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Getting to ERM

A road map for banks and other financial institutions

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Contents

McKinsey Working Papers on Risk presents McKinsey's best current thinking on risk and risk management. The papers represent a broad range of views, both sector-specific and cross-cutting, and are intended to encourage discussion internally and externally. Working papers may be republished through other internal or external channels. Please address correspondence to the managing editor, Rob McNish (rob_mcnish@mckinsey.com).

Getting to ERM: A road map for banks and other financial institutions

Introduction

Few observers of recent years would question that risk management as a discipline has been changing in important ways. In fact, we can argue that risk management is undergoing a quiet revolution, moving from an essentially compliance-driven, quantitative control function toward a senior-management capability relevant at the highest levels of decision making and strategy setting. Enterprise-risk-management (ERM) capabilities and competencies are at the heart of this change. But the journey to an integrated firmwide-risk-management capability is not a straightforward one and several misconceptions and prejudices must be overcome along the way.

In the financial sector, complex quantitative approaches to managing risks have been augmented by new top-down processes beginning with heightened board oversight and accountability. Hard questions have been asked by regulators and shareholders alike about institutions' ability to manage individual risks such as credit or market risk in light of the financial crisis that began in 2007–08. In addition, intense and rapid change driven by Basel III and other emerging industry standards has put more urgent emphasis on improving risk management more generally: what needs to be done to make the moving parts work better? How can banks generate more comprehensive perspectives on their enterprise risk exposures and capabilities?

In many cases, the impulse toward improved ERM comes from an obvious need to protect an institution's downside by ensuring greater transparency, clarity of compliance, and reliability of data provision. But other important factors are involved, including the processes of setting a bank's risk appetite and the organizational and cultural aspects of risk management. One of the historic hurdles facing ERM is that risk management lacks a clear value proposition. In particular, this view has hampered the understanding of operational risk in relation to credit and market risks for financial institutions, mainly on the simple grounds that it is difficult to value counterfactuals. However, the value of risk as an organizing principle for firm management is much clearer today than it was a few years ago. As Exhibit 1 makes clear, thinking about risk at a more strategic level does not mean that other elements are ignored—compliance and loss mitigation will always be vital—but it does mean that higher-order considerations drive how the risk function is empowered and embedded in the firm.

Further, a functional view of risk inside an organization shows just how much broader its impact can be beyond its traditional modeling and control/compliance aspects. Exhibit 2 offers one perspective on this, but the point should be clear that when embraced wholeheartedly risk will pervade an entire operation.

The implications of this "quiet revolution" are enormous. For most financial institutions, an imperative will be a complete overhaul of how the risk function is designed and how ERM is conducted. Concepts such as transparency take on a new meaning, as the managerial (and perhaps regulatory) view switches from a backward-looking approach—"How did we do over the last year?"—to a forward-looking strategic issue—"How are we going to do over the coming year and what are the risk-return trade-offs we are making in order to set ourselves up?" Similarly, this development implies that as individual banks take risk-informed strategic decisions there will be a fragmenting of business models. Each institution must address its natural ownership of specific risks and create idiosyncratic portfolios based on its view of its particular skills and aptitudes. Perhaps most profoundly, risk effectively becomes part of the strategy process, informing discussion and deliberation at all levels, including the top. Risk becomes a capability across an organization, not a function with narrowly defined responsibilities; ERM is the vehicle for this transformation. This makes intuitive sense, as it recognizes the reality that business units already play an important role in risk management.

Nevertheless, the financial industry has been gripped by a sense that it continues to struggle with the challenge of integrating a view and a practice of risk management into a coherent whole that can reliably inform enterprise-level decisions. The chief risk officer of a leading bank recently said, "There will always be crises—we can't do anything about that. But we will have to work to improve our risk management, most importantly our people, processes, and portfolios in order to be better prepared for them." For many top managers, ERM has the potential to make a meaningful contribution to risk-return decisions and to inform the trade-offs necessary for the more optimal deployment of capital.

Exhibit 1 A strategic approach to risk involves compliance and loss mitigation as well as organizational and cultural considerations.

Ensure compliance	▪ Meet **regulatory requirements** (eg, Basel II, Basel III, ICAAP,[1] accounting principles) ▪ Comply with **good industry practices** (eg, customer interaction/KYC,[2] fraud) ▪ **Effective, efficient, and smart compliance**—a change agent for better business decisions
Limit potential losses	▪ Create appropriate **transparency on risk** (eg, credit, counterparty, market, liquidity and funding, operational, business, and strategic risk; risk-modeling challenges, including data/systems, credit rating, EWS,[3] reporting/MIS,[4] economic capital, VAR,[5] stress testing, IT/cybercrime risks), **capital and balance-sheet usage, accounting implications** ▪ Effectively **limit risks** and avoid reputational disasters (eg, risk appetite, capital allocation, limit systems, risk controlling) ▪ Strong **risk controlling and monitoring** ▪ Maintain both **economic as well as accounting perspective**
Improve profitability	▪ Ensure **decision-oriented processes** (eg, credit/deal origination, deal structuring, account management, portfolio management, risk-based pricing for value creation/RAROC,[6] "balance sheet pricing" in mortgage or deposit businesses) ▪ Maintain **efficient and lean** risk management—standardization *and* differentiation ▪ Improve quality of **problem-loan management** (eg, restructurings, workout) ▪ Optimize **ALM[7] and transfer pricing** in cooperation with CFO/treasury
Support growth	▪ Anticipate **changes in company's risk profile** ▪ Ensure **scalability and flexibility** of core processes (eg, credit assessment and approval) ▪ Improve **balance-sheet management** (eg, reduce capital, funding, and liquidity wastage; support capital-efficient and funding-focused business models) ▪ Contribute to **powerful product offering** (eg, new product design, portfolio-risk products like house-price insurance)
Increase quality of strategic and operational decisions	▪ Define the role of **risk and finance in the board and executive committee** decisions ▪ Integrate **risk, finance, and capital perspective** into business-planning process, provisioning, performance management, M&A, market entry and exit, as well as strategic implications (eg, Basel III) ▪ Strengthen **risk and finance capabilities** through frontline tools, trainings, and incentives **in IT/operations, HR**
Improve stakeholder management	▪ Implement a strong **risk and performance culture** throughout the organization, strengthen risk and performance management and understanding across the bank/group ▪ Improve **planning and steering concepts, data management** with CEO, CFO, treasury ▪ Satisfy **board requirements on transparency, decision support, early warning** ▪ Entertain effective **relations to regulator, supervisor, central bank** ▪ Retain and actively manage **target-credit rating**
Define governance and organization	▪ Define **CRO's mandate and organization**, create **independent risk view** in core decisions (eg, through credit-process design) ▪ Define **CFO's mandate and organization** in capital and balance-sheet management, ALM, treasury, funding ▪ Define and implement **enterprise-risk-management** approach throughout the group ▪ Carefully design **incentive system** and **risk-adjusted performance measurement** ▪ Ensure appropriate **people development**: knowledge, experience, stature, motivation, culture

1 Internal Capital Adequacy Assessment Process.
2 Know your customer.
3 Early-warning system.
4 Management-information system.
5 Value at risk.
6 Risk-adjusted return on capital.
7 Asset-liability management.

Exhibit 2 A functional approach to risk can have a broad impact.

Enterprise risk and strategy

- Strategic risk management
  - Budgeting and capital planning
  - Risk appetite and strategy
  - Long-term strategic decisions
- Risk policies
- Risk limits
- Capital/RWA[1] management
  - Capital calculation (eg, Ecap, Regcap, value at risk)
  - Capital planning
  - Capital reporting
  - Capital/RWA optimization
  - Capital allocation
- Balance-sheet management
  - Liquidity management
  - Funding management
  - ALM[2] (including funds-transfer-pricing price setting)
  - Credit-portfolio management
  - New product development
  - Regulatory management
  - Managerial stress testing

Risk communication

- Board of directors
- Executive committee
- Respective committees
- Support functions (eg, finance, ops/IT, compliance/legal)
- Business unit/subsidiaries
- Regulator/MAS[3]
- Rating agencies
- Analysts

Risk assessment and evaluation

- Risk identification
- Risk models[4] development (concepts, tools), validation, implementation, operations (including data quality, system setup, execution)
- Risk-adjusted performance, RAROC[5]
- Loss forecasting and provisioning

Transactions approval and management

- Credit underwriting /transaction approval
- Market/counterparts risk transaction approval
- ALM transactions approval
- Investment/hedging decisions
  - Target customers
  - Scoring/rating
  - Pricing/structuring
  - Credit decision
  - Credit-process design
- NPA[6] management, restructuring, credit collection, and workout
- New product approval

Risk operations

- Loan administration
- Collateral management
- Disbursement
- Risk data and system IT and support tools (demand management)

Risk monitoring

- Risk monitoring[4]
- Early warning system
- Loss forecasting and provisioning
- Risk controlling,[4] limit check
- Risk reporting[4]

Risk governance

- Role of risk in board and executive committee, strategic committee
- Integration of risk in:
  - strategy and planning process
  - performance management and incentive setting
  - M&A decisions
  - market-entry and exit decision
  - material shift in risk profile and business strategy
- Risk organization
- People development, talent management
- Risk and performance culture

Compliance

- Meeting regulatory requirements (eg, Basel, ICAAP[7])
- Integration of economic, regulatory, and accounting perspectives
- Complying with industry practices (eg, know your customer, fraud)

1 Risk-weighted asset.
2 Asset liability management.
3 Monetary Authority of Singapore.
4 Credit, counterparty, market, operational, business, strategic, etc.; individual transactions and portfolio level.
5 Risk-adjusted return on capital.
6 Nonperforming asset.
7 Internal Capital Adequacy Process.

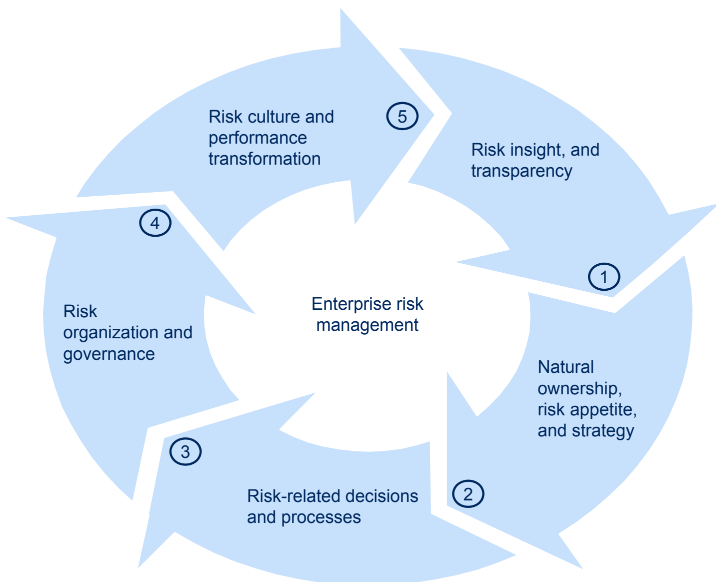
Often, however, the reality is that ERM is an elusive concept, let alone an active and effective daily practice. In this paper, we introduce a proven approach to assessing ERM capabilities and share some insights from those assessments for financial institutions.

We begin with a short recap of our ERM framework. We then highlight each element of our framework and look at the current state of the industry as well as current good-practice and industry trends. Following that, we showcase how a structured diagnostic can be used to get an objective assessment of an institution's ERM capabilities. Finally, we provide an overview of how a diagnostic can lead to a successful transformation with multiple benefits. Even where there might be an intuitive sense among senior managers that their overall risk-management effort is inadequate, it is a big challenge to understand exactly where there might be gaps and no accepted way of measuring gaps to determine which must be closed and which should ideally be closed. Allocating investment to risk-management initiatives at a time of rapid change and significant cost pressure is a formidable task made even more difficult by these uncertainties. ERM sits out there for many organizations as a tantalizing ideal that could potentially transform their business. How can it be grasped?

ERM framework and industry insights

The ERM framework: Thinking about ERM holistically
We have conducted a deep analysis of the shortcomings we have observed during the financial crisis and have found that all of them can be mapped back to five core risk-management capabilities. Based on these observations, we have developed a holistic ERM framework shown here as Exhibit 3.

Exhibit 3 The enterprise-risk-management framework can be mapped to five core capabilities.



Each of the five elements represents a challenge, and only by taking considered action on each one can a true ERM approach be instilled in an organization. Crucially, ERM is not seen as a function, but as a consequence of the successful interaction of numerous processes. Some of these procedures are clearly articulated as risk processes, and others as different institutional languages (legal, compliance, audit), but together they comprise the key elements of a successful and holistic view of an organization's risks. As such ERM covers the roles and responsibilities of the risk function itself as well as the role of risk management in the business and the empowerment of the business. One distinctive feature of this way of thinking about ERM is the emphasis it naturally puts on culture and behavior, aspects of risk management that have often been overlooked or underplayed against their evident importance in many well-publicized risk-management failures.

ERM industry insights
Using the framework shown above, we outline what constitutes each of the elements and assess the current state of the industry regarding ERM capabilities and effectiveness. We then examine the notable characteristics of what leading institutions are actually doing that might constitute a current state of the ERM art, or "good practice." These observations are based on our understanding of ERM, developed through a large number of client interactions and numerous discussions with expert panels, industry forums, and regulators. They are further informed by direct feedback from leading global financial institutions:

Risk insight and transparency cover areas such as risk-data models and data aggregation, risk-IT and data infrastructure, risk modeling (including stress testing, the alignment of risk assessment, and aggregation between different functions), and risk reporting. At its core, risk insight and transparency should capture the sense that the risk-return trade-off is clearly articulated and helps to steer business decisions.

- **Current industry state.** The mechanics of risk transparency are in place for the conventional risk categories banks face (that is, credit, market, operational, etc.). However, most financial institutions are still struggling with how they deal with other risks and how to have a holistic view of their risk exposure, in particular, for those risks that are difficult to quantify (for example, reputational, legal, and conduct risk). Further, many approaches are backward-looking and focus on the current risk profile, rather than interrogating what might be the optimal risk profile for the future, including the consideration of different scenarios, which is something that regulatory pressure tends to exacerbate rather than discourage.

- **Current good practice.** The organization has clarity on top risk drivers and deep insight into the root causes, indirect effects, and early warning signals. This is a result of a number of different factors, including:

  — Stress-testing capabilities that go far beyond the regulatory minimum. Tests help top management to gauge the sustainability of the business model under a range of future scenarios and help it understand the potential impact of changes in the macroeconomic environment; this aligns with the increasingly accepted view that stress testing has moved from the “engine room” to the boardroom as a management tool and a new basis for strategic decisions.[1]

  — The development of new rating methodologies to address current shortcomings, such as the following examples:

    • prediction of key financial indicators under most current conditions

    • differentiation of probability of default estimates for “point in time” and “through the cycle”

    • inclusion of new and innovative data sources

  — Well-structured and concrete risk taxonomy exists with the following qualities:

    • rigorous: includes standards far beyond those defined by regulators or the industry

    • complete: covers all material risks facing the organization

    • precise: clearly defines each risk type

    • granular: drivers are listed for each risk type; differentiates between business units

    • company-specific: tailored to each geography or business unit

  — Increasing importance of risk IT partially integrated with finance and treasury

Risk appetite and strategy covers areas such as the development and specifications of the risk-appetite statement, the metrics used therein, how it is cascaded down through an organization, the relevance of the risk-appetite statement, and the strategy for planning and decision making. It is important to see that in the future world of ERM and risk-adjusted strategy banks will need to be more explicit about their ability to take on and manage specific risks. The “take on” decision will need to be supported by acknowledged skills and capabilities that justify the chosen risk profile. Banks will have, in effect, to demonstrate that they are “qualified” to own particular risks in combination.

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1 *McKinsey Working Papers on Risk*, Number 35: “Strategic insight through stress-testing: How to connect the ‘engine room’ to the boardroom,” July 2012 (mckinsey.com).

- **Current industry state.** Although there has been a lot of progress, with boards playing prominent roles, institutions are generally still struggling with defining and embedding risk-appetite measures and cascading them via a limit system and policy framework through the organization so that they are meaningful for individual business units versus high-level concepts. There is an important link between risk-appetite setting and the management of Internal Capital Adequacy Assessment Process, and this is coming under growing scrutiny from regulators.

- **Current good practice.** Risk-appetite metrics covering risk, financial, and operational indicators linking risk-appetite metrics and performance on a firmwide, business-unit and even desk level—for both aggregated and for specific risk types. The risk-appetite statement is well embedded and is consistent with the firm's risk capacity. It takes into consideration relevant trade-offs between regulatory and economic capital constraints, as well as potential profits-and-losses consequences. A leading practice includes the following:

  — qualitative dimensions (for example, to capture "softer" risk issues such as reputational risk)

  — regular review of risk-appetite statement (for example, annually) as formal process

  — top-down and bottom-up process to define metrics and risk appetite and consciously allocate scarce resources to business areas with highest risk-adjusted return and growth potential

  — limit systems that are aligned with overall governance so that actual and impending breaches are quickly flagged and appropriate counter-measures taken

Risk is embedded in the organization such that it informs all major processes and decisions in a bank on operational, strategic, and transactional levels. This includes such processes as capital allocation, finance and risk alignment, limit setting and controlling, risk-policies definition, credit underwriting, monitoring and workout, counterparty, market, liquidity and operational-risk management, limited liability partnership and loss forecasting, product pricing, strategy adjustments, and people and performance management. As Exhibit 2 shows, risk can contribute to most areas in the firm.

- **Current industry state.** As a consequence of the financial crisis, financial institutions are much more disciplined about treating or mitigating undesirable risk exposures (for example, liquidating poorly understood assets). Many firms now have a much better sense of the risks that are embedded in credit and investment decisions. However, firms are still at a relatively early stage when it comes to embedding risk-reward trade-offs in their strategy decisions. When this does happen it is often in an ad hoc manner in reaction to specific events or pressure from internal and external stakeholders, such as regulators.

- **Current good practice:** Overall risk has an increased role in all relevant processes. We can distinguish between its impact at the portfolio level, which tends to be at the highest levels of management and strategy, and the more transactional level, where often the details are delegated to the business unit, but risk plays a powerful monitoring and shaping role, as in the following examples:

  — more proactive involvement of risk in strategic decisions such as M&A

  — increased focus on ex ante advice rather than miniscule and bureaucratic control processes (for example, compliance and conduct risk)

— monitoring (for example, liquidity-management) processes improved through a number of procedures:

- daily monitoring of all positions (including off balance-sheet) with comprehensive metrics
- includes all positions off and on balance sheet and trading book
- implementing requirements far beyond minimum regulations (for example, comprehensive list of ratios, longer-term forecast beyond ten days)
- robust liquidity plan updated daily and supported by scenario analysis

Risk organization and governance covers questions about where the final responsibility for risk management lies and what the mandate and value add of the risk function can be, how an institution allocates responsibilities vertically, the ways the board influences risk-related decisions, the role, structure, and staffing of the risk organization, and the balance between delegated authorities versus establishing risk committees.[2]

- **Current industry state.** While most institutions have established a chief risk officer who is a full member of the board and have embedded strong risk governance at the board level in reaction to the crisis, there is wide variability in the cascade of risk governance throughout the institutions. In particular, the role of group risk versus divisional risk is often not clearly defined and governance structures are often not aligned between board level and business units. This includes fragmentation of committee structures across the bank and imbalances between delegated authorities and committees.

- **Current good practice.** Risk management is a board and top-management priority and perceived as core to managing the business, while line management takes explicit ownership of key risks with risk-management support. Specific good practice examples include the following:

  — The board has regular involvement on key risk issues beyond annual approval of the business plan, for example, the board defines stress-test scenarios or subportfolios to be analyzed.

  — Centers of expertise and shared-service centers (potentially in offshore locations) are established to focus the workforce and leverage expertise, such as the consolidation of modeling in expert areas.

  — Lean management principles in risk are applied and the ERM function is created.

Risk culture encompasses the mechanisms an institution deploys to strengthen mind-sets and behaviors and how an institution goes about making that possible, for example, by fostering an open and respectful atmosphere in which employees feel encouraged to speak up when observing new risks.

- **Current industry state.** Organizations are still struggling with how best to come to terms with their risk culture—they know that this is a crucial element for containing risks, but how can they assess it and improve it, and how does this relate to broader ERM efforts? What tangible interventions can they make to reinforce their observed risk culture?

- **Current good practice.** Organizations introduce dedicated programs and interventions to reinforce a strong risk culture based on the empowerment of the businesses; they create a dedicated risk-culture function within the risk organization by:

2 For more on this topic, see *Wearing Varifocals—A New Perspective on Risk-organization Effectiveness and Efficiency,"* EMEA Banking practice, March 2012 (mckinsey.com).

- creating awareness and a common language and identifying improvement levers and implement them, for example, by rolling out a semi-annual or quarterly risk-culture self-assessment

- launching a program to assess and transform current risk capabilities with the support of a dedicated change team

- defining specific actions, owners, and milestones, and establishing an ongoing method of monitoring the risk-culture transformation

In addition, we observe structural differences in ERM capabilities between institutions from different regions and of different statuses. Predictably, financial institutions in developed economies report a considerably higher engagement with ERM challenges. Firms in emerging markets exhibit a noticeable lag in relation to risk culture, risk strategy, and risk appetite.

Establishing a state-of-the-art ERM framework is no easy feat. Banks face many tricky conceptual questions, such as how to embed forward-looking modeling or how to define a risk appetite. They must make tricky trade-offs, for instance, choosing whether to move quickly into a new business area or more slowly while building up the necessary risk capabilities. There are significant implications for IT budgets, as an effective ERM system requires substantial change in IT operations. Finally, there are cultural and people-related challenges. How can the right talent be found and deployed? It is no surprise that top-management support for an ERM program is essential and needs to be justified by a clear business case.

Experience has clearly shown that investment pays back. The enhancement of ERM capabilities has a positive impact on the risk profile of the bank and its long-term resilience. It also helps to streamline processes, overcome bureaucracy, and free capacity of up to 20 percent within the risk function, allowing it to focus on other higher-value tasks. Furthermore, strengthened risk management is also acknowledged by regulators and rating agencies and can help a bank to build or rebuild a strong reputation, influencing funding cost and leading to a positive impact on the client and counterparty franchise. But how to best capture these benefits quickly?

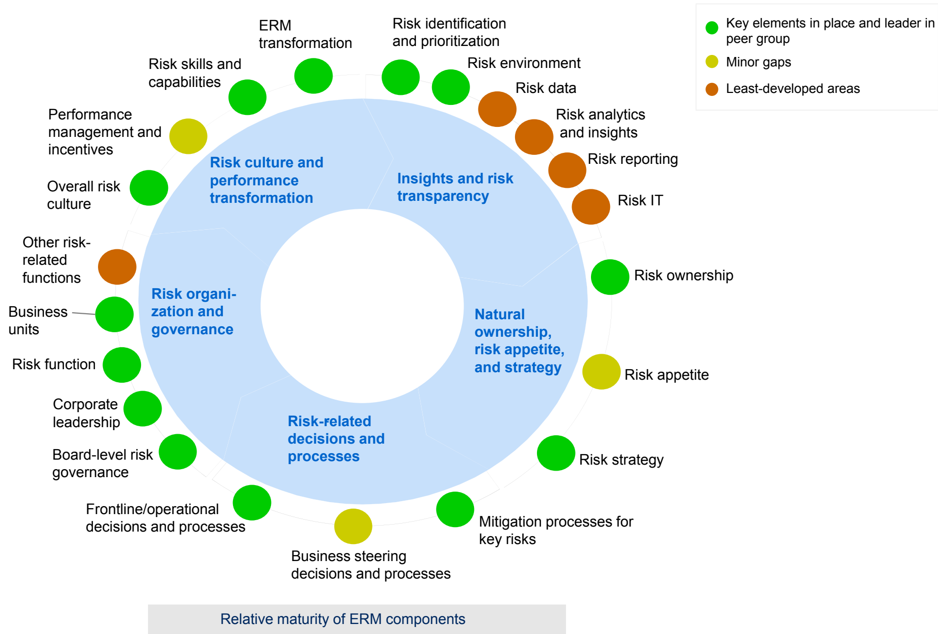
This is where an ERM diagnostic becomes helpful. Given the plethora of approaches to ERM, it is difficult for senior managers to assess where they stand compared to industry standards, including their competitors, as well as in relation to regulatory and other standards. The key question is how leading banks overcome challenges, close gaps, and establish best practices. An ERM diagnostic can help to identify shortcomings in risk management, align priorities, and ultimately lay the foundation for a successful ERM transformation. If a bank knows how far it is from current leading practice, it can set targets and make plans to move closer to its desired end state. It can also be transparent about the business case for making the change.

How to run an ERM diagnostic in banks and other financial institutions

Based on the broad experience we have in ERM, we have developed an approach to conduct a structured ERM diagnostic, which will allow a bank to diagnose and benchmark its organization's ERM capabilities. Even where there are disparate functions and fragmented ownership of risk management, it is possible to conduct this diagnostic by applying a series of standardized and extensively tested questions to key risk functions and processes (Exhibit 4). Some of these cover areas such as IT risks that are often excluded from conventional risk-management frameworks, and thereby ensure that a more holistic view is assessed.

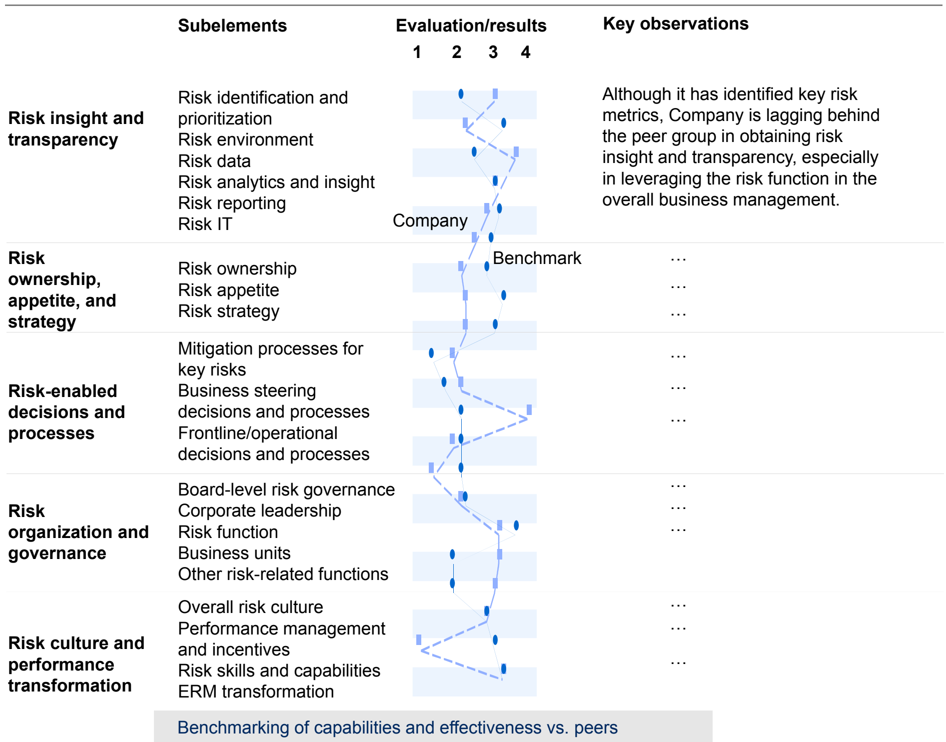
Exhibit 4 A high-level enterprise-risk-management (ERM) assessment clarifies relative strengths and weaknesses.

Overall ERM performance heat map



Source: McKinsey ERM diagnostic database

Fever chart comparing ERM evaluation to peer group

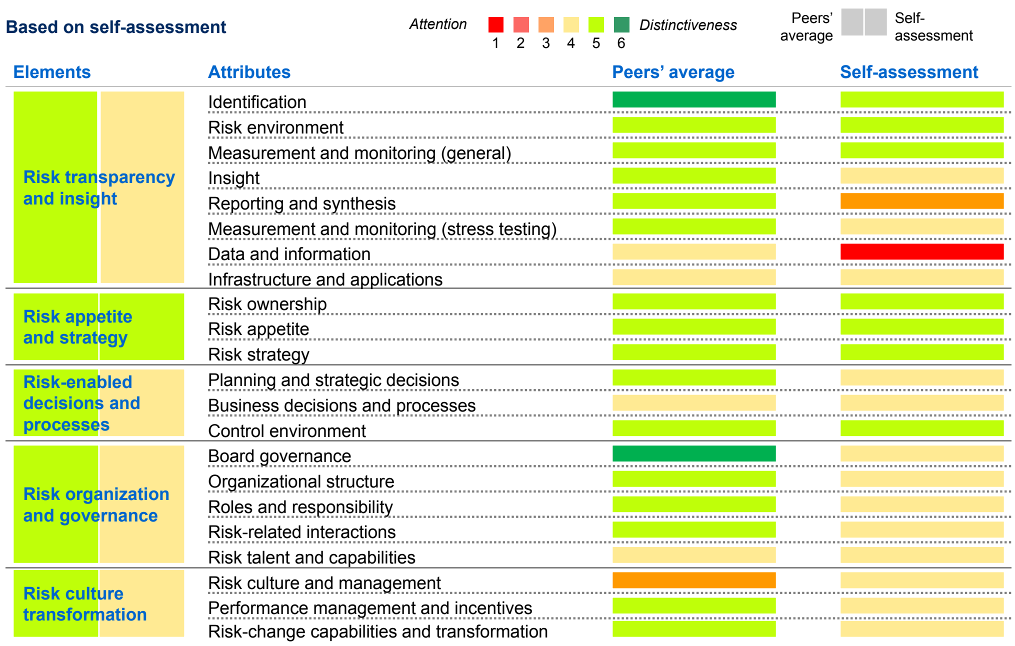


Below, we set out a methodology for undertaking an ERM diagnostic and explain how this can be done effectively in the field by taking into account organizational idiosyncracies.

The ERM diagnostic
Depending on the bank's underlying purpose, there are two fundamentally different approaches to an ERM diagnostic. A "top-down ERM assessment" can be used to provide a high-level perspective within a short period of time on the strengths and weak spots of ERM within a bank. This is designed to inform top management quickly and efficiently where there might be obvious areas requiring attention. A lengthier "ERM baselining" diagnostic provides a deep insight into the processes, systems, skills, and structures of the holistic risk management in an organization and is used to provide a starting point for an ERM transformation. Both diagnostics are structured using each of the five elements of the ERM framework.

Top-down ERM assessment. The diagnostic consists of a series of five to ten structured interviews with senior-management members, following the lines of the ERM framework, to develop an early version of an ERM heat map (Exhibit 5) and a benchmark mapping that compares the ERM evaluation with a peer group, based on qualitative assessment.

Exhibit 5 The top-down self-assessment compares the ERM evaluation against a peer group.



ERM baselining. The diagnostic consists of 30 to 40 interviews with representatives from across the risk function as well as different management levels and covers all units that directly interact with risk, as well as selected units that have only indirect exposure to risk. The diagnostic includes selected deep dives that are identified at an early stage based on the preliminary findings. These deep dives can be conducted through further interviews with a broader set of employees in the specific area, through deployment on specific diagnostic tools for the focus area, or a survey within the organization or with a small set of peer banks. A workshop with senior management can complement the observations from the interviews and surveys. Based on the findings, this workshop provides a platform to discuss and reach a consensus on what the true priorities for the bank are and what the DNA of the ERM capabilities and risk function is or should be. As a result the diagnostic will not only yield a detailed assessment and description of current state, including a detailed description of issues observed, but also an agreed-upon vision of the target state and a list of concrete prioritized actions for the initial phase of the transformation. A pilot-based approach can be developed to showcase early successes.

If either of these diagnostics identifies an area of particular weakness, or there is another reason to understand a certain element of ERM in more detail, there are a number of deep-dive tools that go beyond the above diagnostics, such as a "360" for risk-organization benchmarking and diagnostic or a risk-culture survey, which provide an in-depth look and allow for an even more detailed assessment of that particular element.

Benefits for managers from an ERM diagnostic

In our experience, companies that choose to undertake a comprehensive risk transformation take at least one year and sometimes significantly longer to reach their desired end state. Several obstacles (for example, management buy-in, budget sign-off, incorporation of regulatory change and ongoing initiatives) need to be overcome before a change program can be successful. Any one obstacle can greatly limit and even stymie the overall effort.

Hence, it is important to set the right aspirations in an agreed-upon order of priority and to align this with senior leadership. As in any organizational context, looking for quick wins that can help to demonstrate early success is a powerful means to achieving broader buy in. The ERM assessment process helps to identify potential wins, but it is only the first step in the design and implementation of a successful risk-transformation program.

If implemented successfully, a broad range of benefits far beyond regulatory compliance can be captured by banks through a comprehensive ERM-transformation program:

- better strategic management of the bank thanks to the influence of risk-return dialogue in strategy setting at the highest levels

- an enhancement of risk capabilities, such as improved risk governance, reporting, or even the introduction of advanced stress-testing methodologies

- better services to the business units, for instance by providing tools to obtain insights on risk-adjusted prices for credits

- improved relationships with external stakeholders

- reduced costs and improved efficiency of up to 20 percent reduced run-rate for full-time-equivalent-related cost

It is unlikely that there will ever be a single accepted view of what constitutes ERM and how it should be done.[3] However, our structured approach to ERM diagnostics suggests that most institutions can benefit from a programmatic interrogation of their risk-management capabilities. This can have much greater impact than dealing with single elements of an established risk function. But it is just as specific in its approach, driving dialogue to a very detailed level and helping management to understand the full breadth of the risk-management challenge. The benefits of embracing ERM cannot be overstated. Banks learn to manage themselves using a common risk language, gain transparency as to where they sit in relation to competitors and industry norms, set clear recommendations for where future efforts should be focused, and make explicit the trade-offs and choices that drive the business strategy.[4]

3 *McKinsey Working Papers on Risk,* Number 40, "Enterprise risk management: What's different in the corporate world and why," December 2012 (mckinsey.com).
4 McKinsey has conducted a global ERM survey in conjunction with the Risk Management Association and will publish the findings in 2013.

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