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Reporting on risk: A Q&A with the world's first Chief Risk Officer

Information Management

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Read what James Lam, President of James Lam and Associates, a risk management specialist, said in a recent interview. As an Author, Consultant and former Chief Risk Officer, Lam speaks with an authority that few others can match in the risk management arena.

Q1: Many large corporations, especially in the financial services industry, have invested in risk management over the past decade, and yet they suffered significant losses in the current credit crisis. What happened?

A: That is a very fair question given that this crisis originated with the banks, and what began as a subprime mortgage issue has escalated into a credit crisis and now it looks almost certain that it will become a global economic crisis. While there is plenty of blame to go around, including misguided government policies and lax banking regulators, at the core this has been a failure in risk management. In fact, many risk professionals I know are doing a bit of soul searching right now.

On the positive side, there are companies that have performed significantly better than their peers due to superior risk management. In contrast, companies that have suffered above-average losses generally fall into one of two groups. One group is what I call "risk ignorant" and they simply didn't know what they didn't know. They may have relied mostly on debt ratings from the rating agencies without due diligence or based their decisions on faulty models that only measured one aspect of risk (e.g., credit default without consideration of market risk and liquidity risk).

The other group is what I call "risk incompetent" and they may have good models but they didn't make the right decisions due to organizational problems. These problems include ineffective board governance and management oversight, improper culture and incentives and lack of risk management independence.

Regardless, we are going through the "one in a century" event. All companies would benefit from examining how their risk management capabilities and decision-making processes have performed during this period. Based on my experience, the key challenges include strengthening board and management oversight, establishing an integrated view of risk through better analytics and reporting, enhancing the independence of risk management, revising incentive compensation systems, and last but not least, establishing success measures and feedback loops for the risk management function. In short, companies need to establish an integrated enterprise risk management program and ensure that the program is functioning effectively on an ongoing basis.

Q2: Define what you mean by Enterprise Risk Management (ERM) and its component parts?

A: In my first book *Enterprise Risk Management—From Incentives to Controls*, I defined ERM as:

"An integrated framework for managing credit risk, market risk, operational risk, economic capital, and risk transfer in order to maximize firm value."

While strategic and business risks were implicit in my definition for operational risk, I now believe they deserve explicit treatment. In my current work, and also in my upcoming second book, the definition of ERM has been expanded to explicitly include business risk and strategic risk. This evolution reflects my own education and experience, as well as industry practices. I believe business and strategic risks are the most critical risks for business enterprises, and as boards and executive management become more involved in ERM, their inclusion will be a natural outcome in the future.

Therefore, within the context of ERM my definitions of the five major categories of risk are:

- Credit risk. Risk/return trade-offs due to loan or counterparty credit default.
- Market risk. Risk/return trade-offs due to market price movements (e.g., interest rate, FX, equity, commodity).
- Operational risk. Risk/return trade-offs due to people, processes, systems, or external events
- Business risk. Risk/return trade-offs due to revenue volatility, where revenue flow may be insufficient to cover fixed expenses (current business)
- Strategic risk. Risk/return trade-offs due to strategic decisions on organic growth and acquisitions (future oriented).

Q3: Is there a tool or software application out there that provides dashboard reporting of risk enterprise-wide? How many companies are actually implementing dashboards? How important is this?

A: There are some software products that include dashboard reporting as part of their functionality (vendor specific). However, I think the most valuable dashboard applications would integrate information from disparate systems and databases (vendor neutral). [Author's note: for an example, please see www.cognos.com/dashboards.]

I think developing an ERM dashboard is one of the hallmarks of success in ERM. The purpose of an ERM dashboard is to aggregate risk information, develop an enterprise-wide view of risks and disseminate role-based risk information to the appropriate people. Recently I spoke at an ERM conference and asked how many companies were implementing dashboards, and more than 50 percent of the over 100 attendees raised their hands. However, companies generally do not have all of the information they need to support comprehensive dashboard reporting. They should start with their core risks, and for banks, that would be the development of an aggregate, enterprise-wide view of credit and counterparty risks.

Q4: How do you approach the implementation of a centralized credit risk reporting system if there are already various existing systems in place?

A: Nearly all banks have existing credit risk management policies, systems and processes in place. In terms of implementing an enterprise view of credit risk, I think it is critical to first understand the board's and management's reporting and decision-support requirements, and then develop working prototypes of what a credit dashboard report might look like. Based on the top-down requirements for board and management reporting, the implementation team should then clearly define the data warehouse, analytical and reporting requirements.

At the end, most companies that I've worked with conclude that the optimal strategy is to acquire the best-in-class packaged application, and build their unique requirements as part of the customization and implementation process. In other words, they "buy the best, and then build the rest."

Q5: What do best-practice risk management programs entail?

A: The hallmarks of success in risk management that I look for include the following:

- An engaged senior management team and Board of Directors.
- Established policies, systems, and processes, supported by a strong risk culture.
- Clearly defined risk appetite with respect to risk limits and business boundaries.
- Robust risk analytics for intra- and inter-risk measurement, summarized in a risk dashboard.
- Risk-return management via integration of risk management into strategic planning, business processes, performance measurement and incentive compensation.

Q6: How frequently should risk assessments be done?

A: At most companies risk assessments are performed annually. Leading companies are also updating their risk assessments on a monthly or quarterly basis. More importantly, risk assessments should be performed using a top-down risk-based approach so the most critical risks can be identified and the risk assessment processes can be rationalized. In other words, a more detailed process—including documentation, process mapping, measurement and reporting—should be applied to the most critical risks, while a streamlined process should be applied to the other risks.

Q7: Can you elaborate on the integration of ERM into strategic planning processes? Is this mainly a reporting issue?

A: I believe the integration of ERM into strategic planning (often referred to as strategic risk management) is the next frontier in risk management. It is more of a management issue, but reporting is an important component. When I helped start a capital markets business at GE Capital, we had a corporate process called Policy 6.0. We had to clearly define the key business and financial assumptions underlying our business plan.

More importantly, we established key performance indicators, key risk indicators and "trigger points" for management decisions and actions. On a quarterly basis, we conducted business/risk reviews with corporate management and made key changes to our business and risk strategies based on market opportunities as well as our business performance.

Q8: In addition to the process and system implementation, do you have any items that should be specifically stated within an ERM policy?

A: An ERM policy should include a common risk taxonomy, risk tolerance levels for key risks and risk assessment, measurement and reporting requirements. Some ERM policies also include specific risk escalation levels, such as loss or business impact thresholds, to ensure emerging risk issues are escalated and addressed in a timely manner.

Q9: How do you ensure that a bank has covered at least the key risk analyses needed to mitigate risk effectively?

A: In light of the issues that surfaced during the current credit crisis, banks should take a "back to basics" approach. Clearly, credit risk has been, and will continue to be, the core risk for banking institutions. As such, banks must ensure that, at a minimum, they have effective key risk metrics, early warning indicators and dashboard reporting with respect to credit risk. However, we've also learned that significant risk events are the consequence of not just one risk but a confluence of multiple risks. As such, banks must extend their analytical capabilities to include all critical risks. An example might be the integration of credit, market and liquidity risk analyses.

Q10: How do I help the CIO integrate a strategic technology plan with ERM?

A: First, you can help the CIO to leverage ERM to identify the strategic, business and operational risks associated with the strategic technology plan (including outsourcing risk, technology risk, and other key factors). This risk assessment should also include the credit risk associated with technology and outsourcing partners. Second, the technology plan should also support the ERM program in terms of the risk management systems, database and reporting initiatives.

In order for these initiatives to be successful, an effective partnership must be established among the business unit, risk management, and IT. For example, the CIO, chief credit officer and the chief lending officer must work closely together in determining the requirements for a credit risk dashboard. I have worked on over 50 ERM engagements, two as CRO and the rest as a Consultant, and I can tell you that IT has been a critical component in each one of those engagements.

For more information on these and other related topics, please visit these addresses:

7 Risk Dashboards Every Bank Needs white paper:
http://www.cognos.com/pdfs/whitepapers/wp_7_risk_dashboards_banks_need.pdf

Risk Management Reporting demo
http://www.cognos.com/solutions/demos/risk_management/index.html

More Risk Management resources
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About James Lam and James Lam & Associates

Founded in January 2002, James Lam & Associates (JLA) is a consulting firm singularly focused on risk management. In a 2007 Euromoney survey, Mr. Lam was nominated by clients and peers as one of the leading risk consultants in the world. Mr. Lam has over twenty years of experience in risk and business management. He is widely noted as the first ever "chief risk officer" and an early advocate of enterprise risk management. Previously, Mr. Lam served as Partner of Oliver Wyman, Founder and President of ERisk, Chief Risk Officer of Fidelity Investments, and Chief Risk Officer of FGIC Capital Markets Services, Inc. Mr. Lam is the author of "Enterprise Risk Management: From Incentives to Controls," which has ranked #1 best selling among 25,000 risk management titles on Amazon.com. Treasury & Risk Management magazine named him one of the "100 Most Influential People in Finance" In 2005, 2006, and 2008. More information on JLA can be found at www.jameslam.com.

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