



Beyond ERM - The Roles, Responsibilities and Costs of Risk Management

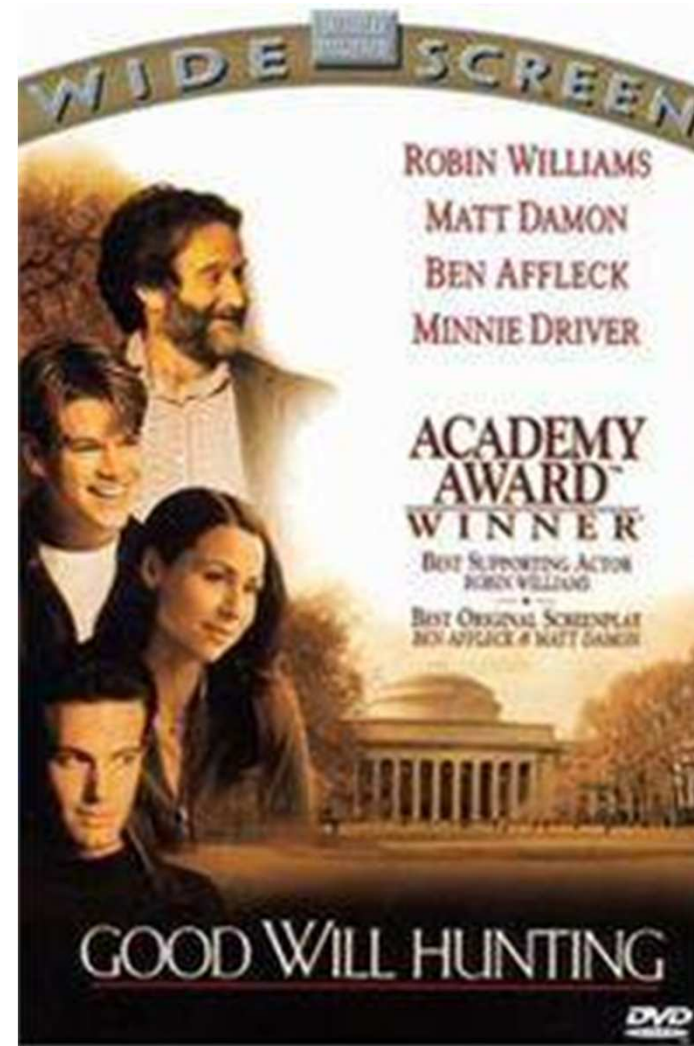
March 28, 2012

Agenda

- Risk Appetite
- What's happening now?
- Risk Management Case Study
- Governance
- Regulatory Insight



Language Myth



Team Myth



“The first step in the risk management process is to acknowledge the reality of risk. Denial is a common tactic that substitutes deliberate ignorance for thoughtful planning.”

— Charles Tremper (author and risk management expert)



“Risk appetite is the amount of risk – on a broad level – an entity is willing to accept in pursuit of value.”

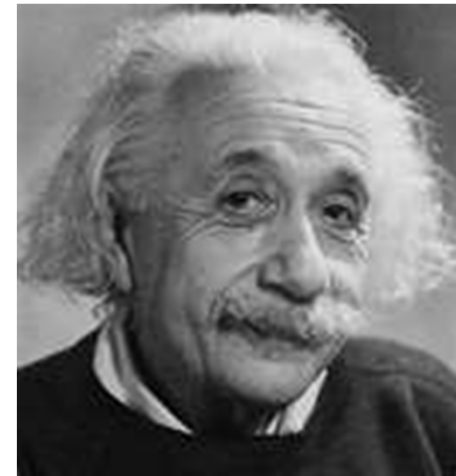
- This allows the institution to differentiate good risks from bad risks



- Risk appetite is a measure of inherent risk

“The level of thinking necessary to address today’s problems must be greater than that which got us here.”

Albert Einstein



What's happening now?





Why is Risk Management Becoming More Important?



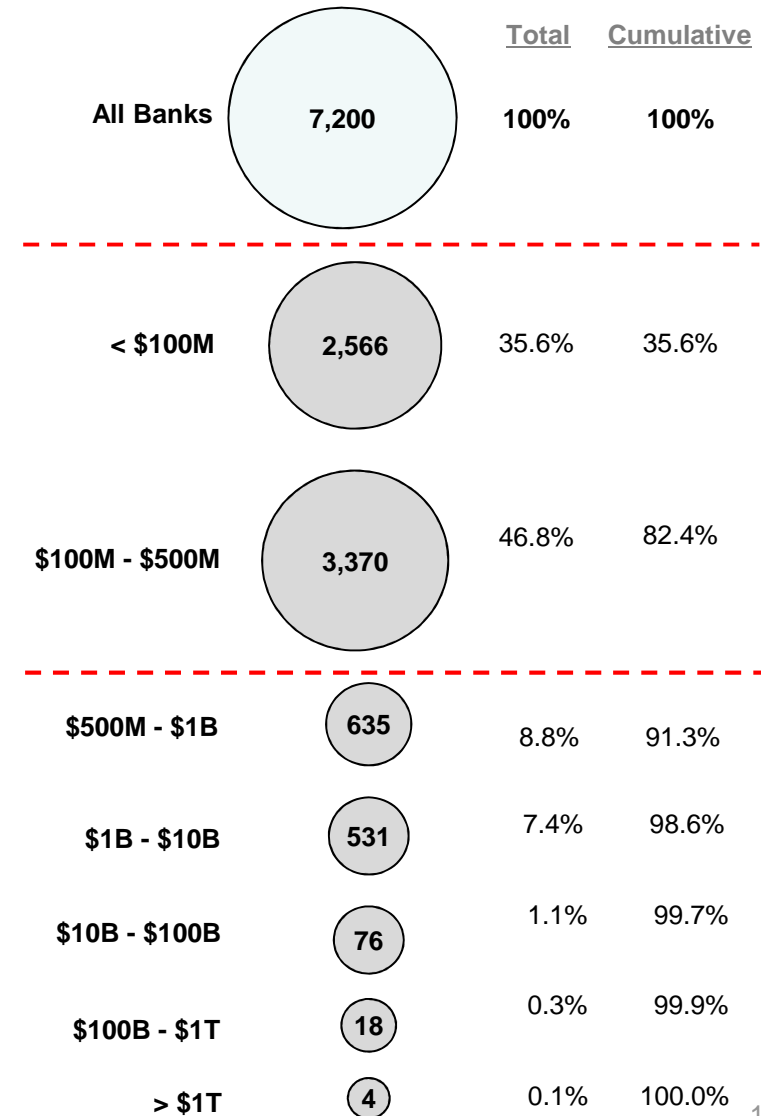
- The current financial environment has significant focus on credit risk management
 - Operational risk management weaknesses have developed (e.g. vendor over-reliance)
- Risk Management governance is becoming a key factor for strategic success
- Dodd-Frank is ushering in a new rules over delivery of financial services
- The game has changed – consolidation
 - The new DNA of community banking

Drivers of Consolidation

Drivers of Consolidation: The Game Has Changed

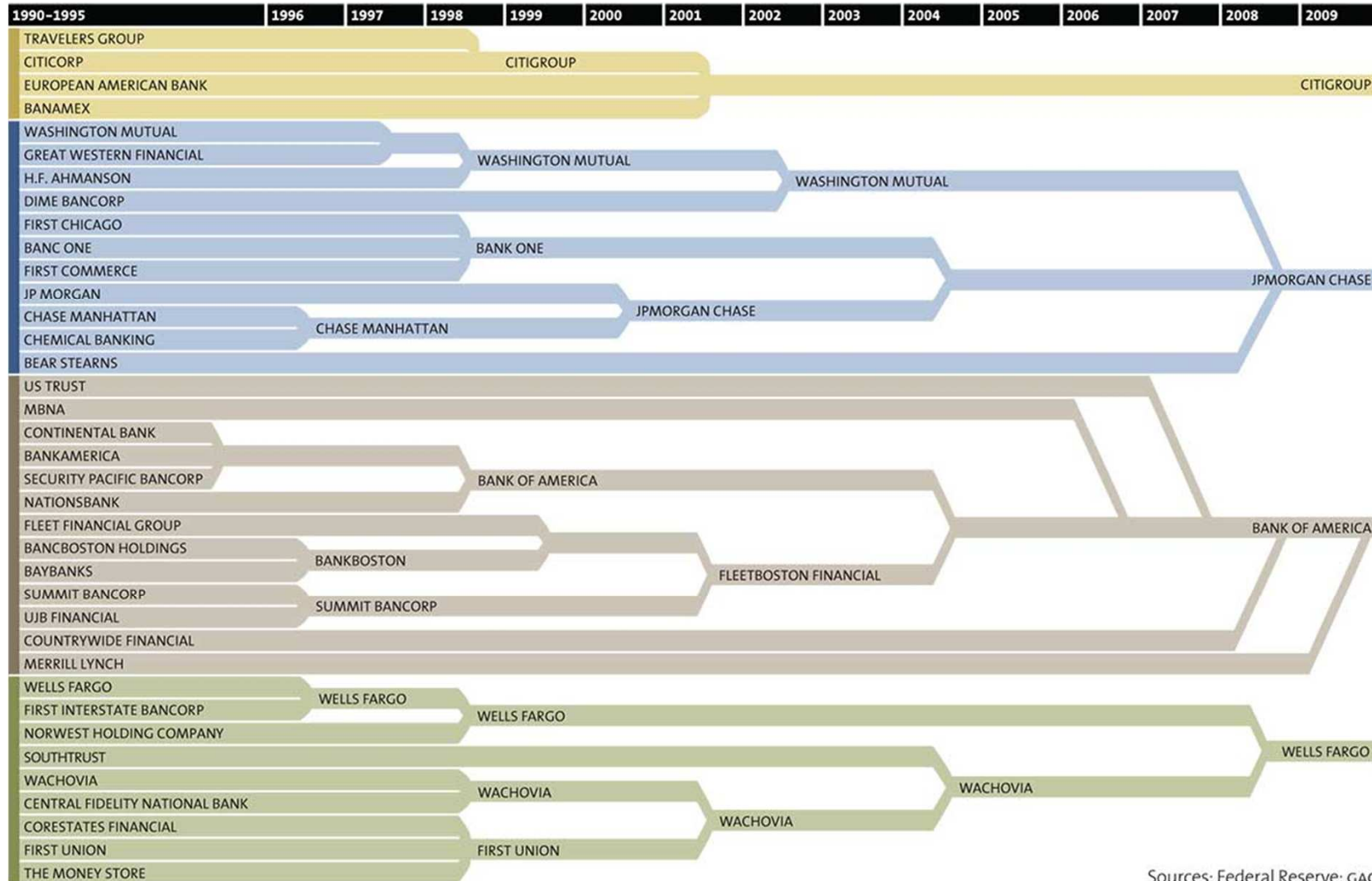
- Excess capacity
- Regulatory Oversight (Dodd-Frank) & Escalating Costs
- Lack of access to capital and net margin decreases
- Slow / low growth economic environment
- Management / Board fatigue
- Operational Costs

U.S. Banking Companies by Assets ¹



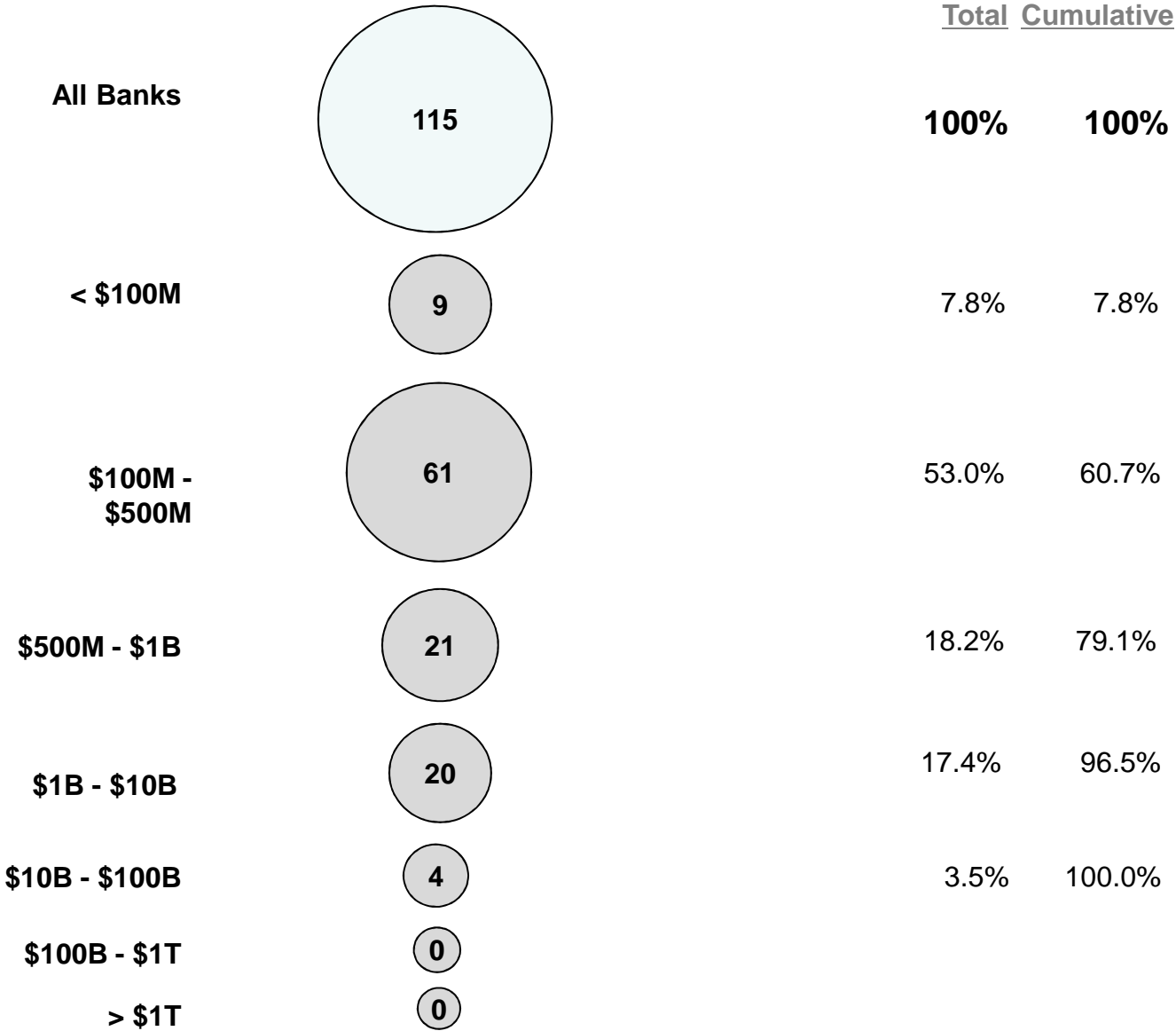
Source: SNL Financial, FDIC; European Central Bank; OSFI; World Bank
(1) Source: SNL Financial, Top tier regulatory consolidated (Q1 2011 data)

How We Got Here



Sources: Federal Reserve; GAO

NJ Banking Companies by Assets



Efficiency Ratio

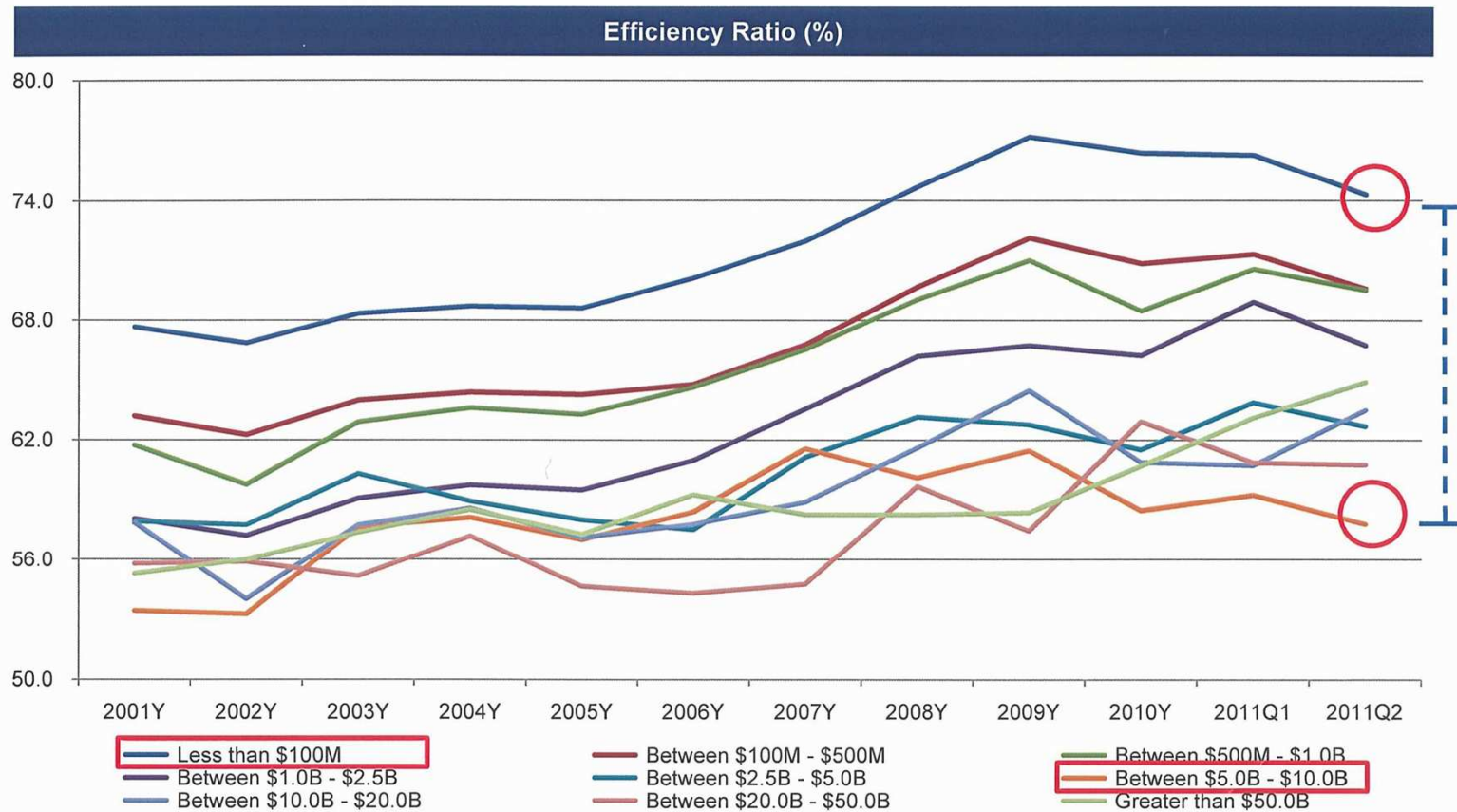
- Non- interest expenses as a proportion of operating revenue.

Expenses	Revenue
Salaries	Net interest income
Technology	interest revenue – expense
Buildings	Fee income
Supplies	
Administrative Expenses	

A cost ratio of 50% or below is admired

Size Creates Operating Benefits

- Advantages are created through acquiring asset size
 - Break point of \$5 billion in assets introduces the widest variance in operating leverage between community banks and thrifts



Source: SNL Financial
Includes all public and private banks and thrifts
Represents median as of the respective period end

Key to Successful ERM Implementation



Cost & Impact

Alignment Strategy

Reporting & Monitoring

Key Success Factors for an ERM Program

1. Define an assessment methodology with consistent measures that everyone performs
2. Build the program from the bottom up to ensure all Threats and Risks are considered. A Top Down approach considers Entity Level risks and is complimentary.
3. Keep it simple! ERM should be explainable to the Board and down to the most junior associates within your institution
4. Integrate the risk management tools into daily activities and operations



Risk Management

Case Study



Management's Objectives:

- What type of management program could we develop to provide meaningful reporting and meet regulatory requirements?
- What should we measure (beyond credit and liquidity), and why should we?
- Can we empower line management to drive better day-to-day decision making?

Opposing Forces

- CEO sees no potential value of ERM to the franchise
- Board not asking for more information; already overwhelmed with new reporting requirements
- Regulators expecting an ERM program but no explicit requirement or specific guidance on how to implement

ERM Case Study

Item	Estimated Cost
Consulting - IRR	\$ 24,400
Consulting - Liquidity	\$ 3,000
Consulting - Liquidity	\$ 2,000
Consulting - FAS 107	\$ 3,000
Internal Audit	\$ 75,000
OTTI Analysis	\$ 20,440
Compliance	\$ 42,500
Impairment Analysis	\$ 5,000
Compliance on the Web	\$ 1,995
Trade Membership	\$ 3,520
IT Vulnerability/Intrusion Testing	\$ 13,000
Compliance Academy	\$ 1,948
BSA/AML Compliance Seminar	\$ 395
Compliance online training	\$ 4,068
Core System - SAS70 report	\$ 800
Disaster Recovery Site fee	\$ 23,664
estimated staff cost - (BSA)	\$ 5,000
estimated staff cost - (BSA)	\$ 15,000
estimated staff cost - IT	\$ 20,000
estimated staff costs - lending	\$ 11,320
Online disclosures	\$ 2,250
CRA/HMDA reporting software	\$ 1,907
Loan Documents/disclosures	\$ 4,365
Loan Documents	\$ 6,254
Annual Privacy/Reg E notice + postage	\$ 6,309
Records Retention/Destruction	\$ 12,300
IT audit logging software	\$ 8,994
IT email virus scans	\$ 2,695
IT intrusion monitoring software	\$ 4,445
IT software blocks malicious websites	\$ 8,635
Total	\$ 334,204



The Cost of Risk Management



Products & Services	TOTAL	Operations Risk				CI	CO	Market Risk					Strategic	Reputation
		TX	IT	VR	BC			Credit	Int	Price	Liquidity	FX		
RETAIL BANKING														
Personal Checking	\$ 57,364	\$ 12,000	\$ 10,000		\$ 5,364		\$ 30,000							
Business Checking	\$ 21,000	\$ 1,000			\$ 5,000		\$ 15,000							
Savings Accounts	\$ 15,000						\$ 15,000							
Retail CD	\$ 1,500	\$ 1,500												
Internet Banking	\$ 6,000	\$ 6,000												
LENDING														
Residential Mortgages	\$ 75,400	\$ 12,000	\$ 5,000		\$ 5,000		\$ 40,000	\$ 8,000	\$ 5,400					
Home Equity	\$ 26,000	\$ 6,000					\$ 20,000							
Consumer	\$ 34,000	\$ 4,000					\$ 30,000							
Commercial Real Estate	\$ 20,500	\$ 5,000						\$ 8,000	\$ 7,500					
Asset Backed	\$ 9,000	\$ 5,000							\$ 4,000					
C&I	\$ 11,940							\$ 4,440	\$ 7,500					
INVESTMENTS														
Trusts & IRA	\$ 18,000	\$ 10,000			\$ 5,000					\$ 3,000				
Brokerage	\$ 6,000	\$ 6,000												
BUSINESS SERVICES														
Cash Management	\$ 11,500	\$ 3,500	\$ 5,000		\$ 3,000									
BOLI	\$ -													
Benefits Administration	\$ -													
Merchant Card Services	\$ 3,000	\$ 3,000												
CORPORATE SERVICES														
Treasury Management	\$ 5,000										\$ 5,000			
IT Operations	\$ 13,000		\$ 13,000											
TOTALS	\$ 334,204	\$ 75,000	\$ 33,000	\$ -	\$ 23,364	\$ -	\$ 150,000	\$ 20,440	\$ 24,400	\$ 3,000	\$ 5,000	\$ -	\$ -	\$ -



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What Did Senior Management Do?

- One senior manager “opted in” as CRO
- Centralized day-to-day oversight of risk assessment activities with the CRO
- CRO given authority to override line managers

Initial Results

- Risk assessment forced a discussion on how we do business
- “We learned so many things about the institution we did not like”
 - Areas where P&P were inadequate or did not exist
 - Areas for potential operating losses
- Senior management believed better outcomes from the risk management discussions would result
 - IT, VR, CO, OR threats
 - Proactive decision making vs. reactive fire drills

- CRO reports to the CEO (implied authority)
- CRO maintains ongoing authority to override line management's assessment of risk
 - “Risk management is not a democracy”
- Board can govern better with the knowledge it now has
 - “What else don't we know?”

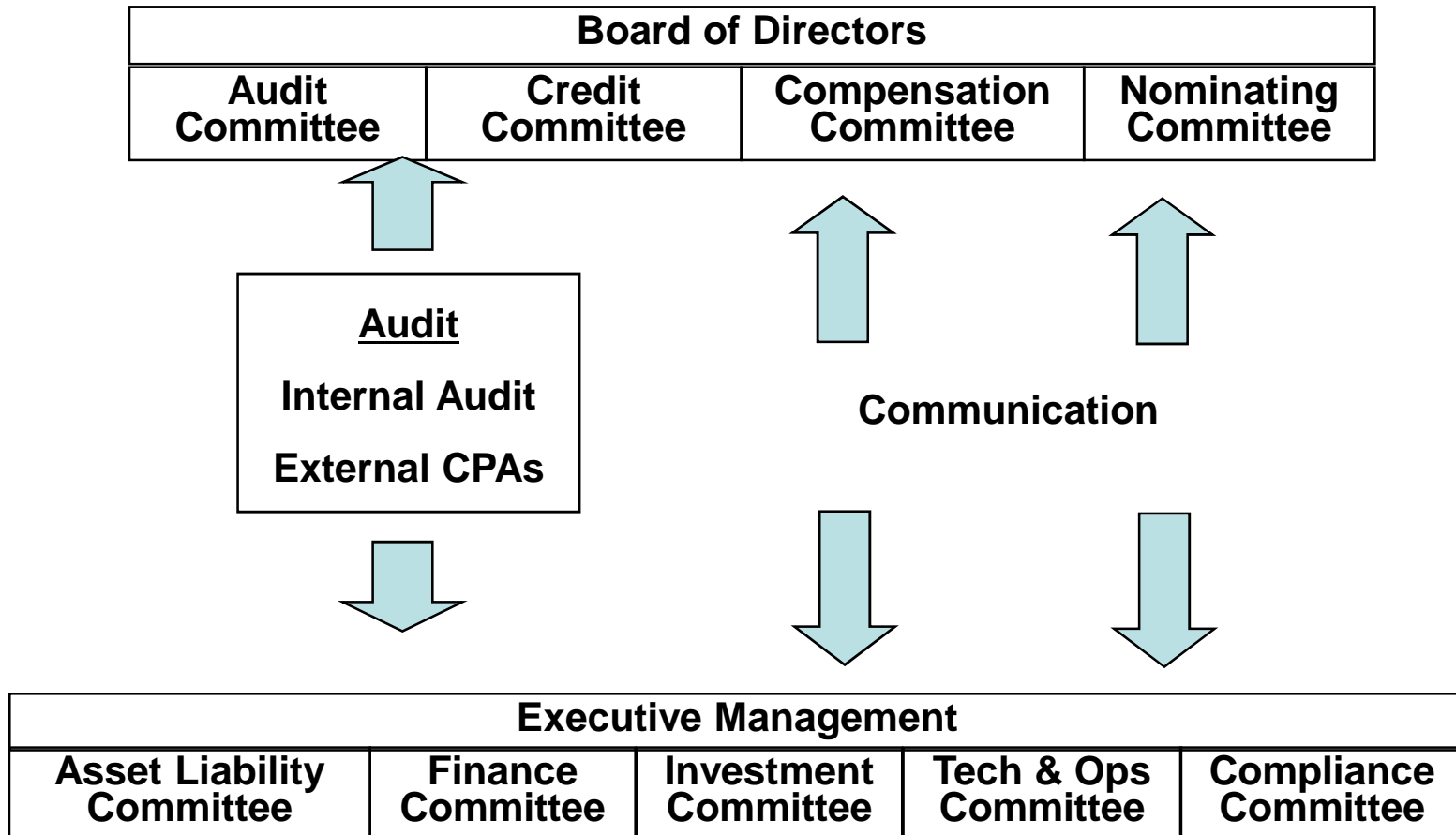
Final Conclusion:

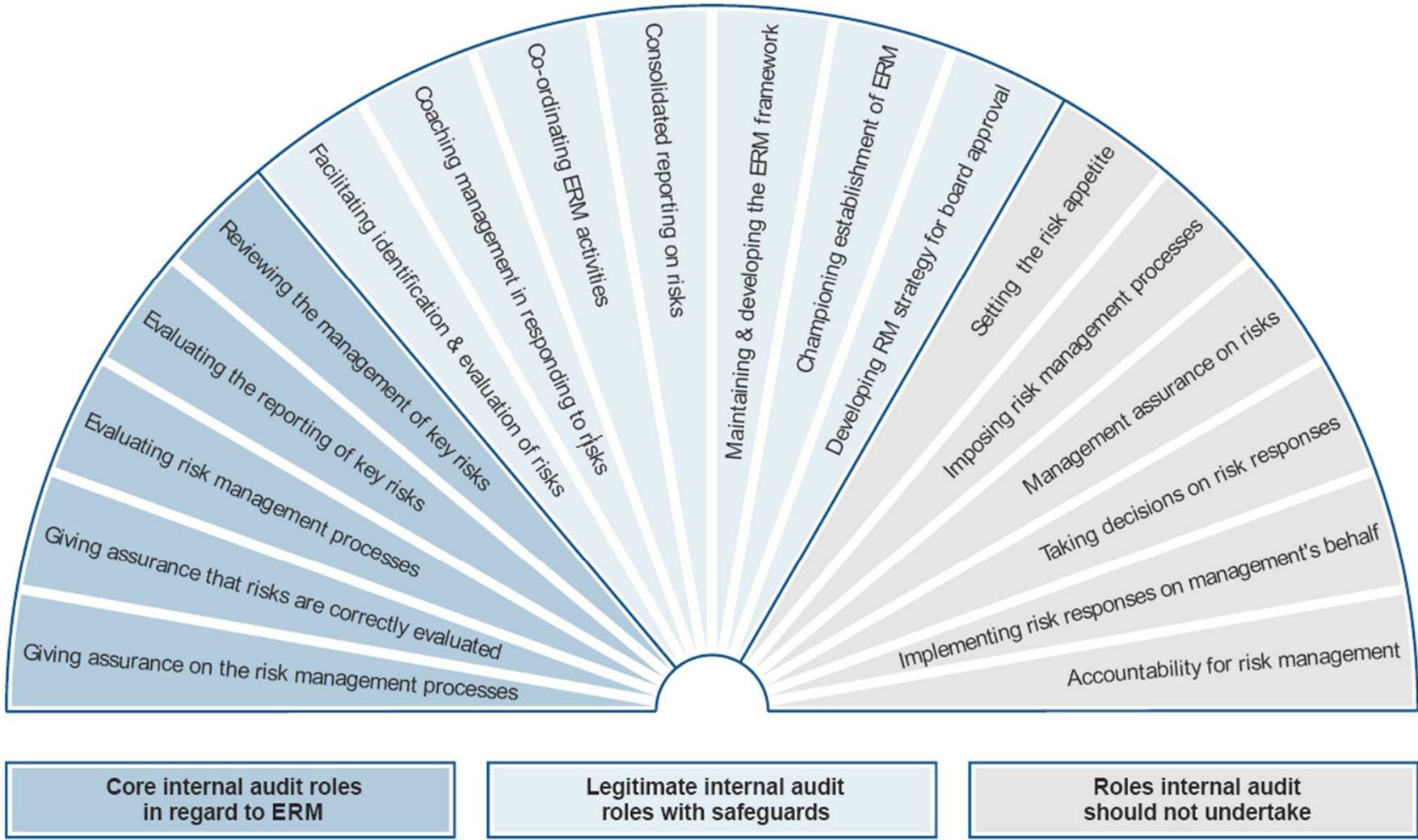
“If there are no “red” categories there are no profits.”

Governance



Traditional Governance Structure





Source: Position paper by IIA: The Role of Internal Audit in Enterprise-wide Risk Management - September 2004

Core Internal Audit Roles

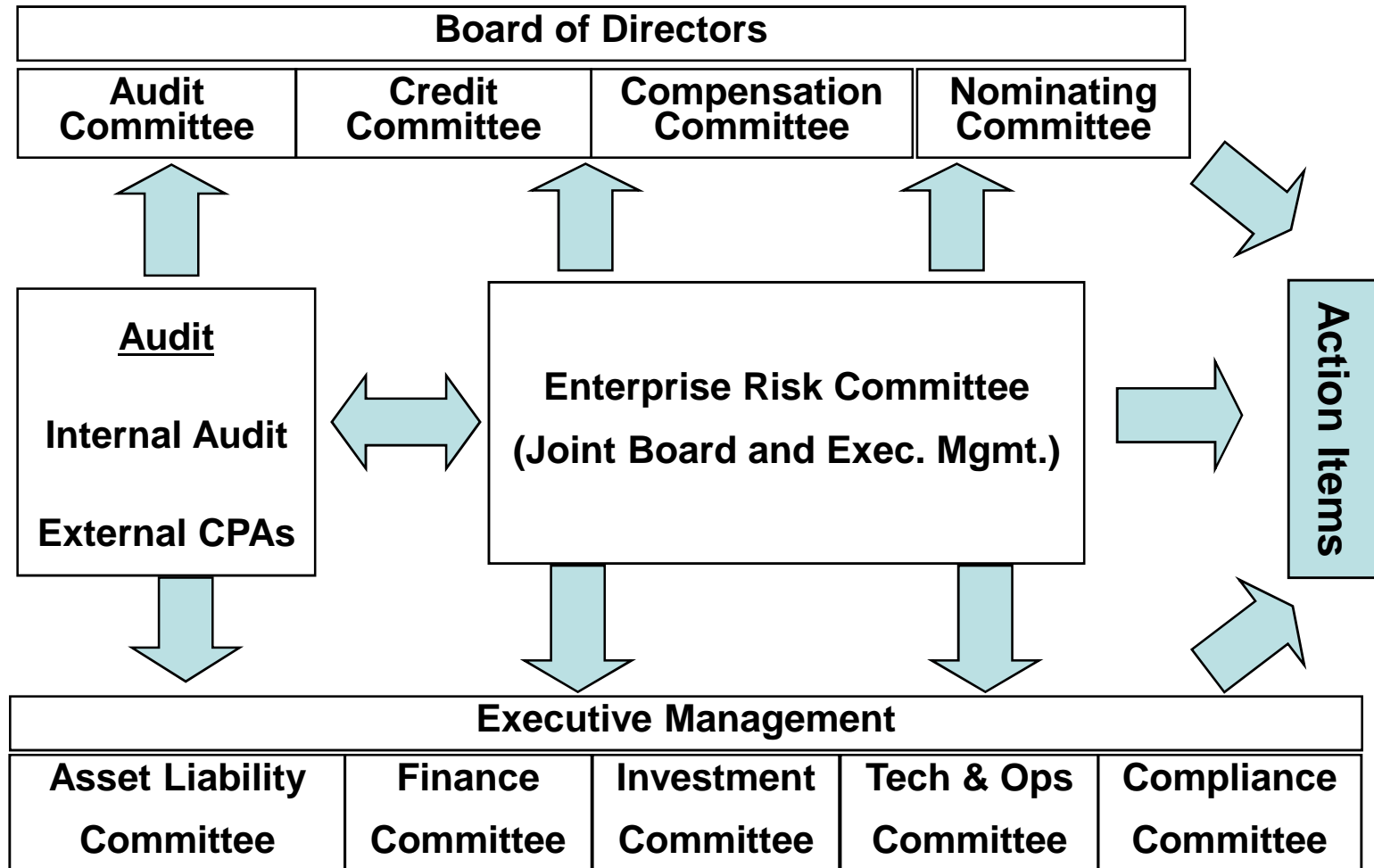
- Reviewing the management of key risks
- Evaluating the report of key risks
- Evaluating risk management processes
- Giving assurance on the risk management process

Internal Audit Roles with Safeguards

- Facilitating identification & evaluation of risks
- Coordinating ERM activities
- Maintaining & developing the ERM framework
- Developing risk management strategy for board approval

- Setting the risk appetite
- Management assurance on risk
- Taking decisions on risk responses
- Implementing risk responses on management's behalf
- Accountability for risk management

Risk Based Governance Structure



ERM: What NOT to do

- ERM is used to upload risk (a.k.a the all work / no results strategy)
- Line managers jointly develop strategy
- Strategy then drives ERM (i.e. here it is, now go monitor it)
- All Risk is “owned” by ERM or the Risk Committee
- Risk appetite is static

ERM: What NOT to do (continued)

- View the ERM Program has a 'quick hit'
- Management by checklists
- No discernible change in how decisions are made
- ERM is a compliance requirement (and nothing else)
- No interaction by the Executive Management Team & Board

- Begins with risk assessment process
- Select optimal profile
- Gap / Results suggest a strategy
- Risk appetite drives the institution
- Shareholder value is pursued via integration of Risks
- Risks are owned by lines of business; separately monitored by ERM

Well designed ERM Program (continued)

- Communication among all stakeholders of risk appetite, backed by transparency
- ERM plan implementation is strategic in nature; process evolves over time
- A CRO or other executive wearing the CRO hat owns the ERM management function
- Communication and buy in from the Executive Management team & BOD
- Take action - Treat risks



Regulatory Insight



Why is risk management a key driver for efficiency and profitability ?

- Interest Rate Risk continues to be a challenge
- Dodd-Frank /regulatory focus on risk management
- Bank earnings are in focus and will remain challenging
- Net Interest Margins remain under pressure and are heading lower
- Asset Yield on a downward trend
- Regulatory burden is a contributing factor but low interest rates drive weak earnings

- Banks must figure out methods to be more efficient
 - ERM is a vehicle to sustain in climate of weak earnings
 - Effective RM practices affects efficiency, yield and protects capital
- Investment in technologies is critical to success
- Maximize net interest margins through smart lending and investment decisions
- Practical & effective risk management programs provide the framework

Looking forward



- Enterprise risk management programs will continue to emerge and develop over the next 3 years
- Operational risk management programs will require the same level of sophisticated management and Board oversight as credit risk programs do today
- Board Monitoring and Involvement
- Financial services supply chain practices will emerge, starting with tracking customer's private information



Thank you!



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- Regulators
 - www.federalreserve.gov, www.occ.treas.gov, www.fdic.gov
 - More to follow...Consumer Financial Protection Bureau
- Basel Committee on Bank Supervision
 - 2004 - Basel II - International Convergence of Capital Measurement and Capital Standards
 - 2008 - Principles for Sound Liquidity Risk Management & Supervision
 - www.bis.org/bcbs
- International Organization for Standardization (ISO)
 - 2009 - ISO 31000: Risk Management - Principles and Guidelines
 - 2009 - ISO Guide 73: Risk Management Vocabulary
 - www.iso.org
- COSO *Enterprise Risk Management – Integrated Framework*
- *Institute of Internal Auditors* – www.theiia.org