A Practical Guide to Enterprise Risk Management

High performing community banks are those that have embraced and learned to effectively manage risk.

By Kenneth W. Proctor, Managing Director, Risk Management

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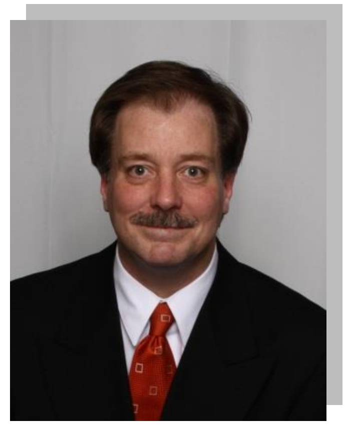


Ken is Abound Resources' Managing Director of Risk Management. During his 40 year banking and consulting career, Ken has served as an internal consultant with a major regional bank, held responsible management positions in the auditing departments of two southeastern regional commercial banks, and worked as a public accountant. He created the Risk Management Practice area for two national financial services consulting companies and has also served as a senior consultant with two international risk management-consulting firms.

Most recently, Ken has developed enterprise risk management programs for financial institutions ranging in assets from $400 million to $11 billion and assisted financial institutions in complying with requirements of regulatory enforcement actions. In regard to the regulatory orders, he has prepared evaluations of Boards and Directors, evaluated management teams and organizational structures, assessed the adequacy of credit administration and credit risk management practices and controls, developed earnings improvement, budgets and forecasts and capital plans, developed liquidity contingency plans and evaluated problem loans and other assets and created risk mitigation, workout and liquidation plans.

In addition to his extensive risk management experience, Ken has also performed profitability and operational process improvement reviews, developed strategic business and technology plans for financial institutions, selected and implemented core processing and other systems. Additionally, Ken has designed, implemented, and tested disaster recovery and business continuity plans for banks across the country.

Ken is a frequent speaker for national and state banking association financial industry conferences and seminars. For 10 years he served on the faculty of the Louisiana State University Graduate School of Banking program, serving as an instructor on Risk Management. In addition, he has managed workshops and delivered presentations to banks, credit unions and thrifts for regulatory authorities, including the Federal Home Loan Bank and FDIC, technology vendors and international banking associations, including FELABAN.

For ten years, Ken served on the faculty of the Louisiana State University Graduate School of Banking program, instructing in risk management. He has authored numerous articles on risk management for various industry publications, including the Northwestern Financial Review, American Banking Association, Bank Marketing Association and others.

Ken holds a Bachelor of Business Administration and is a Certified Public Accountant and a Certified Bank Auditor.

Practical Suggestions for Implementing Enterprise Risk Management

The overriding goals of risk management are to: 1) identify events that might impair a bank's ability to achieve its strategic objectives, and 2) mitigate the likelihood those events will occur.

As a result of the myriad problems financial institutions have experienced in recent years, the prevailing wisdom is that risk is a bad thing. Just ask those people picking through the rubble of failed banks in Georgia, Illinois, California and other states or regulators sorting through the corporate bank failures.

Prevailing wisdom, in this case, however, is wrong. It's difficult to be a high performing financial institution, to consistently exceed the performance of your peers, and meet the expectations of your shareholders, without taking risk. Risk is the essential element of the business of banking. It is, instead, the inadequate management of risk that is the problem.

Unfortunately, financial institution managers have not been as successful at managing risk as they'd hoped. One reason for this lack of success results from focusing attention on the wrong information. Looking at delinquency and non-performing loan reports won't tell you much about risk in the loan portfolio. It might tell you something about future losses, but the risk decision was made months, even years before.

What is Risk Management?

Just as there are misconceptions about risk, there are misconceptions about risk management. Many financial institution executives do not look far beyond those risks associated with loans or interest rates. Some believe that risk management is primarily a compliance issue. Others believe it is primarily about buying insurance, installing security equipment, or implementing internal controls. In truth, it includes, but goes far beyond, each of these issues.

Risk management is all about effective business management. The overriding goals of risk management are to: 1) identify the events or circumstances that might impair a bank's ability to achieve its strategic business objectives, and 2) implement strategies that will either mitigate the likelihood those events will occur or minimize the negative impact on the bank if they do. In many cases, however, there is a poor link between where the bank is trying to go strategically and how much risk it can or must take to get there. Even worse, most banks do a poor job of identifying those events might prevent achievement of the strategic business objectives.

Risk management is not a task assigned to someone to complete. No one person or department "manages" risk. Just because someone completes a "risk assessment", it does not mean the risk is managed. Bank bookshelves are filled with FDICIA, SOX, BSA and other "risk assessment" documentation.

Instead, risk management is a discipline, a process that must become part of a balanced strategic approach to business development and management. The execution of the risk management program must be relevant to and become part of the ongoing business process.

Risk management is a discipline, a process that must become part of a balanced strategic approach to business development and management.

If this most recent crises in the bank and banking industries has pointed up the need for anything, it is that financial institution executives must understand the potential future risk consequences of strategic business decisions they make today. When many made the decision in 2004 and 2005 to grow, funding speculative acquisition, development and construction loans with wholesale funds, did they actually understand whether the institution could survive the effects of a severe downturn in the real estate market and a prolonged recession? When they made the decision to develop significant concentrations of highly profitable real estate related loans, did they consider the impact on earnings and capital adequacy of possible collapse of the real estate prices and rise of foreclosures.

In regard to bank failures, the reasons for failures include:

- Rapid growth of loan portfolios, funded by wholesale funds;
- Over concentration in commercial real estate loans, particularly speculative construction and development loans;
- Poor loan underwriting and credit risk management practices;
- Lack of functional segregation of duties between lenders and credit administration;
- Presence of dominant management that ignored or overrode controls, and
- Inadequate Board oversight.

It is true that many financial institution's earnings, non-performing loans, capital and regulatory problems resulted initially from the economic downturn, but they were exacerbated by poor loan underwriting and credit risk management practices. But, looking at it from a much greater perspective, the problems have really resulted from an overall failure of enterprise risk management. Embarking on high-growth strategies, developing significant commercial real estate loan concentrations, using wholesale funding without considering the attendant credit, interest rate, liquidity, compliance, operational and strategic risk implications has been a primary cause of the issues facing bank's today.

Now is an opportune time to assess your bank's overall risk position and risk management practices. Management should assess risks inherent in the bank's business and operating environment, determine that adequate risk management guidelines have been incorporated in the bank's policies and procedures, ensure management information systems are adequate to monitor the changing nature of risk and establish a comprehensive risk management program.

Financial Institution Risk Management

All financial institutions are exposed to a variety of risks — operational risks, such as crime, employee fraud and natural disaster, and speculative risks, such as credit, market, price and interest rate risk. A primary responsibility of management is to provide shareholders, directors and regulators with reasonable assurance that the bank's business is adequately controlled. Consequently, it is imperative that all banks develop a comprehensive risk management program. Many smaller banks, however, devote fewer resources to risk management than their larger counterparts, believing that less complex institutions don't have the same need or capacity to manage risk as the larger banks do. The reality is that banks of all sizes face the same risks with varying degrees of exposure and have the same need to manage those risks.

It is now abundantly clear, however, that strategic risk issues, such as rapidly changing economic conditions, increased competition and technological innovation, have a dramatic impact on a financial institution's ability to maintain profitability and credit quality.

Traditionally, financial institutions have considered risk to be primarily operational in nature – losses resulting from robberies, theft, fraud or disasters. The primary risk management approach was to buy insurance. During the mid-80s and into the 90s, however, financial institutions learned the critical need to address risk issues other than strictly operational risk, and began directing a great deal of attention toward managing interest rate risk and credit risk. It is now abundantly clear, however, that strategic risk issues, such as rapidly changing economic conditions, increased competition and technological innovation, have a dramatic impact on a financial institution's ability to maintain profitability and credit quality, prevent the critical loss of customers and avoid technology investment mistakes. The failure to manage these risk issues can affect a bank's ability to establish new customer relationships, or its ability to service existing relationships. Inadequate risk management can also expose a bank to regulatory sanction, financial loss, litigation or damage to its reputation. Therefore, it is imperative banks carefully evaluate all types of risk facing the financial institution.

Unfortunately, many financial institutions do not have a formal risk management program or process. Recent research has revealed that just over half of all financial institutions have implemented a formal risk management program. Even fewer have a formal process for evaluating risk before launching a new product or outsourcing critical services to a third-party vendor. Decisions are made, strategies implemented, technology deployed and products developed without sufficient consideration of risk.

The failure to adequately manage risks exposes financial institutions not only to the possibility that they may suffer fraud, loan or other losses, but, more importantly, to the possibility that they may not achieve their strategic business objectives - growth, earnings, safety and increased shareholder value.

Approaches to Enterprise Risk Management

As one risk manager once told me, "Financial institution managers have always done a great job of driving down the road while looking in the rearview mirror". That approach might work fine, as long as the road ahead is straight and level. As the last two years have shown, however, the road ahead can be full of potholes and sudden, sharp turns.

Yet, risk management at most financial institutions continues to be fragmented, expensive and inefficient. Even as the concept of enterprise risk management becomes more widely accepted across the industry, many financial institutions are creating silos of analytical information and a hodgepodge of different solutions. While each database of information may be high in quality, they often lack the capability to interact with other solutions to provide a true picture of risk across the enterprise. Additionally, they are often inaccessible to management. To address the risk management issue, financial institutions are increasingly are turning to ERM.

A number of approaches to implementing an enterprise risk management system have been proposed, with two, the COSO model and the BASEL II model, garnering the most attention.

BASEL II, and the new BASEL III model rolling out in 2013, are not the best enterprise risk management models. They are primarily capital adequacy models. That was the intent of their design. Its methods are complex and confusing, and consequently, its results are difficult for management to interpret, making it difficult to for them to communicate to others at the bank and to respond to changing risk conditions in a timely manner.

The COSO model offers a more comprehensive "strategic focused" framework for the effective management of risk. The COSO model consists of 5 key elements: 1) understanding of Strategic Business Objectives, 2) establishment of an effective general control environment, 3) development of systems to identify and measure risk exposures, 4) implementation of appropriate controls and strategies to mitigate risk and 5) maintenance of on-going information systems to track the changing nature of risk and effectiveness of risk management controls.

While a lot of people are talking about risk and risk management, there is no commonly accepted definition of risk management, or comprehensive framework outlining how the process should work. We have developed an *enterprise-wide* approach to managing risk that provides management and directors a comprehensive model. The Enterprise Risk Solution Framework, addresses regulatory requirements for risk management – to identify, measure, monitor and control risk, while focusing the bank on a strategic approach to risk management.

More importantly, the model clarifies the definition of risk. If you speak with an auditor about risk, they will likely view it as something negative, to be managed and controlled. There is a tendency to think of risk only as the downside, or negative consequence, of a certain action or event. It is just as important to consider risk as an opportunity, or not taking risk as an opportunity lost.

The objectives of the Enterprise Risk Solution Framework are to:

- Aid the Board and management in determining the risk, at a broad level, that is acceptable in the pursuit of the bank's strategic objectives
- Help bank management align strategic objectives and risk appetite

- Define risk tolerances and ensure that risks taken are consistent with the level of risk the bank desires
- Provide sufficient, appropriate information about risk positions and trends to aid management in making effective risk management decisions
- Ensure that risk management strategies and controls employed are both appropriate and cost-effective

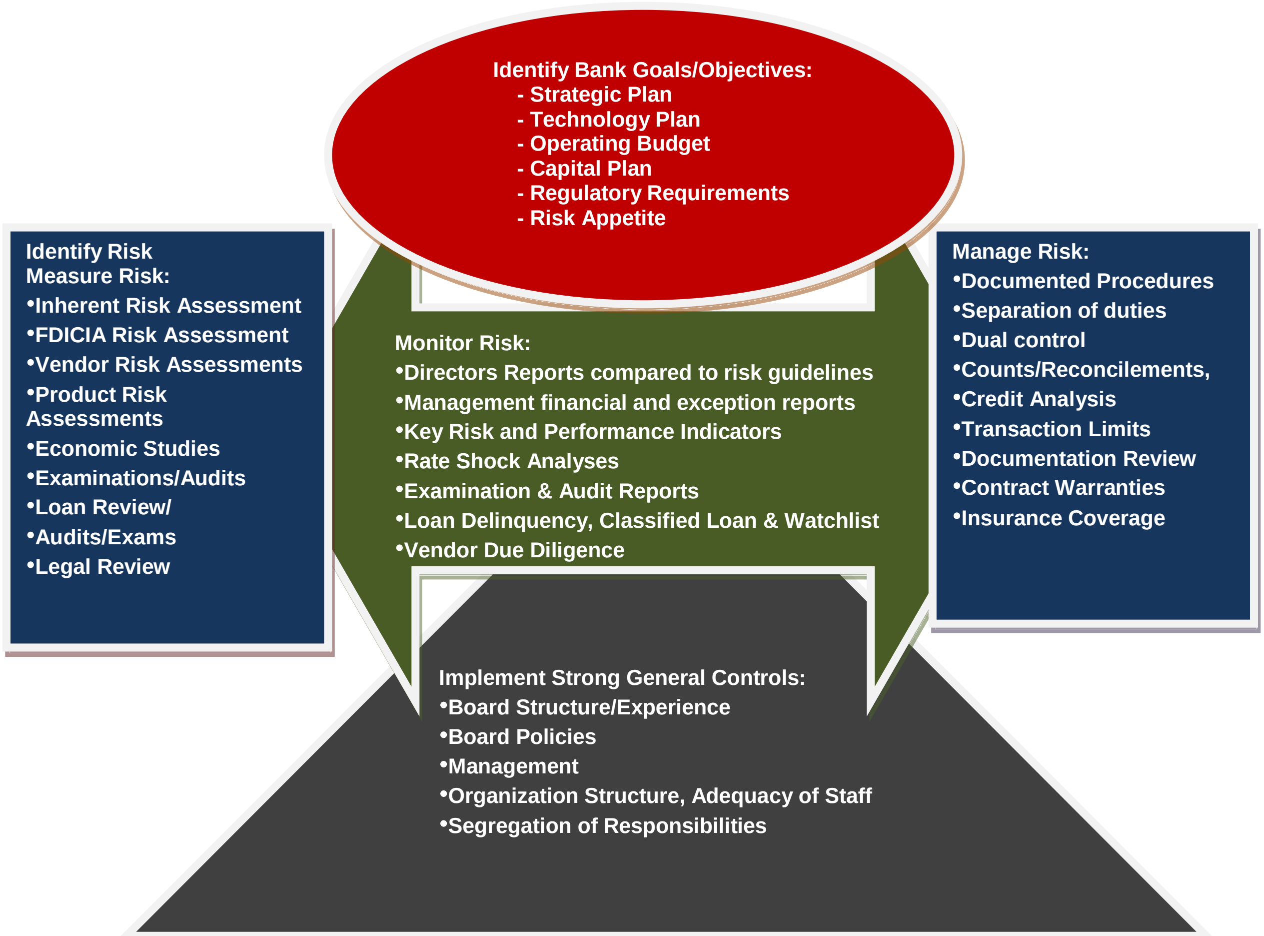
The ERS Framework:

- Considers risk as a critical component in strategy formulation
- Recognizes the interdependencies of risks and risk management practices among business units throughout the bank
- Improves the bank's ability to identify and take advantage of future opportunities
- Facilitates and improves communication about and understanding of risk and
- Applies risk management techniques throughout the bank's business units and to its products, services and delivery channels.

Figure 1 on the following page illustrates the COSO ERM Framework.

Enterprise Risk Solution Framework

Figure 1



Key elements of the ERS Framework include:

1. **Strategic Goal and Objective Setting** – The strategic direction, and specifically its goals and objectives, are critical in determining how much risk the bank can, or even *must*, take. Clearly, the setting of objectives implies the bank desires to move from its current position or state to a future, improved state. Objectives calling for significant growth or improvements in ROA/ROE and efficiency will require the bank to do something different than it has in the past. Management must make critical decisions about how the bank will build value. Likely, these decisions will result in a changed, and perhaps increased, risk profile. It is vital that management and the board consider the effect of risk on the bank's risk management and control systems and capital requirements in setting strategy. The potential

effects of strategic decisions should be evaluated as part of the bank's "risk appetite" setting process.

2. **Risk Identification and Risk Measurement** – As tactical decisions are made to implement the chosen strategies of the bank, you must be aware of the events that might impair its ability to successfully implement strategy and achieve its business objectives. Again, these decisions may result in exposure to new or increased events with negative, downside potential. Similarly, decisions may be made in the name of risk that preclude significant opportunities. Without a clear understanding of the risks, potential exposures and potential benefits resulting from a decision, informed decision-making is not possible. More importantly, effective decisions about risk management strategies and controls cannot be formed.
3. **Risk Monitoring** – Risk does not exist in a static environment. It is constantly changing and the impact of events, both within and outside the bank's control, significantly impact the identification and assessment of risk and exposure. Consequently, management must have a clear understanding of the current risk environment, as well as the position of the bank in relation to the risk environment. Reports of key risk indicators, both leading indicators and trailing indicators, is vital to this process.
4. **Risk Management** – General risk strategies to be employed, such as retention, transfer, avoidance and control, or specific decisions about risk controls, must be consistent with the level of risk desired, and information about the changing nature of the risk environment.
5. **Risk Management Environment** – There is an old saying that the fish rots from the head. If a financial institution has not established a strong general control environment, the presence of other controls really doesn't matter. Their effectiveness is already fatally compromised. It is vital that the bank employ knowledgeable, engaged and informed directors, experienced management with a strong sense of business ethics and adequate staff. Further, steps should be taken to build a strong risk management base by developing comprehensive policies and ensuring adequate segregation of functional responsibilities within the organization.

The objectives of the Enterprise Risk Solution Framework are to:

- Help bank management achieve alignment of strategy objectives and risk appetite
- Define risk tolerances and ensure that risks taken are congruent with the level of risk the bank desires
- Provide sufficient, appropriate information about risk positions and trends to aid management in making effective risk management decisions
- Ensure that risk management strategies and controls employed are both appropriate and cost-effective

As many CEOs and Directors learned over the last few years, just having strong net worth and earnings doesn't mean you've managed risk carefully. Earnings and capital can evaporate quickly in a severely down turning economy. Many banks that overly concentrated in acquisition, development and construction loans and buying loan participations learned this from 2008 to 2010.

4 Key Steps

Abound recommends 4 key steps to manage risk on an enterprise basis.

Step 1: Evaluate risk. Determine just how much risk your bank can take, must take, can afford to take to reach its strategic business objectives; or how much it must avoid risk. Prepare a comprehensive "risk appetite" statement. For example, based on the types and amounts of loans you plan to originate, calculate best, expected and worst case loss scenarios. If you don't have sufficient net worth to absorb the possible losses in the "worst case" scenario, maybe you should rethink the strategy.

Step 2: Translate the "risk appetite" into measurable risk guidelines. What amount of loss exposure is management and the Board comfortable with in different types of lending (i.e., direct vs. indirect, real estate, business lending, credit card, etc.). Translate the risk appetite into industry and geographic risk concentration guidelines. Make them specific. Consider the risks associated with various types of commercial real estate loans. They are not all the same. Commercial real estate loans can be office buildings versus retail use buildings, owner-occupied versus non-owner occupied, etc.

Step 3: Monitor and evaluate risk on an on-going basis. Measure the bank's performance against its risk guidelines. Identify key leading and lagging indicators of risk and track them regularly. If the bank's strategic business objective is to increase its penetration of the "millennial" market, then track the number of accounts sold to that group. If a risk in a significant portion of the portfolio is driven by employment, home sales, new home starts, whatever, track those indicators. If the risk guidelines set a limit for customer business loans as a percentage of new worth, track that. Consider tracking the dollar-weighted risk grades of loans in particular segments to look for signs of deteriorating quality. Use forward looking, leading risk indicators, like loans made as exceptions to credit scores or policy guidelines, not just lagging indicators like past dues.

Step 4: Implement an effective risk management structure. Consider outsourcing as a cost-effective means to ensure sufficient, skilled resources are available for compliance, audit, loan review and IT security. Don't stop at audit, compliance, etc. Make sure controls are effective and appropriate within the business units for the risk environment of the bank.

Finally, investigate enterprise risk management (ERM) systems that automate risk assessments, create audit reports and track audit findings. These systems are still evolving and even if you are not ready to consider a purchase, you can learn a lot about the concepts of managing bank risk by viewing vendor demonstrations.

Each of these four steps is explained in the` following sections of this report.

Step 1: Develop a Risk Appetite Statement

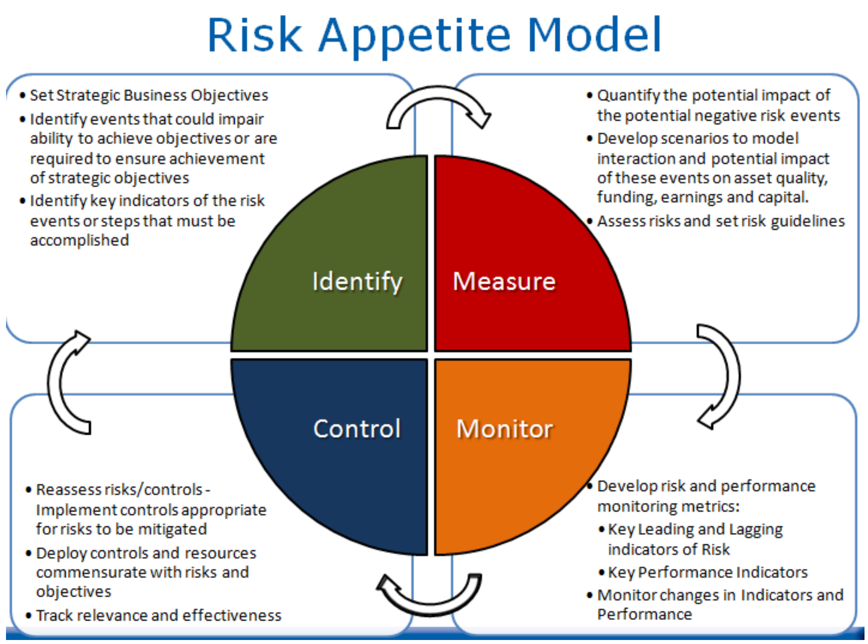
Risk appetite is the amount of risk, on a broad level, the bank is willing to accept in pursuit of its strategic objectives. It reflects the bank's risk management philosophy, and in turn influences the bank's culture and operating style. Risk appetite guides the allocation of capital and resources, as well as the alignment of the organization, people, and processes in designing the infrastructure to effectively respond to and monitor risks.

An effective risk management process involves the board of directors, management, and pretty much everyone else at the financial institution. It begins with the setting of a strategic direction, and the recognition that there are varying degrees of risk associated with these decisions. To fully implement enterprise risk management in a bank, managers must know how much risk is acceptable as they consider ways of accomplishing objectives, both for the bank and their business unit.

To survive and thrive in the future, financial institutions must consider the future risks of strategic decisions made today. In short, they must be able to define the institution's "risk appetite". This understanding is generally documented in a "risk appetite statement", part of the Strategic Business Plan.

On the face of it, this seems easy to do. Isn't it simply the institution's capital structure and solvency needs which determines its ability to withstand shocks, or risks, and therefore represents its risk appetite? For some smaller firms this approach may well be enough, but for others, determining the risk appetite is a bit more complicated affair and goes right to the heart of setting the institution's strategic business strategy and its risk governance, compliance and risk management structure.

Defining a financial institution's risk appetite goes beyond just considering the potential future losses of a single strategic decision. Other issues must be considered as well. How, for example, would the planned growth be funded, for example? What were the implications of the chosen funding strategy. Pictured below is an illustration of the risk appetite setting process.



As the model illustrates, setting the risk appetite is an iterative process....setting strategic objectives, evaluating the related risk and determining if that is acceptable, recasting the objectives as required.

Beyond consideration of the growth and funding issues, did the institution manage risk effectively? Did Directors and management believe credit underwriting and risk management practices were sufficient to protect the institution if the real estate market turned against them with a vengeance? Did they develop appropriate contingency funding plans?

The risk appetite statement goes beyond a simple projection of losses and assessment of capital adequacy. Properly crafted, a financial institution's risk appetite statement sets the boundaries between strategic decision-making, day-to-day business decisions and risk management.

Step 2: Incorporate Risk Guidelines or Tolerances in Policies

Once a risk appetite statement is developed, it provides the basis for determining specific risk tolerances. Policies must be approved by the Board that contain clear guidelines on how much and what type of risks the bank finds acceptable. These policies should also provide guidance on how management should respond to changes in risk and exposure. If, for example, the aggregate internal risk rating on loans of a particular type, collateral, or industry decline, what action should be taken to protect the bank from future losses. When should the bank stop making these loans and begin reducing the related loss exposure?

Step 3: Implement Effective Risk Management Information Systems

Risk management is not just setting policies. Policies are only as effective as the controls and processes that assure and monitor compliance with them. Consequently, a key role of the Board and management is the monitoring of compliance with risk and regulatory guidelines.

Once the risk appetite statement is developed and the risk guidelines incorporated into policies, the bank must track key leading and lagging indicators of risk. These indicators are initially derived from the risk guidelines in the policies. They should though extend beyond just those guidelines to include external, economic and business information that might provide insight into whether the forecast scenarios around which the strategic objectives were constructed bear any relationship to the real world and current trends.

It is critical to evaluate the management information reporting system – what comprises the management information system at your bank and is it providing directors and senior managers with meaningful information about the risk position of the bank? Are current risk positions presented in comparison with approved risk guidelines? For example, do senior managers and directors receive periodic reports that compare concentrations of credit to the limits in the credit policy? Are risk trends provided and are their potential effects on future earnings, credit quality, capital and liquidity clearly understood? For example, is information about the effect on earnings, equity and liquidity of 100, 200 and 300 basis point shifts in interest rates provided regularly to management and directors? Are current positions compared to risk guidelines established in the interest rate risk and asset/liability management policies?

Step 4: Implement an Appropriate Governance, Risk and Compliance Structure

Once the strategic objectives are set and the potential risk consequences are understood, management can make informed decisions about the organizational structure and staff resources required to successfully manage risk.

Regulatory compliance is eating up more time and resources than ever before and the trend shows no sign of abating.

We've identified two key tactics to cost-effectively improve regulatory compliance. The first is to ensure that compliance and risk management practices are incorporated into daily business processes, workflow or efficiency process improvements. For example, when redesigning your loan origination process, develop loan procedures and controls so you can capture and resolve exceptions before they become a reporting issue. Pay for an interface to minimize styling differences on legal names. Automatically notify the credit officer if a document is missing before you get to closing. Good systems should improve both efficiency and risk management.

Second, consider the emerging model of co-sourcing for regulatory compliance. Vendor management is quickly moving to a co-source model where banks use consultants to either help with large evaluation and negotiation projects or to run their entire program. Regulators expect banks to add more people to stay current with compliance but you will never be able to afford the number of experts required. Co-sourcing becomes a cost-effective alternative to building expertise in house and adding to staff. Additionally, law and consulting firms are expanding their staffs which creates a talent shortage and drives up salaries. We suggest considering at least two distinctly different models:

	In House Model	Co-Source Model #1	Co-Source Model #2
Compliance Functions			
· Advise	In House	Outsource	In House
· Monitor	In House	In House	Outsource
· Train	In House	Outsource	In House
· Manage projects	In House	In House	Outsource
· Audit	Outsource	Outsource	Outsource
Type of In House Personnel Needed	1-2 experts and several generalists	Several generalists with project management skills	1 compliance expert, typically an attorney in larger institutions
Pros	More control	Easier to staff, more expertise, less expense	Less expense
Cons	More expense, less expertise	Less control	Less control

One co-sourcing model outsources technical expertise and training while relying on internal staff to handle day-to-day projects and monitoring. Another outsources monitoring, reviews and project management while in house staff stays current on technical expertise and handles internal training. In either model, the bank still owns the process (it's co-sourcing, not outsourcing), but benefits from outside expertise. As an added bonus, examiners look more favorably on independent, external reviews.

* * * * * * *

In today's complex financial services environment, a risk management plan is a critical element of any responsible management structure. Banks that pursue proven risk management techniques will consistently deliver higher and more stable returns over a prolonged period of time. Moreover, they will be prepared to deal with adverse economic changes and unexpected operational problems. Clearly, devoting resources to risk management is money well spent.

To aid financial institution managers in developing a risk management framework, the following guide will: (1) promote a common language of risk in the bank, (2) highlight potential risk events and exposures and (3) provide guidelines for addressing these risks.

Managing Financial Institution Risk: Categories of Risk

Managing all areas of risk is critical to the successful achievement of a financial institution's strategic business objectives, its profitability and potentially its long-term viability.

An effective risk management and control program cannot be structured without an understanding of the bank's risks and exposures, and an effective risk management process. Risk management is defined as the ability to identify, measure, monitor and control risks. The bank, through its Board, management and staff, must be able to respond to changing circumstances and to address risks that might arise from changing business or economic conditions, a decline in the effectiveness of internal controls; the initiation of new business activities or the offering of new products and services.

It is important to the success of a bank's risk management efforts that risks be defined consistently throughout the bank.

Regulators acknowledge that financial institutions face different types of risk, depending on their business strategy, size, and other variables and have identified a list of risk exposures common to modern financial institutions. The FDIC has identified seven risk categories that banks should manage including strategic, credit, interest rate, liquidity, compliance, transaction, reputation and strategic risk. The Office of the Comptroller of the Currency has identified nine risk categories, while the Federal Reserve Bank has identified six. All regulators agree though that the following seven risk categories - credit, interest rate, liquidity, operational, compliance, reputation and strategic risk - are the key risks financial institutions should manage.

Credit Risk

Credit risk is the most recognizable risk associated with a bank. This definition, however, encompasses more than the traditional definition associated with lending activities. Essentially, credit risk is the risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with the bank, or other failure to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer or borrower performance. Any time bank funds are extended, committed, invested or otherwise exposed through actual or implied contractual agreements, whether recorded on or off the bank's balance sheet, the bank is exposed to credit risk. Credit risk may arise where the performance of guarantors is required. Credit risk may also arise in conjunction with a broad range of non-lending activities, including selecting and purchasing portfolio investments, and processing and settling investment transactions with counterparties.

Interest Rate Risk

Interest rate risk is risk to earnings, the value of rate sensitive assets and liabilities or capital resulting from movements in interest rates. Interest rate risk occurs due to (1) differences between the timing of rate changes and the timing of cash flows (repricing risk); (2) changing rate relationships among different yield curves affecting bank activities (basis risk); (3) changing rate relationships across the range of maturities (yield curve risk); and (4) interest-related options embedded in bank products (options risk). Valuation of interest rate risk must consider the potential effect of complex, illiquid hedging strategies or products, and the potential effect on fee income— which is sensitive to changes in interest rates. Interest rate risk exposure is present in each interest income producing asset and interest cost liability on the organization's balance sheet. This risk can expose the bank to significant financial loss, thereby damaging its reputation overall and impairing capital. Further, interest rate risk can significantly impair a financial institutions liquidity as the values of interest rate sensitive assets decline.

Liquidity Risk

Liquidity risk is risk that may occur to earnings or capital that arises from changes in the funding sources. It is present in numerous types of bank services, including the more extensive bank services of asset management and agency transactions. Liquidity risk can also arise from the bank's inability to meet its obligations when they come due, without incurring unacceptable losses (i.e., liquidating investments that declined in value due to rising interest rates).

Operational Risk

Transaction or operational risk is risk to earnings or capital resulting from problems with service or product delivery. It may include potential financial losses from human error or fraud, incomplete information or operational disruption. Transaction or operational risk is a function of internal controls, information systems, employee integrity and operating processes.

Compliance Risk

As a publicly chartered bank, operating as a major community business organization, the bank, its directors, management and staff must operate in compliance with laws, rules, regulations and related accepted industry standards. Compliance risk, as weighed by bank directors, is risk to earnings or capital that occurs from violations of or nonconformance with laws, regulations, or prescribed practices, industry or ethical standards. Furthermore, compliance risk may jeopardize a bank due to fines, civil money penalties, damages payments and voiding of contracts.

Reputation Risk

Reputation risk is risk occurring to earnings or capital that results from negative public opinion. It can be present throughout the organization and banks must take the responsibility to carefully evaluate this type and level of risk in dealing with customers and the community.

Strategic Risk

Strategic risk is risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. It includes the misalignment of business and technology strategic plans, the failure to achieve economies of scale in "scale" driven businesses (e.g., mortgage loan servicing, credit card account servicing, etc.) or improper market positioning (e.g., retail delivery strategies, geographic positioning, etc.).

It is vital that banks periodically, and formally, assess all types and levels of related exposure, and determine their impact on the risk control and monitoring system.

Enterprise Risk Management Guidelines

The following risk management guidelines, organized by risk category, are general guidelines that financial institutions may employ to manage and mitigate risk.

These guidelines are examples and are not intended to detail every control procedure that might be put in place. They will, however, give you a sound framework for an Enterprise Risk Management program.

Credit Risk – The risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or other failure to perform as agreed.

Credit Risk

RISK MANAGEMENT GUIDELINES

Community banks are critical to the small businesses and small agricultural enterprises they serve, and, as Ben Bernanke said, "because of their detailed knowledge of the needs of their customers and their close ties to the communities they serve."

Unfortunately, community banks are often not in the position to diversify their exposure to credit risk, and so must take care to ensure that these risks are effectively managed within the institution's risk appetite. This requires clearly defined credit policies approved by the Board and effective credit administration practices to ensure they are complied with.

Other key issues to consider in managing credit risk include:

- Develop, implement, and maintain formal underwriting and approval standards. Segregate responsibilities for originating loans and analyzing credit quality.
- Limit loan approval authority. Consider tiered co-approvals between lenders and credit personnel.
- Develop appropriate, specific concentration of credit guidelines, including limits as a percentage of capital and guidelines for the quality of loans in a concentration, based on aggregate risk weighting of a concentration.
- Evaluate loan portfolio composition and balance credit risk. Consider:
    - Originations, types, and volume

  - Mix of loans – commercial, commercial real estate, mortgage, consumer, credit card, etc.
  - Industries
  - Size of loans and leases
  - Customers and relationship among them
  - Ratings of credit risk
  - Sources of repayment
  - Collateral
  - Geographic regions/markets or credit extensions
- Identify and monitor concentrations of credit as percentages of capital (e.g. Tier 1) and based on their aggregate credit risk rating
- Maintain sufficient collateral protection on a loan-by-loan and portfolio basis
- Regularly assess and monitor the bank's exposure to unfunded commitments
- Regularly analyze trends in loan volume and growth, delinquencies, nonperforming and classified loans, and losses
- Establish a regular, periodic internal credit review process to identify credit problems. Strongly consider use of an outside, independent group to review loans
- Ensure that the allowance for loan and lease losses is periodically reviewed, analyzed, and maintained at a level in line with current credit risk levels. Establish specific homogenous groups for assessment of risk on an aggregate basis and stress testing for larger loans
- Stress test the portfolio on an overall basis, by concentration groups using Best, Expected and Worst Case scenarios and related loss percentages
- Develop and maintain control mechanisms to grade portfolios, ensure accuracy of data, and monitor laws and policies related to compliance credit risk
- Monitor volume and credit exposure for capital market instruments, including options, forwards, futures, swaps, and repurchase agreements and secondary market credit activities

Interest Rate Risk
– The risk to earnings or capital arising from movements in interest rates and its affect on the costs of funds and yields on interest-earning assets, as well as its affect on the value of portfolios of financial instruments.

Interest Rate Risk

RISK MANAGEMENT GUIDELINES

Interest rates, both short- and long-term, have been at historically low levels for the past 3 years. Regulators are concerned about the potential for a substantial increase in market interest rates and the impact on member banks, thrifts, and credit unions.

Although the specific guidance issued and the oversight and surveillance mechanisms used by regulators may differ, supervisory expectations for sound interest rate risk management are consistent. Ultimately, bank management is responsible for ensuring that the capabilities of the risk management process match the risks being taken.

Banks should consider the following in establishing an effective interest rate risk management program.

- Identify and detail the size and stability of net interest margins and interest-sensitive fee income
- Evaluate the various component and aggregate levels of interest rate risk, relative to earnings and capital
- Assess the character of risk, such as the volume and price sensitivity of various products
- Ensure a process independent of the ALCO function measures and analyzes risk in all significant activities, including interest rate movements under a variety of scenarios
- Design, implement, and utilize rate scenarios and stress-testing models to assess interest rate risk vulnerability
- Examine the vulnerability of earnings and capital positions under rate changes, such as gradual rate shifts and rate spikes
- Assess the relative volume and future prospects of continued support from low-cost and/or stable funding sources
- Detail the sources of price risk relative to interest rate, foreign exchange, commodity, and equity prices
- Monitor and control interest rate risk relative to futures, forwards and options risk, if the bank is exposed

- Assess the flexibility afforded by the current price profile versus management's ability to hedge the risk at reasonable cost
- Determine the size of open positions versus revenues generated, supervising a balance of risk versus reward

Liquidity Risk –The risk to earnings or capital arising from the bank's inability to meet its obligations when they come due without incurring unacceptable losses. This results from a failure or inability to manage unplanned decreases or changes in funding sources or the failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

Liquidity Risk

RISK MANAGEMENT GUIDELINES

Regulatory emphasis on liquidity management has significantly increased following bank failures in 2008. Liquidity forecasts based on sources and uses of funds, long-range liquidity forecasts and stressed liquidity forecasts are now essential to manage this risk, as well as effective contingency plans.

Other issues to consider include:

- Establish a management and/or Board ALCO committee
- Adopt a liquidity management policy
- Analyze and set guidelines for the various elements of funding, both volume and composition, including wholesale versus retail funding, concentrations in large funds providers, and the level of dependence on credit-sensitive sources
- Assess the diversification of funding sources, including proportion of funding from direct relationships (as opposed to brokers, money-managers, out-of market sources, etc.) and sources of funds providers (e.g., over reliance on specific types of providers, instruments, or maturities)
- Prepare regular, periodic sources and uses of funds analyses, identify funding gaps, with an emphasis on short-term exposures, including projected funding needs or the ability to cover potential funding gaps at reasonable prices
- Review on- and off-balance sheet portfolios, including cash flows, collateral, early termination arrangements, and the availability and size of second markets to convert instruments to cash
- Assess cost of funding for the bank versus costs paid by its competition
- Develop a comprehensive funding contingency plan, and update as necessary

- Design, implement, and use rate scenarios and stress-testing models to assess liquidity risk vulnerability
- Stress liquidity for at least a 12-month period, utilizing scenarios including run-off of deposits, reduction or elimination of borrowing lines and securities devaluation

Operational Risk

RISK MANAGEMENT GUIDELINES

***Operational Risk** - Risk to earnings or capital arising from problems with the delivery of bank services and products or losses due to violations of the system of internal controls, employee infidelity, robbery and fraud or business interruptions.*

There is probably no greater operational risk management control than to ensure that there is adequate functional segregation of responsibilities over key operational processes, such as lending. No employee should have sole control over the origination of a transaction, the ability to disburse funds, the recording of the transaction and the reconciliation of accounts. Loan officers, for example, should not be permitted the authority to originate and approve a loan, cause the documents to be prepared under their control and to control the disbursement funds and recording of the loan.

Other operational risk management guidelines include:

- Establish control mechanisms to monitor data accuracy, proper accounting treatment, and compliance with bank policies as well as laws and regulations
- Develop the technical knowledge and skill levels of management and staff to stay abreast of changes in financial services industry operations
- Ensure the development, issuance, and enhancement of internal management information reports that are sufficiently detailed, accurate, and timely
- Widely communicate the importance of properly conducting business for the bank, relative to the exposure to transaction risk and its impact on the bank
- Adopt code of ethics and conflict of interest guidelines
- Establish guidelines for developing and managing all outsourcing relationships relative to processing business

- Rank vendors and complete appropriate due diligence on critical vendors
- Reduce, without reducing risk safety networks, the costs of administration and accounting, seeking to primarily reduce administrative and accounting exceptions as the primary cause of such costs
- Evaluate exposures to transaction risk from human error or fraud, incomplete information, and operational disruption; analyze methodologies to address cited areas of exposure and seek out cost-effective ways to reduce such risks

Compliance Risk

RISK MANAGEMENT GUIDELINES

Compliance Risk – The risk to earnings or capital arising from violations of or nonconformance with laws, rules, regulations, prescribed practices or ethical standards

The objective of compliance risk management is to establish and maintain an effective framework of business process controls and compliance monitoring practices that ensure compliance with laws and regulations. Compliance is the joint responsibility of all staff members of a commercial bank and its senior management shall take a lead in the execution thereof. Consequently, key to implementing an effective compliance function is to make business units responsible for performing their jobs in compliance with regulations. Don't put it off on the Compliance Department.

Other steps to ensure effective compliance include:

- Prepare a comprehensive assessment of compliance risk throughout the bank. Determine which business unit and what positions are responsible day-to-day for key or high risk regulations.
- Prepare a compliance testing/monitoring schedule, indicating when and to what degree the compliance department, or an outsourced service, will check and test compliance with key, high risk regulations.
- Utilize standardized worksheets, forms, and checklists to assist bank staff, as they perform their job functions, in complying with regulations, laws and rules, etc. To the extent possible, incorporate these into automated systems, such as loan origination and account opening systems.

- Use technology wherever possible to implement automated compliance controls or exception warning systems to assist in compliance
- Create synopses of those laws, regulations, and guidelines with which the bank must comply and make them available to staff
- Institute performance for risk control reward system for bank staff
- Develop training materials and sessions that integrate compliance risk training as part of overall training. Ensure that this training includes not only background information on regulations, but specific training on the bank's compliance procedures and specific examples related to the bank.

Reputation Risk – *Risk to earnings or capital arising from negative public opinion.*

Reputation Risk

RISK MANAGEMENT GUIDELINES

While building and maintaining a solid reputation is important for all types of organizations, it is especially important for financial institutions. It could be argued that protecting a financial institution's reputation is the most significant risk management challenge that boards of directors face today.

- Actively solicit customer feedback through surveys (i.e., weekly survey of a segment of the customer base) and focus groups, and track the trend of results
- Monitor customer feedback, particularly complaints
- Maintain a strong compliance function, particularly with regard to issues such as Bank Secrecy Act and Community Reinvestment Act guidelines
- Develop comprehensive customer relations program
- Track hours of involvement and numbers of employees in community support groups
- Adopt conflict of interest guidelines and monitor compliance with them
- Carefully manage litigation
- Ensure the bank has comprehensive reviews of financial information before it is released to the press
- Develop a Media Management Plan for crisis response

Strategic Risk – The risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions.

Strategic Risk

RISK MANAGEMENT GUIDELINES

Uniformed strategic decision-making is one of the greatest risks a bank faces. Consequently, an integrated business planning process that aligns strategies, goals, tactics and resources is vital to managing strategic risk. In keeping with the ERM approach, the planning process begins with the setting of a risk appetite.....getting agreement between the Board and management on key strategic objectives and the level of risk acceptable in achieving those objectives. The planning process must filter through the bank's business units, who create business unit plans that are aligned with the bank's strategic direction and that include initiatives, tactics and metrics that can be monitored to ensure adherence to overall strategic and individual business unit plans.

While planning is vital, it is equally important to monitor the execution of the plan and assess current risk conditions. Business units should perform quarterly self-assessments, considering changing market and business conditions, and the overall risk in meeting objectives. The Board and executive management in turn monitors, reviews and evaluates the plans and self-assessments in view of the overall strategic plan. Other key steps to manage strategic risk include the following:

- Develop strategic goals, objectives, and future initiative planning, which all consider and balance risk
- Develop a comprehensive risk appetite statement
- Integrate risk management practices into overall strategic planning, track progress and change in risk through Key Risk Indicator Dashboards
- Implement performance versus goals tracking, with variances and risks tracked and reported accordingly
- Provide guidance for new initiatives, whereby minimal capital risk exposure exists and generally represents nominal impact to earnings
- Benchmark performance and spending to local and high-performing peers

Summary

Effective risk management is increasingly viewed as a key determinant of a bank's ability to compete successfully. As banks seek to return to profitability after the recent financial crisis, their ability to manage risk strategically is what will set them apart.

To achieve high performance, informed, proactive risk management must become part of the way the bank does business.

Abound's Professional Services

Strategic Services

- Strategic Planning
- Plan Progress Monitoring
- Management and Board Retreat Facilitation
- Product Development
- Industry Profiles and Market Assessments

Risk Management Services

- Risk Management Best Practices Reviews
- Enterprise Risk Assessment
- Information Security Program Assessment
- Information Security:
    - Vulnerability Assessment
    - External Penetration Testing
    - Internal Penetration Testing
    - Application Security Review
    - Social Engineering
- Outsourced and Co-sourced Internal Audit
- Outsourced and Co-sourced Compliance Advisory, Monitoring and Audit
- Information Technology Audit
- BSA/AML Compliance Management
- Business Continuity Planning Services
- IT Disaster Recovery
- Loan and Asset Quality Review
- Vendor Management (√mRisk™ Reports)

Risk Management Software Solutions

- bControl: Financial, Operational and Compliance Risks and Control Assessment
- bComply: Compliance Risk Assessment
- bPlan: Business Impact and Continuity Planning
- bFact: Managing Fact Act Risk and Controls
- bSecure: Information Security (GLBA) Risks and Controls
- bSAComply: BSA / AML and OFAC Risk Assessment
- bAudit: Risk Based Audit Planning
- bVendor: Managing and Sharing Files to Support Enterprise Risk Management

Earnings and Process Improvement

- Operational Efficiency Improvement
- Process and Profit Improvement

System Selection Services

- Business Requirements Analysis
- RFP Development
- Vendor Selection and Liaison
- Contract Negotiation Services
- Conversion Services

Merger Advisory Services

- Merger Assessments and Due Diligence
- Transition Planning and Merger Integration

Technology Planning Services

- Technology Assessments
- Strategic Technology Plans
- Project Management
- I.T. Governance and Design

Knowledge Sharing

- CEO, CIO and Risk Management Forums
- Speaking Engagements
- Webinars
- Audio Briefings
- Whitepapers
- Tools and Templates

Troubled Institution Assistance

- Board of Director Oversight Assessment
- Management Assessment
- Earnings Improvement Analysis
- Profit Improvement Planning
- Capital Planning
- Criticized Asset Reduction Planning
- Liquidity Forecasting and Planning
- Capital Analysis and Planning
- Audit and Control Reviews
- Compliance Assessment
- BSA/AML Lookback

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