RISK MANAGEMENT ENTERS THE 21ST CENTURY
And the vital role a comprehensive set of risk categories plays in safeguarding your institution.

All federal regulatory agencies in charge of supervising the nation’s various financial institutions stress the importance of effective and comprehensive risk management. This regulatory priority was recently underscored when the Office of the Comptroller of the Currency (OCC) published its final guidance for heightened risk management expectations for banks with more than $50 billion in assets. This watershed moment suggests that the time has passed for institutions with less than $50 billion in assets to decide whether or not to adopt an Enterprise Risk Management (ERM) approach. The time has now come for deciding how best to achieve a fully operational, easily managed, results-oriented ERM framework.

This white paper will explore one of the most critical elements of an effective ERM framework—a comprehensive compilation of all federal regulatory agency risk categories. It will then describe how today’s most sophisticated ERM tools can help institutions of all sizes (no matter their prudential regulator) more effectively and efficiently identify, measure, monitor and control risks.
THE AGE-OLD RISK/REWARD CONUNDRUM

The business of banking has, and always will be, based on the notion of taking calculated risks in order to reap the rewards. As the National Credit Union Administration (NCUA) describes it, “the desired reward for taking risk is stable profitability and increased net worth.” But risk and reward must be balanced. Take on too little risk, and the reward may not be worth the effort to satisfy shareholders, whether private or public. Take on too much risk, and it may or may not yield the anticipated reward—but could lead to federal regulatory action.

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In order to stay in business and remain profitable, financial institutions must constantly perform a delicate balancing act in regard to risk taking. While this conundrum is age-old, the environment at any given point in time can alter the risk picture, much as the Great Recession did not too long ago. In this second decade of the 21st century, the risk picture includes challenges and threats that show no sign of letting up, making it that much more difficult for financial institutions to calculate risks that generate success rather than failure.

RISK IN THE 21ST CENTURY

While the risk picture at each institution is unique and also ever-changing, there are certain major challenges that threaten the risk environment at all institutions, today and for the foreseeable future.

In February 2015, American Banker warned that the viability of many of the nation’s big banks is at risk because of faulty risk data. “Big banks are making critical risk management decisions with data that is often old, incomplete, or even inaccurate.” The management of risk itself has become a major risk factor, and this doesn’t just correspond to the bigger banks. It also is certainly an issue at smaller institutions, where tighter budgets and limited resources often affect the ability to capture the necessary data to adequately quantify and qualify risk.
The OCC touched on this theme and the threat it poses in its Risk Perspective Fall 2014, the agency’s semi-annual review of the current risk environment. “Projects to modernize systems and implement or adapt risk management for new regulatory requirements or evolving risks make expense reduction difficult to achieve without diminishing the quality of control environments.”

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- American Banker

Beyond risk itself, there are several other threats that have emerged in this century that pose potentially decades-long challenges for financial institutions. While not a comprehensive list of threats, it is a universal one to which no institution is immune. The OCC encapsulated these threats in its perspective:

- **Financial Success After the Great Recession:** Many institutions continue to dig themselves out of the hole that was left by the 2008 financial crisis and consequent recession. Credit portfolio issues still linger at many institutions, which when combined with new regulatory requirements out of the Dodd-Frank Act, put significant pressure on institutions’ ability to generate profits.

- **Intensified Competition:** The playing field for bank customers (loan and deposit) continues to broaden, particularly with non-bank entities like Walmart jumping into the game. Regulators worry that this intensified competition will lead institutions to loosen underwriting standards to an unsafe level in order to gain the new business needed to generate their desired returns.

- **Cybersecurity:** There is no denying that cybercrime is one of the biggest threats to financial institutions in the 21st century. Despite the billions of dollars spent on cybersecurity, institutions face a constant struggle to stay ahead of threats that are always evolving.

- **Increasing Regulatory Compliance Burden:** The OCC warns of increasing pressure on institutions’ BSA/AML compliance programs as the sophistication of money laundering and electronic bank fraud grows. And there is always the compliance risk exposed when institutions do not adequately manage their existing compliance programs or effectively account for emerging regulatory changes.

- **Faulty Strategic Planning:** If outdated data is used to identify risks, so too is the data used by institutions to develop and implement strategic plans. The OCC noted that “many community banks struggle to execute strategic and capital plans.”
RISK AS RATED AND DEFINED BY FEDERAL REGULATORY AGENCIES

All federal regulatory agencies rate their supervised institutions using the uniform interagency rating system known as CAMELS. Most, however, go beyond that composite rating and use a more granular set of risk categories when examining an institution’s risk picture. These specific categories provide an in-depth view of both the quality and quantity of risk at an institution, as well as the direction of risk over time. This allows examiners to more accurately assess the institution and assign it an overall CAMELS rating.
USING A COMPREHENSIVE SET OF RISK CATEGORIES YIELDS THE MOST ACCURATE RISK PICTURE

Regardless of an institution’s prudential regulator and its correlating risk categories, all institutions are wise to view risk at its most granular level. Using a comprehensive set of risk categories ensures that the most accurate risk picture has been identified. And without proper or complete risk identification, an institution’s subsequent risk measurement, risk monitoring and risk control will inherently be flawed.

This comprehensive set of risk categories covers all major areas within an institution, no matter its size, type or prudential regulator. They each have the potential to threaten earnings or capital:

- **Credit Risk:** When an institution’s obligors fail to perform as agreed. Federal regulatory agencies view this risk category much more broadly than they did in less complex financial times. For instance, the OCC’s Examination Handbook notes that, today, credit risk “encompasses more than the traditional definition associated with lending activities.”

- **Price Risk:** When unexpected or underestimated changes in the value of trading portfolios or other obligations occur. The OCC Handbook notes that this is most often associated with “market-making, dealing, and position-taking in interest rate, foreign exchange, equity, commodities and credit markets.”

- **Interest Rate Risk:** When unforeseen fluctuations in interest rates occur. The OCC describes it as resulting “from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting bank activities (basic risk); from changing rate relationships across the spectrum of maturities; and from interest-related options embedded in bank products (options risk).”

- **Liquidity Risk:** When an institution cannot meet its obligations. The OCC points out that “the nature of liquidity risk has changed in recent years. Increased investment alternatives for retail depositors, sophisticated off-balance sheet products with complicated cash-flow implications, and a general increase in the credit sensitivity of bank customers are all examples of factors that complicate liquidity risk.”

- **Reputational Risk:** When issues involving an institution are aired in the public forum, hence affecting its ability to acquire new customers and maintain existing ones.

- **Operational Risk:** When an institution’s processes, internal controls, systems, staff or third-party service providers underperform or fail.

- **Compliance Risk:** When an institution fails to comply with any and all laws or regulations, ethical standards or contractual obligations.

- **Strategic Risk:** When an institution’s strategic planning and overall business decisions do not adequately or accurately take into account the institution’s situation, the industry’s direction and/or the economic environment.

While individually identified, all of the risks above may be interdependent on the others, and therefore each risk category can positively or negatively correlate to another category at any given time. As the OCC warns “these categories are not mutually exclusive.”
THE RISK CATEGORIES USED BY THE OCC

Of all the federal regulatory agencies, the OCC uses the most comprehensive list of risk categories, which matches the set described on page 5. The OCC also provides the most detailed guidance on risk management, which is helpful resource material to all institutions—even those supervised by the Federal Reserve (Fed), the NCUA, or the Federal Deposit Insurance Corporation (FDIC). This explicit guidance also is a major reason that the OCC is cited throughout this white paper.

THE RISK CATEGORIES USED BY THE NCUA

The NCUA’s risk categories provide another practically imperceptible variation from the OCC, due to the use of slightly different terminology:

- Price risk and interest rate risk are combined under one term—interest rate risk.
- The NCUA uses the term transaction instead of operational, but the category basically covers the same general area of an institution.

THE RISK CATEGORIES USED BY THE FED

The Fed uses a slightly less finite set of risk categories to cover the same ground as the OCC. While the categories of credit, liquidity, reputation, and operational are the same, the Fed covers the remaining categories as follows:

- Price risk and interest rate risk are combined under the broader term of market risk.
- Compliance risk falls under the term legal risk.
- Strategic risk is reflected in all other risks rather than listed as a category on its own.

*Risk identification is nearly standard across the various agencies: As the risk categories chart shows, there are only minor differences between each of these agencies’ risk categories. And those differences are in terminology, not substance.

THE RISK CATEGORIES USED BY THE FDIC

The FDIC is the only federal regulatory agency that does not provide a specific list of risk categories. It instead considers and reflects these matters within its CAMELS ratings of its supervised institutions. They correlate as follows:

- The CAMELS Asset Quality rating covers credit risk.
- The CAMELS Sensitivity to Market rating covers price and interest rate risk.
- The CAMELS Liquidity rating covers liquidity risk.
- The CAMELS Management Quality rating covers reputation, operational, compliance and strategic risk, as well as credit, interest rate, and liquidity risk.
Risk Management for the 21st Century

CSI WHITE PAPER

RISK AS MITIGATED BY AN EFFECTIVE RISK MANAGEMENT APPROACH

All federal regulatory agencies agree that an effective risk management system must include the four tasks outlined below. The first task (Identify Risks) is the most critical to get right, because the other three flow from it. That’s why it is so important to use a comprehensive set of risk categories when identifying risks. Remember the adage: garbage in-garbage out. Conversely, quality and comprehensive input equals quality and comprehensive output.

1. **Identify Risks:** “Risk identification should be a continuing process and risks should be understood at the transaction (or individual) level and the portfolio (aggregate) level.”

2. **Measure Risks:** “Accurate and timely measurement of risk is essential to effective risk management systems. A bank that does not have risk management tools has limited ability to control or monitor risk levels.”

3. **Monitor Risks:** “Banks should monitor risk levels to ensure timely review of risk positions and exceptions. Monitoring reports should be timely, accurate, and informative and should be distributed to appropriate individuals to ensure action, when needed.”

4. **Control Risks:** “Banks should establish and communicate risk limits through policies, standards, and procedures that define responsibility and authority.”

There is a general concern among industry experts and regulators that financial institutions are not doing an adequate job of performing those four risk management tasks.

“**A bank that does not have risk management tools has limited ability to control or monitor risk levels.**”

- The OCC

American Banker reports that, “the Basel Committee found that in the years leading to the global financial crisis, banks’ information technology and data architecture were inadequate to support prompt and accurate identification and measurement of financial risks. More than seven years have now passed since the crisis. But despite the billions of dollars that the financial industry has spent improving IT architecture, banks have failed to prioritize risk data management.”

**Note:** While the descriptions above were derived from the OCC’s Examination Handbook, they match the risk management guidance of all federal regulatory agencies.
ERM: THE GOLD STANDARD OF RISK MANAGEMENT APPROACHES

There’s little doubt regarding the need for more effective risk management systems at the majority of the nation’s banks, hence the OCC’s recent action. Its final Heightened Expectations for Large Banks requires covered institutions to implement a risk management approach that includes a formal framework, a three-year strategic plan and a risk appetite statement.

But ERM also is the logical risk management solution for non-covered, OCC-supervised institutions, as well as those supervised by the Fed, FDIC and NCUA. It is simply the gold standard in risk management because of the principles it utilizes:

1. Active Leadership: requires the leadership of the board of directors and senior management.
2. Strategic Thinking: looks at risk through a strategic (short-and long-term) lens.
4. Comprehensive View: provides a complete risk assessment by identifying all risks AND their interdependence.

ERM AUTOMATION—THE LATEST IN ADVANCED TECHNOLOGY

Why implement something that is not required?

1. Regulatory Stance: a formal ERM framework provides undeniable proof to regulators of an institution’s commitment to safety and soundness and its compliance with current risk management guidance. Although the OCC’s heightened expectations are not currently required, or even informally applied, at smaller banks, the agency does recommend its use to help them strengthen their risk management stance. It would come as no surprise to many in the industry if the Fed, FDIC and NCUA follow suit with similar recommendations.

2. Affordability and Efficiency: with the automated ERM tools available on the market today, it is now both affordable and manageable to implement and maintain such a framework, even at institutions with very limited staffing levels.

3. Improved Bottom Line: because business decisions are made through the lens of this comprehensive ERM framework, they yield stronger and more consistent business results day in and day out, year in and year out.
CSI’S WATCHDOG® ELITE SMARTRISK IQ—THE GOLD STANDARD OF ERM AUTOMATION

Smaller institutions need not make the same mistakes as the big banks. CSI’s WatchDOG Elite SmartRisk IQ provides them with the ability to efficiently and continually generate risk data that is current, complete and accurate.

How does SmartRisk IQ make possible that which feels impossible?

1. Facilitates Comprehensive Risk Identification:
   Through an automated tool that covers the most comprehensive set of risk categories (credit, price, interest rate, liquidity, reputation, operational, compliance and strategic), SmartRisk IQ walks an institution through possible threats to each of them. For example, it asks if an institution has any lawsuits currently pending. Regardless of whether that institution is supervised by the Fed—which categorizes that under legal risk—or by the OCC or NCUA, which categorize that under compliance risk, the risk itself is identified so that it can be measured, monitored and controlled going forward.

2. Produces Accurate Risk Measurement:
   Through a sophisticated algorithm, SmartRisk IQ produces a risk assessment that measures the current and trending status of each risk category, which the board of directors and senior management can use for making business decisions based upon the institution’s declared risk appetite.

3. Streamlines and Customizes Risk Monitoring:
   SmartRisk IQ easily generates timely and accurate reports showing internal trends and even industry benchmarks because it stores, tracks and analyzes the risk identification and risk measurement data over time. It also allows an institution to determine how often it needs to complete the risk identification phase, based on the requirements and guidance of its prudential regulator.

4. Ensures and Engenders Risk Control:
   The solution keeps all risks in full view on the front burner for the board of directors and senior management through the SmartRisk IQ-generated Risk Assessment and Reporting features. This makes both short- and long-term risk control more possible than ever.

In addition to benefitting from SmartRisk IQ’s software sophistication, institutions that utilize it to implement and manage their ERM programs also have ongoing access to CSI consultants, who provide expertise, knowledge and advice on risk management and current regulatory guidance.
Risk in the 21st century is far more challenging and complicated than at any other point in modern history. Balancing that level of challenge and complication requires a more intricate risk management framework—ERM—as well as a comprehensive set of risk categories, which we’ve described in this white paper.

But while ERM is complex enough to manage modern risks, smaller institutions need not fear that its implementation or management is too expensive or difficult. Today’s advanced, automated ERM tools like SmartRisk IQ significantly simplify the work required of institutions and yield more accurate and comprehensive risk data, which in turn leads to a more efficient and protected institution.

Contact CSI today to learn how SmartRisk IQ can help your institution gain a comprehensive view of your risk and compliance posture.

ABOUT CSI REGULATORY COMPLIANCE
CSI takes risk management and regulatory compliance seriously; we know you do, too. Since regulations constantly change, we’ve developed comprehensive solutions that address today’s requirements and adjust to meet tomorrow’s demands. Our industry-leading solutions include consulting, social media compliance, testing and watch list screening. Financial institutions and businesses alike trust CSI’s expertise to enhance their compliance programs and reduce operational costs.

LEARN MORE AT WWW.CSIWEB.COM

ADDITIONAL RESOURCES:
White Paper: Banish the Separative Approach to Risk Management
Conquer Your Fear of ERM
2015: A New Year, But the Same from the Regulatory Agencies?
SmartRisk IQ web page

i http://www.ncua.gov/Legal/GuidesEtc/ExaminerGuide/chapter01.pdf; National Credit Union Administration; Examiners Guide; Chapter 1.

ii American Banker; Bad Risk Data Could be Big Banks’ Downfall; Mayra Rodriguez Valladares; Feb. 27, 2015.

iii Office of the Comptroller of the Currency; Semiannual Risk Perspective, Fall 2014; Dec.17, 2014.