Do Community Banks Need ERM?

Why should Community Banks be talking about Enterprise Risk Management? Isn't this a risk management tool for large, multi-national financial institutions? What are the benefits of implementing ERM?

WHITE PAPER

Implementing Enterprise Risk Management at Community Banks

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Why should Community Banks be talking about Enterprise Risk Management? Isn't this a risk management tool for large, multi-national financial institutions?

Community Banks have simple offerings that are easy to understand. They don't deal with exotic products such as foreign exchange lines of credit or credit-default swaps, so why should they need an ERM program?

The underlying premise of ERM is that every bank, whether large or small, mutual or stock, exists to provide value for its stakeholders. And a key objective of an enterprise-wide, risk management framework at a Community Bank is to help management deal better with risk in achieving the bank's objectives.

> *"But we already manage risk at my Bank: we have a credit committee, we have a compliance officer, we have BSA audits. How does an ERM program change what we currently do?"*
>
> *-CEO of a Community Bank*

Enterprise Risk Management at a Community Bank is a process, designed by a bank's board of directors, management and other staff, applied across the organization, to identify and manage potential risks to ensure long-term success.

ERM will help a Community bank better identify and manage cross-enterprise risks. It will assist in the integration of responses to multiple risks by formally incorporating tracking and feedback processes into an existing risk management program. But most importantly, it will allow an organization to improve the deployment of capital and the assignment of human resources to take advantage of opportunities and reduce risks.

A successful ERM program at a Community Bank will accomplish three risk management objectives:

1. It will ensure there is a written, ***specific*** risk appetite document that complements the bank's detailed strategic objectives.
2. It will link that risk appetite charter to specific metrics that define risk tolerances and boundaries across the organization.
3. And it will create a framework for cross-enterprise reporting and the active management of risks throughout the entire institution.

Isn't ERM Just Another Layer of Bureaucracy and More Costs?

A well-implemented ERM program at a Community Bank is integrated into the basic operating activities of the institution. The ERM response mechanisms should intertwine with management activities and existing reports. While there will be some one-time, incremental costs in deploying an ERM program, one of the benefits of a comprehensive approach to risk-taking should be reduced costs – and therefore higher returns – for the same level of risk.

Based upon our extensive experience at Community Banks, the hardest part of developing and implementing a successful and effective enterprise-wide approach to risk management is creating a common way of defining and discussing risk. In order to manage risk effectively, management and directors need to ensure that everyone is using common language and tracking/reporting elements.

Therefore, as a first step to an ERM implementation, banks need to develop a consistent way of measuring and using risk metrics across the organization. Once an organization can measure and talk about risk on a consistent basis, the board and management are then able to define the acceptable risk parameters and boundaries of the bank. (This will become the foundation of a risk appetite strategy for the institution.)

These two elements, a consistently used and well-defined terminology and a risk appetite strategy, will give a bank the essential infrastructure of an enterprise risk culture. Then, when management talks about risk in department meetings and with the board, managers will have a common framework and language to begin the process of containing and exploiting risk across the entire organization.

How Do We Talk About Risk at the Enterprise Level?

Risk can produce gains and losses. Management's job is to deploy its people and capital, producing profits and minimizing losses, while following the risk appetite set out by its stakeholders.

A risk management strategy and reporting framework can accomplish several important goals. It allows management to see where risk is imbedded in the organization; it provides a way of measuring and tracking risk across the entire organization; it accelerates the alignment of people and capital to take advantage of opportunities and minimize unwanted exposure; and it facilitates the way management and the board can discuss the opportunities and uncertainties confronting the bank.

So how does a bank go about measuring and tracking risk? In order to ensure organizations capture all the right risk elements, they need a measurement system that looks at risk from multiple viewpoints. That is, in order to have a holistic view of risk, banks need to expand their perspective to ensure they have a complete view of what is happening. When identifying the appropriate risk metrics for a bank, line management should focus on process risks, quality risks and price risks at the department level. And at the senior management level, executives should focus on the metrics that provide a comprehensive view of the risk profile of the institution.

Once processes are defined and tracked, managers and executives can define boundaries of performance and risk that are in alignment with a bank's written risk appetite. Then, when individual units are working within defined risk parameters, these components can be elevated to an executive level for enterprise-wide risk management. The cumulative effect of this approach will enable an institution to have an appropriate, bank-wide discussion of capital allocation, risk management and risk-adjusted investing. This is the beginning of an enterprise view of risk.

Typical Top-Level Risk Metrics

At the highest level, each institution should define the top ten to twenty metrics that frame the enterprise risk profile of the institution. These measurements will vary from bank to bank, depending upon the type of lending and business each institution conducts. Typical metrics could include return on average assets (ROAA), return on equity (ROE), net income, net interest income, customer satisfaction, employee retention, deposits growth, cost of funds, allowance for loan and lease losses (ALLL), provision for loan loss, total past due loans, Risk Adjusted Return on Capital, weighted average risk rating of individual product portfolios, Tier 1 Capital and efficiency ratio. While each bank, based on its unique structure and product lines, will identify its own particular list of standards, this list of risk metrics is an excellent starting point.

The final selection of top-level metrics should include items from the four major risk categories – reputation risk, operations risk, financial risk and credit risk – and the more that top level metrics can be tied to regulatory reports (e.g., the Call Report), the more consistent and trustworthy the selected benchmarks will be.

Measuring Risk at the Department Level

Departmental (and process level) metrics should build off each bank's self-identified top-level measurements, and each department should integrate risk metrics into their current reporting and management package. Here are two examples of risk metrics at the departmental level.

The human resources department can look at the inputs from its functional group that affect top-level risk metrics such as net income, efficiency ratio, customer satisfaction and employee retention. This department may elect to measure bank staff turnover, salary compared to industry averages, exit interview statistics, customer satisfaction surveys and any other metrics deemed inputs to the Top-Level measurements.

In the residential lending department, managers can look at operational data on each residential loan processed including key milestone dates, individuals who worked on the loan approval and third-party costs. These inputs can then lead to measurements that track individual and department statistics such as average days to close a loan, processing costs and customer satisfaction. Residential lending is also a great place to look at a bank's Net Promoter Score (that is, how likely are customers to recommend the bank to a friend or colleague).

Rationalizing an Investment in ERM

Besides a reduction in overall institutional risk for the same return-on-investment (or higher ROAA/ROE for the same risk), there should be lower operating expenses associated with the proper implementation of an ERM program. There are at least four areas of hard cost savings that can be realized from an investment in better risk management practices:

1. A reduction in the ALLL due to better portfolio management and credit risk practices
2. Reduced problem loan charge-offs, management costs and third party expenses
3. Higher net interest income due to risk adjusted pricing
4. An improved efficiency ratio, allowing the bank to grow with steady costs

For a $500 million Community Bank, the net project benefits of an ERM program should be at least $100,000 in savings after the first 12 months. And executives should have a stretch goal of $200,000 to $300,000 in annual cost reductions within 24 months of full program implementation.

In addition to improving the bottom line, integrating an ERM culture into a Community Bank can lead to more confident decision making at the board and senior management levels, more collaborative responses to change by department managers and more efficient execution of programs and tasks by better informed employees across the entire organization.

Conclusion – Is ERM Right for Your Bank?

How do banks determine if they are ready for an enterprise-wide approach to risk management? Here are three questions that a senior management team should be asking itself:

- Q. Is our board willing to work with senior management to articulate a risk appetite strategy for our institution?
- Q. Are we capable of measuring and tracking risk at the department level?
- Q. When faced with trustworthy and sufficient data, will management re-deploy capital and people to reduce risks or take advantage of opportunities in the marketplace?

To answer these three questions, executives need to gauge their organization's strengths and weaknesses – and be honest in their assessment. If an organization is not capable of tackling ERM today, then management has a challenge: to improve the skills and ability of the organization so that everyone is capable of talking about risk and making sound decisions based on facts.

Ignoring how an institution responds to external risk is no longer acceptable. The financial landscape is moving too quickly – and often against Community Banks – as large-scale competitors continue to take market share away from local institutions and supervisory organizations try to over-regulate risk taking. With ever-increasing requirements to build and store capital, Community Banks need to act judiciously in deploying people and assets. A clear understanding of the risks an institution faces – and a mechanism for interpreting those risks and deploying solutions – is now an essential element of management's charter.

Once a bank is capable of measuring and discussing risk in individual business lines and functional departments, then data can be transformed into information. And as information begins to flow between boards and executives, organizations can begin the institution-wide discussion of capital allocation, human resource assignments and risk-adjusted profits. Then, as this occurs, Community Banks will have begun the enterprise-wide management of risk. Ω

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About the Author

Jay Gallo is a partner in the Boston office of RMPI Consulting, LLC, where he specializes in business strategy and enterprise risk consulting services for the firm.

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With offices in Boston, Tampa and Chicago, RMPI Consulting provides risk and credit management services to Community Banks across the credit life cycle. The company also helps clients with interim, outsourced staffing, and its thought leadership has defined industry "best practices" on a broad range of risk management services.

Recognizing there is no "one size fits all" solution for all Community Banks, RMPI will work with each client to develop an appropriate, custom solution to solve their specific problem at a reasonable cost in an efficient manner within a schedule deadline.

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