# Enterprise Risk Management 101

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Enterprise Risk Management is a hot topic for community bank directors and executive management. This is, in part, because of the widely-held perception that excessive risk taking was the primary cause of the recent financial industry crisis and the resulting economic recession. The purpose of this article is to summarize the Enterprise Risk Management concept and to discuss the advantages and disadvantages of alternative methods of implementing it.

## Definition

Essentially, Enterprise Risk Management is the systematic gathering of all relevant and material risk-related information to permit the centralized and deliberate identification, measurement, monitoring, and control of the level and types of risk taken by the bank on an organization-wide basis. Enterprise Risk Management does <u>not</u> result in the elimination of risk, and any quest to completely eliminate risk will reduce revenue, increase costs, and diminish shareholder value. Rather, effective Enterprise Risk Management:

- Identifies areas of risk that warrant attention,
- Evaluates both individual transaction and bank-wide risk, and
- Results in a bank-wide risk monitoring system to manage and control the bank's risk exposure while identifying potentially profitable business activities and opportunities.

## Risk Types

In general, a community bank is concerned with the following types of risk:

- <u>Credit Risk</u> – The potential loss and other adverse consequences arising from a borrower's failure to meet its obligations to the bank when due.

- <u>Liquidity Risk</u> – The adverse consequences arising from the bank's inability to meet its obligations to others when due.

- <u>Accounting Risk</u> – The adverse consequences arising from a failure of a financial reporting system to accurately and properly present the bank's financial results and condition.

- <u>Legal and Compliance Risk</u> – The adverse consequences arising from a failure to comply with legal or regulatory requirements.

- Operation Risk – The adverse consequences arising from inadequate or failed internal controls, information systems, or operating processes.

- Interest Rate Risk – The adverse consequences arising from fluctuations in interest rates and/or financial markets.

- Strategic Risk – The adverse consequences arising from poor business decisions, improper implementation of business plans, or lack of responsiveness to economic, technological, competitive, legal and regulatory, or other environmental changes.

- Reputation Risk – The adverse consequences arising from negative publicity or negative public opinion.

The goal of an Enterprise Risk Management system is to open up the lines of communication among the directors, executive and junior officers, and employees so that the above-noted types of risk are effectively and efficiently identified, measured, managed, and controlled on a bank-wide basis. An effective Enterprise Risk Management system also encourages the efficient deployment of capital because the Board's risk tolerance is clearly defined with regard to the bank's asset selection, funding sources, and business activities.

**Potential Pitfalls**

Because community banks are often operated in "silos," the Board will need to regularly evaluate the implementation of the Enterprise Risk Management system to make sure that it does not create additional layers of bureaucracy that suppresses business development and the entrepreneurial spirit while increasing cost unnecessarily.

**Chief Executive Officer**

The logical leader of an Enterprise Risk Management system is the bank's Chief Executive Officer, who is the point person for implementing the Board's strategic business plans and balancing bank-wide risk with profitable business activities. However, the organization of the program below the Chief Executive Officer must be carefully considered. If the Chief Executive Officer relies too heavily on the bank's officers to individually manage and report the results of their activities and their departments, these officers may have an incentive to present a rosier picture of their activities than may actually exist. This can be true if an officer is more concerned with the perception of short-term success rather than his or her contribution to the bank's actual long-term economic success.

Another pitfall resulting from excessive delegation is the "silo effect." If individual officers are too autonomous, then communication among the bank's officers is limited, which results in a fragmented approach to risk management that avoids the bank-wide view that is a basic goal of an Enterprise Risk Management system. For example, the bank's lending officers may be making loans that comply with the credit underwriting and loan administration guidelines in the Loan Policy. However, the bank, as a whole, may have significant credit risk because of the inadvertent concentration of credit in a certain industry, such as commercial real estate development. Therefore, it is the goal of an Enterprise Risk Management system to identify these activities and measure the risk involved in order to provide the Board with the information to properly monitor and control the level of risk on a bank-wide basis.

**Chief Risk Officer**

To combat the potential silo effect, some banks have appointed a Chief Risk Officer to analyze risk on a bank-wide basis. The Chief Risk Officer's goal is to identify the level of risk exposure that is apparent only when looking at the bank as a whole. Consequently, the Chief Risk Officer's job is to implement a systematic approach to gathering information about risk on a bank-wide basis and enforcing the Board's established risk tolerance limits.

There can be pitfalls with this arrangement as well. A Chief Risk Officer has a natural bias toward not taking even reasonable risks because he may feel that his performance and compensation depend on avoiding adverse consequences. If unchecked, this tendency may result in too few business activities in order to avoid the risk of adverse consequences, which will cause profitability to suffer. Consequently, the bank's officers must have the opportunity for significant input through open lines of communication so that potential rewards may be carefully considered when evaluating the risk of engaging in those activities. The goal is for the bank's officers to work together with the Chief Risk Officer in order to provide the Board and the Chief Executive Officer with an accurate and comprehensive picture of bank-wide risk.

**Risk Management Committee**

Board oversight of the Enterprise Risk Management system is critical to its effective and efficient implementation. Some banks believe that the most efficient structure for Board oversight of the Enterprise Risk Management system is through a Risk Management Committee. Ideally, the Risk Management Committee is composed of representatives of the other Board committees that oversee various business activities exposed to significant risk. This composition should facilitate open communication about the risk involved in all of the bank's significant business activities.

The obvious downside to establishing a Risk Management Committee is the additional bureaucracy. Consequently, the committee's membership and decision-making authority should be streamlined to promote efficiency and effectiveness. The goal is to avoid complicating the risk management process by confusing the directors about their respective roles. However, if implemented properly, improved communication can lead to greater transparency regarding risk that would be difficult to otherwise achieve.

**Conclusion**

In conclusion, an Enterprise Risk Management system involves many of the same processes and systems that bank boards and executive management have historically used. The goal of an Enterprise Risk Management system is to open up lines of communication so that information regarding risk, which is often widely dispersed among the bank's officers and employees, is gathered and communicated to the Board so that it, or its designated committee, may make accurate and informed business decisions that consider not only the potential reward, but also the risk involved, on both an individual transaction and a bank-wide basis.