

THE ESSENTIALS OF RISK MANAGEMENT

Third Edition (EoRM3)

ONLINE CONTENT FOR CHAPTER 4

Box 4-6 of EoRM2

From pp. 178–179 of *The Essentials of Risk Management, Second Edition* (EoRM2)

BOX 4-6

IS IT POSSIBLE TO SCORE THE QUALITY OF AN INSTITUTION'S RISK MANAGEMENT?

In much of this chapter, we talk about establishing the right structures for best-practice risk governance. But is there any way to score risk management practice across an institution so that both the institution itself and external observers can gain some objective idea of the institution's risk management culture and standards?

One of the authors has worked with a credit rating agency to construct such a score.

Under this approach, the risks underlying each aspect of the enterprise risk management function within institutions are assessed using a questionnaire tailored along three key dimensions:

- **Policies**—For example, is the tolerance for risk consistent with the business strategy? Is risk properly communicated internally and externally?
- **Methodologies**—For example, are the risk methodologies tied into performance measurement? Are the mathematical models properly vetted? Does senior management understand the risks in the models?
- **Infrastructure**—For example, are the appropriate people and operational processes (such as data, software, systems, and quality of personnel) in place to control and report on the risks?

The basic PMI (policies, methodologies, infrastructure) framework can be used for most industries, while within each of the three key dimensions, more detailed questions can be developed that tackle aspects relevant to a particular industry.

For example, for trading financial institutions, we might require a description of the process around limits delegation for market risk and credit risk (as it pertains to the trading book).

Gathering this information involves supplying questionnaires and also scheduling the time of senior management at the trading institution for review sessions. The completed assessments

would be presented to an internal committee at the rating agency, where the primary credit analyst will take them into consideration in the rating agency's overall review of the institution.

A negative assessment could affect the credit rating of the institution—a clear indicator of how important the nexus between risk management, corporate governance, and risk disclosure has become.