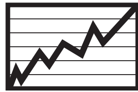
Chapter 2

ERM AND THE BANK'S CULTURE



Ambition has no risk

Edward George Earle Bulwer-Lytton (1803–1873),
playwright, *Richelieu*, Act iii. Sc. i.

There's a legend at Federal Express that tells of a driver who, when getting to the last drop box of the day, realized that he had no key with which to open it. Since he did not have the time to drive back to his home base to get the key and return to the drop box, ensuring that the box's contents would get to their destinations as FedEx promises, he made a quick decision. He ripped the box out of the ground, taking the box to the key rather than bringing the key to the box.

At FedEx, he's considered a hero. His counterpart at the U.S. Postal Service, if he did the same thing, however, probably would be considered a thief. FedEx and the U.S.P.S.—two companies with very similar business models, but two very different cultures.

Formula for Success

There is no secret to successfully implementing an ERM in a bank. Just remember to:

- ➤ Match the implementation strategy to the bank's culture.
- ➤ Consider the individual values of the most successful people in the organization.
- ➤ Work within the culture given you; do not try to change the culture.

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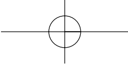
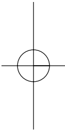
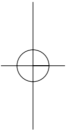
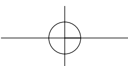


This chapter provides bank executives with strategies for implemening ERM within the context of their bank's culture. It will help bankers determine the culture of the organization and give practical applications for matching the strategy for implementation with the collective values of the people in the bank.







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THE RISK-AWARE CULTURE

Culture is a huge differentiator in the marketplace. If a bank is successful, its success is due mainly because of its culture. Since culture is built into a bank's very DNA, for any strategy to succeed, it must fit, or work within, that culture. Consequently, bank executives must design an ERM implementation strategy to complement their bank's culture, not compete with it. A good start is to make the bank team risk aware.

Making the Bank Culture Aware of Risk

The advent of modern risk management came with the calculation of probabilities, corresponding specifically with the growing popularity of gambling[9] (The prospect of achieving wealth is irresistible for most people). Taking risks and managing them has to do with taking stock, measuring the risk inherent in an opportunity. Do we take these steps? Can we afford to? Can we afford not to?

Calculating Probabilities

The engine behind ERM is that measurement leads to improved capabilities. It is important then, in making the culture risk-aware, that the bank executive views ERM as a process. Any process can be measured, and with measurement comes the potential for improvement.

The problem with measurement, however, is that employees may become defensive, and a bank's culture may exacerbate that emotion. Employees who have practiced their craft over time will resist someone looking over their shoulder as they would a new hire. It is, therefore, important to first "type" the culture to find out what obstacles the bank executive must overcome to implement ERM.

Typing the Culture

What type of culture does your bank have? Is it risk averse, risk neutral, or risk tolerant?

When determining which of these characteristics describes your bank's culture, it is important to be objective. A common pitfall is to look at risk from one's own perspective, forgetting that the culture is the collective values of all of the people in the organization. In fact, a bank can "type" its culture by looking into the characteristics of its most successful people or even by using the "pig in the parlor" analogy discussed below.

The Most Successful People

What are the characteristics of the most successful people in the organization? A bank's culture is reflected in the values and behaviors of those people. Who gets the plum assignments? Who gets to rescue a failing initiative? Who gets an appointment with the CEO without going through line management? The list one develops is indicative of the organization's culture.[10] It will not overtly help the bank executive assess risk, but it should indicate whether the organization is risk tolerant, risk averse, or risk neutral. And that is a very good starting place in determining how big and far-reaching an ERM initiative will be.

How would a bank executive normally react to a proverbial pig in the parlor, the bank's main lobby? After all, pigs, on one hand, have been the subject of nursery rhymes and cartoons. Risk tolerant? On the other hand, pigs can appear to be big and disgusting creatures. Risk averse? If one were in the lobby, what would a banker do? Order it out, or what?

Strategies for Building Risk Awareness

Chances are that a bank executive will find himself in a risk-tolerant culture, particularly if the bank is successful. If the

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EXHIBIT 2.1 Value-Added Strategies for Company Buy-In, by Culture Type

	Risk-Averse Culture	Risk-Neutral Culture	Risk-Tolerant Culture
Value-Added Strategies	➤ Remove or neutralize a threat. ➤ Add controls and measures. ➤ Regularly report on the ERM initiative. ➤ Elevate the roles of Internal Audit and Compliance within the organization.	➤ Prove that ERM is not a regulatory exercise but a business strategy. ➤ Connect ERM not only with SOX, GLBA, and FDICIA, but also with everything else the company does: business decisions, new products and services, hiring key executives, and so forth	➤ Find the competitive advantages and economic incentives ERM brings to the organization. ➤ Design systems that will keep regulatory agencies and corporate insurers comfortable. ➤ Show how more sophisticated approaches to managing risks will delight shareholders, ratings agencies, and Wall Street.

bank were not prepared to take risks, it would not open its doors in the morning. However, it remains important to type the culture to build ERM within its context and adjust the implementation strategy to fit it, as described below in detail and summarized in exhibit 2.1.

Risk-Averse Culture Strategies

A risk-averse culture will see ERM as a way to focus on the threats to the bank's business. Internal communication should zoom in on corporate scandals such as those that occurred at Allied Irish and Barings (rogue brokers), on well-publicized regulation violations (for example, SARs filings, BSA/AML issues) at Riggs and AmSouth banks, on capital deficiencies, or on the

bank's own internal and external exam findings. All of the strategies to push ERM throughout the culture should center on:

- ➤ removing or neutralizing a threat
- ➤ adding controls and measures
- ➤ reporting regularly on the ERM initiative
- ➤ elevating the roles of internal audit and compliance within the organization

In a risk-averse organization, the "pig in the parlor" would be driven out immediately and at all costs. A word of caution: in a risk-averse organization, people may see a pig when there is no pig, or they might see something as an undesired pig when, in actuality, it might be something very desirable.

Risk-Neutral Culture Strategies

A risk-neutral culture is not as quick to move on a real or perceived threat. It would take the posture: is a pig a bad thing? It might work well within the organization. Can we form a task force to find out? Is the pig something we can live with? What if the CEO likes the pig (i.e., sees it as something desirable for the organization)?

ERM strategies in a risk-neutral company are a bit more challenging. The bank executive must make the ERM initiative about:

- ➤ proving that ERM is not a regulatory exercise but a business strategy (see chapter 1).
- ➤ connecting ERM not only with SOX, GLBA, and FDICIA, but also with everything else the company does: business decisions, new products and services, hiring key executives, and so forth

Risk-Tolerant Culture Strategies

A risk-tolerant culture presents the biggest challenge of all: it may not see the pig. In this case, bank executives should forget

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selling ERM on the basis of threats to the organization and turn their attention to:

- finding the competitive advantages and economic incentives ERM brings to the organization
- designing systems that will keep regulatory agencies and corporate insurers comfortable
- taking the opportunity to show how more sophisticated approaches to managing risks will delight shareholders, ratings agencies, and Wall Street

A summary of these strategies appears in exhibit 2.1 below.

Commitment from the Top

Gaining CEO commitment and executive management buy-in is essential to the success of any corporate-wide initiative. Executive management support helps the sponsor of the initiative to mobilize the entire organization toward the goal, a process that is difficult in and of itself and cannot otherwise be achieved.

This is particularly true for the bank executive turned enterprise risk manager. Since it rarely has a large support staff, the job is extremely challenging. The enterprise risk manager typically has responsibility but not direct resources. Management by influence is the cornerstone for success, and the CEO's blessing is essential to achieve the credibility to build influence.

The challenge faced by executives responsible for ERM is even greater, since other managers oversee many of the risks with which the ERM bank executive also is mantled. Each one of those managers has infrastructure to support him, as well as the responsibility for the day-to-day management of the risks under his control (for example, credit, interest rate, market, operational, and so forth). The executives who run these respective departments often perceive the ERM bank executive as a usurper, someone who is looking at their work to find

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flaws, a threat that needs to be managed. They fail to see the added value that an enterprise-wide view brings to the table, as well as the overall portfolio approach to risk. The challenge associated with such an attitude is huge, since these departmental managers control the necessary resources for their respective risk management, as well as the flow of information about the risks that they manage. Both attitude and information are key to the ERM bank executives' accurate assessment of corporate-wide risk profile and their ability to execute risk optimization across departments and lines of business.

More Overhead or Value-Added?

For the CEO making the decision to add ERM to his or her own duties, finding the value-added proposition is not an issue; he or she already has found it. But what should a newly appointed ERM bank executive do to obtain the necessary buy-in from both the CEO and the executive suite, as well as from other risk managers within the organization, if the support is not already there? Demonstrating the value added to the organization by their presence and vantage point is the answer. An ERM bank executive may be viewed either as unnecessary overhead or as an essential strategic partner to all lines of business and executive management.

The CEO and the other managers must see the ERM bank executive as someone who helps them perform their jobs better. It is critical that the ERM executive view other managers as clients and vital collaborators to be won over, not as competitors or obstacles to success. Treating them as prospective customers changes not only the ERM manager's behavior, but also the customers' view of the ERM manager, for the better.

Clients and Collaborators

The first person on this list is the CEO, and the list includes all heads of lines of business as well as the risk functions within

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the bank.[11] The simple question is: what's in it for them? Several thoughts:

First, at the corporate level, effective risk management goes well beyond any individual risk. Corporate ERM looks at the portfolio of risks the bank incurs and assesses the interaction among them. As a result, risk might be reduced because two lines of business could counteract each other. A classic example is mortgage origination and servicing. Clearly, these two businesses are counter-cyclical; when one is doing well, the other is suffering. While their dual presence already is considered an interest-rate risk-reduction tool, there are other, similarly positive implications for capital requirements, organization-wide profitability, and other elements. Examining all lines of business together as a single portfolio to determine which ones create additional risk through their mutual presence and which ones reduce risk as pairs or other combinations is the sole purview of the ERM bank executive. Everyone in the organization can learn from a demonstration of how to reduce various risks by considering them together instead of as a stand-alone issue. This knowledge is valuable to all business owners as well as the CEO, and the ERM executive is the only person in the bank who can take the gestalt view—seeing all the risks in all lines of business in a unified whole.

Second, demonstrate reliance on existing risk managers and their resources. As a professional with limited resources, the executive assigned to oversee enterprise risk management relies on the existing infrastructure for information, ideas, and brainstorming. The successful ERM bank executive does not compete with the various risk managers. Instead, he or she accepts them as equal partners. The organization will cooperate if the executive in the enterprise management position becomes the warehouse of enterprise-wide risk information and not the owner and manager of the risks themselves. In other words, the ERM bank executive is not there to criticize and second-guess existing conclusions, but to use the information in a different, much more strategic context.

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Third, provide analytics that are currently missing from the executive table to facilitate sounder decision making. Few organizations truly consider the full range of risks—which, depending on the size and scope of the business, could number in the hundreds—in making decisions, mainly because it is difficult to expand the view outside of individual lines of business. The ERM bank executive has a unique opportunity to add this dimension to the executive table by producing a unique analysis of information provided by others to highlight the tradeoffs the company is making with and without full consideration of the risks. For example, is capital allocation to all businesses reflective of the risks embedded in those businesses? The ERM bank executive can lead the executive team in recognizing the differences across businesses and allocating capital properly to yield true and effective risk-based decisions. He or she can add the risk dimension to strategic business discussions that currently are missing that element. For example, diversification across businesses rarely is considered when lines of business are evaluated for expansion, additional investment, or contraction. Each decision is viewed as a stand-alone tactic. In reality, there are risk reduction benefits to building revenue streams across lines of business that might not be taken into account in the discussion. The ERM bank executive can add that dimension to the team.

Finally, add the risk analytics to presentations to investors. Analysts are getting more and more concerned with companies' risk profiles and their self-awareness of their situation. The ERM bank executive can help the CEO and CFO improve investor relations by adding just a couple of slides to their show, illustrating the incorporation of the risk element into the company's decision making and information dissemination. Analysts are not looking for risk avoidance; they are looking for risk awareness. Who better than the ERM bank executive to provide that component to outside audiences?

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Back Seat or Driving Force?

The CEO's endorsement of the ERM function in the bank is, as mentioned, an essential element in building the credibility and sphere of influence of the ERM bank executive. The CEO needs to recognize, publicly and repeatedly, the value of the function and voice his or her expectation of intracompany collaboration. This action will improve the company's risk profile under the ERM bank executive's leadership. The CEO will only do so if he or she feels the function truly provides value and that the ERM bank executive can contribute to the quality and profitability of decision making at the highest levels.

Toward that end, think about the decisions and corporate-wide risk management issues from the CEO and CFO's vantage point rather than from the auditors' or the other risk managers'. Learn *their* definition of success for the ERM function. Starting from their definition of success will prevent the ERM bank executive from looking at the function from his own personal perspective only and will help him become more effective. Different CEOs have different visions for ERM, which often reflect their management philosophy. Transplanting a "perfect" ERM plan into the company might be a noble ambition, but if the plan does not fit the culture, it is doomed to fail. Tailoring the approach, staffing the ERM position and integrating ERM into the CEO's specific vision and the company's culture will facilitate success for the ERM bank executive and the value he or she can bring to all constituencies.

For example, some companies are highly analytical. A quantitative approach to risk management and reports that fit the company's overall format will enhance the ERM executive's credibility and help integrate the ERM function effectively into the bank. However, when the CEO's management style is more "from the heart," producing reams of reports would only distance the ERM bank executive from the focus of management, thus separating ERM from the rest of the bank. In that case, the

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ERM executive fares better using persuasive and team-based methods of management. Knowing the company's culture and fitting into it are important ingredients to success.

The ERM bank executive can dispel a CEO's skepticism of the risk management function by:

- ➤ effectively considering the riskiness associated with different ventures
- ➤ adding value without increasing cost significantly
- ➤ working with others within the organization

The Board of Directors

After Sarbanes-Oxley and the amendments to the U.S. Sentencing Guidelines, the bank executive is finding a more engaged and better-informed board of directors. The bank's culture also will dictate how the board responds to ERM. There are many schools of thought about reporting responsibility, but overall, there are two broad choices: the ERM function reports either to the entire board or to a board committee. The selection should be based on whether senior management wants the entire board thinking about ERM *part* of the time, or a board committee thinking about it *all* of the time.

If a bank chooses to have the ERM function report to a board committee, there are two choices here, too. The ERM function can report to an existing committee or to a committee dedicated only to ERM. The problem with the former is that members of an existing board committee already have a particular function. A dedicated ERM committee may dilute the existing committee's effect on the organization. Additionally, having ERM report to an existing board committee may send a message the bank does not wish to send_that ERM is an audit or corporate governance function. Creating a separate ERM board committee, however, can be costly and perpetuate an attitude that ERM is a "siloed," not an enterprise, function.

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CONCLUSION

There are many paths through which a bank can develop an organizational ERM program. Each has its own pitfalls as well as opportunities. One thing is clear, however. ERM cannot survive in a vacuum. Its success or failure is determined by how well it fits and works with the culture of the company.

Key Points

ERM and the Bank's Culture

- It is important to determine whether the bank is risk averse, risk neutral, or risk tolerant; tailor the strategies for adoption of ERM to that determination.
- Integral to any ERM effort is the buy-in at the top of the organization as well as throughout management.
- The ERM bank executive should be seen as a collaborator and an aide to the business line. A risk manager should not be seen as a hindrance or usurper, or as unnecessary overhead.

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