A Review of Enterprise Risk Assessment

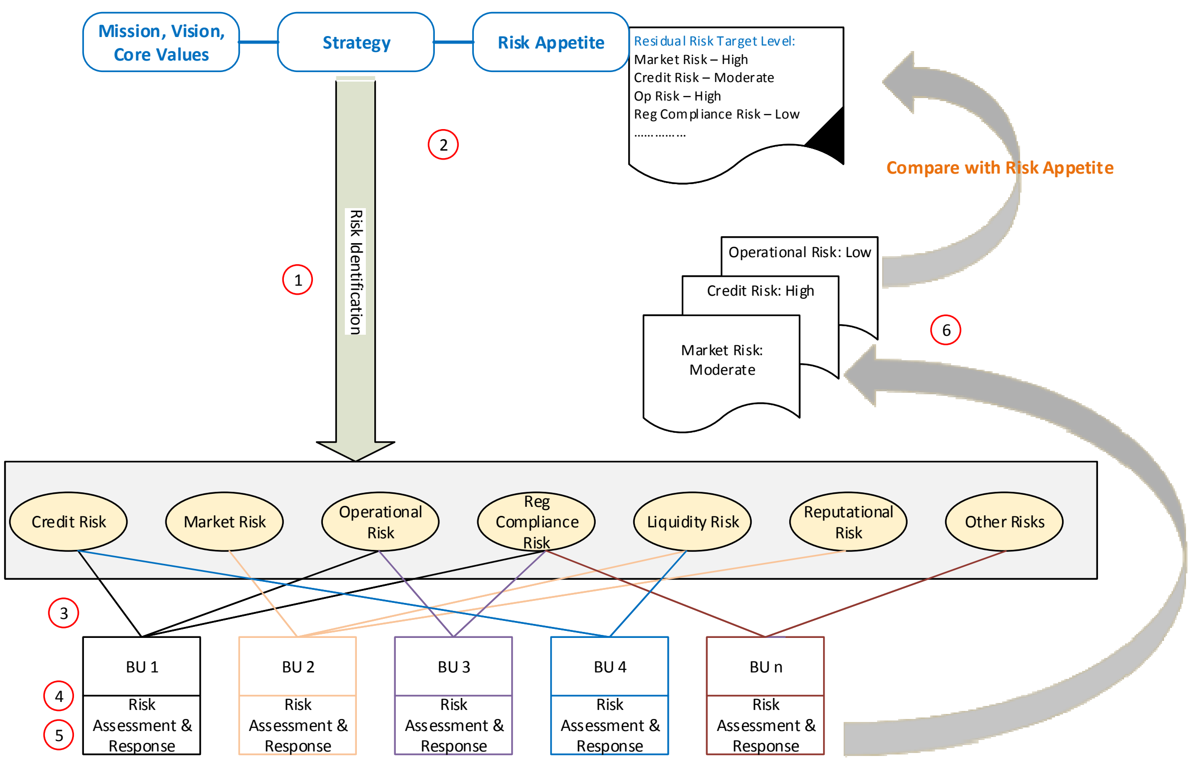
by Claire Yu

Integrated risk management requires tremendous coordination and effort. Whenever this concept is brought up, I would remember how Virginia Woolf crafted her master piece novel of *Mrs Dalloway*. Truly they are very similar in that the intention of both is to incorporate multiple perspectives, multiple dimensions and multiple themes into an entity as a whole.

In this article, I have conducted a review of entity risk assessment (ERA) as a key component of integrated risk management, focusing on the comparison of a traditional ERA approach and a better ERA approach, and outlining potential solutions to overcoming challenges arising from new ERA implementation.

Traditional ERA Approach

ERA has been an integral part of risk management process in almost every company. A typical traditional ERA approach is illustrated in the following diagram.

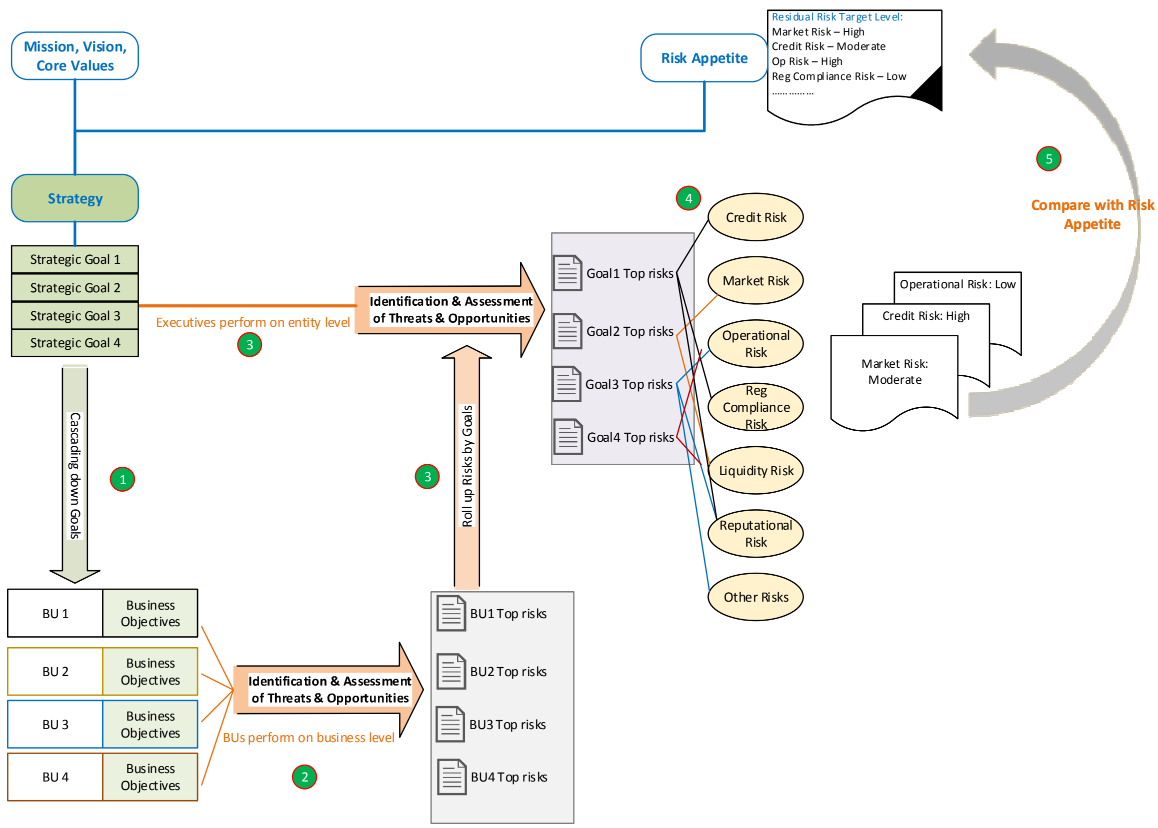


In such typical ERA process, there are pre-defined material risks to which the organization is exposed, such as credit risk, market risk, operational risk, liquidity risk and so on. For each material risk, every business unit would conduct risk assessment and corresponding control assessment based on a general understanding of its business activities. The major gaps and issues inherent in such an approach are as follows:

1) **Strategic goals are not well rolled out to business objectives**. For example, strategic goals typically include a target risk-based return. However, business units are prone to focus on business growth and profit target without due consideration of expenses such as funding/liquidity costs and regulatory/economic capital required. Such gaps could impact negatively the execution of company strategies.
2) **ERA is not explicitly or closely linked to either strategic goals or business objectives**. In the cases where there are no business-level risk appetite statements, the ERA conducted by business units is not directly linked to the entity-level risk appetite either. As a result, business leaders cannot see the clear linkage between strategy, risks and performance, and therefore do not see much value of this process. Instead, ERA is conducted by business units as extra work for the Risk Management group on top of their core responsibilities which are day to day business activities.
3) **As the ERA is not framed by strategy and business objectives, risk and control assessment could be unstructured and random**. The quality of the assessment relies on how much effort a business unit leader is willing to input into the process and could vary significantly across different functions.
4) **ERA ignores the fact that in some areas the organization could take more risks within its risk tolerance range so as to realize a better return.** This is because it focuses solely on negative risks which are threats and ignores positive risks which are opportunities to achieving strategic goals. Again, business leaders' reluctance to conducting ERA cannot be blamed because of this one-side emphasis on problems they need to handle only but not on potentials they can benefit from.
5) **Incomplete or broken risk assessment results in inappropriate risk prioritization and responses**. A risk could be assigned a high priority at the business level but a low or moderate priority at the entity level; likewise, a risk that is not properly identified at the business level could turn out to be a high-priority risk at the entity level. Accordingly, risk responses should vary.
6) **Corporate risk profile could be misrepresented.** The ERA results from business level assessment tend to focus on the activities and processes specific to a business unit, and therefore may not fully capture the risks affecting strategic objectives on the entity level. A typical approach to aggregating ERA results from business level to entity level is either averaging the risk rating/level or selecting the most severe risk rating for a particular material risk (e.g., credit risk, market risk, operational risk and etc.). Such an approach could obscure corporate risk profile because it fails to develop a portfolio view in which top risks assumed in achieving entity-level strategic objectives are articulated and assessed.

A Better ERA Approach

A better ERA approach is illustrated in the following diagram.



The key steps that distinguish this approach from the traditional approach are outlined below:

1) Overall strategies are formed in alignment with the organization's risk appetite, based on which strategic goals or objectives on the entity level are established. Strategic goals are then cascaded down to business units to establish business objectives on the business level so that business objectives align and support the strategy.
2) Business units conduct ERA in the context of business objectives, identifying and assessing both threats and opportunities at the operational level. In addition, for each risk statement associated with every business objective, KRI/KPIs are defined to track performance.
3) To identify top risks at the entity level, the top risks identified at the business level are rolled up by strategic goals to the entity level (bottom-up approach), based on which Executives collaborate to identify and assess additional risks, again including both threats and opportunities, impacting the entity as a whole (top-down approach).
4) Once the top risks associated with strategic goals are assessed, they can be categorized into material risk types which the organization is exposed to; so are the corresponding KRI/KPIs, risk prioritization and responses.

5) The risk rating/level assessed for each material risk is compared with the target risk rating established in the Risk Appetite Framework to obtain a portrait of the corporate risk profile.

This process can be implemented quarterly rather than annually to make it dynamic and reflect any change in the risk profile timely.

Key Challenges and Solutions in Implementing a New ERA Approach

Key Challenge Point	Descriptions of Challenges	Potential Solutions
Buy-in from Stakeholders	Stakeholders do not understand why the traditional ERA should be discontinued.	Socialize stakeholders with: • Summary of key changes • Benefit of new ERA as part of integrated risk management
Cost of Time	Stakeholders are reluctant to spend precious time in learning how to conduct new ERA instead of executing business activities.	Provide effective ERA tools, templates and documents to facilitate the process, especially enabling automation to save data entry time.
Quality of ERA	Quality in identifying and assessing ERA components, including business objectives, risk statements, KRI/KPI, and risk responses, varies.	• Make sure to frame ERA in the context of strategic and business objectives. • Risk Management provides challenges based on the results collected from all units. • Executives provide challenges collaboratively to the ERA results at both business level and entity level.
Portrait of Risk Profile	It is difficult to determine what information should be extracted from the ERA results into the portrait of risk profile.	There should be two levels of risk profiles: 1) Corporate risk profile – top risks and performance associated with entity level strategic objectives; and 2) Business risk profile – top risks and performance associated with operating unit level business objectives.

Conclusion

Risk management practitioners have to become increasingly savvy in their effort to implement and evolve integrated risk management. This involves developing a solid understanding of why and what existing processes should be changed, utilizing advanced technology and creating effective tools to facilitate better practice, and last but not least, sharing with all stakeholders the vision of a desirable risk management state, which will strongly support for achieving strategic and business objectives. Such effort is required for any key component of integrated risk management, including ERA.

Claire Yu is a capital market and risk management practitioner, currently working as a Risk Strategist at ZTE Quant Research (www.zte.ca). She has led many large-scale complex consulting engagements and internal audit projects with respect to financial risk management in various financial institutions.