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# The Banks Invented ERM and They Blew Up, So Why Should We Bother?

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Seat belts have been widely touted to be highly effective in reducing fatal injuries from auto accidents. Yet, despite requirements that drivers and passengers "buckle up," there are still about 40,000 traffic fatalities every year in the United States. So one might conclude that seat belts just do not work all that well. But if you go past the headline and read the whole story, you find that in about 60 percent of the fatalities, the person was not wearing his seat belt. So putting seatbelts in all cars and requiring their use is not sufficient—people must actually use them!

So it is with ERM. A number of people have observed that banks, long the advocates of ERM, have been struggling mightily in the past year and struggling because they have mismanaged their risks. But if you dig a little deeper into the story, you find that just like the seatbelts, ERM must be effectively applied to have the desired result.

Below are the conclusions of an excellent spring 2008 report produced by an international group of banking regulators.* The report analyzed the experiences and ERM practices of 11 major banks and securities firms in 2007 through the first part of the current financial market turmoil. The report looks at the differences in ERM practices between the banks that were more successful during 2007 from the practices they observed, and the firms that experienced greater difficulty.

Four differences in practices emerged:

1. The better banks quickly shared risk and exposure information broadly among business unit, risk management staff and top management. This meant that they started reacting to the emerging issues as much as 12 months earlier than the banks without these practices.

2. The better banks used rigorous internal practices to evaluate their risk positions. These practices and models were consistent across all businesses.

3. The better banks had a centralized area that coordinated cash planning. They generally tried to avoid or limit activities that created large contingent liquidity needs and set incentives to make that activity unattractive to business unit management.

4. The better banks used multiple risk assessment tools and metrics and generally had very adaptive risk models. They tended to track net and gross positions as well as notional and market values.

The graduates of the school of hard knocks are often very well prepared, but the tuition is usually very high. Here is a situation where most insurers get to audit this particular course for a very low cost. However, these types of reports give great insights, but require the reader to spend some time in translating the results into the insurance environment.

So what can insurers take away from the banks' experience? First and foremost, it is apparent that ERM was not the cause of the banks' problems, but it was rather their lack of effective execution of ERM. In just the same way that traffic fatalities are not necessarily evi-

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*Observations on Risk Management Practices during the Recent Market Turbulence March 6, 2008 Senior Supervisors Group.

dence of ineffective seatbelts, bank subprime losses as indicated by the supervisors' report indicate a failure to effectively implement risk management. ERM can appear as though it is implemented while in benign markets, but a half-hearted ERM program will usually not have the desired benefit when times get tough.

From this report, insurers can see that they should be concerned if they find that:

- Business units are empowered to add significantly to risk concentrations without frequent disclosures and/or justifications to top management.
- Business units all have their own risk models.
- Risk sign-off sometimes relies totally on the presumption that someone else is doing good analysis.
- They do not usually identify contingent risks.
- They need to plan out a year in advance to make changes to their risk models.
- "Nobody believes those stress tests anyway, so we don't put much time into them."

And they should be encouraged if they can say that their risk management programs include:

- Open communications between business units, risk management staff and top management;
- Enterprise level decision-making about major risk accumulations;
- Systematic internal evaluation of risks;
- Low reliance on third party risk evaluations;
- Identification of and plans for contingent risks;
- Incentives for business units to minimize contingent risks;
- Multiple risk management tools and metrics;
- Flexible and adaptive risk models;
- Aggregation of net and gross exposures in addition to expected losses; and
- Stress testing results that are credible to top management, such that management action can and does occur.

The report also notes one major difference between the banks with better results in 2007 and their less effective peers. The better banks were able to keep their degree of attention on risks in their fastest growing area proportional to the level of activity, while the worse banks did not increase risk scrutiny as the business increased. This component is absolutely the most difficult aspect of risk management and requires not just support from the top, but specific direction from them as well. Challenging the high growth area of company business can only be done from the top. ✦

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