

Risk Culture Is a Necessary Condition for Enterprise Risk Management to Succeed

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Introduction

Risk culture is essential for the success of enterprise risk management (ERM). Enterprise risk management is different from silo risk management where risks were mainly managed by one department. Enterprise risk management means that the risk management is integrated from Board to the last employee of the organization. This is much easier said than done. This means that every employee of the organization has a role to perform as a risk manager; this is essentially the essence of the three lines of defense model. It is not just important for a business to achieve the sales objective and other key performance parameters, but the real question is long-term sustainability which comes from managing the risks.

This article touches upon the different aspects of risk culture which is a building block of success of ERM currently prevailing essential for developing a good risk management practice.

Current Position of Risk Culture

In many financial organizations across the world where Chief Risk Officer (CRO) position is mandated by the respective regulators. This means that the Company has a dedicated risk management function headed by CRO. In all such organizations, Board is the owner of the risk management where the baton is passed to the CRO to lead the race of development of risk management.

In all such organizations, enterprise risk management is practiced. This means that various components of ERM such as risk management processes, policies, integration of risk management across the Company, setting risk appetite, three lines of defense model, strategic risk management, etc. are practiced in the Company. However, there are different levels of embedding of risk management across the different organizations which differentiate them among themselves in risk management terms. One of the key components of ERM is the risk culture, that is, how does every employee use risk management in practice. Under the three lines of defense model, the first line of defense is all employees except in risk, compliance, and audit function and they are the primary risk managers. The audit is the third line of defense and Risk and Compliance are the second line of defense.

It is widely believed in the organizations that the job of risk management is of Risk function which is not fully true. The job of risk management in an organization is of the first line of defense as they are the owners of the business objective and they have to identify the risks that can impede the achievement of their objectives. Further, the first line of defense is the subject matter experts, therefore, they are better placed to identify and manage the risks.

The role of the second-line is to provide the risk oversight and not to do the job of risk managers. They can help the first line in understanding the risks and challenge upon what risks have been identified along with comments on mitigation action.

This is an ideal scenario; however, realities are far from ideal. In many organizations, risk management is performed by the risk function with very little idea to the first line that they are the risk managers. In some organizations, risk management is somewhat embedded but risk function is still playing a key role in the risk management exercise.

The best litmus test can be performed by asking the employees working in the branch office about risk management. They would mostly refer the risk management is performed by someone sitting in Head Office.

In such a situation, the three lines of the defense model are not working well or working with minimal efficiency and this is where the fundamentals of ERM start crumbling because risk management is not fully integrated across the organization.

Under this situation, the full benefits of risk management will not come. Therefore, there is a great need to develop the risk culture.

Further, underdeveloped risk culture is a breeding ground for operational risk. Operational risk results from the failure of people, processes, and systems resulting in losses. Therefore, underdeveloped risk culture will impact all three drivers of operational risk. Under a risk-based capital regime, there is a regulatory requirement of keeping additional capital for operational risk. Therefore, it can be seen that risk culture has a direct impact on capital requirements.

Development of Risk Culture

The most important requirement of ERM to succeed is for the first line to think like a risk manager. There is a difference between doing a regular job and thinking like a risk manager. So, it is like double hatting for employees. Doing the regular work is perhaps is easy because that is where their education, training, and experience have been so far and make them experts in their areas. So, when thinking like a risk manager, one has to question, their own work from a “What if” point of view. This is not easy. It is like doing the job and thinking about what can go wrong and find a solution. That is where a change is required for ERM to embed.

There is a need to develop a mechanism for how to approach the problem at hand with a “what if” mindset, and this is where entire risk management training is required to educate the entire workforce.

This is the reason why despite many CROs believing that ERM is well embedded in their organization, the branch guy will still not able to tell who is a risk manager.

There are many components of the development of risk culture within an organization. Though there is a requirement of proper training to the first line about risk management, the biggest human attraction towards learning is incentives and remunerations. It has been found in many developed markets that inclusion of incentive in the pay structure help improves the risk management practices.

Though at first hand, it may look like a cost center, in a long term, it is an investment in risk management as better ERM help improve the shareholder’s value. This has been proven in many academic kinds of literature and implemented in many developed markets.

Conclusion

Risk culture is essential for fully embedding ERM within an organization; the exercise should continue till employees at the branch office are able to identify the risk in their own work. It is just like the last screw of the engine is tight.