

# Risk Management and Community Banks

John J. Wixted Jr.

Vice Chair

The Risk Management Association

Enterprise Risk Management:

Credit Risk

Operational Risk

Market Risk

Chief Risk Officer and EVP

PNC Mortgage Company

# The Risk Management Association

- ▶ Founded 1914
- ▶ Member-driven
- ▶ Advance the use of sound risk principles
  - Information, education, peer sharing, and networking
- ▶ 2,600 institutional members
  - Over 2,400 community bank institutional members
- ▶ 18,000 risk management professionals
  - Chapters in North America, Europe, and Asia/Pacific

# Five Most Dangerous Words in Banking

**“This time things are different.”**

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# What Is Risk?

- ▶ Anything that can go awry
  - **And** adversely affect your ability to achieve your strategic objective
- ▶ Each of the potential risk events
  - **PLUS** the likelihood of multiple risks occurring at the same time

# Risk Management?

- ▶ Integrates acute awareness of risks into decision-making
- ▶ All employees held accountable for managing risk
- ▶ Board of Directors actively involved

# Why Practice Risk Management?

- ▶ Reduce earnings volatility
- ▶ Understand, control, and articulate
  - The nature and level of ALL risks across the enterprise
- ▶ Reveal escalating risks
  - They develop as you pursue business strategies
- ▶ Unlock shareholder value
- ▶ Mandated for safety and soundness and compliance

# Risk

Gallant?

Wise?

Foolish?

Calculated?

Well-managed?

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# Causes of Crisis

- ▶ Liberal Underwriting
- ▶ Rapid Growth
- ▶ Concentrations
- ▶ Liar loans
- ▶ Securitizations so complex that no one understood them
- ▶ A shadow banking industry run amok
- ▶ Unscrupulous mortgage companies
- ▶ CDOs...AND CDOs<sup>2</sup>
- ▶ Credit default swaps
- ▶ Greedy speculators

# How to Begin?

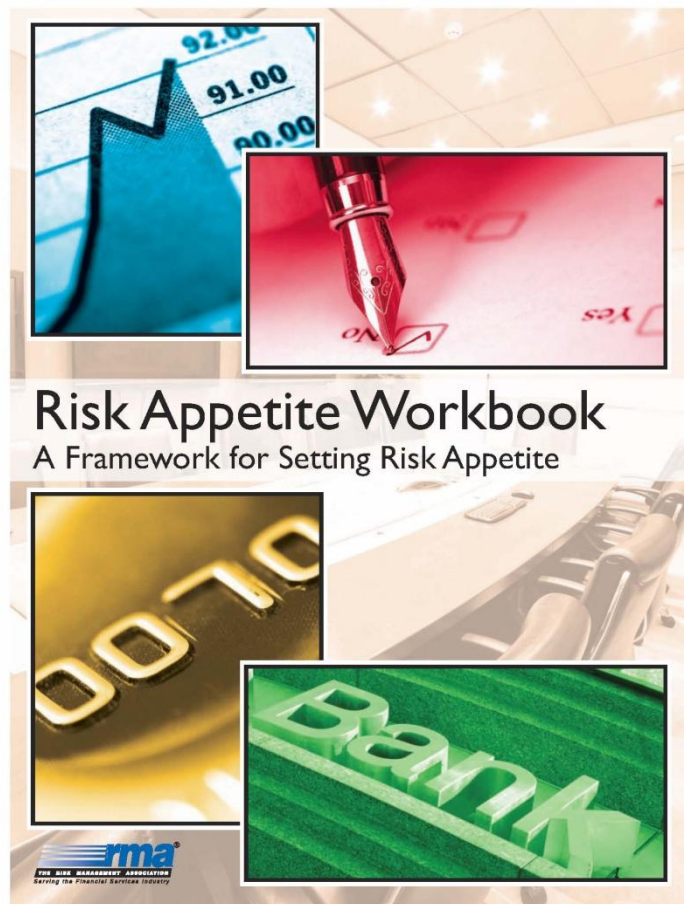
- ▶ No one-size-fits-all
  - Asset size
  - Geographic diversity
  - Product line
  - Appetite for risk
- ▶ Align strategy with the risk appetite
- ▶ Institute a strong risk culture
  - Assign accountability throughout the organization
- ▶ Require stronger risk management expertise at the board

# Components Of Enterprise Risk

- ▶ Credit risk
- ▶ Market risk
- ▶ Operational risk
- ▶ Interest rate risk
- ▶ Reputation risk
- ▶ Compliance risk
- ▶ Management risk

*And the interrelationship of all these risks*

# Risk Appetite Workbook



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# Risk Appetite Statement

- ▶ Spell out the level and types of risk you will take
  - Both on and off the balance sheet
- ▶ Set a tone
- ▶ Include metrics
- ▶ Consider earnings volatility
- ▶ State capital requirements
- ▶ Prohibit specific activities
- ▶ Limit financial losses by product
- ▶ Specify diversification and concentration

# Risk Appetite Framework

- ▶ Make the appetite statement actionable
- ▶ Follow a process for monitoring your risks
- ▶ Ensure portfolio remains within risk appetite bounds
- ▶ Continually assess and reassess how you're doing
  - As business model changes or volume shifts

# Stress Testing

- ▶ Drills down into your balance sheet/uncovers asset class concentrations
- ▶ Require senior management to determine stress tests and scenarios
- ▶ Be realistic and honest
- ▶ Change the assumptions regularly
- ▶ Consider all of the potential environmental impacts
- ▶ Report outcomes of stress tests
- ▶ Take action in a **timely** way; be consistent with strategy and risk appetite
  - Raise more capital?
  - Sell loans or investments to reduce concentrations?
  - Tighten underwriting standards to reduce asset class growth?

*Note: Data on your loans and investments must be accurate*

# Other Enterprise Risk Concerns

- ▶ Data Integrity
- ▶ Vendor Management
- ▶ New Product Risk
- ▶ Reputation Risk
- ▶ Management Succession Risk

# Critical Role of Board of Directors

- ▶ Exercises fiduciary responsibility with management's assistance
  - Hires management with appropriate expertise for size and complexity
- ▶ Establishes:
  - Compensation to balance growth goals and risk management objectives
  - The strategic plan, the risk appetite and appropriate policies and procedures
  - An effective risk management program
    - ❖ Independent from the business line with appropriate expertise
      - Internal audit, compliance, and loan review
- ▶ Breaks down silos and demands a holistic review of risk
- ▶ Creates and reviews the top risk list of the bank and holds management accountable
- ▶ Ensures appropriate and timely reporting by senior management to the board

# Other Hot Buttons

- ▶ Consumer Regulations
- ▶ Fair Lending
- ▶ Bank Secrecy Act
- ▶ Anti Money Laundering

# Recap

- ▶ Board and bank management establish risk appetite
- ▶ Establish an effective ERM framework
- ▶ Assign appropriate expertise
- ▶ Manage bank data
- ▶ Use stress testing proactively
- ▶ The board ensures appropriate management compensation
  - And not taking on any undue risks
- ▶ Actively manage bank vendors
- ▶ Board ensures there is a viable management succession plan

# Is It Doable for Community Banks?

- ▶ Yes
  - Critical tasks can be parceled out to existing staff
  - Already possess some of the key competencies
    - ❖ Credit risk
    - ❖ Interest rate risk
    - ❖ Liquidity risk
- ▶ Requires a more integrated, holistic view
- ▶ Requires adding some nontraditional risks types
  - Analysis and monitoring

# Making It Doable

- ▶ Ensure defined accountability/ risk management committee
  - Oversee the entire span of risk
- ▶ Ensure policies for things that you may already be monitoring
  - E.g. regulatory and compliance risk
- ▶ Add competencies and systemic approaches
  - Operational risk
  - Strategic risk
  - Reputation risk
- ▶ Examine risks in an integrated fashion --- not left in silos

# Watch Words

*Next time ...*

*it won't be different.*

# Thank You!

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