Community Banks Directors Guide

A series of articles specifically tailored for Community Bank Directors on board membership, governance and risk management.

A Framework for Strengthening Risk Management at Community Banks

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About the Community Bank Directors Guide
The Directors Guide series is a set of leadership articles specifically tailored for Community Bank directors. Topics include board membership, governance and risk management. In each article we discuss the role of the director, what key information needs to be reviewed, relevant questions to be asking management and how directors can improve their performance as leadership figures.

A Framework for Strengthening Risk Management at Community Banks

According to the **Institution for International Finance** October 2012 research report, "Governance for Strengthening Risk Management," which looked at risk management across commercial and community banks, there are four elements for directors to address when looking to improve risk management:

- Risk culture
- Risk appetite
- The role of the board and board risk committees
- The role of the chief risk officer

Let's examine each of these components to determine how directors could be strengthening risk management practices.

Risk Culture

Risk culture is identified as a crucial element in strengthening risk governance. While it is difficult to measure, as it is primarily behavioral, the "tone at the top" is crucial to building and embedding a strong framework. Important steps in establishing and implementing the right risk culture include the following:

- Embedding risk culture at all levels of the organization,
- Conducting firm-wide risk assessments or risk surveys that focus on a variety of indicators of risk culture,
- Implementing a formal risk education program and
- Aligning compensation with good risk practice.

Embedding Risk Culture

Embedding risk culture involves ingraining the belief that "risk is everyone's business." Building the desired risk culture can take several years. The main challenge, however, is to embed culture deeply in the firm, so that changes in the economic cycle, leadership changes and staff turnaround do not cause it to fade away.

Conducting Risk Assessments
Using objective measures to identify and assess culture is not straightforward. Developing risk culture assessments and, most importantly, deciding what to do with the results, is an area that many Community Banks find challenging – in particular, teasing out actionable results from the "soft" issues likely to arise from any such assessment.

Implementing a Risk Education Program
Education has an important role to play in communicating a clear and consistent attitude toward risk. This involves training not only on the technical aspects of risk, but also communicating the bank's attitude toward risk and expected risk behavior. Challenging aspects include deciding who is to be train, how to deliver the various technical and behavioral aspects of risk training and how to weave risk into existing training programs.

Aligning Compensation
The extent to which risk culture is embedded in an organization can be evidenced by the degree to which compensation policies are risk-based and encourage appropriate behavior. Continuing challenges include designing policies that are truly risk sensitive, providing incentives for the right behavior and aligning the timing of risk-based compensation with the time horizon of the risk taken.

Risk Appetite
A major component of risk governance is the development of a robust risk appetite framework. A well-crafted, written, risk appetite document provides a consistent mechanism for understanding risk through the organization and provides a means to ensure that risk considerations are ingrained in the day-to-day operation of the bank. Three particularly challenging aspects of implementing a risk appetite framework are as follows:

- Linking risk appetite to the planning process and being able to demonstrate a functional link between the two,
- Effectively cascading risk appetite through the organization and
- Developing risk metrics, including linking risk appetite to risk limits.

Linking Risk Appetite to the Planning Process
Developing and setting the firm's risk appetite should be integrated into strategic and corporate planning at the beginning of the process. Strategy should be based on risk appetite and risk appetite should incorporate the strategic strengths and weaknesses of the bank. The two documents must be synchronized if a bank is to have proper risk adjusted growth.

Cascading Risk Appetite
Linking risk appetite, actual business decisions and accountability for those decisions is critical to implementing a risk appetite framework. The organization's risk appetite, tolerance and risk limits should be defined in a way that is relevant for the business. Staff in the business units should be able to answer the question – "what does risk appetite mean to me?"

Developing Risk Metrics

Organizations need to develop metrics to monitor their risk profile against the stated risk appetite. There should be a consistency of metrics used throughout the firm, yet these must be meaningful and measurable in varied departments.

Risk appetite is about goals and boundaries. Are there risk metrics – and limits/goals – to define appetite clearly for everyone? Do metrics cascade through the organization so that there are measurements at the executive and department levels? Department level reports should be used by managers to improve processes and manage risks within their units. Executive reports can be distilled from unit level reports.

What Do We Mean by Risk?

Banking is about risk, and at a bank, risk is everyone's business. Risk is not just losing money on a loan. Risk is a rightly unsatisfied customer who gets no help from the teller in and leaves the bank complaining to friends, family and co-workers about the incompetence of his local branch. Risk is a poorly administered ATM program that leaves customers constantly going across the street to a competitor's ATM to get money because their own bank's machine never works or is always out of cash. Risk is a mediocre residential loan application process that leaves borrowers unenthusiastic about their community bank. Risk is also an aging retail customer base that requires fewer and fewer products and services as time passes.

Role of the Board and Board Risk Committees

The board and board risk committees have a critical role in strengthening risk governance that include setting the "tone at the top," reviewing strategy and approving the firm's risk appetite. It is the board that is ultimately responsible and accountable for risk governance. These responsibilities require that board members and board risk committees have the appropriate expertise and experience to make rigorous and informed judgments on risk.

Some of the key challenges faced by firms strengthening risk governance and organizational structures include the following:

- Building strong risk governance committees,
- Managing the interaction of various board and executive risk committees,
- Achieving comprehensiveness while maintaining "comprehend-ability" in risk reporting to the board,
- Providing the board with meaningful stress test results and associated risk analysis to facilitate strategic decision making and
- Conducting board self-evaluations to assess how the board fulfills its risk responsibilities.

Strengthening Risk Governance Committees

It can take time to find Community Bank board candidates who combine solid and relevant risk experience with the stature and judgment required to confidently challenge management on risk. It is essential, however, that Community Bank boards grow in their understanding of risk management

through either training or bringing on new members with specific skills. Regulators are constantly upping their requirements for risk management, and boards need to maintain the pace.

Interaction of Board Risk Committees

Some Community Banks do not have a single risk committee but instead have various committees that have responsibility for some aspects of risk oversight. With multiple groups dealing with individual slices of risk, it is important to consider the danger that risks might fall between the cracks or that risks are dealt with in silos and their interaction is not properly assessed and considered. Boards need to find ways of coordinating risk across the organization so that there is an "enterprise –wide" view of risk and risk management.

Board Risk Reporting

It is important that directors are given information that allows them to understand and appreciate risk issues, challenge management on risk decisions and have a plain-language conversation about risk at the board level. The biggest risk reporting challenge for many banks is achieving a balance of comprehensiveness and clarity that enables the board to focus on decision-making.

Stress Test Results

Stress testing should be used to determine the impact that severe but plausible stresses would have on the firm's balance sheet and financial health. Stress tests presented to boards should facilitate strategic decision making, while simultaneously improving data aggregation and other inputs.

Conducting Board Self-Evaluations

With increased pressure for boards to take more responsibility for risk governance, it is important that board members are confident that they are meeting stakeholder expectations. Self-evaluations are one way of accomplishing this. The challenge lies in using self-evaluations as a diagnostic tool to make improvements in board risk governance practices. Teasing out the root cause of any problems or inefficiencies uncovered requires an objective analysis of the results as well as a willingness by board members to examine critically their interaction with the bank's management and with each other.

Self-evaluations should be designed to identify training and education requirements for directors. The evaluations should not serve as a tool to "weed out" individuals.

Role of the Chief Risk Officer

The Chief Risk Officer is the senior officer responsible for risk management in the firm. Since the financial crisis, it has generally been recommended that the CRO have sufficient seniority, voice and independence from line business management to have a meaningful impact on decision-making. It is considered essential that the CRO have direct access to the board or board risk committees in some form.

The CRO should have a strong working relationship with other members of the senior management team, including the Chief Executive Officer, Chief Financial Officer and Senior Loan Officer, as it is this coordination that ensures that risk considerations are taken into account early in the decision-making process.

The key implementation challenges in strengthening the role of the CRO are as follows:

- Ensuring that fundamental ownership of risk resides in the business – not in the risk function,
- Defining the CRO's role in decision making,
- Deciding on the optimal balance of technical versus business expertise for the CRO and
- Developing the CRO's role and reporting line to reflect the organization's governance structure while ensuring the CRO's stature and authority.

Ownership of Risk

Effective risk governance requires that the ownership of risk and accountability for risk are clearly denoted. Regardless of how an organization delineates its risk responsibilities, the guiding principle is that ownership of risk clearly resides with the business. This involves more than putting into place risk governance structures, policies and procedures. Ingraining the belief that risk is everyone's business requires positive and negative reinforcement of desired risk behavior.

Defining the CRO's Role in Decision-Making

It is crucial that the CRO has sufficient status and seniority to influence decision-making within the firm. The CRO should have the stature to have an impact on decisions affecting the bottom line. A test of the CRO's seniority and influence on decision-making might be to ask when was the last time the CRO's opinion was fundamental in stopping something material from happening or fundamentally changed a core decision.

Balancing Technical vs. Business Expertise

Both technical risk management expertise and a sophisticated understanding of the business are essential for the CRO to effectively influence board and business decisions. Combining these two characteristics in one person is not easy, and banks may need to strike a balance between the two.

Developing the CRO's Reporting Line

Different board structures, business models and regulatory requirements mean there is no one model for CRO reporting lines. Matrix reporting is often unavoidable. The difficulty lies in ensuring that the CRO has the required access to the board and senior management to ensure input on risk issues at an early stage in strategic and business decision-making.

Conclusion

Embedding a strong risk culture is an ongoing process and cannot be accomplished in a short period of time. Persistent effort is needed, with constant evaluation to monitor progress made and to assess the challenges that remain. Similarly, putting a robust risk appetite framework into place is an iterative process.

Increasing the risk role and responsibilities of the board, board risk committees, senior management and the CRO are areas rightly receiving a great deal of regulatory attention. Building a board risk committee with directors who combine solid and relevant risk experience with the stature and judgment required to challenge management on risk, in a confident manner, can sometimes take time: but it is worth the effort. Equally, ensuring the stature and independence of the CRO to influence decision-making is an ongoing process.

It is important to note that there is no single or uniform approach to improving risk governance, and measures taken should be proportionate to the bank's nature, scale and complexity. Ultimately, aligning the institution's risk governance structure with its broader corporate governance framework and strategy will make for a more robust and lasting improvement in risk management. 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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