ENTERPRISE RISK MANAGEMENT FOR BANKS

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1. INTRODUCTION

Risk management in banking sector is in limelight especially after the recent turbulence that has impacted the very existence of banking sector as a viable industry. The journey of risk management started way back in early 1800’s, where the banks had recognized the significance of the role of risk management and had adapted the same by creating a risk function in their organizations. Not only the bank’s, even the various government bodies have recognized the repercussions / impact of not managing the risks effectively in banks and accordingly enacted several regulations to control risks that arise in the banking business and operations.

From there onwards, the risk function in the banks has evolved over a period of time and reached to a stage where the need felt to have a common criteria to measure & quantify the risks so that a comparative analysis of the banks can be performed and made available to the stakeholders. This development has lead to introduction of BASEL Norms by BIS Committee. The committee has guided all the central banks of the participating countries and the banks governed by them to adapt and align their risk management practices to the norms over a period in time. The Basel norms are focused on the risks in Operational, Credit and Market areas which in turn helped the banks to quantify the risks and standardize their risk management practices across the said areas.

However, most of the banks have seen Basel norms as another mundane exercise of regulatory compliance instead of a tool for effective risk management which has resulted in reality as a pure eye-wash act to satisfy the regulatory authorities. The situation resulted was mainly on account of banks being under constant scrutiny of the regulatory authorities and cornered with multiple number of regulations to be complied with.

In other words, banks in their efforts to comply with these multi-regulations realized that complying with all the mandatory regulations is too cumbersome because many times the data and approach required to meet different requirements are quite similar resulting in duplicated efforts and increased costs. One way, these multi-regulations have jeopardized the very essence of the regulations and risk management itself.

Moreover, given the depth n breadth and geographical spread of the banking business and operations, banks realized that Basel norms are not comprehensive enough to establish a comprehensive risk management system which could help them to identify, mitigate risks across enterprise in all the areas and at the same time rationalize and mature their risk management practices across the enterprise.

The above said factors lead to a scenario where the banks started looking beyond Regulatory compliance and Basel norms for an Enterprise-wide approach to cater to all risk requirements in more cost effective and efficient manner.

Banks have identified and started adapting the Enterprise Risk Management Framework released by COSO (Committee of Sponsoring Organizations of the Treadway Commission) as a framework to drive their initiatives in risk management beyond Basel norms and regulatory compliances. The COSO ERM framework has all the components that could help the banks to stand a chance to derive business value while meeting compliance requirements. The ERM Framework is structured around eight key components and four key objectives of business viz. strategic, operations, reporting and
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compliance. The components of the ERM Framework are given below:

Enterprise Risk Management enables the organizations to pragmatically deal with uncertainty and associated risk and opportunity thus enhancing the brand value and profitability. Enterprise risk management helps in identifying and selecting among alternative risk responses – risk avoidance, reduction, transfer, and acceptance. It helps to ensure effective reporting and compliance with laws and regulations, and avoid damage to the entity’s reputation and associated consequences.

To summarize, Enterprise Risk Management helps an entity get to where it wants to go and avoid pitfalls and surprises along the way. An organization has to understand the challenges, various risk domains and risk areas relevant to the business and the different kinds of ERM activities which need to be carried out to successfully implement ERM application.
2. RECENT FINANCIAL CRISIS AND WHAT WENT WRONG

The Banks worldwide should take a cue from the recent battering that many of the financial services companies have faced in the last 12 months. Although the banks have already adopted and implemented Basel II norms and established enterprise risk management programs, most of them were unsuccessful in understanding how the market forces have influenced their “Risk Appetite” and their risk management systems were not robust enough to identify and report on how the risk culture is being influenced by the internal and external forces.

For instance, Banks and other investors continued to purchase newer types of investments without having the proper infrastructure in place to identify and manage the risks. This is a classic example of trading risk mismanagement.

Moreover, in reality, the risk management function is always seen as a non-contributing asset, which is in place to meet the some regulatory requirements. This had lead to underestimating the role of risk management in the growth and sustenance of an organization which resulted in a secondary role of risk function and consideration of risks in decision making. It is obvious that in most of the banks the business gets priority over risks, and decisions were made by overlooking the controls to mitigate the risks (in other words, an eye wash exercise).

The learning that comes out of this episode is that the risk management practices have to be more rigorously & seriously followed and the banking industry should put up the necessary resources to constantly improve on the guidelines.
3. INITIATING AND IMPLEMENTING ENTERPRISE RISK MANAGEMENT

Globally banks are realizing that they need a more pragmatic approach for managing a growing plethora of risks enveloping the banking and financial industries landscape and have now understood the significance of ERM to sustain their organization.

ERM can be defined as a process that enables banks to effectively deal with varied types of risks and opportunities, thus increasing the stakeholder value. In addition to that what makes ERM so compelling is that, it expresses risk not just as a threat, but also as an opportunity.

ERM enables the banks to move away from the “silo” approach to risk management (i.e. different internal groups responsible for each type of risk) and move towards the “holistic” view of enterprise wide risks. ERM helps the organizations to eliminate the duplicates and , redundancies in risks & related control procedures that exist mainly because of different groups define same risk differently, implement different control procedures and use different analytical models based on different assumptions and underlying data sets.

A first step towards initiation of ERM program in the organization starts with understanding the risk appetite, setting tone for risk governance and planting & nourishing the risk culture across the entity. Among the others, also it includes:

- Creating a standardized, enterprise-wide risk framework i.e. views of risk, including common definitions, assumptions and analytics.
- Setting risk objectives and ensuring that they are aligned to corporate objectives, risk appetite and culture
- Ensuring risk management remains independent of business lines. This includes changing reporting lines so risk management functions report directly to the Board of Directors rather than the CEO. CEOs and other senior executives are typically rewarded for short-term gains in the institution’s performance, and this creates an incentive to maximize short-term gains, even if it increases the institution’s long-term risk exposure.
- Expanding internal model governance groups responsible for the independent review and validation of risk models.

The next step is to identify the “Risk Domains”, “Risk Areas” to define the boundaries of “Risk management” function in the enterprise. Once the boundaries are set, the focus will move to identify the threats & vulnerabilities and creating a risk profile for each risk area in particular and for organization as a whole. Then the journey of ERM will move towards identifying and selecting strategies for mitigation of risks (includes establishing controls) and setting up a system of continuous monitoring and managing risk profile.

Before embarking on the ERM path, the banks should clearly identify and understand the strategy and business objectives. Banks should also have a broad outline of various types of risk being faced by the organization and recognize that ERM is not a quick process but a long and arduous journey. The data and the results which come out of the ERM should be used to improve the holistic ERM practice and thus it is more of an iterative approach rather than a one time process. Strategically, ERM can be viewed as key component of corporate governance framework.
4. CHALLENGES IN ADOPTING ENTERPRISE RISK MANAGEMENT

ERM implementation will have to overcome multiple inherent challenges like strong support from top management, sufficient resource in terms of cost and trained professionals, expert knowledge in risk management and the continued focus on the implementation without losing steam in the middle.

For instance, integration of market risk management, credit risk management, liquidity risk management and operational risk with other “financial” risks is a difficult step which requires a significant efforts, time and costs to improve the underlying data management.

Top challenges being faced by banks to adapt ERM:

<table>
<thead>
<tr>
<th>Improving efficiency</th>
<th>Achieving greater efficiencies in the risk and control processes, improving coordination, unifying and streamlining approaches.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Challenging regulatory environment</td>
<td>Ever changing regulatory demands, high degree of regulatory scrutiny, variation of regulations across jurisdictions, preparing to operationalize/compliance with Basel II</td>
</tr>
<tr>
<td>Keeping pace with business growth and complexity</td>
<td>Rapid business growth, competitive intensity, M&amp;A activity, global expansion, increasing product complexity, increasing customer expectations.</td>
</tr>
<tr>
<td>Attracting and retaining talent</td>
<td>Shortage of good talent in competitive markets, especially in specialized areas or emerging geographies</td>
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<tr>
<td>Managing Change</td>
<td>Dealing with people and organizational issues as new processes demand new methods of work</td>
</tr>
<tr>
<td>Fear of compliance failures and emerging risks</td>
<td>Fear of compliance failures despite best efforts, due to human error or unanticipated events; identifying and preparing for future risks.</td>
</tr>
</tbody>
</table>
ADDRESSING ERM ADOPTION CHALLENGES

ERM as a process is a long and arduous journey. It’s a never ending process and the risk convergence journey can be divided into three broad phases of coordination, alignment and integration. The initial convergence program is mainly focused on streamlining of basic activities, including developing a common risk language and framework, identifying and reducing redundancy, and sharing data. The banks which have embarked on the process find silo infrastructures, people’s natural resistance to embracing major operational changes, and inflexibility of existing legacy systems.

The objective of risk convergence is to establish an integrated approach and consistent set of processes that reduce the redundant risk & control activities eliminate duplication in the business units, and cut down costs.

Risk convergence begins with senior management. It starts with clearly defining the roles and responsibilities of the personnel in various departments related to the organization’s risks. It also includes laying the foundation needed to support a more coordinated and effective risk management process, creation of a common data structure and common technology architecture. Having this kind of involvement from top management fosters communication, increases coordination among various risk stakeholders and increases risk understanding for the organization as a whole. Also it requires contribution from each of the department in the bank.

As explained above, an organization should have a holistic understanding of the risks it faces and a common risk control process, common technology architecture and ideally a common data warehouse which has reconciled data from all the business segments. ERM can’t become a success story without the senior management’s active involvement because of its size and complexity.

Successful ERM implementation leads to better corporate governance process, decreases and control the overall cost of risk management, reduces bank’s overall bank’s risk profile, helps better capital allocation commensurate to the banks overall risk exposure and substantial increase in the stakeholders and regulators confidence in bank’s activities.
5. WIPRO’S APPROACH TO ENTERPRISE RISK MANAGEMENT

Wipro’s approach to enterprise risk management is a blend of top to bottom and bottom to top approach. Wipro works closely with the senior management to understand their vision and strategy and at the same time to understand their risk appetite. These continued sessions with senior management help them to understand the risk appetite and accordingly drive them to set the tone for ‘risk culture’. Simultaneously, Wipro works with the other layers of management to understand the existing risk function / practices and the risk awareness in the organization. Wipro through this blended approach helps the senior management to set up appropriate risk governance structure and to define appropriate risk objectives which are aligned to the strategic objectives of the organization.

Once the tone at the top is set properly, the focus will move towards identifying the threats & vulnerabilities and creating a risk profile for each of risk area in particular and risk profile for organization as a whole. Then it moves ahead with designing and implementing risk mitigation strategies and at the same time to setting up the processes for continuous identification, determination and assessment of risks & controls in the organization.

Wipro recognizes the important of risk dash boarding and reporting and spends a considerable amount of time to understand the reporting requirements at various layers of the management especially the top management. This includes an objective evaluation of various risk metrics and measures (i.e. Key performance indicators, key risk indicators, critical success factors etc), defining the metrics & measures at various levels and risk dash boarding to the top management. The ERM approach is given below:
WIPRO’S CAPABILITIES

Wipro Risk & Compliance practice has worked with many clients right from initiating risk management programs to implementing and then managing their end to end risk management function. These exposure and experiences helped us to rationalize, standardize and automate processes and the design, develop and deliver enterprise wide risk management solutions. We leverage the knowledge gained from working with various clients and have developed off- the-shelf, re-usable components which make the design and implementation of ERM easy and customizable to meet the needs of organizations standing at different levels of maturity. Our consultants can help you in

- **ERM Readiness Assessment & Strategy:**
  - Identify value and defining appropriate enterprise risk management strategy.
  - Establish the risk management objectives; correlate them with strategic objectives and measures & metrics to achieve them.

- **ERM End to End Implementation:**
  - off-the-shelf, re-usable components which can make ERM initiative sail smoothly and successfully resulting in good return on investment

- **ERM Operations Management:**
  - “Risk Management Operations Maturity Framework” which can make risk function optimized resulting in good return on investment.
  - Support in understanding the current level of maturity and guide to move up in the maturity ladder.
  - Onsite-offshore transition model can help to identify the activities that can be performed at offshore, enable smooth transition to realize the benefits of off-shoring / outsourcing.

- **ERM Automation:**
  - To identify the activities / processes that can be automated
  - Perform product analysis to identify appropriate tool that fits to the organization requirements and drive the implementation.

- **ERM Assessment/ Auditing:**
  - Plan and schedule a continuous monitoring / assessment program to keep IRM strategy and framework up-to-date / current.
  - To define appropriate metrics, key risk indicators and built-in the system so that alerts can be triggered for timely action.

- **ERM Awareness Sessions:**
  - Create a program for enriching the knowledge levels of stakeholders and at the same time create a platform wherein, the stakeholders play an active role in managing the risks

In other words, Wipro can help banks in ERM process by

- Advising on implementation of ERM in the Bank
- Drafting EOI/RFP for ERM process map
- Creating Functional Specification document
- Evaluating various compliance solutions for Basel II, AML, ALM, Sox etc.
- Developing Framework & Implementation Roadmap for graduating to better practices
6. CONCLUSION

A successful ERM process would ensure that risk taken by bank is compensated by commensurate level of reward and the bank is completely aware of the amount of risk that it wants to take on. Many banks are now looking at ERM to integrate risk and control processes and create a common framework for assessing and monitoring all kinds of risks. An integrated model helps in delivering tangible benefits in terms of costs associated with compliance and gives better picture of risk being faced by the bank. The risk management process becomes more robust because of common data structure and a common technology architecture supporting the entire process.
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Wipro is the first PCMM Level 5 and SEI CMMi Level 5 certified IT Services Company globally. Wipro provides comprehensive IT solutions and services (including systems integration, IS outsourcing, package implementation, software application development and maintenance) and Research & Development services (hardware and software design, development and implementation) to corporations globally.

Wipro’s unique value proposition is further delivered through our pioneering Offshore Outsourcing Model and stringent Quality Processes of SEI and Six Sigma.

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