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VIEWPOINT

Move Fast on Risk Plans

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As we make our way through the aftermath of the worst financial crisis since the Great Depression, industry participants, lawmakers and regulators alike continue to contemplate its causes and propose legislation, standards and practices to prevent a recurrence.

The recently enacted Dodd-Frank Act requires the **Federal Reserve** Board to promulgate "heightened overall risk management requirements" for systemically significant institutions, and regulators worldwide are promoting tough new capital and liquidity requirements that are inextricably linked to enterprise risk management. Though these enhanced standards initially apply only to systemically significant banking institutions and a few large nonbanks, they will surely migrate to institutions of lesser size and complexity, perhaps more quickly than expected.

Well-managed banks and other financial institutions are using the lessons of this cycle to significantly improve risk management systems, programs, processes and cultures. Likewise, some regulators are suggesting it is no longer acceptable to have just "satisfactory" risk management. The developing standard, or expectation, appears to require "strong" risk management, an expectation that, though not well defined or easily measurable, will be applied to all large institutions. As these heightened standards and expectations become better defined, institutions will be expected to conform fast or face regulatory action.

The bar is clearly being raised by regulators — as it should be, considering the prior outcome — and this means that whatever is being done now to manage risk and shore up controls will have to be ratcheted up. Organizational awareness of and attitudes toward risk must be unambiguously supported by an appropriate tone at the top, and reinforced by strong communications and compensation/incentive structures that incorporate and enforce individual accountability. Risk management and independent control functions, such as internal audit and loan review, will be expected to demonstrate independence and empowerment not only in proactively identifying risks but also in altering behavior. Regulators will expect risk measurement and reporting to be multidimensional, enabling active, anticipatory risk management; sound governance and quantification and planning for capital and liquidity.

In addition, regulators will expect institutions to be able to demonstrate the robustness and "sustainability" of risk management programs and processes, as well as their linkage to capital adequacy assessment and planning. (See for instance the Nov. 17, 2010, release by the Board of Governors of the Federal Reserve System related to dividend increases and other capital distributions for the 19 Supervisory Capital Assessment Program bank holding companies.)

Regulators will expect capital assessment and planning to leverage and complement risk management programs. They clearly are focusing more than ever on the robustness and sustainability of institutions' enterprise risk management and internal capital adequacy measurement and planning. Institutions should expect regulators to directly tie their deliberations on expansion plans, dividend payments, Tarp repayment requests and enforcement actions to compliance with these expectations.

Though we do not yet know all there will be to know about the prospective "heightened" standards, and may never know the regulatory definition of "strong risk management," it is clear that expectations are rising. This means that getting to where you are today will, for many, not be enough.

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