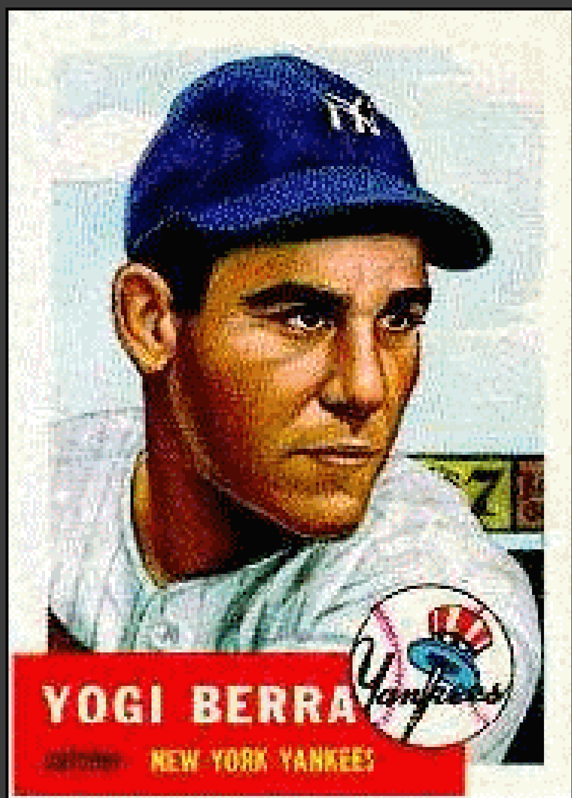
November 3, 2010

ENTERPRISE RISK MANAGEMENT

Enterprise Risk Management



"You've got to be careful if you don't know where you're going.

You might never get there."

Yogi Berra

Expectations for ERM

- A thrift should be able to identify, measure, control, and manage all material risks
  - *Identify*, *Measure*, *Control*, and *Manage* are the key components of a risk management system
  - A risk management function should be consistent with <u>size</u> and <u>complexity</u> of firm
  - Assessing a firm's risk includes both an assessment of its internal risk management function and inherent risk of its activities, which, in turn, depend on external economic environment

How to Achieve Successful ERM

- Effective firm-wide risk identification and analysis (beyond the silos)
  - Robust dialogue among members of the
    - Senior management team
    - Business line risk owners
    - Control functions
  - Firms that manage risk well generally share quantitative and qualitative information effectively across the organization

More Successful ERM

- Board approval and active involvement
  - Periodic reports, annual reassessment of risks
- Independence and power
- Credible Commitment of Resources—MIS and appropriately skilled staff
- Ideally, ERM is *more than a regulatory exercise* – it should be part of how the business is managed because, in the long-run, it is good business

Even More Successful ERM

- Views ERM as providing a competitive business edge
- Finds the economic incentives facing players within firm – is it consistent with risk management objectives?
- Mitigates the high price of taking “excessive risk”
- Increases the firm’s profitability long-term

What about ERM wasn't always working

- Recent bank and thrift failures often show firms paid insufficient regard to key risks such as liquidity and concentrations
- Using a silo approach to firm-wide ERM
- Some relied unduly on historically low losses and profitability while risks slowly changed
- Grabbing market share in competitive markets led to mispriced products and, *underestimating* risks

Managing Risk Well = Competitive Edge

"You've got to know when to hold 'em

and

know when to fold 'em"

--Kenny Rogers

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What to expect -

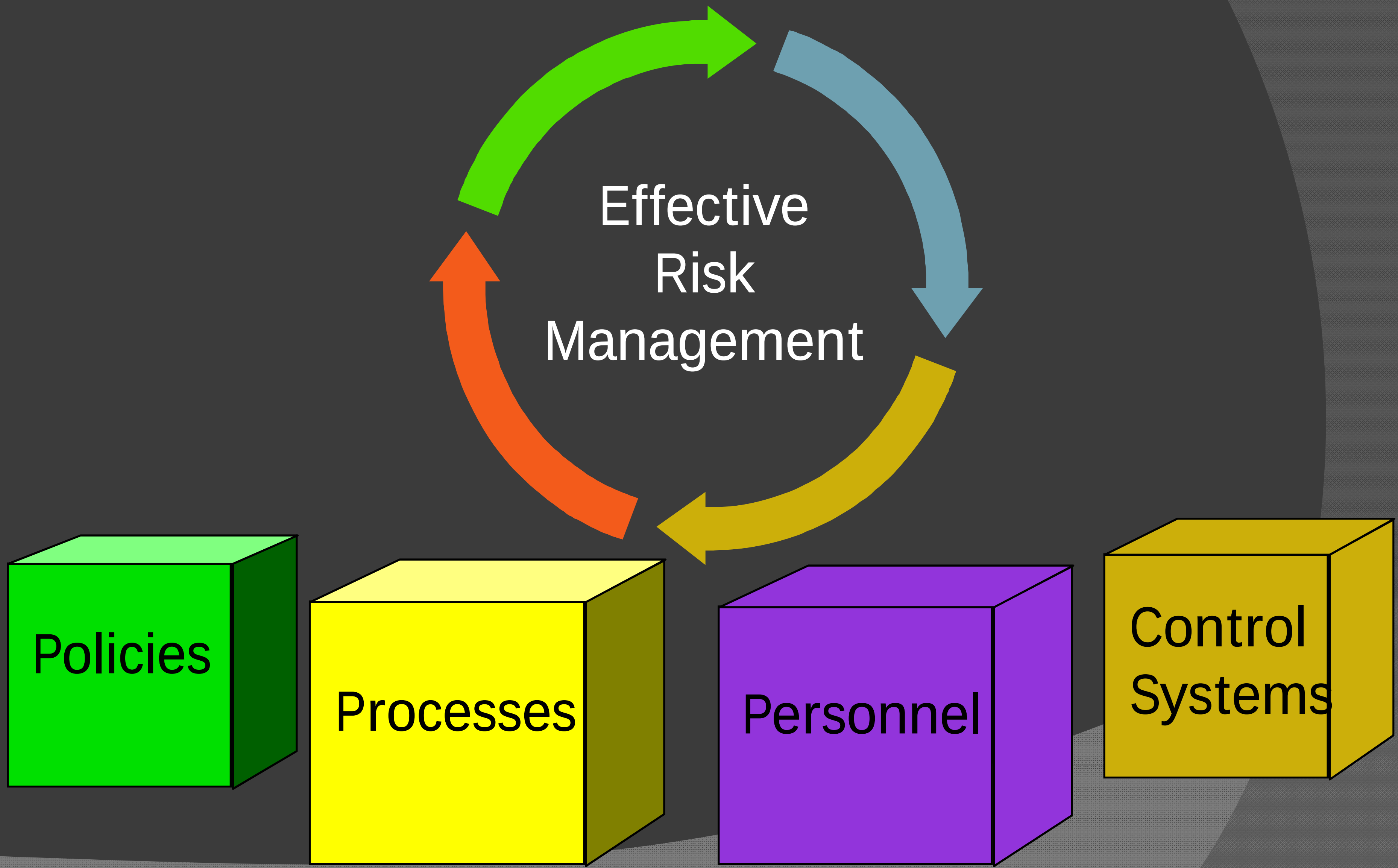
- *ERM is the thrift's responsibility*
- Supervisors may require particular analyses as part of a bank's internal risk assessment process
- Supervisors should evaluate the thrift's procedures used in assessing risk--this may include internal verification of validation procedures
- Supervisors should evaluate whether the risk function, the Risk Officer, or Risk Committee has both independence and power to address internal risk concerns

High Risk Areas

- Effective management of market and funding liquidity, capital, and the balance sheet growth and concentrations
  - Robust liquidity planning – including interaction of asset and liability market conditions
  - Ongoing capital adequacy assessment
  - Active control over specific business line *growth*, as well as aggregate *growth*
  - Interest Rate risk can quickly change to credit risk

Evaluating Quality of Risk Management

Risk Evaluation



Evaluating Overall Risk

Quantity of Risk

Quality of Risk Management

RISK

Direction of Risk

Aggregate Risk

Measuring Quantity of Risk

The quantity of risk and quality of risk management should be assessed independently.

The assessment of the quantity of risk should not be affected by the quality of risk management, no matter how strong or weak.

Quantity of risk is the level or volume of risk that the bank faces and is characterized as low, moderate, or high.

Strong capital support or strong financial performance should not mitigate an inadequate risk management system.

Whether this quantity is good or bad depends on whether the bank's risk management systems are capable of identifying, measuring, monitoring, and controlling that amount of risk.

Conclusion

- Enterprise risk management in not only your friend, it's becoming the law.
- Pay close attention to the incentives people face within your organization.