ENTERPRISE RISK MANAGEMENT

"Decoding The Fundamentals"

VIRTUAL SEMINAR

AN EVENT FOR INDUSTRY LEADERS, PRACTICIONERS & PROFESSIONALS

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ERM DRIVERS – COSO, REGULATIONS, STANDARDS

NEXT LEVEL SOLUTIONS

in association with

Hubert Edwards, MBA, FCCA, LLB

Managing Consultant, Next Level Solutions

THE COMPARISON

Traditional Risk Management vs. ERM

Traditional Risk Management

- Tactical, compliance focused
- Silo-based processes
- Business line or risk type view
- Looks at risks individually
- Business decisions not closely linked to risks
- Driven by Risk Management and Internal Audit
- Supported by rules

ERM

- Strategic, performance focused
- Consistent risk management approach across the enterprise
- Holistic view of key risks
- Considers risk interactions
- Business decisions based on a clear understanding of risks
- Driven by the board and owned by the business
- Supported by a “risk culture”

RISK MANAGEMENT - MOVE FROM THE TRADITIONAL OUTLOOK!

. . . a ***systematic approach*** enabling an organization to consider ***all factors*** that threaten its ability to meet ***business objectives*** and **implement** appropriate ***risk management controls*** according to the organization's ***risk appetite***.

STRUCTURING AN ENTERPRISE RISK ASSESSMENTPROTOCOL: TRADITIONAL PRACTICE AND NEW METHODS

Mark Abkowitz

Janey Camp

RISK MANAGEMENT EFFORTS ARE CALIBRATED BY RISK APPETITE … THE GUARDRAILS - NextLeveL

ERM DEFINED - COSO

****

BE STRATEGIC, KILL THE SILOS OR SUFFER!

"…a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives."

Source: COSO Enterprise Risk Management – Integrated Framework. 2004. COSO.

RISK MANAGEMENT IS ALL ABOUT VALUE PROTECTION AND CREATION. ANYTHING OTHERWISE IS AN INACCURATE PERSPECTIVE - NextLeveL

WHY ERM IS IMPORTANT

ERM supports value creation by enabling management to:

- **Deal effectively with potential future events that create uncertainty.**
- **Respond in a manner that reduces the likelihood of downside outcomes and increases the upside.**

ERM DEFINED - COSO

The definition reflects certain fundamental concepts. Enterprise risk management is:

- A process, ongoing and flowing through an entity
- Effected by people at every level of an organization
- Applied in strategy setting
- Applied across the enterprise, at every level and unit, and includes taking an entity-level portfolio view of risk
- Designed to identify potential events that, if they occur, will affect the entity and to manage risk within its risk appetite
- Able to provide reasonable assurance to an entity's management and board of directors
- Geared to achievement of objectives in one or more separate but overlapping categories

RISK MANAGEMENT WHICH DOESN'T INFORM STRATEGY IS A WASTE OF RESOURCES - NextLeveL

THE DRIVERS - REGULATORY & STANDARDS

- SARBANES OXLEY – FINANCIAL REPORTING
- OECD PRINCIPLES – GOVERNANCE
- TURBULL GUIDANCE/COMBINED CODE –GOVERNANCE
- COSO – ERM FRAMEWORK
- COBIT – IT GOVERNANCE FRAMEWORK
- BASEL ACCORD – CAPITAL ADEQUACY FRAMWORK
- IFRS – ACCOUNTING STANDARDS
- RISK BASED APPROACH FOR REGULATORS
- AML/CFT COMPLIANCE

- COMMITTEE OF SPONSORING ORGANIZATION (COSO)
- GOVERNANCE/RISK/COMPLIANCE (GRC)
- IFRS 9 / 17
- STRESS TESTING
- BASEL ACCORD
- AML/CFT COMPLIANCE
- RECOVERY AND RESOLUTION PLANNING*

COSO – DEFINING ERM

The underlying premise of enterprise risk management is that every entity exists to provide value for its stakeholders. All entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value. Uncertainty presents both risk and opportunity, with the potential to erode or enhance value. Enterprise risk management enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value.

COSO – DEFINING ERM

Value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity's objectives. Enterprise risk management encompasses:

- *Aligning risk appetite and strategy* – Management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.
- *Enhancing risk response decisions* – Enterprise risk management provides the rigor to identify and select among alternative risk responses – risk avoidance, reduction, sharing, and acceptance.

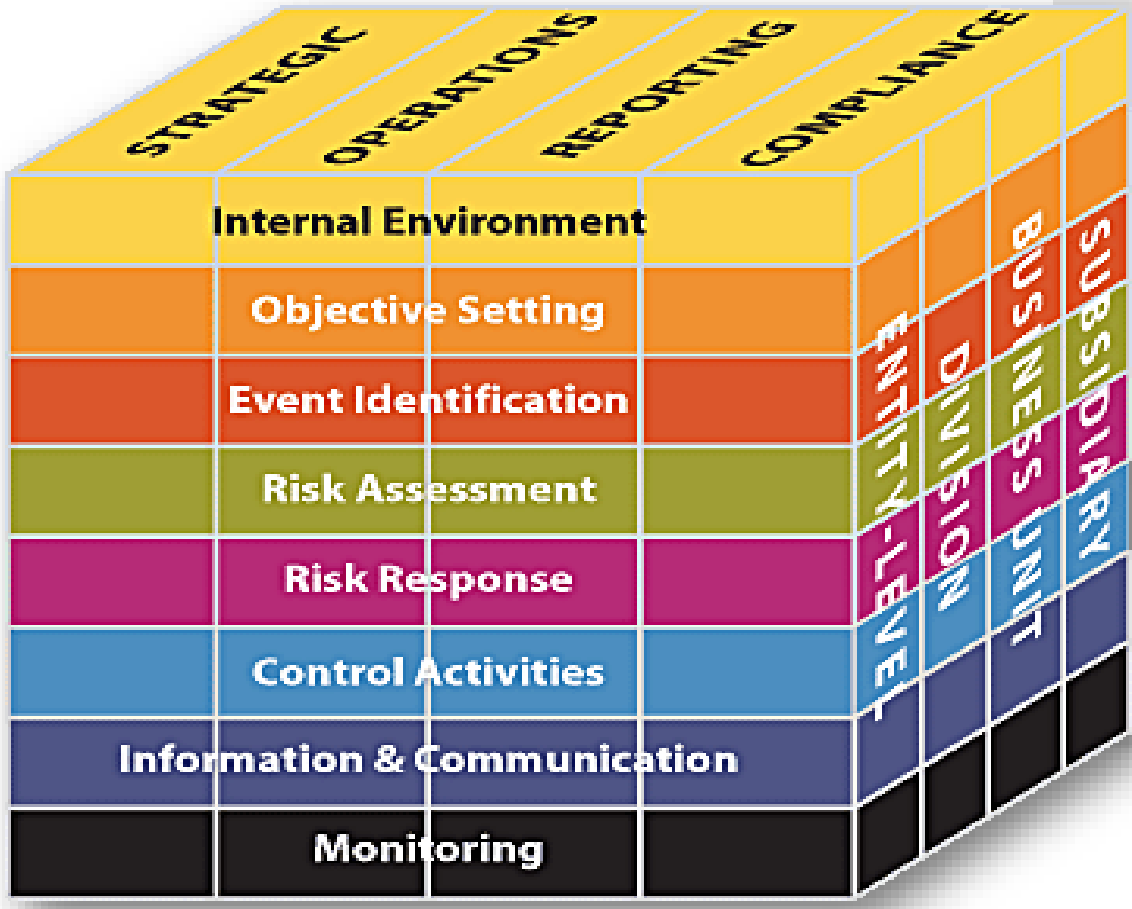
COSO – DEFINING ERM

- *Reducing operational surprises and losses* – Entities gain enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses.
- *Identifying and managing multiple and cross-enterprise risks* – Every enterprise faces a myriad of risks affecting different parts of the organization, and enterprise risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks.
- *Seizing opportunities* – By considering a full range of potential events, management is positioned to identify and proactively realize opportunities.
- *Improving deployment of capital* – Obtaining robust risk information allows management to effectively assess overall capital needs and enhance capital allocation.

ERM - THE COSO INFLUENCE

Entity objectives can be viewed in the context of four categories:

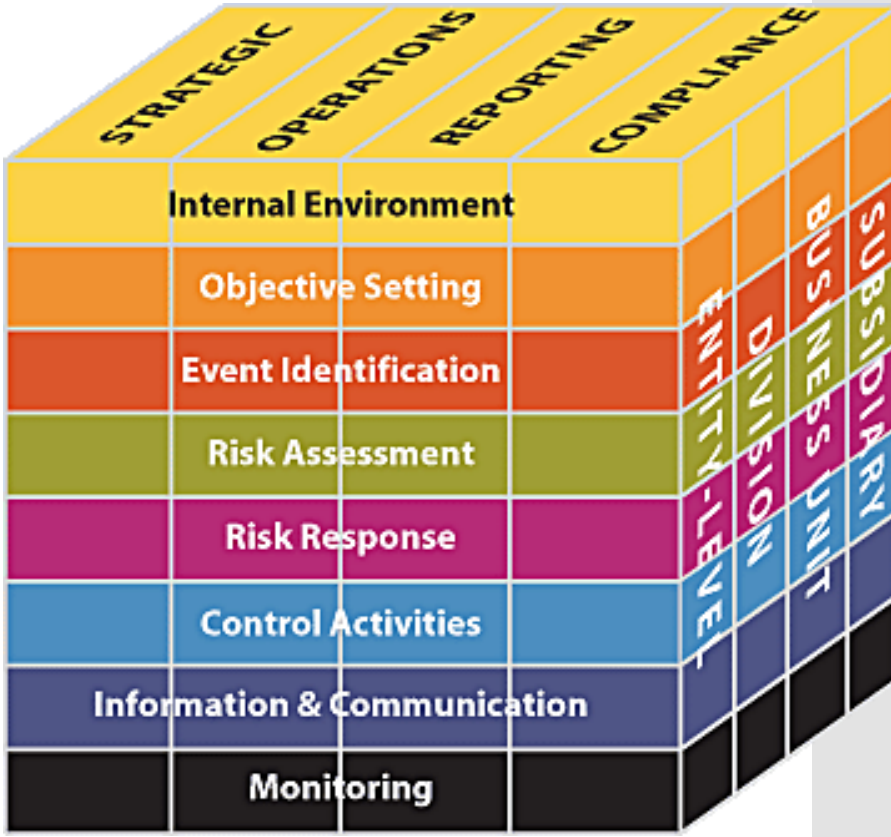
- Strategic
- Operations
- Reporting
- Compliance



ERM – THE COSO INFLUENCE

ERM considers activities at all levels of the organization:

- Enterprise-level
- Division or subsidiary
- Business unit processes



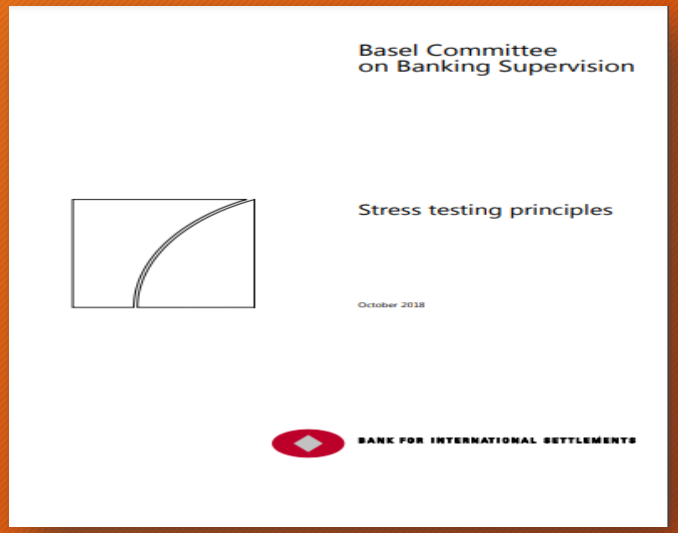
PLUS THE 8 COMPONENTS

THE OBJECTIVES

- *Strategic* – high-level goals, aligned with and supporting its mission
- *Operations* – effective and efficient use of its resources
- *Reporting* – reliability of reporting
- *Compliance* – compliance with applicable laws and regulations.

REGULATIONS

STRESS TESTING



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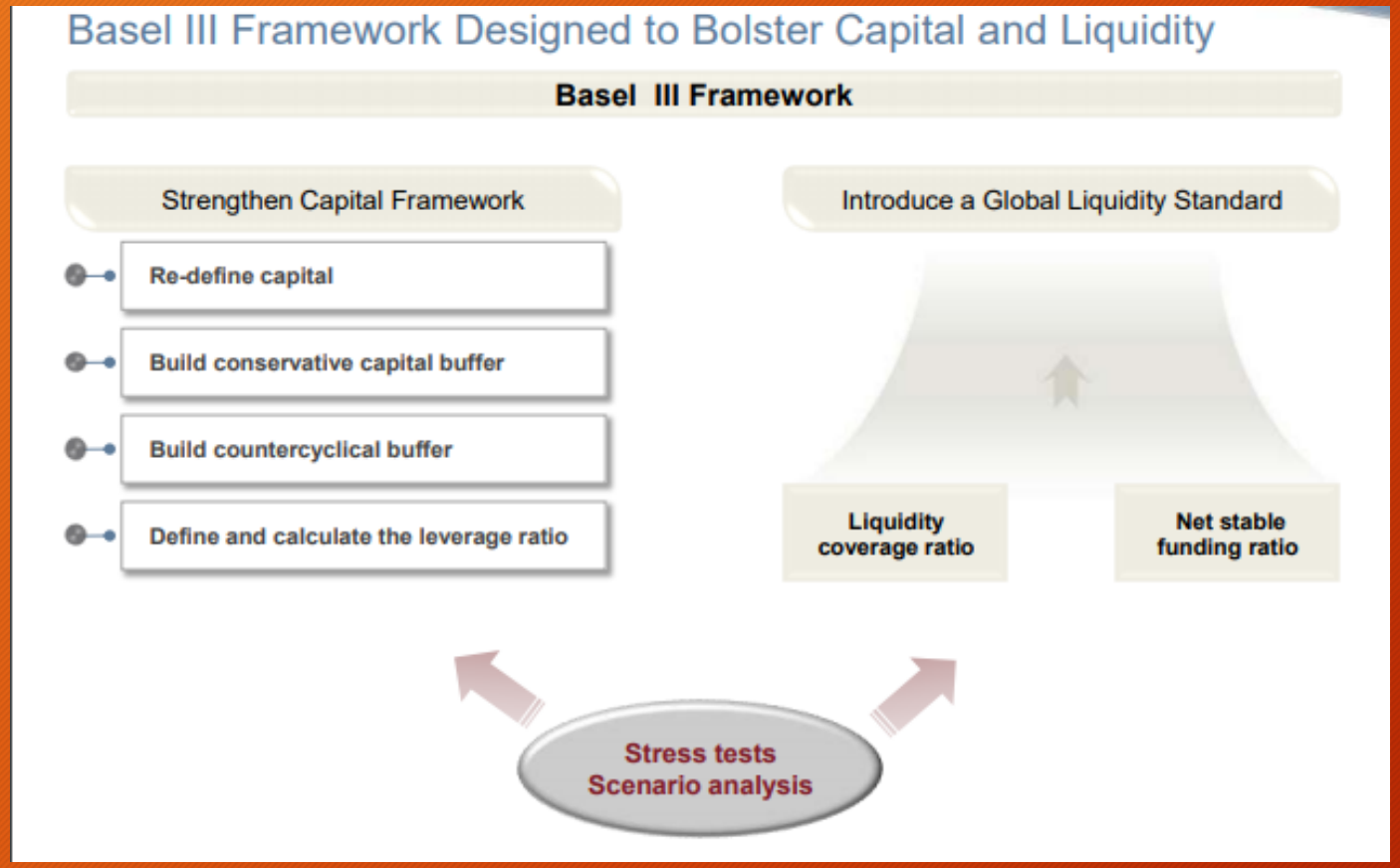
1. Stress testing frameworks should have clearly articulated and formally adopted objectives 3
2. Stress testing frameworks should include an effective governance structure 3
3. Stress testing should be used as a risk management tool and to inform business decisions 4
4. Stress testing frameworks should capture material and relevant risks and apply stresses that are sufficiently severe 6
5. Resources and organisational structures should be adequate to meet the objectives of the stress testing framework 7
6. Stress tests should be supported by accurate and sufficiently granular data and by robust IT systems 7
7. Models and methodologies to assess the impacts of scenarios and sensitivities should be fit for purpose 8
8. Stress testing models, results and frameworks should be subject to challenge and regular review 9
9. Stress testing practices and findings should be communicated within and across jurisdictions .10

BASEL III LCR & NSFR & STRESS TESTING

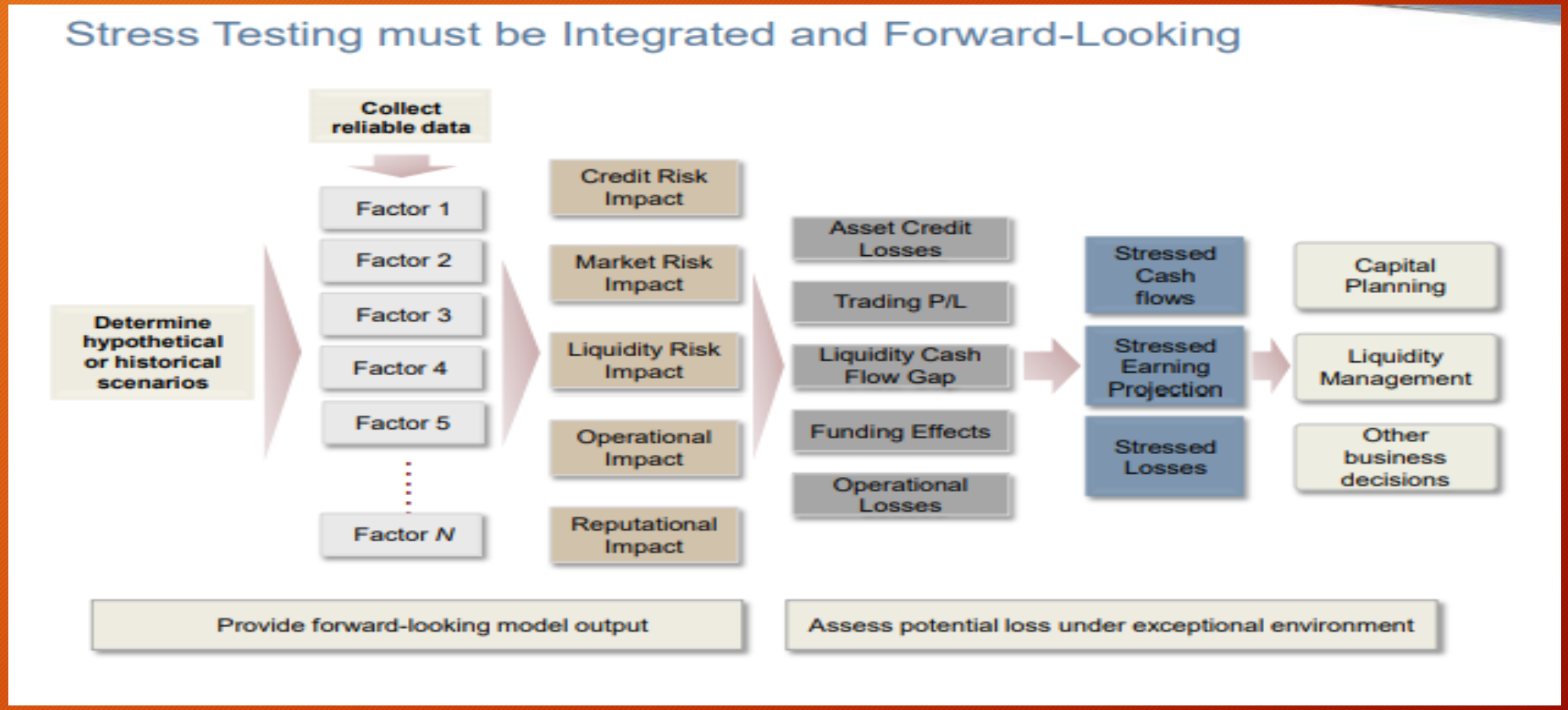


STRESS TESTING

Implications for Bank Capital and Liquidity

Key Change	Implication
Increased quality and quantity of capital	• Banks will have to pay more attention to their balance sheet items • Banks will be faced with additional capital requirement, and are likely to raise significant capital as common equity along with retention of profits and reduced dividends • There are expected to be further add-ons for Pillar 2 risks, SIFIs and the counter cyclical capital buffer so banks may target a total capital ratio of 13-15 percent
Leverage ratio	• The introduction of the leverage ratio could lead to reduced lending and is expected to further motivate banks to strengthen their capital position • Banks may be required by the market and rating agencies to maintain a higher leverage ratio than required by regulators
Liquidity coverage ratio (LCR)	• LCR would contribute to reducing the risk of a bank run, resulting in higher stability of the financial sector • The introduction of the LCR will require banks to hold significantly more liquid, low yielding assets which may negatively impact profitability
Net stable funding ratio (NSFR)	• NSFR motivates banks to increase the stability of their funding mix and reduce reliance on short term wholesale funding • Since it may be difficult to increase the proportion of wholesale deposits with maturities greater than one year, it may result in higher funding costs • Stronger banks with a higher NSFR will be able to influence marketing pricing of assets

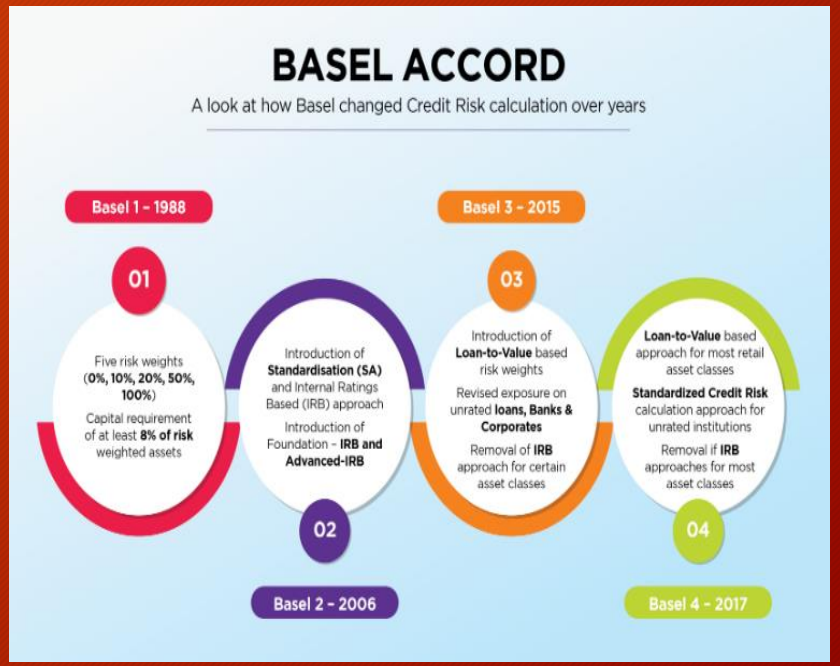
STRESS TESTING EUQATES ERM APPROACH



BASEL III & IV – INFLUENCE ON ERM

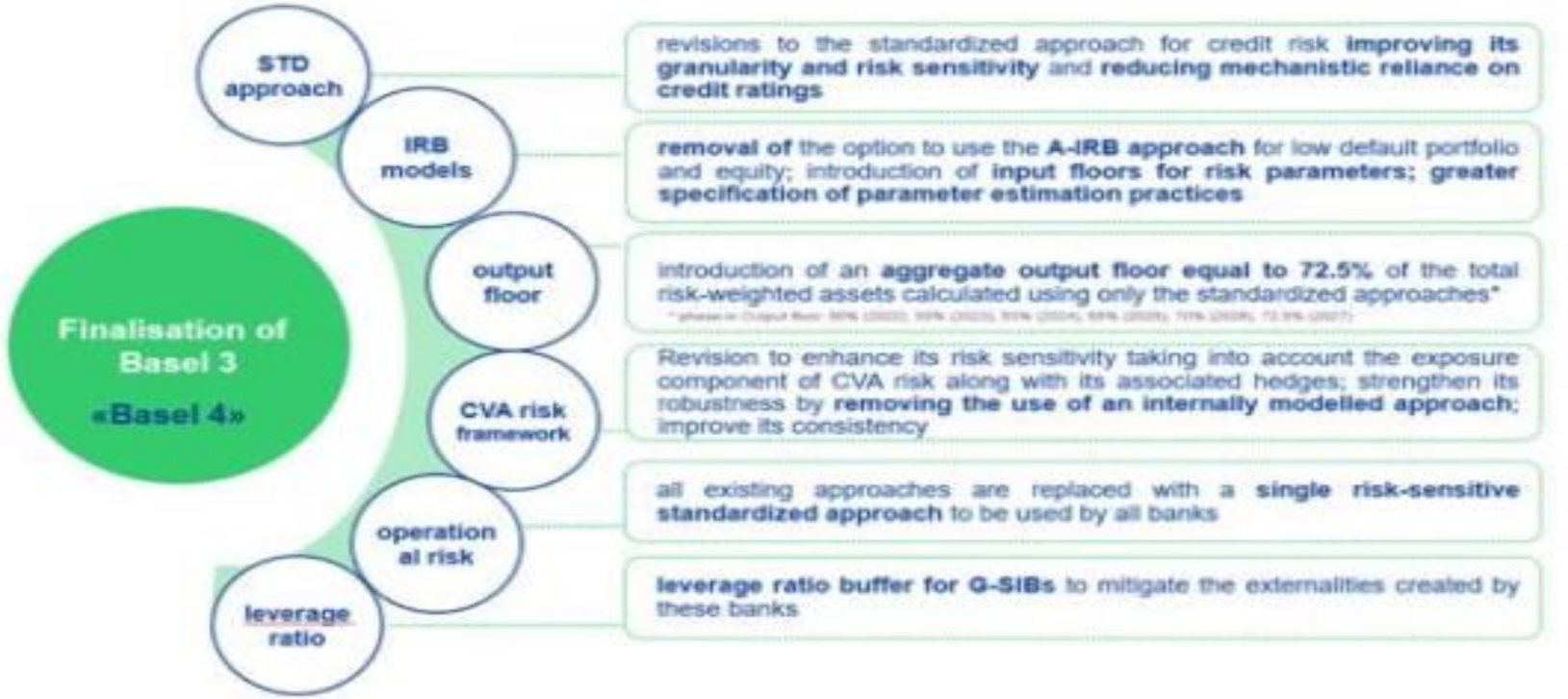
Focus of Basel III	*Capital definitions, buffers and liquidity requirements*
Focus of Basel IV	*Capital requirements*: Credit Risk; Securiti-sation; Counter-party Credit Risk; Market Risk; Opera-tional Risk; CVA Risk; Step-in Risk Capital floors (BCBS 306); Interest rate risk in the banking book (BCBS 368) 2018; SA for credit risk (BCBS 347) IRB approach (BCBS 362); Revi-sions to the secu-ritisation frame-work (BCBS 374) 2018; SA counter-party credit risk (BCBS 279) 2017; Funda-mental review of the trading book (BCBS 352) 2019; Revi-sions to opera-tional risk (BCBS 355); Review of the CVA risk frame-work (BCBS 325); Step-in Risk (BCBS 349)

CREDIT RISK EVOLUTION



FEATURES OF BASEL IV

Fig.2 - Basel 4: main features



Source: Prometeia based on BIS – "Basel III: Finalizing post-crisis reforms" - December 2017

THE ERM RISK UNIVERSE

Draft - Enterprise Risk Management Risk Universe

Strategic

Governance & Leadership

❖ **Governance**
- Board Structure & Performance
- Culture and Ethics
- Control/Risk Environment
- Social Responsibility

❖ **Planning and Resource Allocation**
- Organizational Structure
- Strategic Planning
- HR Strategy
- IT Strategy
- Partnership Development & Management
- Innovation

❖ **External Environment**
- Demographics
- Lifestyle Trends
- Socio-Political
- Economic Factors
- Hazards (Pandemic, terrorism, natural disasters, etc)
- Business Continuity

❖ **Major Initiatives**
- Vision and Direction
- Planning and Execution
- Measurement and Monitoring
- Business Acceptance

❖ **Corporate Reputation**

Stakeholder Relations

❖ **Communication and Relations**
- Public and Media Relations
- Patient Relations
- Government Relations
- Employee Communication
- Vendor Relations
- Union Relations
- Crisis Communication

Operational

Patient Care

❖ **Service Delivery**
- Admission, Transfer and Discharge
- Transitional planning
- Assessment & Diagnostics
- Care & Service Accessibility
- Care Plan/ Service Plan
- Treatment
- Coordination of Services
- Patient Rights
- Patient Equity

❖ **Support Services**
- Supply Chain
- Food and Laundry Services
- Facilities Management
- Health Information Management

❖ **Patient Safety**
- Infection Prevention Control
- Incident Reporting
- Education & Training
- Security
- Medication Management
- Medical Device Reprocessing

Human Resources

❖ **Recruitment, Selection & Retention**
- Credentialing
- Medical staff
- Support staff
- Contractual staff
- Professional staff
- Employment Equity

❖ **Development & Performance**
- Training and Education
- Succession Planning
- Performance Management

❖ **Labor Relations**
- Labor Agreements
- Contingency Planning

❖ **Compensation & Benefits**
- Salary Administration and Compensation Management

❖ **Employee Safety**
- Health and Safety

Information Technology

❖ **IT Management**
- E-Health

❖ **Access & Security**

❖ **System Reliability & Continuity**
- Back up and recovery
- Disaster Recovery

❖ **System Integrity**

❖ **End User Support & Education**

❖ **Infrastructure**
- Asset replacement, deployment and retirement
- Inventory Management

Physical Assets

❖ **Asset Management**
- Replacement Management

❖ **Capital/ Construction Acquisition & Disposal**
- Asset Acquisition
- Commitment Tracking & Processing
- Contract/Project Management
- Asset Disposal

❖ **Equipment Acquisition, Maintenance & Disposal**
- Equipment Acquisition
- Commitment Tracking & Processing
- Contract Management
- Maintenance
- Equipment Obsolescence & Disposal

❖ **Site/Asset Security**
- Asset storage & handling
- Facilities
- Security and Access

❖ **Inventory Management**
- Contract Management
- Distribution
- Inventory Shrinkage and Obsolescence
- Valuation
- Product Recalls

Compliance

Compliance

❖ **Standards of Business Conduct**
- Ethics
- Fraud
- Conflict of Interest
- Industry Relations

❖ **Legal & Regulatory**
- Governing Legislation, Bylaws & Regulations
- Contractual Agreements
- Professional Regulatory Bodies
- Prescribed Standards of Practice
- Data Protection
- Privacy
- Environmental, Health & Safety
- Research
- Facility Standards
- Procurement Practices
- Patient Safety
- Intellectual Property
- Negligence

Financial

Financial

❖ **Funding**
- Capital
- Operating
- Debt
- Foundation

❖ **Market**
- Interest Rates
- Foreign Exchange
- Financial Instruments
- Investments

❖ **Liquidity and Credit**
- Cash Management
- Credit and Collections
- Insurance

❖ **Accounting and Reporting**
- Accounting, Reporting & Disclosure
- Internal Control Requirements
- Trust Accounts/Special Purpose Accounts

❖ **Pension Funding**

❖ **Budgeting and Forecasting**

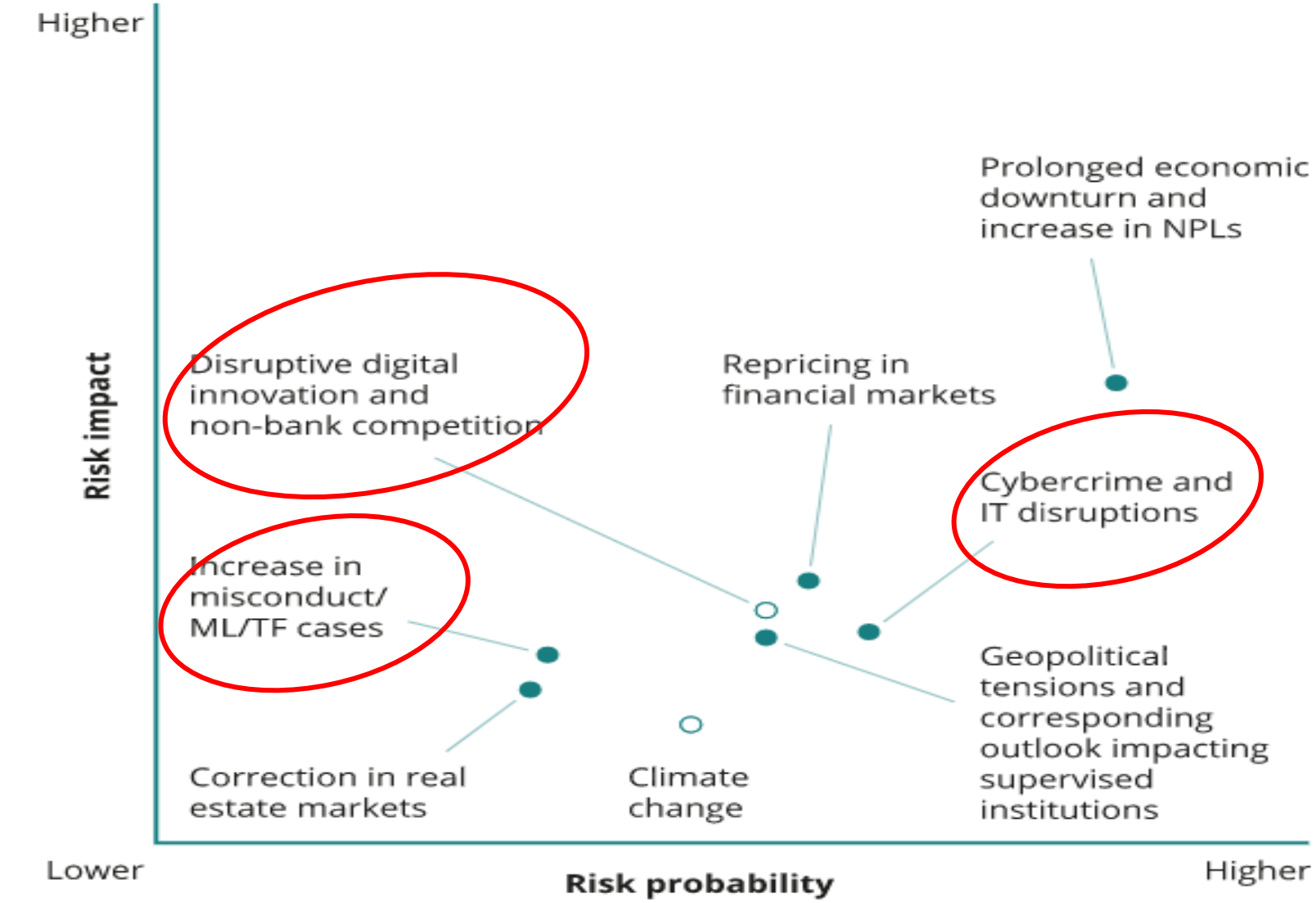
❖ **Taxes (Property, Commodity)**

RISK DRIVERS OF NOTE - "GLOBAL" DRIVERS

(S&P Global)

- **Key Risk #1: Economic Disruption From COVID-19 Gets Worse Or Lasts Longer**
- **Short-Term Support To Borrowers May Leave Longer-Term Overhangs**
- **Digital disruption - risk, competitive implications, opportunities**
- **Geopolitics :** Economic nationalism and geopolitical tensions constitute one of the top risks
- **PANDEMIC AND FINANCIAL CRISIS – Credit and Liquidity / Asset Quality**
- **EM vulnerability**: Emerging market banking systems are exposed, by varying degrees, to local economies' heavy reliance on external funding, concentration on specific sectors (such as the hospitality sector or industrial or service exports to developed countries) or commodities (such as oil or gas). Another vulnerability in some countries is the lack of government capacity to continue providing meaningful support.
- **ESG:** Investors and their stakeholders now demand more clarity on environmental, social, and governance (ESG) issues for decision-making

MAPPING RISK - (ECB) A COMFIRMING PERSPECTIVE



Source: ECB and national competent authorities.
Note: Dots with a white fill denote risk drivers that are expected to increase strongly over the next five years;

SOME OTHER DRIVERS

- EMERGENCE OF NEW PRODUCTS & SERVICES - DIGITIZATION
- CRYPTO CURRENCIES AND BLOCK CHAIN TECHNOLOGY

- CYBER SECURITY RISK
- EMERGENCE OF FINTECHS OR FINTECH LIKE ENTITIIES

- CONVERGENCE BETWEEN FRAUD vs. AML
- ENFORCEMENT - CORPORATE GOVERNANCE AND MANAGEMENT

- CONVERGENCE OF GOVERNANCE – RISK - COMPLIANCE (GRC)
- EUROPEAN UNION AND POTENTIAL BLACK LISTING

- IFRS 9
- IFRS 17 – INSURANCE CONTRACTS

- AML/CFT COMPLIANCE
- RECOVERY AND RESOLUTION PLANNING

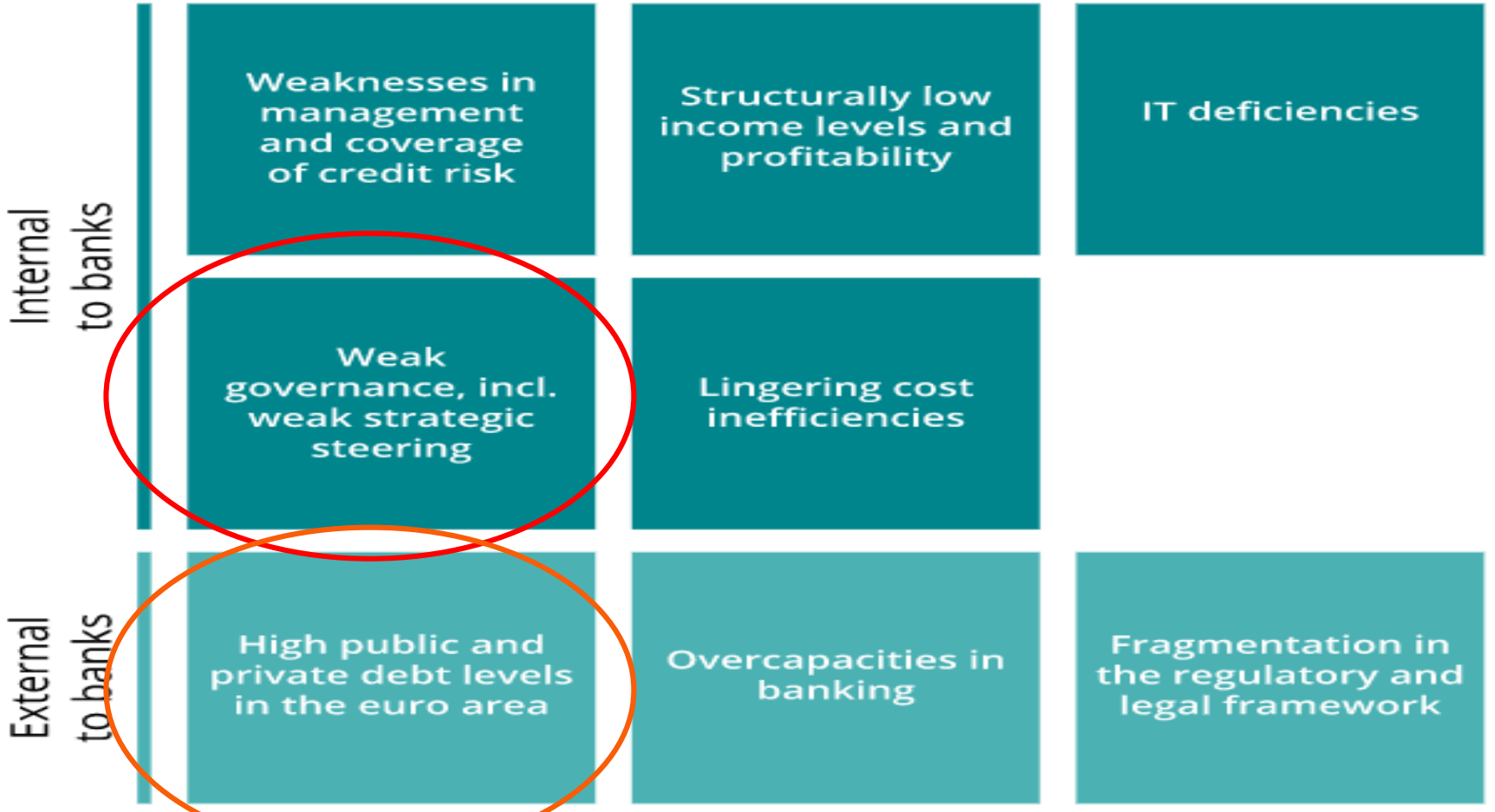
US AML ACT 2020 - LOOK OUT FOR SHADES OF PATRIOT ACT!

Highlights

- The Anti-Money Laundering Act of 2020 (AMLA 2020) is the most consequential anti-money laundering legislation passed by Congress in decades.
- Among its many provisions, AMLA 2020 provides for 1) expanded whistleblower rewards and protections, 2) the establishment of a beneficial ownership registration database that will be implemented by the Financial Crimes Enforcement Network (FinCEN), 3) new Bank Secrecy Act (BSA) violations and enhanced BSA penalties for repeat and egregious violators and 4) expanded subpoena power.

VULNERABILITIES FOR 2021 - THIS IS NOT JUST ABOUT FINANCIAL SERVICES!

Table of vulnerabilities for 2021



Source: ECB and national competent authorities.
Note: Internal vulnerabilities can be addressed by the banks themselves, while external vulnerabilities refer to the environment in which banks operate.

STANDARDS

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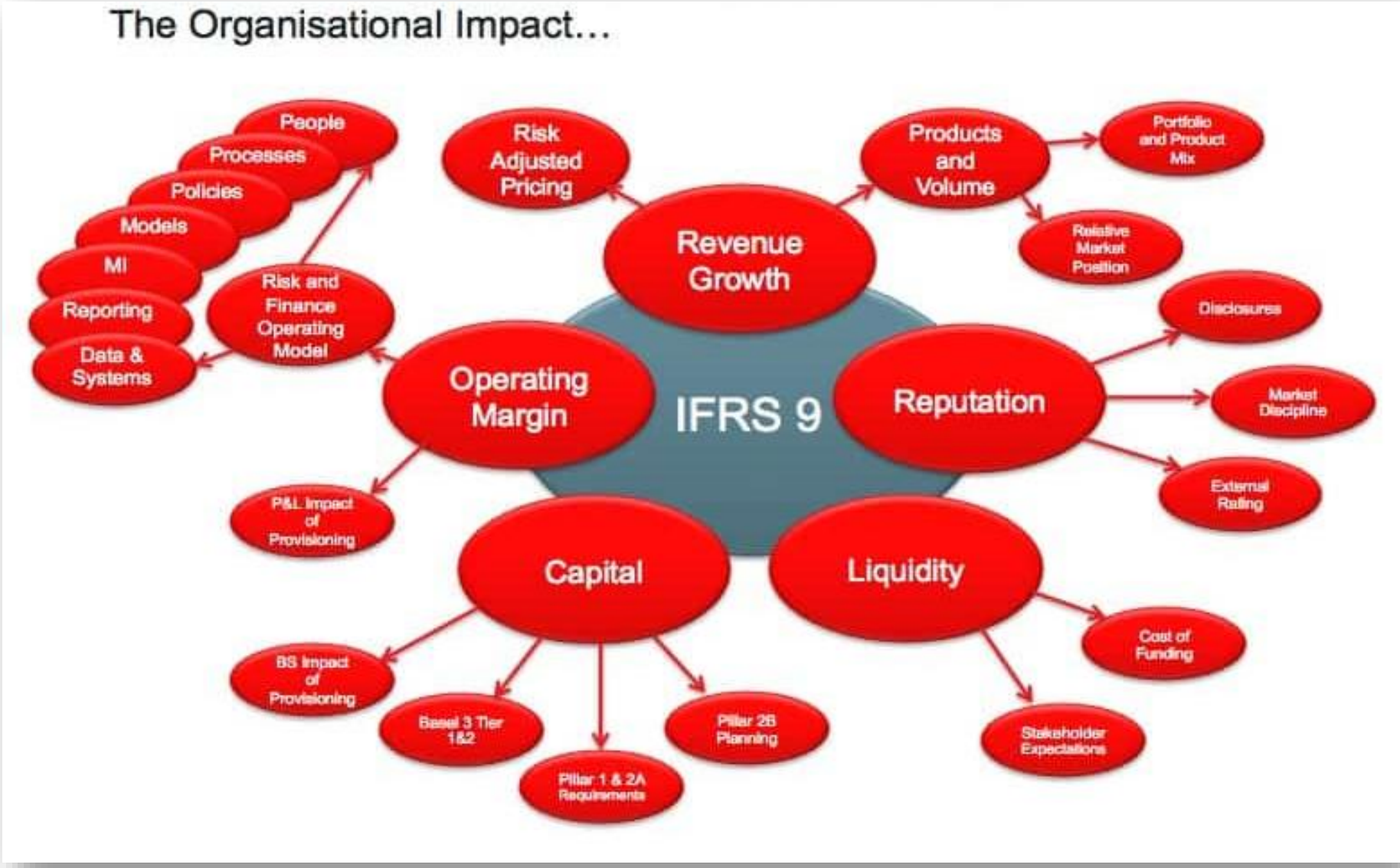
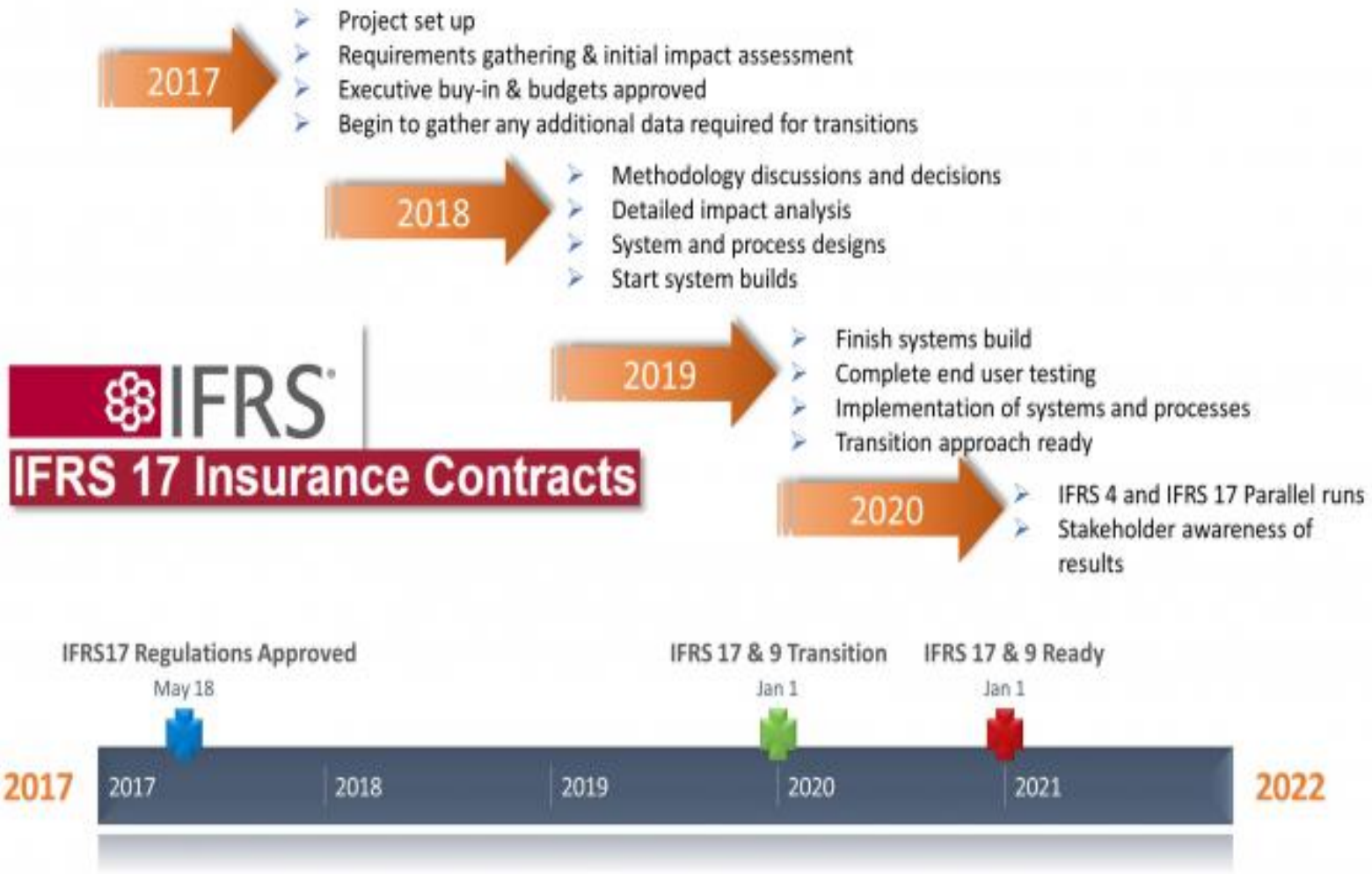
IFRS – 9 …. EXPECTED CREDIT LOSS

"Its implementation is not limited to an accounting project. The project has impacts on the organization, on the Risks and Finance functions, on the production of accounting, regulatory and prudential reporting, on all business sectors and activities."

https://glceurope.com/



INSURANCE CONTRACTS - IFRS 17



COVID-19 Accelerates Digital Transformation

- The **COVID-19** pandemic **accelerates** the **digital transformation**.
- Many Asian and Northern European banking markets lead by offering products fully digitally. The move to **cashless economies** is accelerating broadly.
- Preparedness and agility to swiftly **shift business models** to the new digital normal become crucial to deliver on faster-changing client preferences.
- We expect banks to go from testing a move to the **cloud** to standard use and leverage **digital tools** to **streamline costs** and prepare for peaks in usage.
- **Regulators** will further promote digital transformation by requiring detailed digital agendas, adjusting accounting rules, and provide more guidance on IT outsourcing and data management.
- **Digital currencies** might eventually impact banking business with governments exploring options to implement and test required infrastructure in various countries.

THE CREDIT RISK AHEAD

Key Areas Driving Long Term Creditworthiness

Asset Quality And Profitability

- Lower-for-longer rates are the new normal
- High corporate leverage may lessen credit demand
- Consolidation as way to reduce overcapacity and improve efficiency
- Digitalization; cashless transactions

Technology

- More investment is needed to respond to changing customer preferences, but could boost efficiency over time
- Shifts to working from home, big data, artificial intelligence
- Cyberrisk
- Antifinancial crime

ESG

- Environmental, social and governance considerations are better integrated in business strategy and risk management
- Reporting is more standardized
- Offer growth opportunities and act as a differentiating factor
- A wider stakeholder approach with ability to reprice and restructure

Regulations

- Use of regulatory buffers
- Path and speed to regulatory normalization
- Resolution versus government support
- The way out of forbearance
- The unwinding of liquidity support

Source: S&P Global Ratings.

S&P Global

A REGULATOR'S PERSPECTIVE

— FEDERAL RESERVES

"During recent years, the Federal Reserve has increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the institutions it supervises.

This greater emphasis reflects the view that properly managing risks has always been critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets.

Accordingly, while an institution's financial performance is an important indicator of the adequacy of management, it is essential that examiners give significant weight to the quality of risk management practices and internal controls when evaluating the management and overall financial condition of banking organizations."

SR 95-51 (SUP)

DIVISION OF BANKING SUPERVISION AND REGULATION

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

ERM - THE COSO / GOVERNANCE INFLUENCE

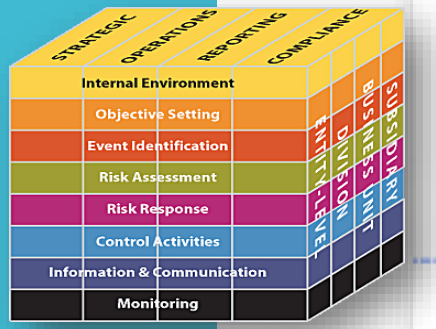
Governance
- Strategy
- Goals and objectives
- Policies and procedures
- Structures and processes

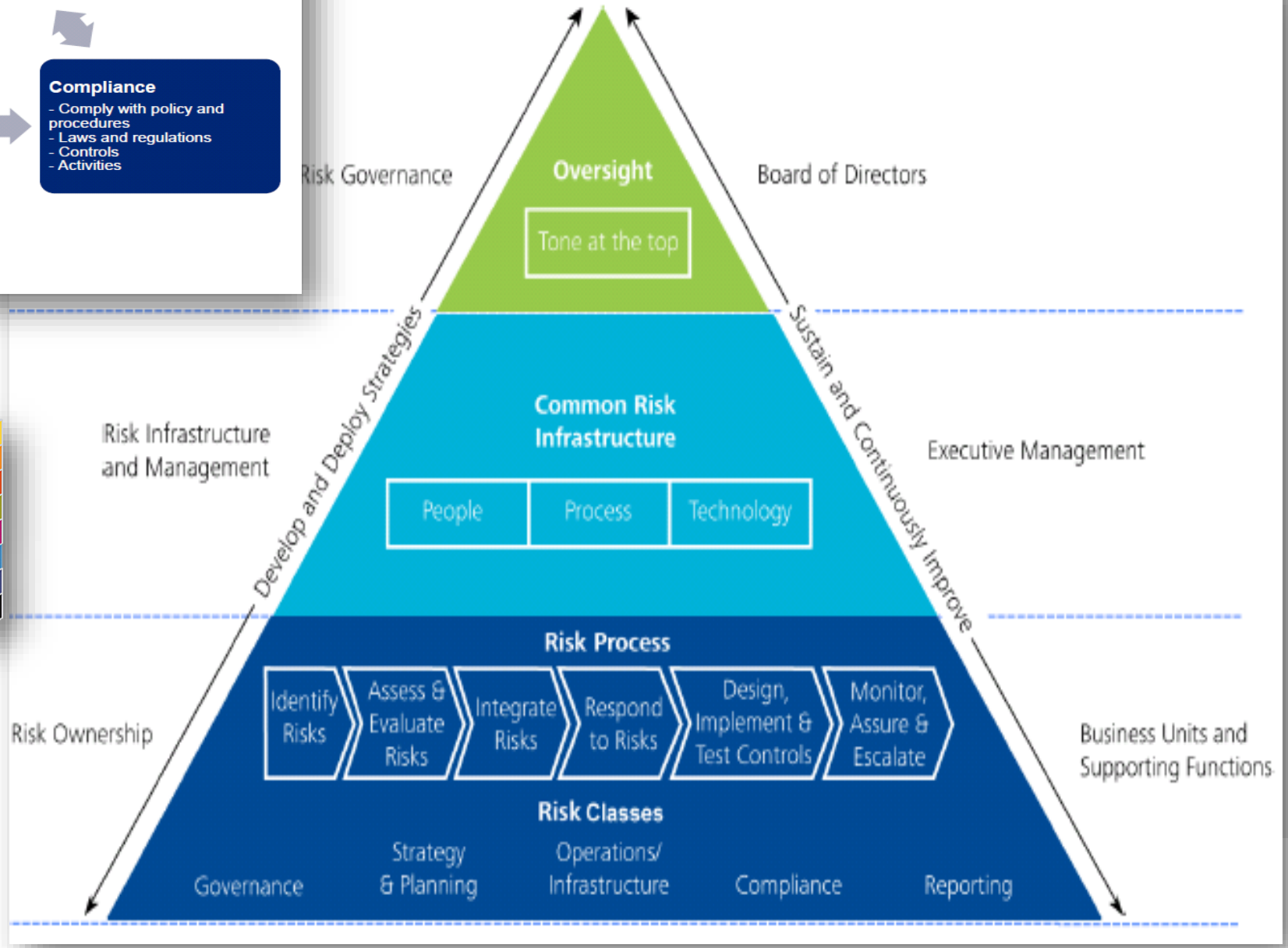
Risk Management
- Identify risks
- Risk analysis
- Risk profiles
- Risk Monitoring
- Achievement of objectives

Compliance
- Comply with policy and procedures
- Laws and regulations
- Controls
- Activities

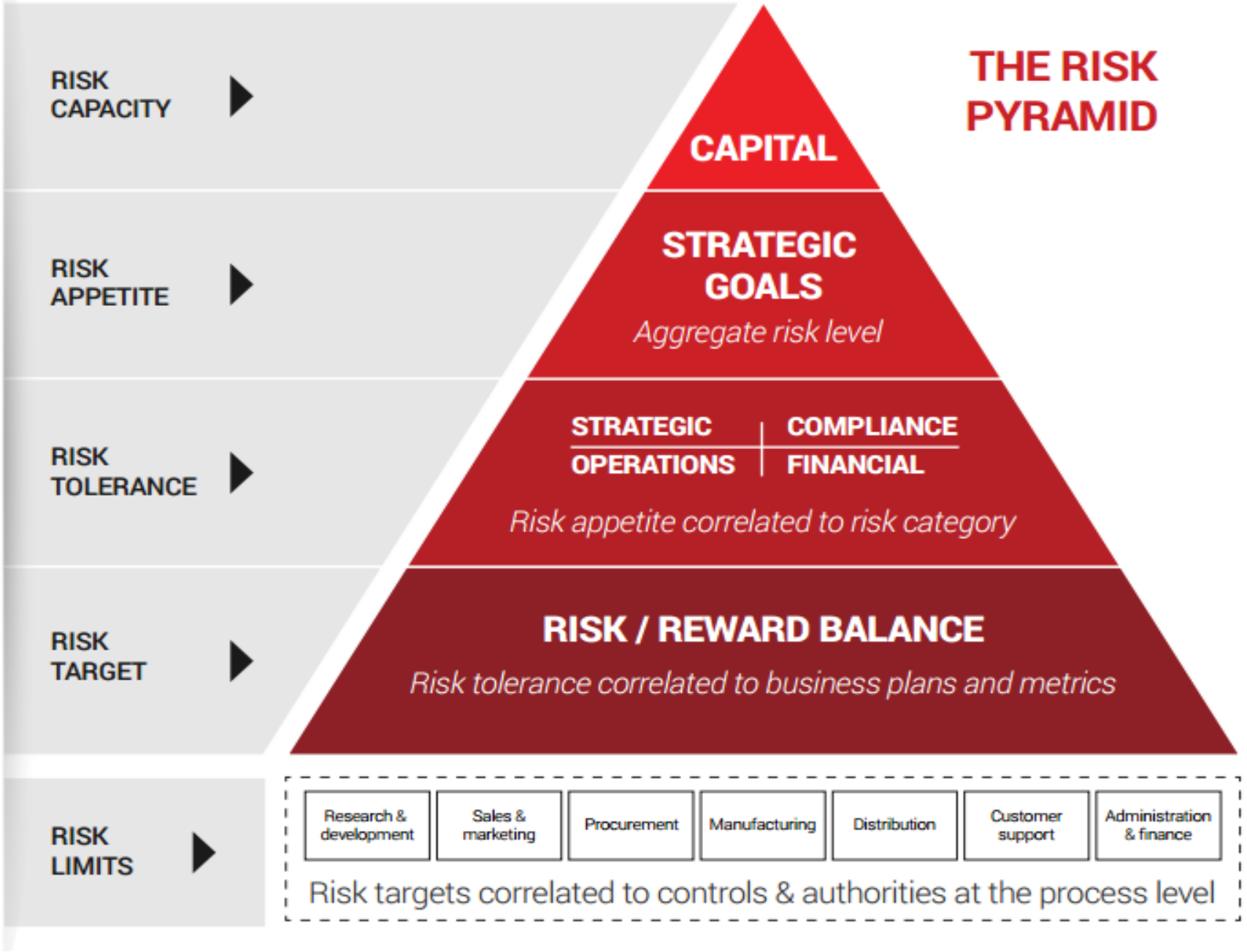
Entity objectives :

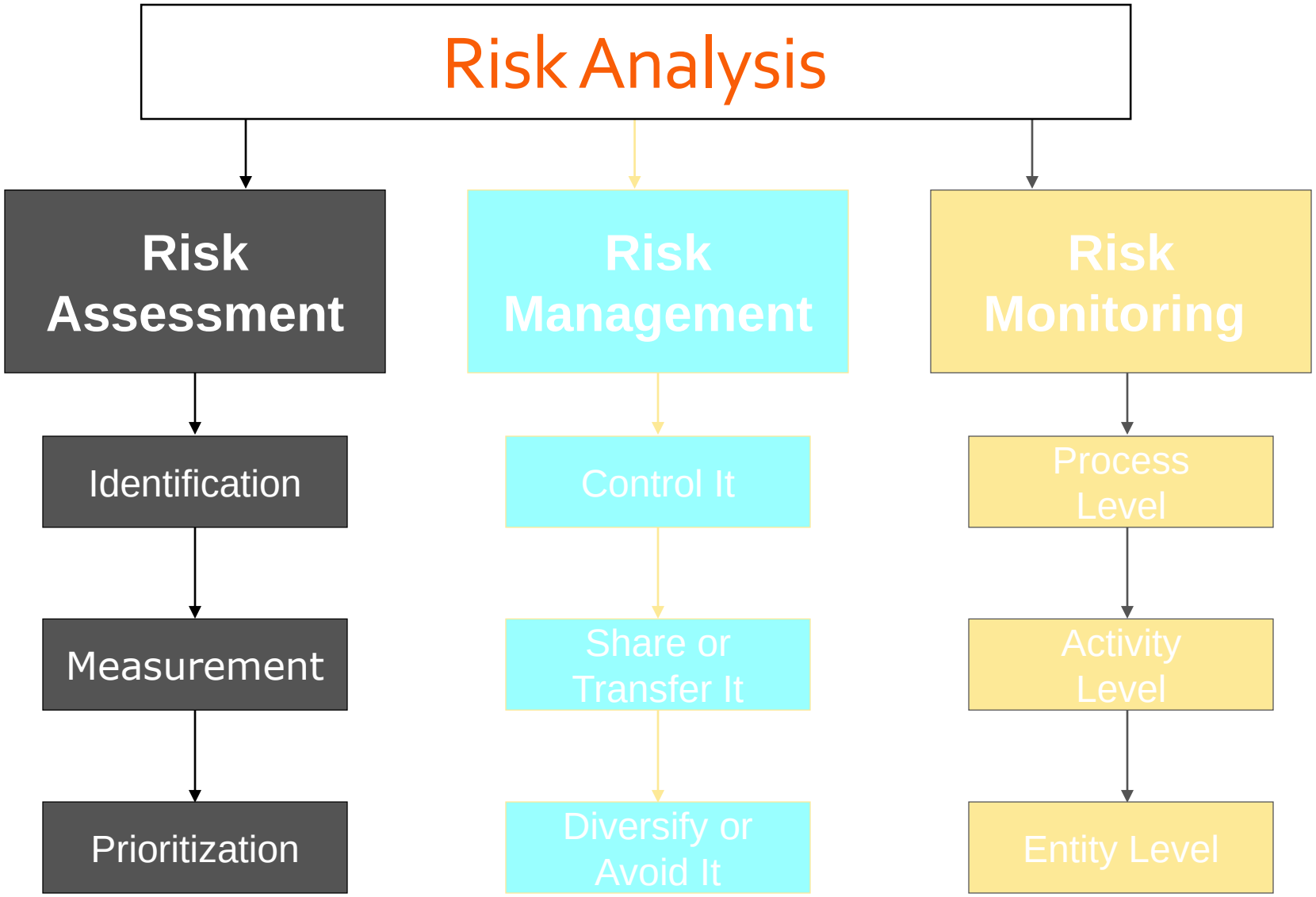
- Strategic
- Operations
- Reporting
- Compliance





ERM - THE RISK PYRAMID





Source: Business Risk Assessment. 1998 – The Institute of Internal Auditors

DETERMINE RISK APPETITE

- **Risk appetite is the amount of risk — on a broad level — an entity is willing to accept in pursuit of value.**
- **Use quantitative or qualitative terms (e.g. earnings at risk vs. reputation risk), and consider risk tolerance (range of acceptable variation).**

DETERMINE RISK APPETITE

Key questions:

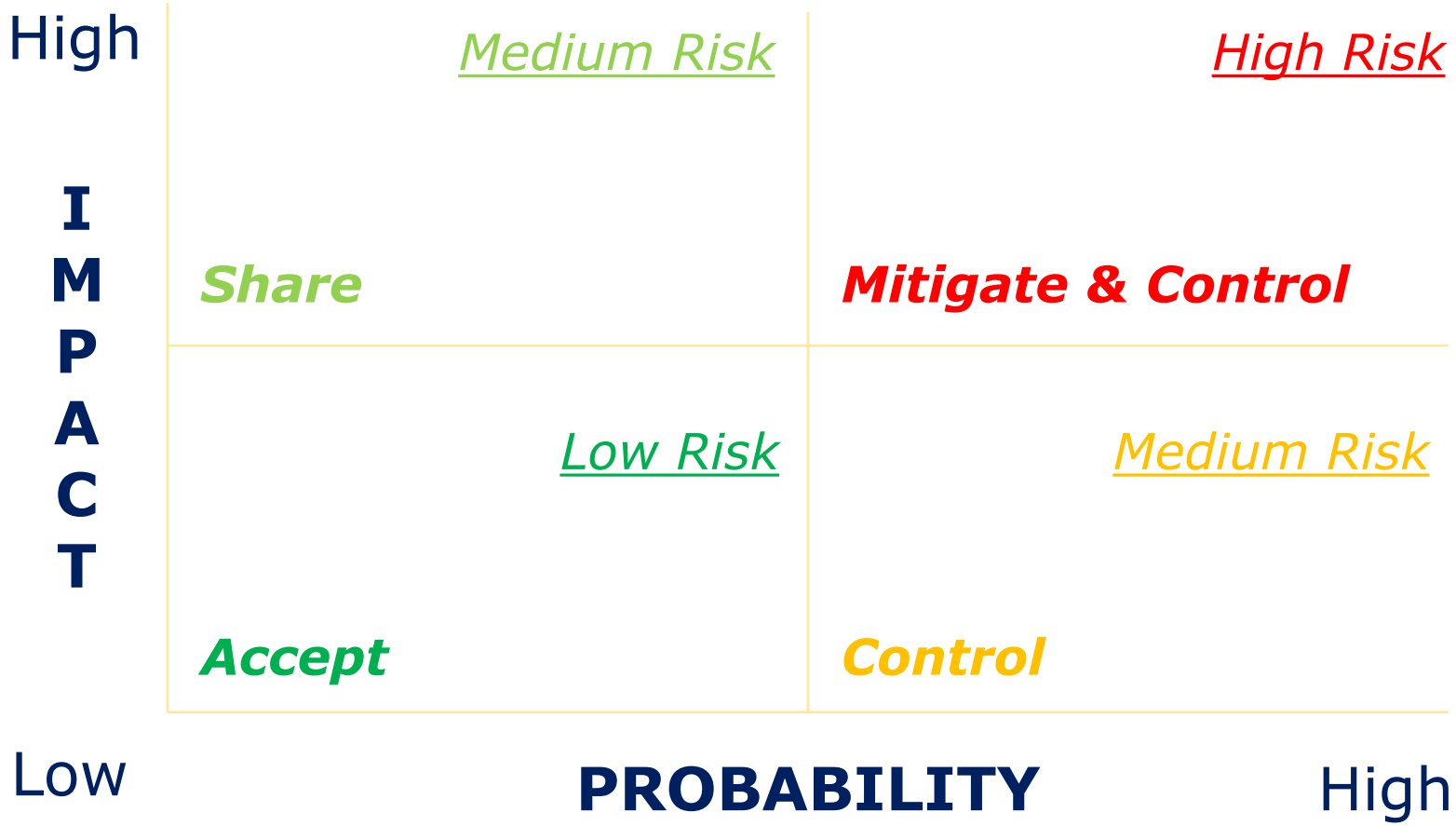
- **What risks will the organization not accept?**
  (e.g. environmental or quality compromises)
- **What risks will the organization take on new initiatives?**
  (e.g. new product lines)
- **What risks will the organization accept for competing objectives?**
  (e.g. gross profit vs. market share?)

IDENTIFY RISK RESPONSES

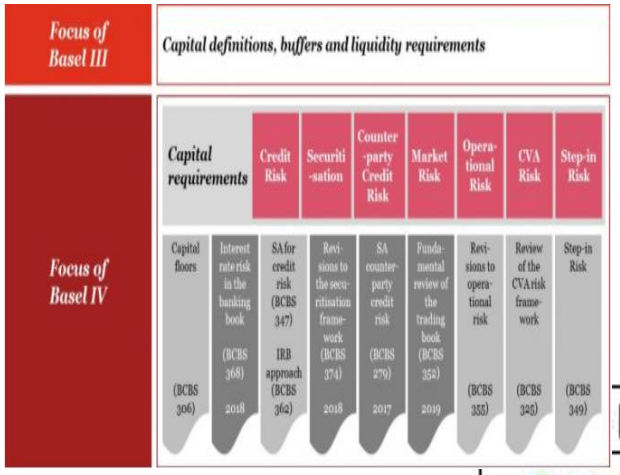
- **Quantification of risk exposure**

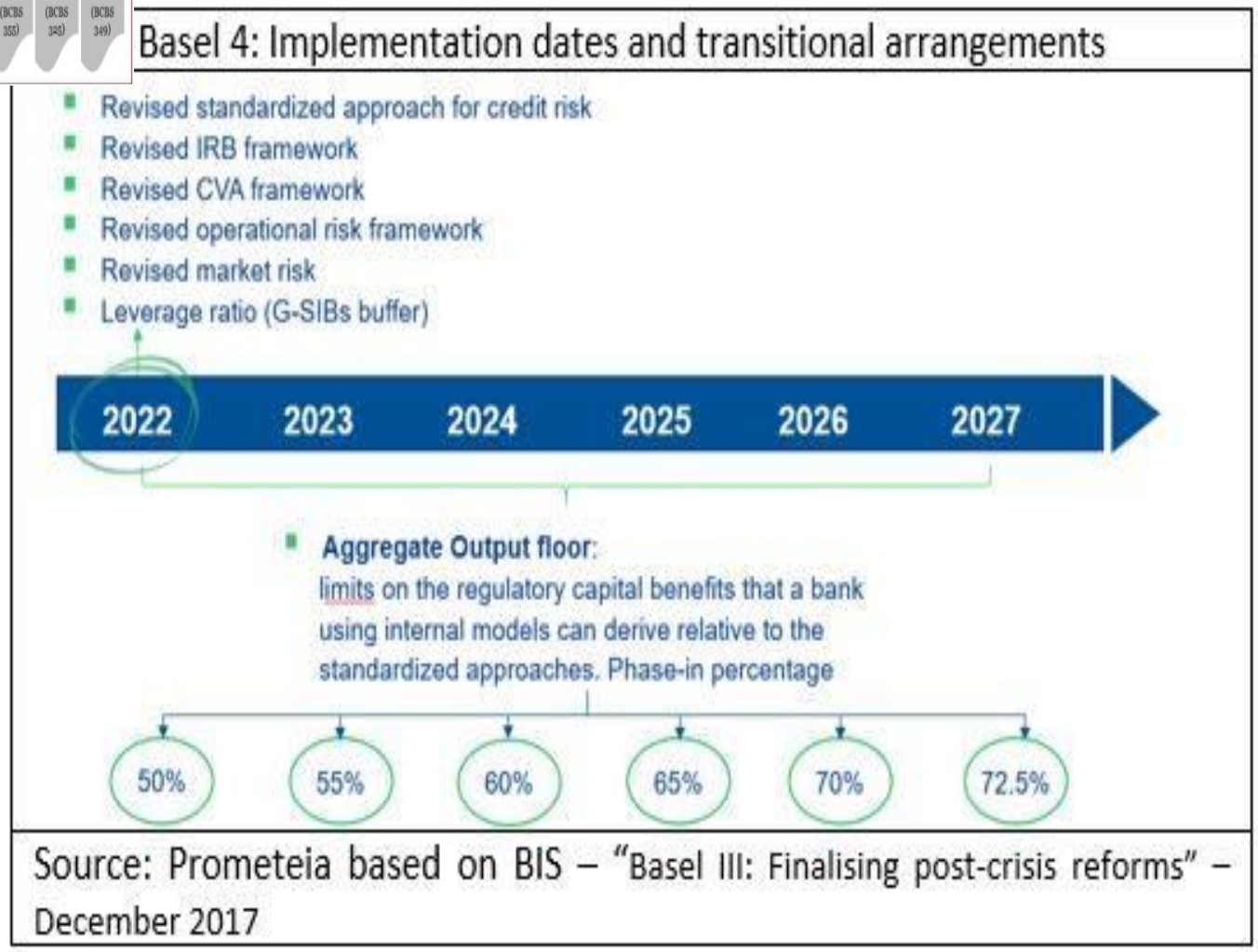
- **Options available:**
  - **Accept = monitor**
  - **Avoid = eliminate *(get out of situation)***
  - **Reduce = institute controls**
  - **Share = partner with someone *(e.g. insurance)***

- **Residual risk *(unmitigated risk – e.g. shrinkage)***

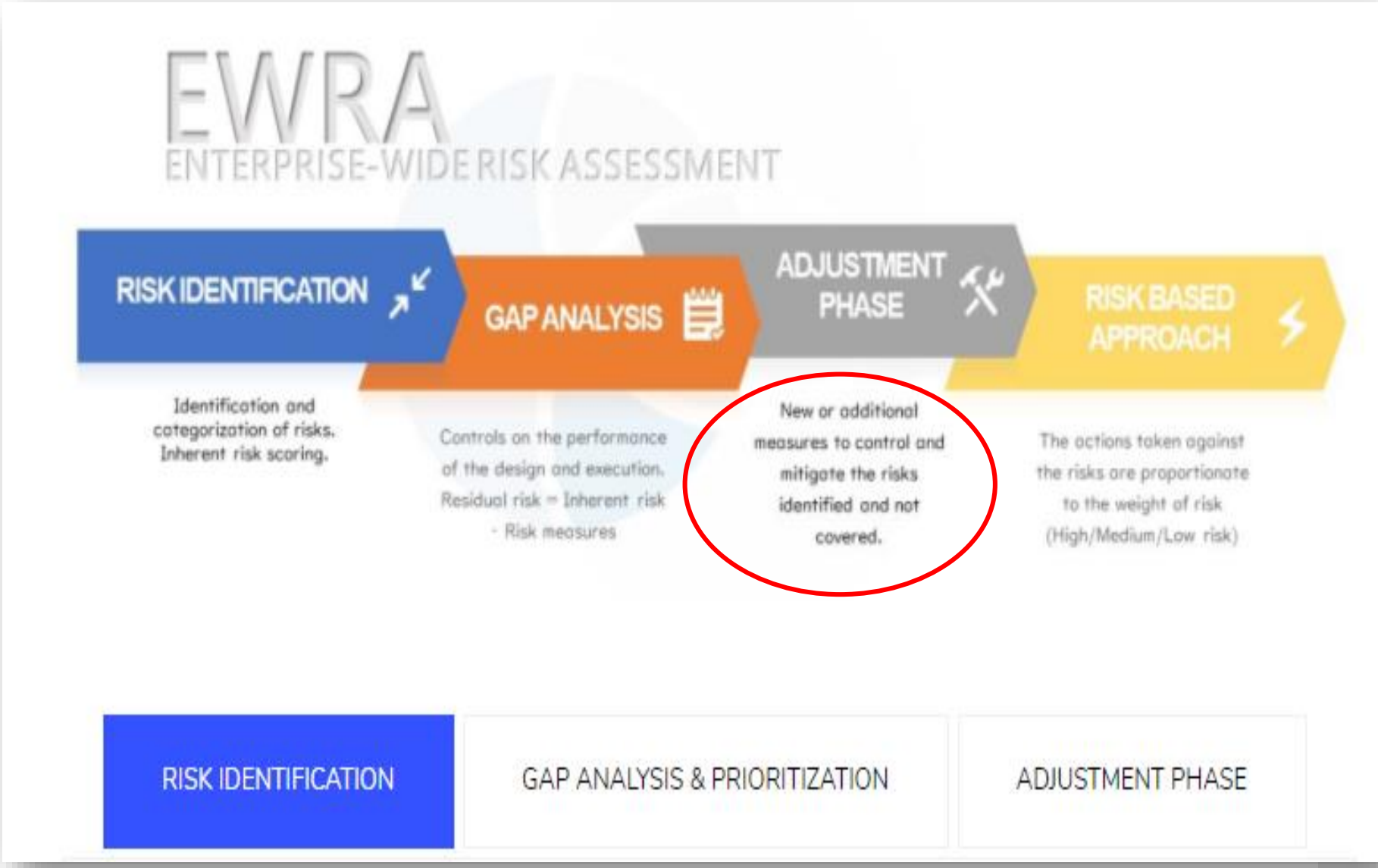

High
IMPACT
Low
Medium Risk
High Risk
Share
Mitigate & Control
Low Risk
Medium Risk
Accept
Control
PROBABILITY
High

BASEL III & IV – INFLUENCE ON ERM



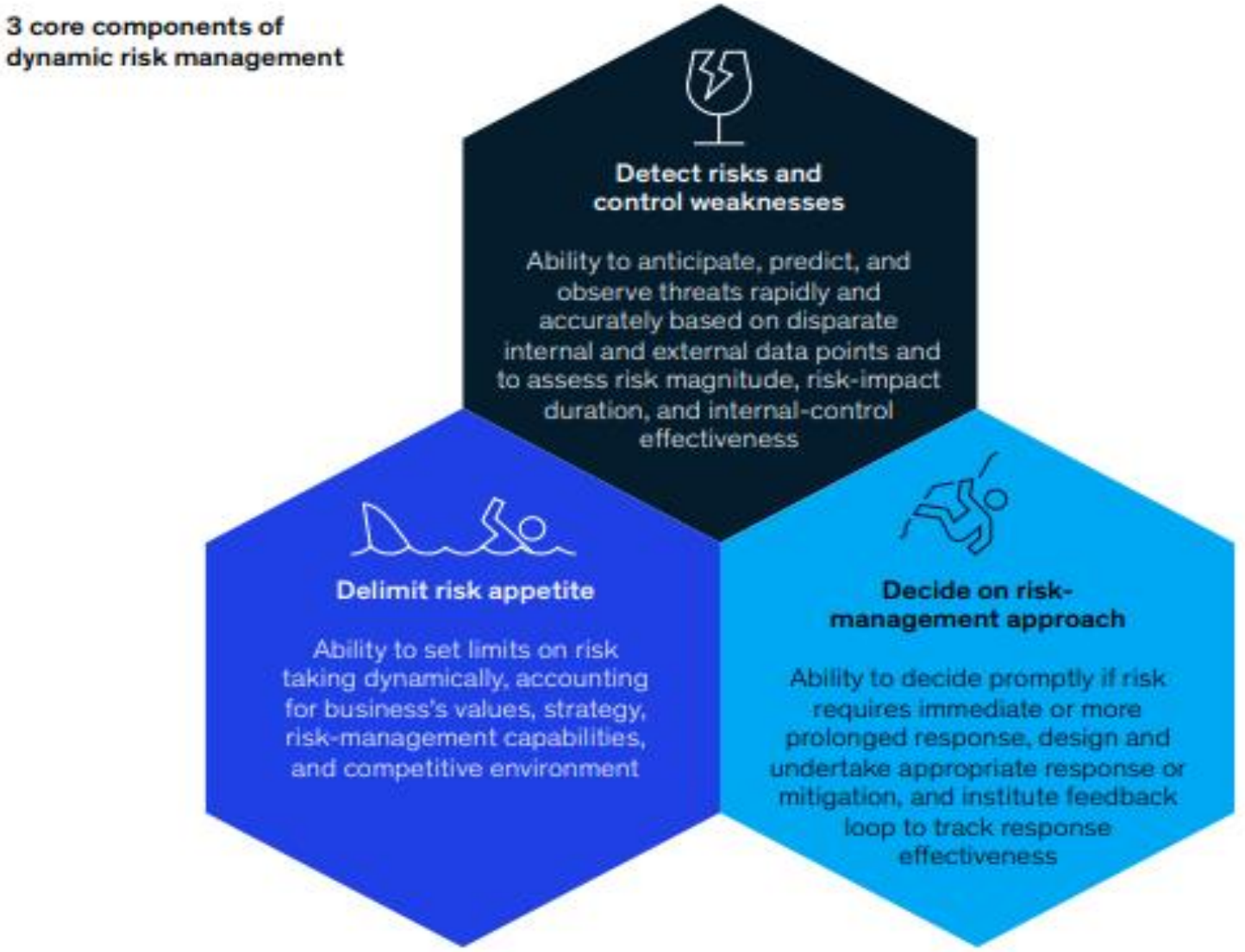


AML/CFT/KYC COMPLINACE - RBA



THE RESPONSE – DYNAMIC AND FLEXIBLE RISK MANAGEMENT

Companies require dynamic and flexible risk management to navigate an unpredictable future in which change comes quickly.



(SOURCE: McKINSEY)

DYNAMIC & INTEGRATED RISK MANAGEMENT

Dynamic and integrated risk management, which includes the ability to detect risks, determine appetite, and decide on action, is growing ever more critical.

5 actions to establish capabilities needed for dynamic risk management

Reset aspiration for risk management

Move risk from prevention and mitigation to dynamic strategic enablement and value creation

Establish agile risk-management practices

Authorize cross-functional teams to make rapid decisions in business, innovation, and risk management

Harness power of data and analytics

Digitize transaction workflows; use data to expand view of risk characteristics; deploy algorithms to enable better error detection, more accurate predictions, and microsegmentation

Develop risk talent for future

Develop new capabilities and expanded domain knowledge to support full understanding of risk landscape

Fortify risk culture

Build true risk-culture ownership in front line; hold executives accountable for cultural failings; link risk culture with daily business activities and outcomes

McKinsey & Company

NEXT LEVEL

SOLUTIONS

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