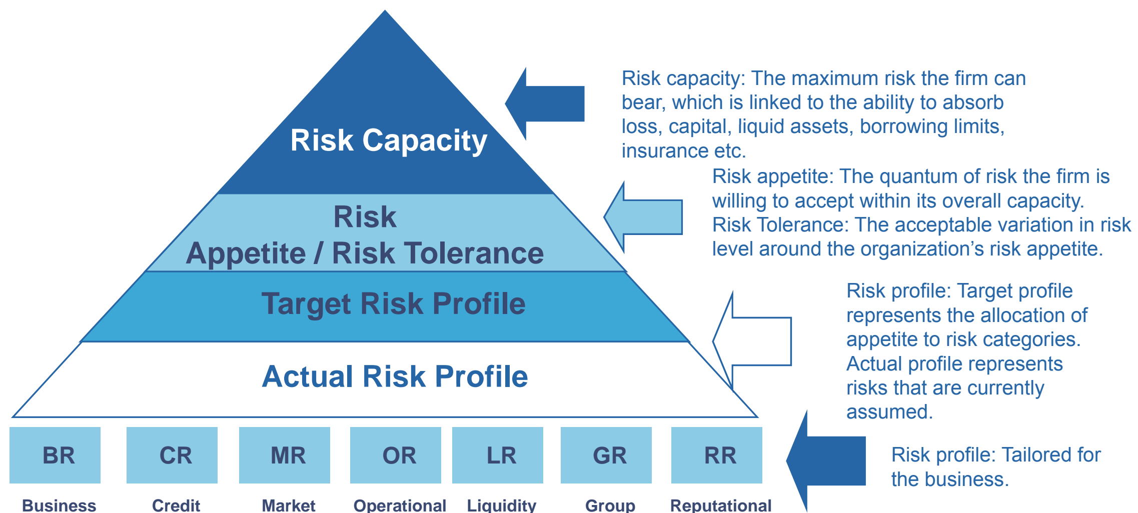
- **Comprehensive** - considers the full spectrum of risks the organization faces
- **Interconnected** - linkages between risks are considered and reflected in the management approach
- **Integrated with the business** - strategy setting, decision making, execution and monitoring
- **Forward-looking** - innovative mindset to contribute to strategic decision making, in addition to a perspective on historical trends and events
- **Multi-faceted** - all levers to manage risk – process, structure, metrics and culture - are utilized
- **Efficient** - no overlaps in risk management activity, cost effectiveness of activity
- **Collaborative** - line management own risk, close engagement between Risk and the business
- **Value focused** - both a protection and enhancement focus

Best practice is leading to the development of a common ERM framework which is pushed out to the responsibility for risk management to the lines of business but maintains a strong corporate function that ensures alignment, harmonization and exploits synergies.

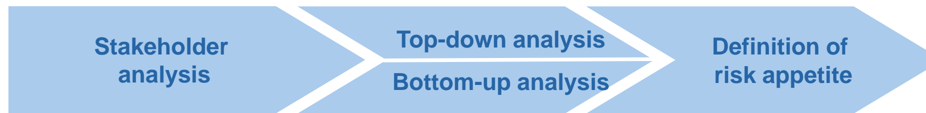
Leading Organizations understand developing a culture of risk awareness in the organization sets the tone and foundation for effect Risk Management

- The Risk Culture model (illustrated at right) identifies eight elements of the culture that have particular importance in a risk context. The model is built on:
  - The realization that an holistic approach to risk management is required, and a focus on controls and processes is not sufficient to drive the right behavior.
  - Values, objectives and practices across the organization must be aligned to achieve a culture of well-managed risk.
- The challenge for organizations is to establish a culture that:
  - Encourages individual accountability for managing risk (and therefore addresses accuracy of individual risk perception);
  - Includes systems to monitor and reinforce desired behaviors; and
  - Takes into consideration differences in the risk environment for different roles, and an individual tolerance for risk.

Leading organization are driving effective Risk Management through setting risk appetite and translating it into a target risk profile for the organization



The most effective firms understand that setting appetite requires that multiple dimensions are considered and integrated to determine a firm's risk appetite



An analysis of external and internal stakeholders and their expectations

A 'top-down' assessment of risk appetite, linked to strategic and business objectives

A 'bottom-up' assessment of the actual risk profile of the firm derived from the underlying business areas

Analysis to ensure that the actual risk profile reflects Board risk appetite, and to make adjustments where necessary

- Regulators focus mainly on unexpected losses
- Shareholders focus on maximising value in relation to risk
- The amount of capital needed per unit of unexpected loss is dependent on the organizations risk appetite

Lead practices in setting risk appetite bring together measures across three dimensions to provide the organization guidance and direction.

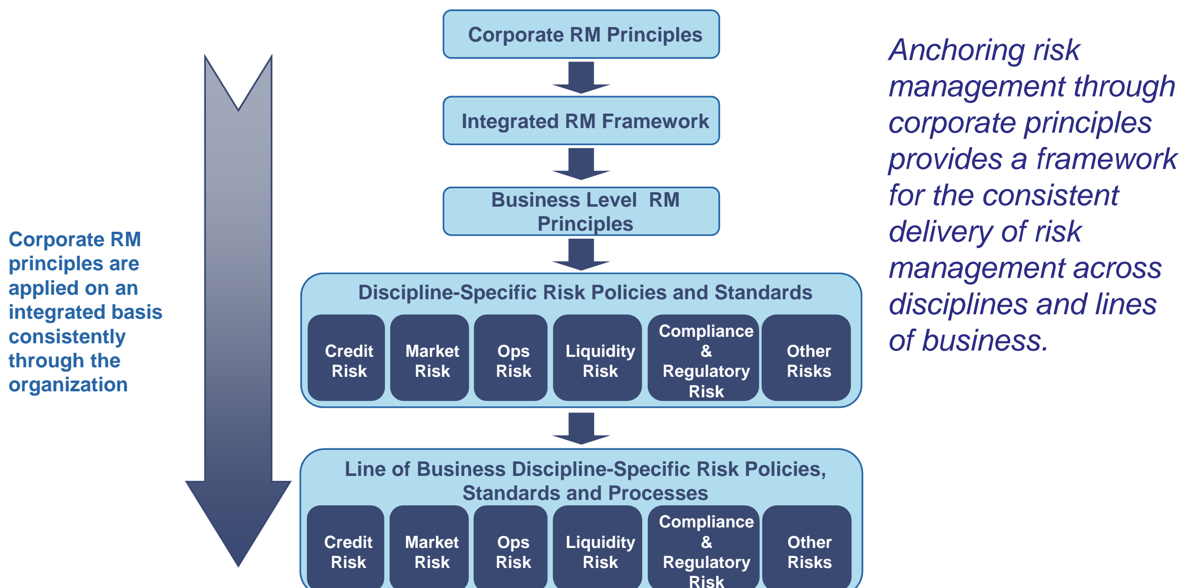
Quantitative Measures	▪ Hard measures of risk ▪ Describe the type and quantum of risk the business wants and is willing to take ▪ Relate directly to business plans and risk measurement processes ▪ Example – appetite for earnings volatility
Qualitative Measures	▪ Recognize that not all risk is measurable but can affect business performance ▪ Example – appetite for business activities that are outside of core competencies
Zero Tolerance Risks	▪ A subset of the above which identifies the categories of risks to be avoided ▪ Example – appetite for regulatory mis-compliance

The practices for managing risk appetite are continuing to evolve as firms gain experience with risk management and as approaches take root in firms

- **Established Practices**
- Risk appetite is managed “bottom-up” to some extent - via ongoing monitoring and Senior Management involvement.
- The determination and/or management of risk appetite includes some form of consideration of: the firm's capacity to bear catastrophic losses; the firm’s strategic objectives; the firm’s relative competencies; the risk-reward trade-off; and the economic environment.
- A framework exists for all risks (including, increasingly, business/commercial type risks).
- Appetite is described in quantitative / absolute terms, and related to clear financial / strategic objectives (as opposed to ‘medium’; ‘conservative’; ‘risk averse’ etc.)

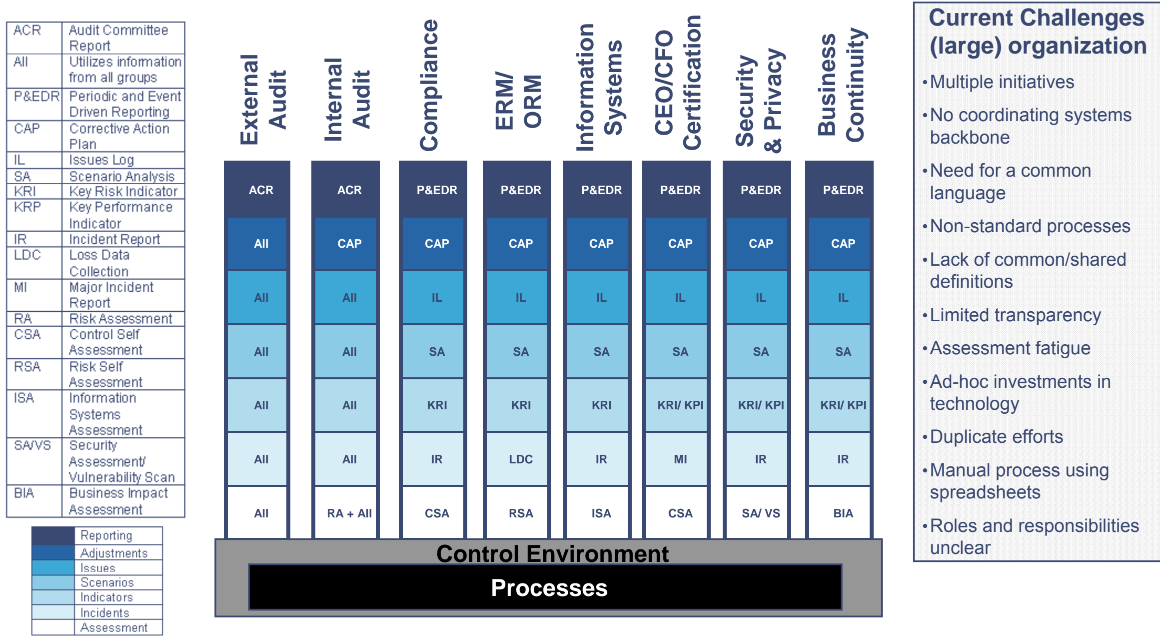
- **Emerging Practices**
- Much stronger and explicit link between the organizational objectives (more than maintaining a desired credit rating) and the specification of its risk appetite.
- Risk appetite is expressed at more than one confidence level and/or time horizon.
- Analysis of the risk-reward trade-off is becoming more sophisticated, recognizing that different forms of risk carry different costs (i.e. require different returns).
- Definition of risk appetite extended beyond tolerance (i.e. how much risk) to include which risks and why (i.e. what are the right/wrong risks, having regard for stakeholder expectations, view on credit cycle, relative competencies etc).

Leading firms are driving Risk Management through corporate principles, aligning the focus of Risk Management to objectives, outcomes and setting the expectation for how they will be achieved



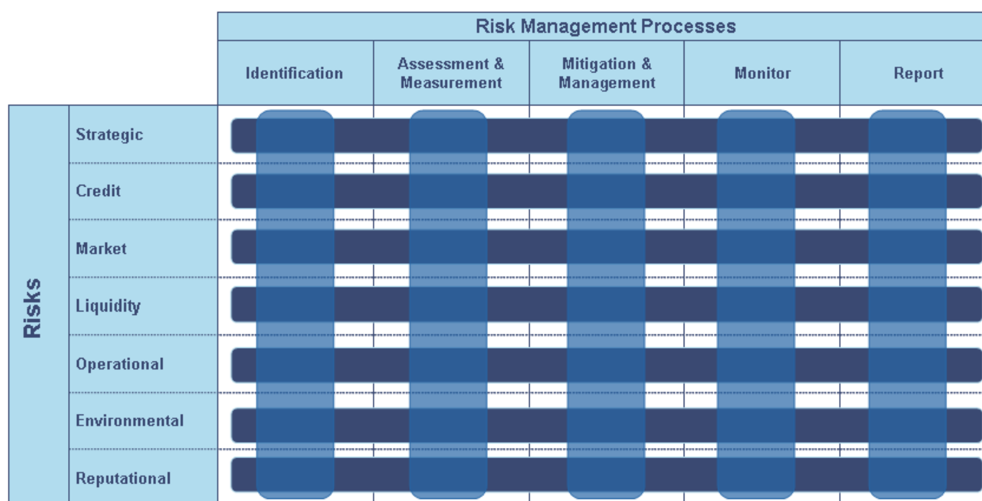
Anchoring risk management through corporate principles provides a framework for the consistent delivery of risk management across disciplines and lines of business.

In moving forward with an integrated approach to Enterprise Risk Management organizations typically have to deal with siloed, replicated and disconnected processes and systems

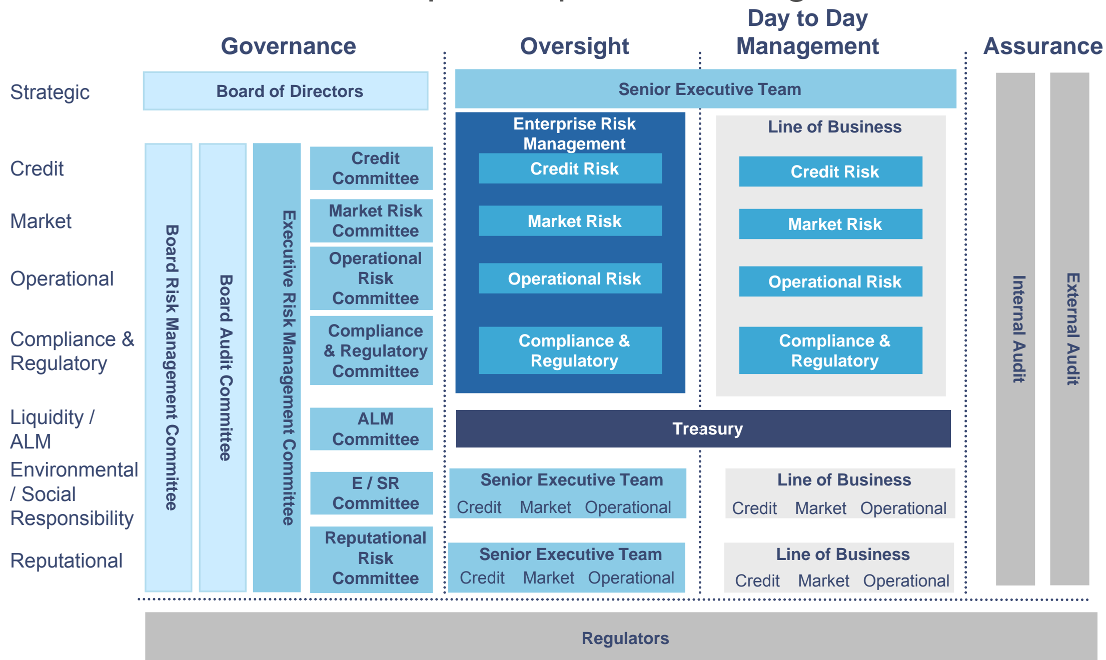


The integration of Risk Management processes increases transparency and supports the simplification of the processes while improving the effectiveness of Risk Management

To provide a complete picture of risks across the enterprise, risk management processes need to be integrated across risk disciplines.

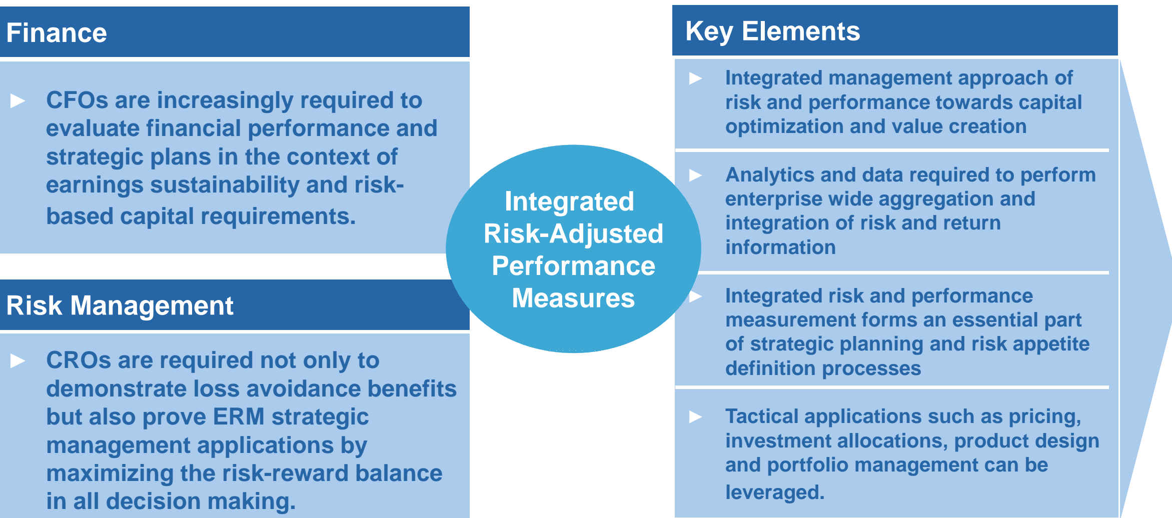


Effective ERM in today's increasing complex and connected business environment requires operational alignment as well



Managing risk is an integrated process that relies upon multiple groups within an organization

Within financial institutions the finance and risk management disciplines are now merging in a way that necessitates the integrated management of risk, return and growth



Emerging Risk Management Organizational Practices

	Theme	Outcome
	Strengthen **risk management rigor** by engaging the business	Strong **senior management commitment**, Risk management becomes **embedded in the business** and the tone at the top pervades the organization
	Clarity of roles, responsibilities, rewards and consequences (board, business lines, risk management, I/A)	Strong central risk group, **aligned performance measures, incentives and rewards**. Unambiguous accountability and escalation requirements
	Bring a **strategic risk perspective** to risk management and look beyond traditional financial risks. Embed risk in the strategic planning process	Timely **valuable independent risk insight** and effective discussion about inherent business risks Improved **performance balancing risk and reward**
	Define risk capacity, tolerance and appetite to improve our understanding of the risks we are assuming	**Strengthen analytical capability**, improve risk judgments and clarify the communication about the risks we are assuming
	Improve the **formality and effectiveness of the risk management processes**. Integrate credit, market and operational risk management practices	Improved **data and process quality** to deliver comprehensive transparent reporting. Improve operational excellence across the business **(no surprises)** Improve the formality of **operational controls, models, metrics, limits, valuation**
	Improve **relationships with stakeholders**	Restore **regulatory goodwill** and relationships

Summary of the Canadian Bank's approach to Risk Management - findings from Annual Reports*

- Each bank has a risk management framework that includes credit, market, liquidity, operational, environmental and strategic risks.
  - Responsibility for managing credit, market, liquidity and operational risk generally belongs with the LOBs.
  - Environmental risk is typically incorporated in credit risk.
  - Strategic risk is the responsibility of the Senior Executive Teams.
- Each bank has a risk management committee at the board level. Typical responsibilities are reviewing and approving risk management strategies, policies, standards and limits.
- Each bank has executive level risk management committees. Generally, the committees either directly or through sub-committees, have responsibility for credit, market and operational risk.
- Oversight for risk management activities is performed by a central risk management function.
- Risk management is performed by independent risk professionals within the business units.
- Internal audit is not involved in day to day risk management activities, but performs periodic reviews of the effectiveness of the risk management framework.
- Market risk is responsible for trading risk. Non-trading risk and liquidity risk is managed by Treasury with oversight from the ALCO or its equivalent.
- Where Canadian banks differentiate themselves in credit risk is their discipline and enforcement of risk policy to meet corporate objectives.
- Compliance risk is managed differently across the banks. RBC has a Global Compliance Group which is part of Enterprise Risk Management. Compliance risk is managed by Operational Risk at Scotiabank.

* Annual reports reviewed for BMO, CIBC, TD, Scotiabank, RBC and NBC.

Overall Risk Management Framework in the Canadian Banks

Category	Industry Practice	Observations
Enterprise Risk Management Framework	▪ Leading industry practice is to have an Enterprise Risk Management Framework that clearly defines key roles and responsibilities: – Business units responsible for taking and managing risk – Independent risk and compliance functions responsible for setting standards, providing tools and objectively monitoring risk – Internal Audit responsible for providing independent validation and assurance that the risk management system is designed and operating effectively – Board and senior management both responsible for overseeing effective and efficient enterprise risk management. ▪ Leading industry practice is to have an integrated Risk Management Framework that drives cross-functional effectiveness and efficiency with respect to people, processes, technology and information. ▪ Consistency in corporate and business unit organizational structures helps achieve framework integration, effectiveness and efficiency objectives.	▪ Each of the major Canadian banks have Enterprise Risk Management Frameworks that include Credit, Market, Liquidity, Operational, Environmental and Strategic risk. Within each bank, responsibility for managing risks generally belongs within the business units for Credit, Market, Liquidity and Operational risk. Environmental risk (lending related) is generally managed through credit risk. Two banks (TD and RBC) have Corporate Environmental Affairs groups for the oversight of Environment risk (non-lending related) management. Strategic risk is the responsibility of the Senior Executive team. Oversight for liquidity management is generally the responsibility of Treasury. ▪ While each bank has a risk management framework, only the Royal Bank of Canada provides a description of their risk appetite framework and the risk management principles that guide their risk management activities (see Appendix II).

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