The View of ERM from E*Trade's Risk Chair

When the brokerage firm's board took a new approach to risk oversight, it positioned the company for revitalizing successes.

By James Lam

This article is excerpted from the author's forthcoming book, Enterprise Risk Management: From Methods to Applications *(Wiley, 2017).*

In September 2012, I received a call from an executive recruiter representing the board of E*Trade Financial. He said the company was looking for a new director "with risk in his or her DNA." On Nov. 14, 2012, I was appointed to the company's board, named chair of the risk oversight committee (ROC), and became a member of the audit committee. Serving on a public company board had long been one of my top career goals, so this was a joyous occasion.

The general public may know E*Trade best for its Super Bowl commercials featuring a cute talking baby. Today, our advertising campaign features more experienced actors. This change is an apt metaphor for the company's evolution from an Internet darling to a mature S&P 500 company.

Turnaround

E*Trade has an interesting turnaround story. The company became an early digital disruptor in retail investing when it executed the first electronic trade by an individual investor more than 30 years ago. But in 2007, E*Trade found itself on the brink of collapse due to sizable, ill-timed investments in mortgages and other asset-backed securities that deteriorated during the economic crisis. In the five years that followed, these losses led to a troublesome capital position, activist investor pressure, and intense regulatory scrutiny. During that difficult time, the board and management team worked tirelessly to stem losses and save the company. While their good efforts provided a line of sight to better financial performance, we still had to travel a long road to get to improving our regulatory standing and risk management capabilities.

In November 2012, the company was undercapitalized and losing money, with stock trading around $8 per share and debt ratings of B– and B2. We were also operating under the tight regulatory restraints of memorandums of understanding (MOUs) from the Office of the Comptroller of the Currency and the Federal Reserve. Since then, we have achieved solid profitability, reduced our corporate debt burden, stripped risks from the balance sheet, and established a far stronger capital position. Last year, the MOUs were lifted, and the first stock buyback program in more than eight years was announced. As of June 30, the stock closed at $23, and our debt ratings stand at BBB– and Baa3.

Over the past three years, the E*Trade board and management team worked collaboratively to establish a best-in-class enterprise risk management (ERM) program, including an innovative first-of-its-kind performance feedback loop. As the chair of the ROC, I had the opportunity to practice what I preached with respect to effective risk oversight.

The GPA Framework

Prior to E*Trade, I had served on the boards of two private technology companies, one of which I founded. I also worked as a senior risk advisor to U.S. and international boards across a wide range of industry sectors, including banking, insurance, asset management, healthcare, technology, and nonprofit. Based on my experience, I created the governance, policy, and assurance (GPA) framework to focus attention on three key components of board risk oversight:

Governance. The board must establish an effective governance structure to oversee risk. Should there be a separate risk committee? How should the board and its committees share risk oversight responsibilities? What is the interrelationship between strategy and risk oversight? How can the company ensure the independence of the risk and compliance functions?

Policy. The board must challenge and approve risk management policies that provide effective guidance and limits to management. Is there a sound risk appetite statement that clearly defines the types and levels of risks that the company is willing to accept? What is the alignment between the company's risk policies and its compensation policies?

REUTERS/LUCAS JACKSON

In November 2012, E*Trade Financial Corp. was undercapitalized and losing money, with stock trading around $8 per share and debt ratings of B– and B2. Since then, the board and management team have worked collaboratively to establish a best-in-class ERM program, including an innovative first-of-its-kind performance feedback loop, to help establish a stronger capital position.

Assurance. The board must receive evidence-based assurances that the company's ERM program is effective. What metrics and feedback loops will the company use to evaluate ERM performance? How can risk reports convey the right information efficiently? How should the company provide risk transparency to investors, rating agencies, and regulators?

It is management's role to manage risk, and the board's role to govern and oversee. By addressing the fundamental elements of board risk oversight, the GPA framework has been useful in my work as a board advisor. The E*Trade appointment was my first opportunity as a public company director and risk committee chair to apply it.

Top Priorities for the ROC

As the incoming chair of the ROC, I focused on addressing the regulatory requirements and expectations set forth in the MOUs, as well as overseeing the build-out of a comprehensive ERM program. After an initial assessment, I outlined five top priorities for the ROC. I reviewed them with the other ROC members and the chair, CEO, and chief risk officer (CRO) to gain their acceptance and support. Relative to the GPA framework, priority Nos. 1 and 2 address governance, No. 3 addresses policy, and Nos. 4 and 5 address assurance. The five priorities are as follows.

1. Establish a strong ERM agenda. Board time is limited and precious, so I wanted to make sure the ROC spent it productively. I worked with the CRO and committee members to establish an annual calendar. This calendar included agenda items required by charter, policy, law, or regulatory guidance. It also included deep dives into specific risks, such as credit and cybersecurity, as well as capital adequacy and stress testing results.

In the past, the ROC focused mainly on financial and regulatory risks, but I wanted our scope to include strategic and operational risks as well. Empirical studies of public companies have consistently shown that major stock price declines were mainly caused by strategic risks (about 60 percent), followed by operational risks (about 30 percent) and financial risks (about 10 percent). As such, it is imperative that any ERM program addresses strategic and operational risks.

The MOUs placed significant constraints on the company, so their resolution was mission critical for the ROC. At each meeting, the chief compliance officer provided a status update on our progress in addressing all of the MOU requirements. We also sought to engage our regulators and to develop good relationships with them outside the boardroom, so the chair, CEO, and I scheduled regular one-on-one meetings with them.

The ROC also received regular updates on our progress against the ERM road map. This multi-year road map included specific milestones and work plans to develop our risk and compliance (second line of defense) and internal audit (third line of defense) capabilities. It also included a risk culture program that encompassed training, executive town halls, and an annual risk culture survey.

2. **Strengthen independent risk and compliance oversight**. The independent reporting relationship between internal audit and the audit committee is a long-established standard in corporate

Evaluation of the Chief Risk Officer

At least annually, the risk oversight committee, in consultation with management, shall evaluate the performance of the company's chief risk officer and shall:

- Have, following consultation with management, the authority to retain and to terminate the chief risk officer; and
- Provide input to management and the compensation committee with respect to the compensation structure, annual performance goals, and incentives for the chief risk officer.

Management must obtain the committee's approval prior to making any organizational reporting change, material changes to overall compensation, and/or hiring or termination decisions with respect to the chief risk officer.

governance. This is not always the case with risk and compliance functions. Yet, as we painfully learned from the economic crisis and other corporate disasters, the independence of oversight functions is critical to their success.

When I first joined E*Trade, there were reporting lines between the ROC and the CRO and chief compliance officer, but aside from a PowerPoint slide, there was no documentation on what those lines really meant. I worked with the CEO and general counsel to adopt measures in the ROC charter to formalize the independent reporting relationships between the ROC and the CRO and, separately, the chief compliance officer *(see sidebar, left)*.

3. Enhance risk policies, with a focus on the risk appetite statement. Risk policies should not be written in stone. They should be living documents that explicitly communicate the organization's risk management processes, guidelines, and risk tolerances. At E*Trade, we have over a dozen risk policies for different types of risk. However, they did not always share consistent structure, content, or process for renewal and board approval. For example, some had clearly defined risk metrics and risk tolerance levels while others did not. In the first cycle of annual policy renewal and approval, we established a set of guidelines for all existing and new risk policies. These guidelines created common standards such as risk oversight and management responsibilities, risk tolerance levels, and exception reporting processes.

We also developed a comprehensive risk appetite statement (RAS). The RAS establishes acceptable types and levels of risk for the overall company. Because it provides the key risk metrics and tolerance levels, the RAS is the most important risk policy. For each risk type, we defined our core objectives with qualitative statements and supported them with quantitative risk-tolerance levels. Each type of risk also has a defined governance structure with respect to its management at the operating units (the first line of defense) and its oversight at the risk and compliance functions (the second line of defense). Moreover, the company communicates the RAS to every employee in order to support a common risk culture.

4. Improve the quality of risk reports. The quality of risk reports the board receives influences the quality of its discussions and decisions. Initially, the ROC package mainly consisted of lengthy PowerPoint presentations, granular risk assessments, and detailed metrics. However, it was often unclear where committee members should focus their attention or whether risk metrics were within acceptable levels.

To improve the quality and effectiveness of risk reporting, I worked with the CRO to develop a standard CRO report to provide a concise summary of the company's risk profile. A week prior to each ROC meeting, we receive the CRO report along with the ROC package. The CRO report includes the following information:

- **Executive summary.** The report begins with an overview of E*Trade's aggregate risk profile and most critical risk issues. It also draws the ROC's attention to the meeting's key discussion and decision points.

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- **New risk and loss events.** This section provides a summary of material risk and loss events, including initial loss estimates and root-cause analyses. These events may involve business practices, policy exceptions, regulatory issues, information technology and cybersecurity events, and financial and operational losses.
- **Follow-up on prior risk and loss events.** This section provides updates of previously reported risk and loss events.
- **Emerging risks.** This section identifies emerging risks that may impact the organization, as well as risk trends and developments for the industry.
- **Risk assessments and metrics.** This section provides a summary of the major risk areas. Each summary includes expert commentary and a risk appetite dashboard that displays the key risk metrics relative to risk tolerance levels. It also explains any

deviations from risk tolerance levels. The risk categories include strategic; market; interest rate; liquidity; credit and counterparty; operational; cybersecurity; reputational; legal, regulatory, and compliance; and capital adequacy.

- **Progress against the ERM road map.** This section provides an update on the key accomplishments, progress to date, and major initiatives relative to the ERM road map.
- **Terms and definitions**. The report concludes with a glossary of technical terms, performance and risk metrics, and acronyms used.

5. Establish an ERM performance feedback loop. How do we know if risk management is working effectively? This is a fundamental question that every board must address. Boards often evaluate risk management performance based on the achievement of key milestones or the lack of negative events. However, qualitative milestones and negative proofs are necessary but insufficient measures for success.

A performance feedback loop is a critical tool to support continuous improvement by adjusting a process (e.g., ERM) according to the variances between actual and desired outcomes. In order to establish a performance feedback loop, a company must first define its objective in measurable terms. The objective of ERM is to minimize unexpected earnings volatility. In addition to earnings, a company may also strive to minimize unexpected changes in enterprise value and cash flows. It is important to note that the goal is not to minimize absolute levels of risks, but simply those from unknown sources. Once you define the objective, you can create the feedback loop.

At the beginning of the reporting period, the company performs an earnings-at-risk analysis to identify the key variables (business drivers, interest rates, credit performance, etc.) that may produce a range of earnings. At the end of the reporting period, the company performs an earnings attribution analysis to determine the actual earnings drivers. The combination of these analyses provides an objective feedback loop on risk management performance. Over time, the organization strives to minimize the earnings (or shareholder value) impact of unforeseen factors.

In my first meeting with E*Trade's CRO, I made clear that of the five ROC priorities, the ERM performance feedback loop is likely the most challenging and also the most valuable. It took about a year for the CRO, in collaboration with the CFO, to implement this innovative technique. By comparing *ex-ante* earnings-at-risk analysis to *ex-post* earnings attribution analysis, we are able to monitor the earnings impact of changing trading volumes, interest rates, credit performance, and other risk drivers. We can also isolate unexpected earnings volatility as a performance feedback loop for our overall ERM program. To my knowledge, E*Trade is the first company to do this kind of analysis.

Rapid Development

Serving on the E*Trade board has been one of my most gratifying professional experiences. Today, I am honored to be a member of a board that is diverse, engaged, and effective. In my career, I have worked on more than 50 ERM projects as CRO, risk consultant, and now risk committee chair. E*Trade has made the most significant progress in a three-year period. In retrospect, several factors contributed to the rapid development of ERM at the company, including a good partnership between management and the board, effective leadership by the CRO and chief compliance officer, sufficient commitment of time and resources to the ERM build-out, and a focus on instilling a strong risk culture throughout the company.

No company should ever rest on its laurels, especially when it comes to risk management. E*Trade will continue to face new risks. Yet with the right ERM framework, performance feedback loop, and engagement from the executive team down to the front-line employee, E*Trade and its board are prepared to face these challenges. Going forward, we are building on our heritage as a digital disruptor, and innovating in a manner that embraces risk.

James Lam is president of James Lam & Associates, a risk management consulting firm, and chair of the risk oversight committee of E*Trade Financial Corp. He is the inaugural recipient of the Risk Manager of the Year Award from the Global Association of Risk Professionals. Portions of this article relied on research information taken from *Enterprise Risk Management: From Incentives to Controls*, second edition, by James Lam (Wiley, 2014).

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