



inform. educate. connect.



## **Chairman's Forum**

*August 9, 2011  
Los Angeles*

*August 10, 2011  
San Francisco*

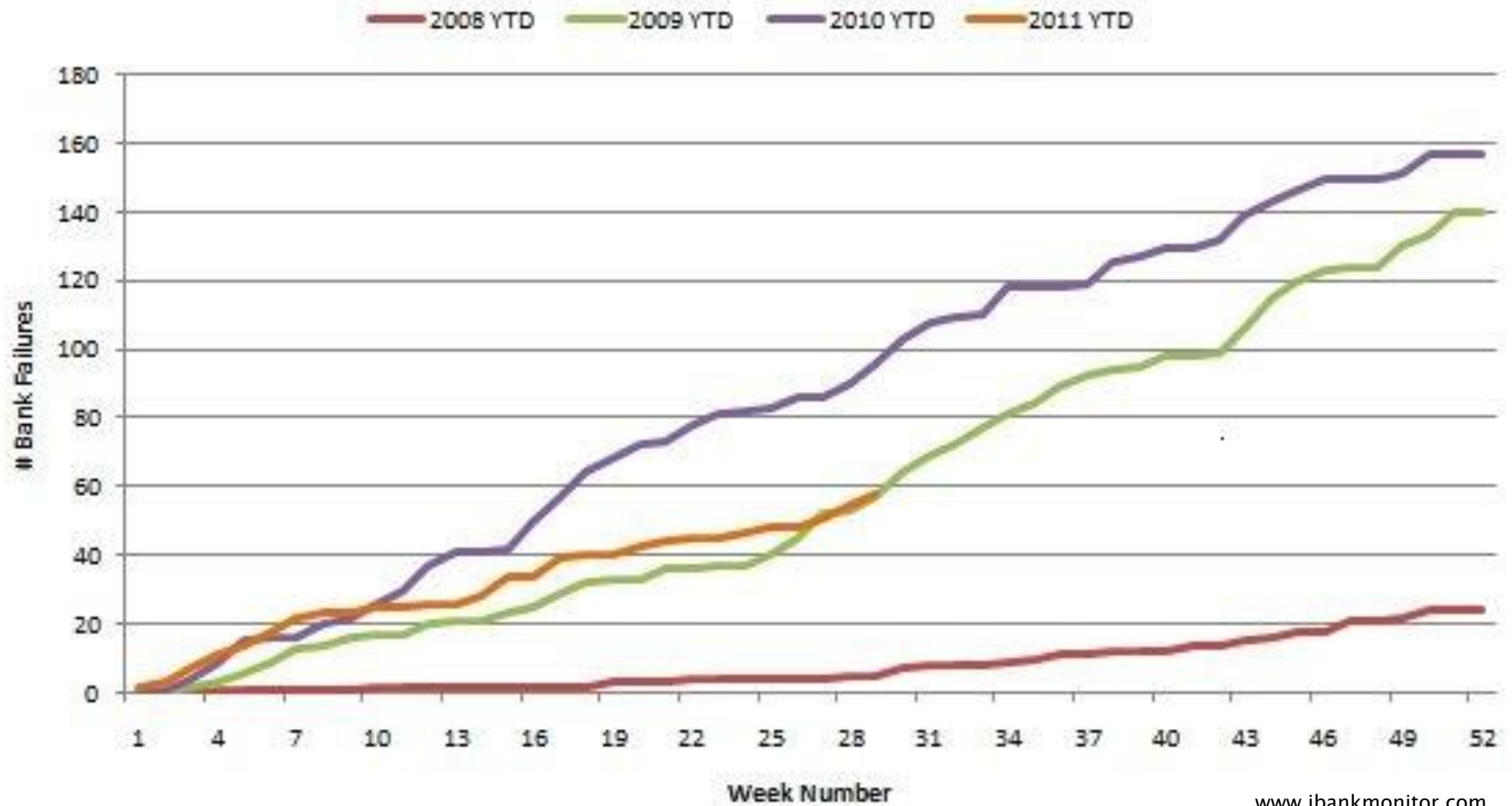
# RISK MANAGEMENT'S IMPACT ON CORPORATE GOVERNANCE

Ed Jamison, Director of Consulting  
Jeff Chase, CPA

[www.hkgllp.com](http://www.hkgllp.com)

**H | K | G** Hinton, Kreditor & Gronroos, LLP  
Certified Public Accountants

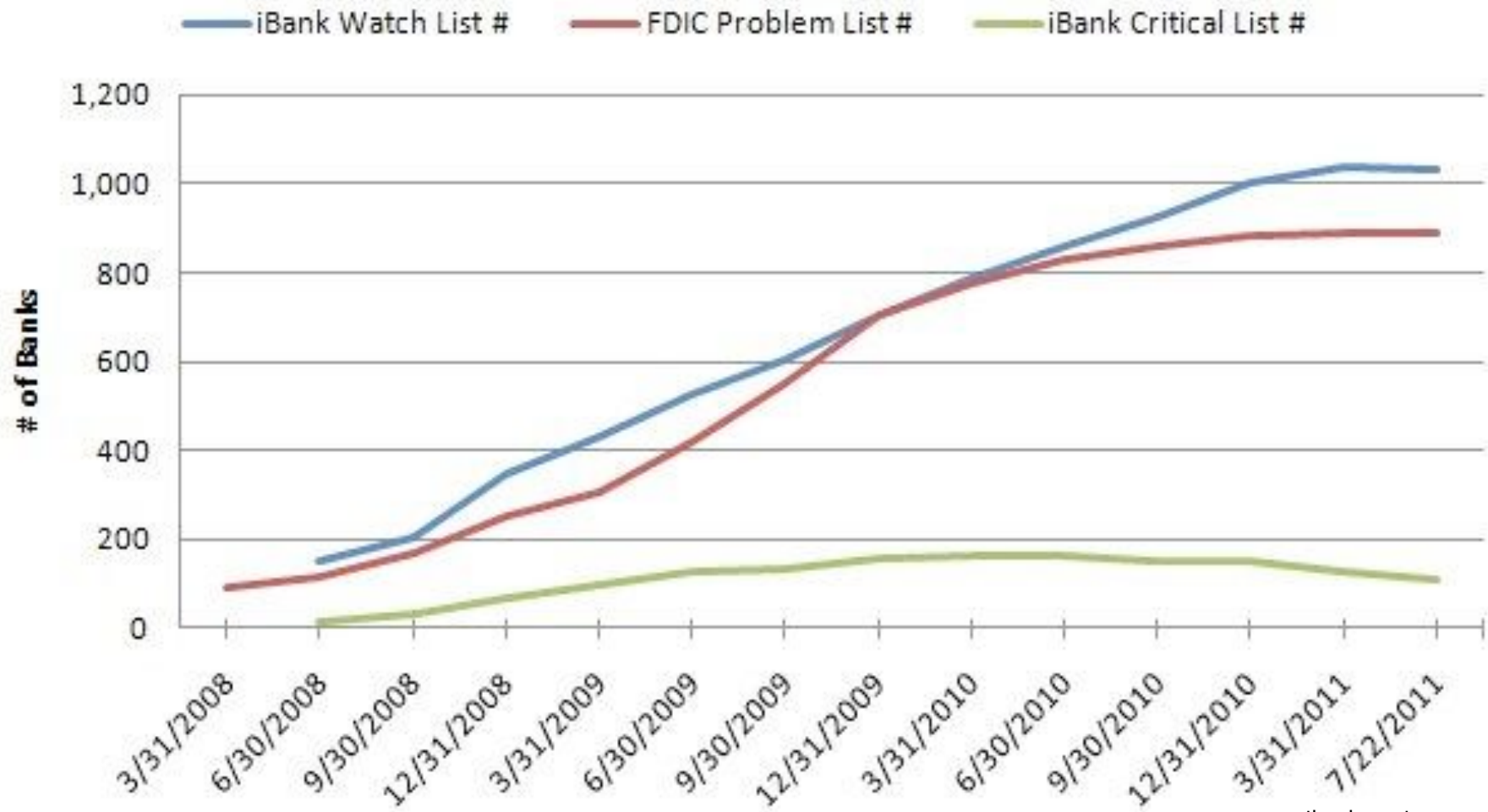
## Year to Date Bank Failures



www.ibankmonitor.com

H | K | G

# # Troubled Banks (Net of Failures)



www.ibankmonitor.com

# *What have the regulators claimed in recent enforcement actions against banks?*

- Lack of Board oversight
- Inadequate capital based on the banks risk profile
- Inadequate management
- Inadequate ALLL methodology
- Inadequate loan policies and procedures
- Failure to follow loan policies and procedures
- Inadequate controls and monitoring of interest rate risk
- Inadequate liquidity
- Inadequate earnings
- Poor credit administration
- High loan concentrations
- Reliance on brokered deposits

# Material Loss Report



Cause of the failure...

“Bank XYZ failed because its Board of Directors and management did not properly manage and control the risk associated with the bank’s...”

*Who is responsible for  
RISK in your institution?*



## Board and Management Responsibilities



*“The Board must establish the company’s strategic direction and risk tolerances. In carrying out these responsibilities, the board should approve policies that set operational standards and risk limits. Well-designed monitoring systems will allow the board to hold management accountable for operating within established tolerances.”*

Comptroller’s Handbook, January 2010

# Role & Responsibility of Chairman of Board of Directors or Lead Director

## Independent director / Outside director

- Insure that the Board and each director understands it is their responsibility to “guide” the bank and judge its operational performance

## Officer / Management / Inside director

- Same responsibilities but defined differently by employment status

# *Where is your bank?*

Recommended practices:

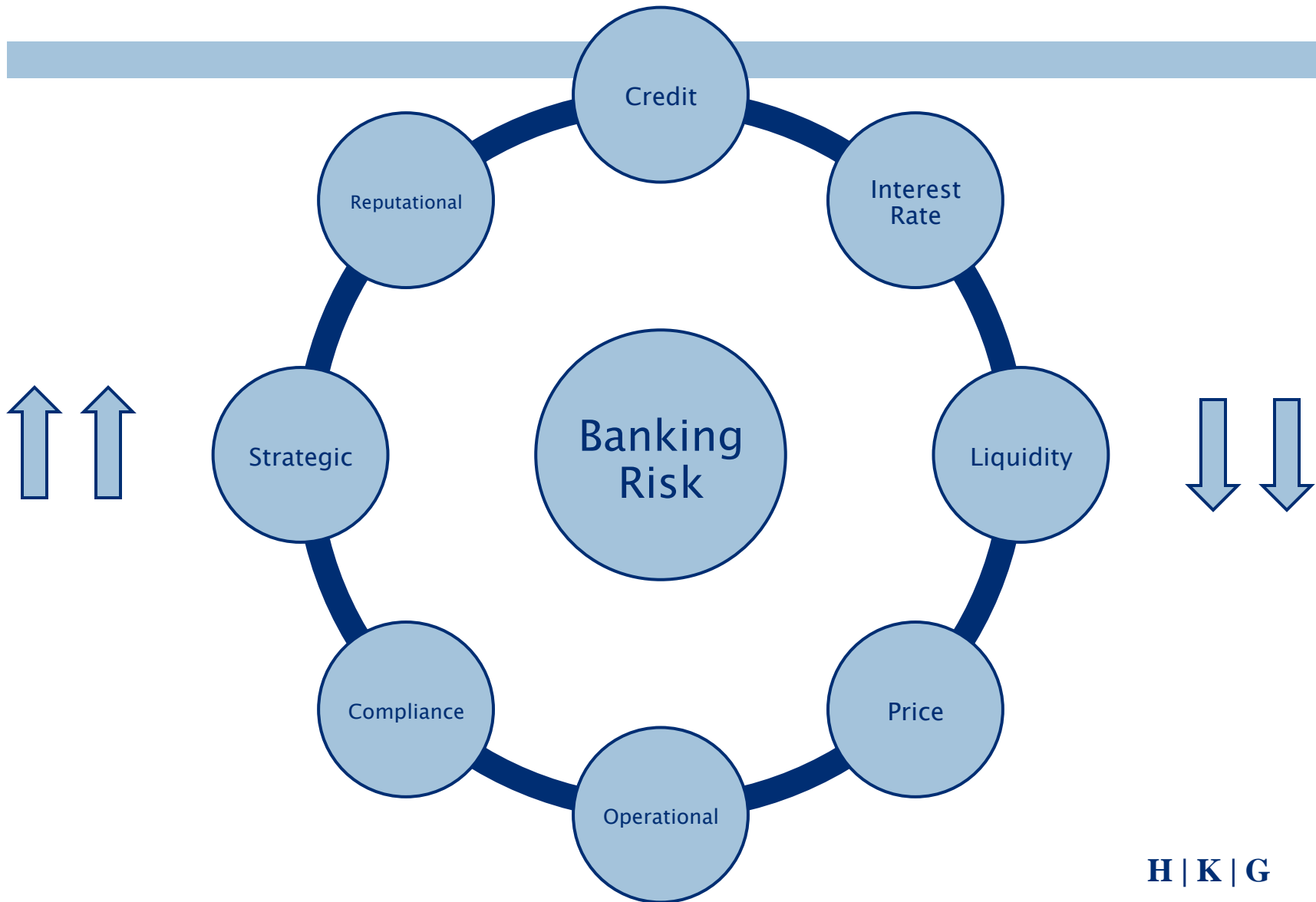
- Manage from the top
- Integrate with your strategic business plan
- Track, report, review and adjust to current conditions

“Generally, a risk is effectively managed when it is *identified, measured, monitored,* and *controlled* as part of a deliberate risk/reward strategy.

It should be within the bank’s capacity to readily withstand the financial distress that such risk, in isolation or in combination with other risks, could cause.”

Large Bank Supervision, Comptroller’s Handbook, January 2010

# Banking risks



**Risk is involved in everything we do in life.**

Could we have planned,  
modeled, and predicted what  
has happened and continues  
to happen within our  
economy?

YES.

Could we have looked at risk within our organization using forward looking models of performance rather than historical performances during the “past” economic downturn?

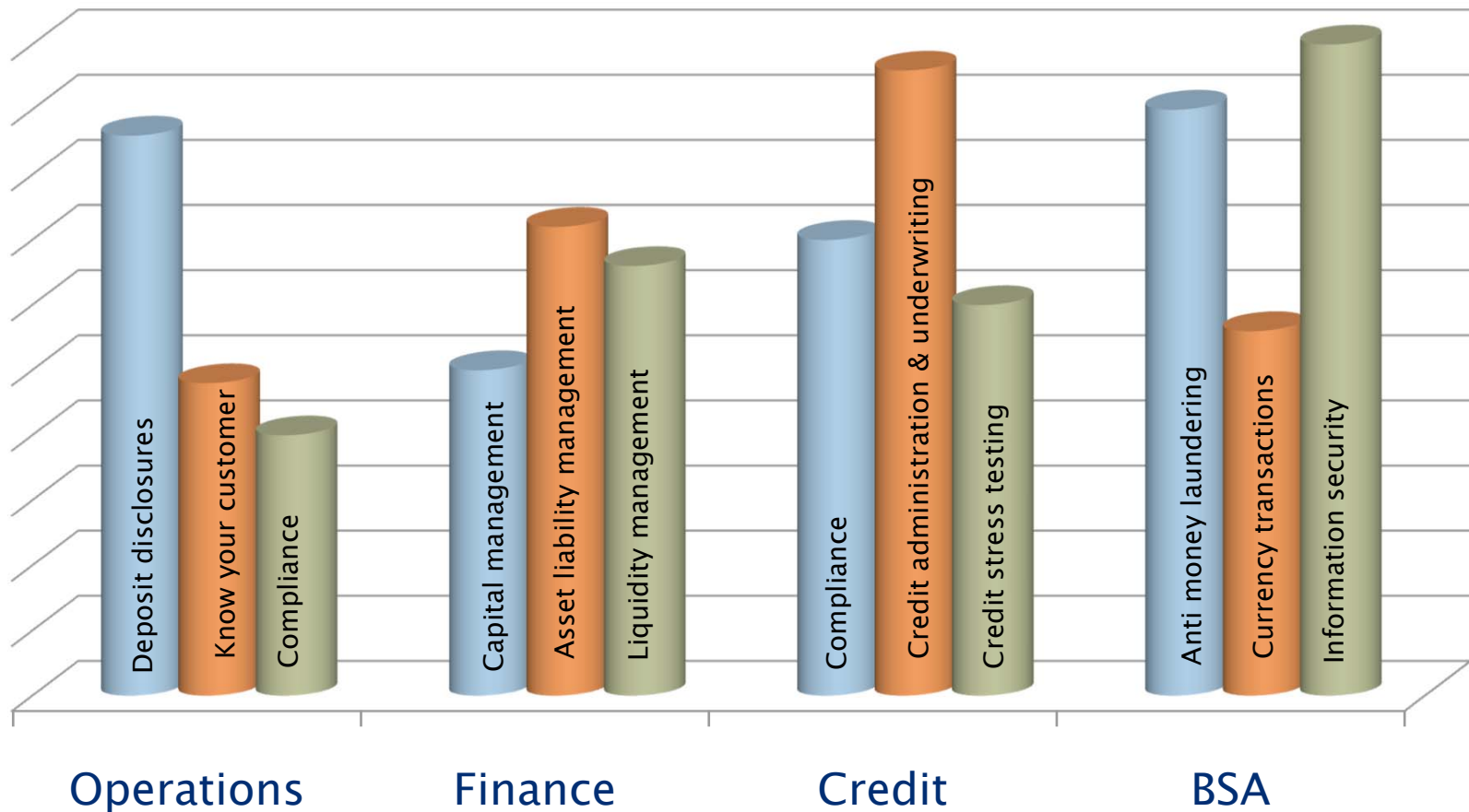
YES.

Organizations and banks in particular need to address risk in a more enterprise wide perspective rather than relying on a “silo” approach to risk management.



H|K|G

# BANKS SILO'S RISK MANAGEMENT





## Enterprise Risk Management (ERM)

“ ...a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

Source: COSO Enterprise Risk Management–Integrated Framework. 2004. COSO

# *Why ERM is important*



## Underlying principles:

- Every entity, whether for-profit or not, exists to realize value for its shareholders.
- Value is created, preserved, or eroded by management decisions in all activities, from setting strategy to operating the enterprise day-to-day.

## ERM considers activities at all levels of the organization:



- Enterprise level
- Division or department
- Business unit processes

**Enterprise risk management requires an entity to take a portfolio view of risk.**

# ERM Framework



Entity objectives can be viewed in the context of four categories:

- Strategic
- Operations
- Reporting
- Compliance

ERM supports value creation by enabling management and the Board to:

- Deal effectively with potential future events that create uncertainty.
- Respond in a manner that reduces the likelihood of downside outcomes and increases the upside.

## Start with small steps in developing your ERM

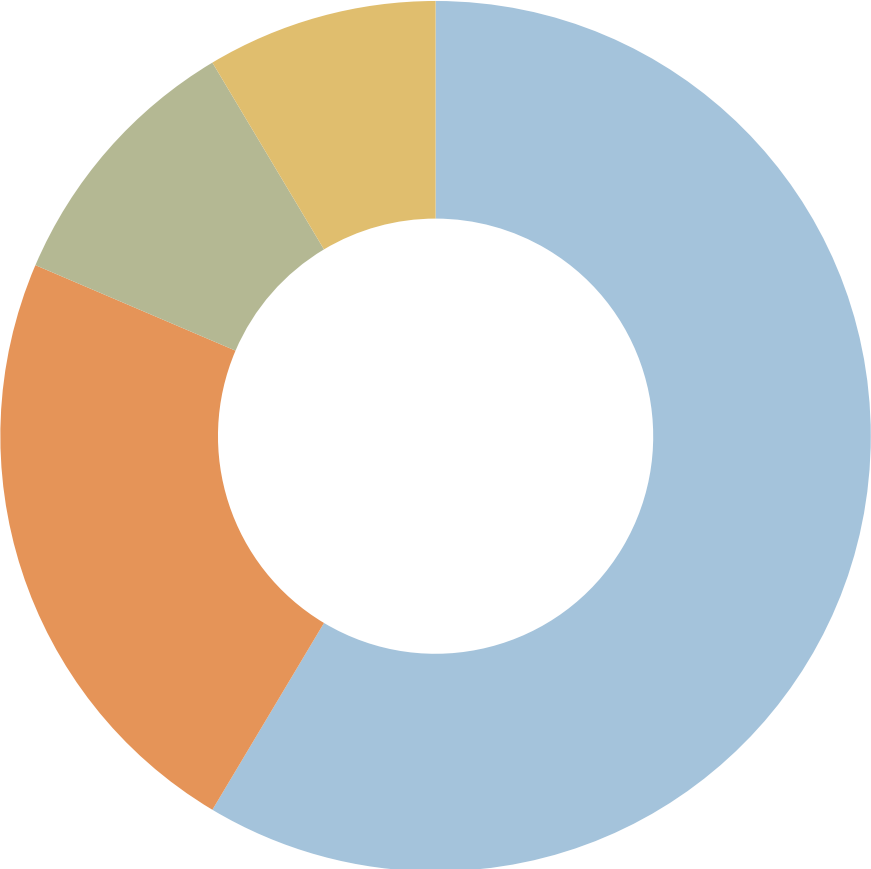
- First you might look at a limited number of risk
- Look at risk from an enterprise basis and;

View risk from a “holistic” approach rather than operational “silos.”



H | K | G

# ENTERPRISE RISK – HOLISTIC



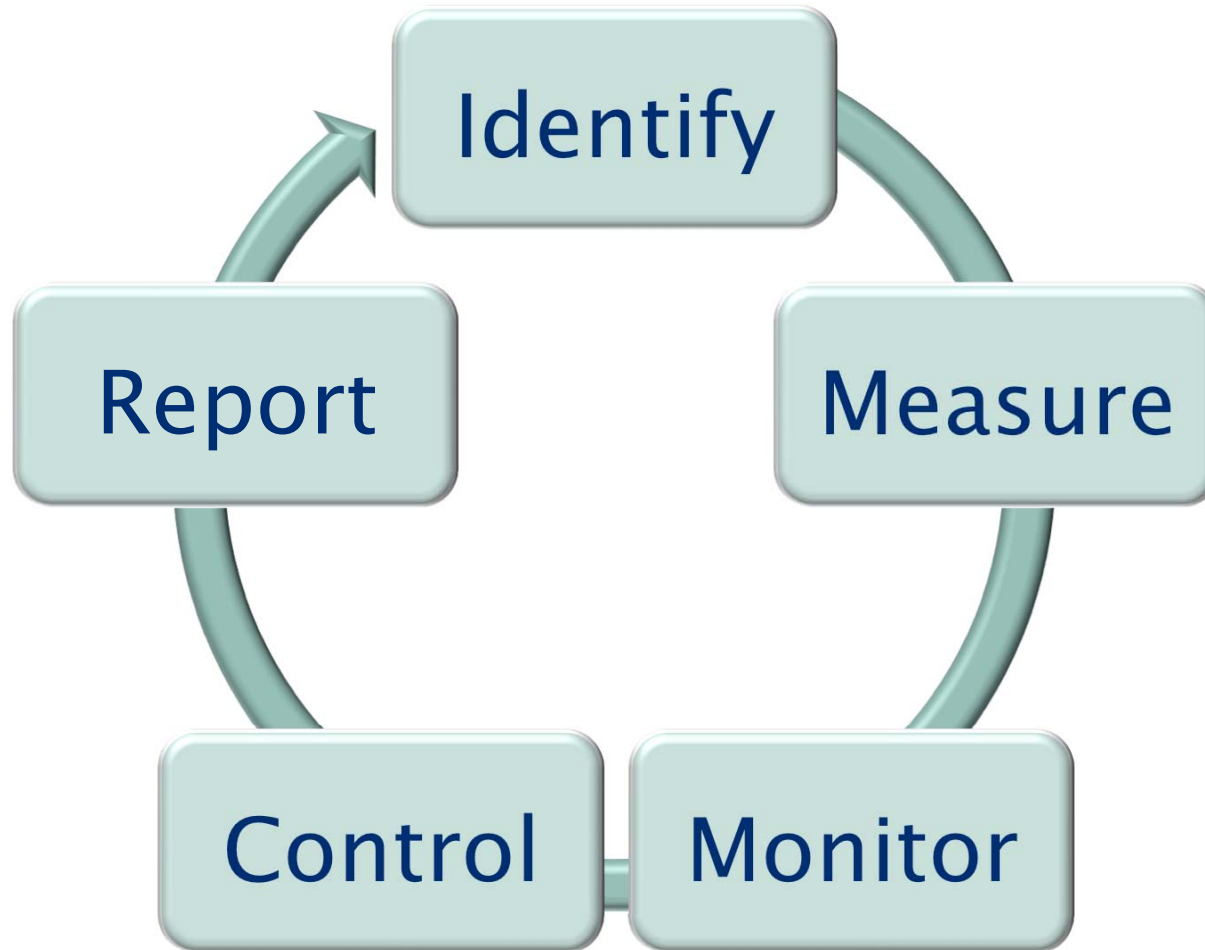
# CONSIDERATIONS



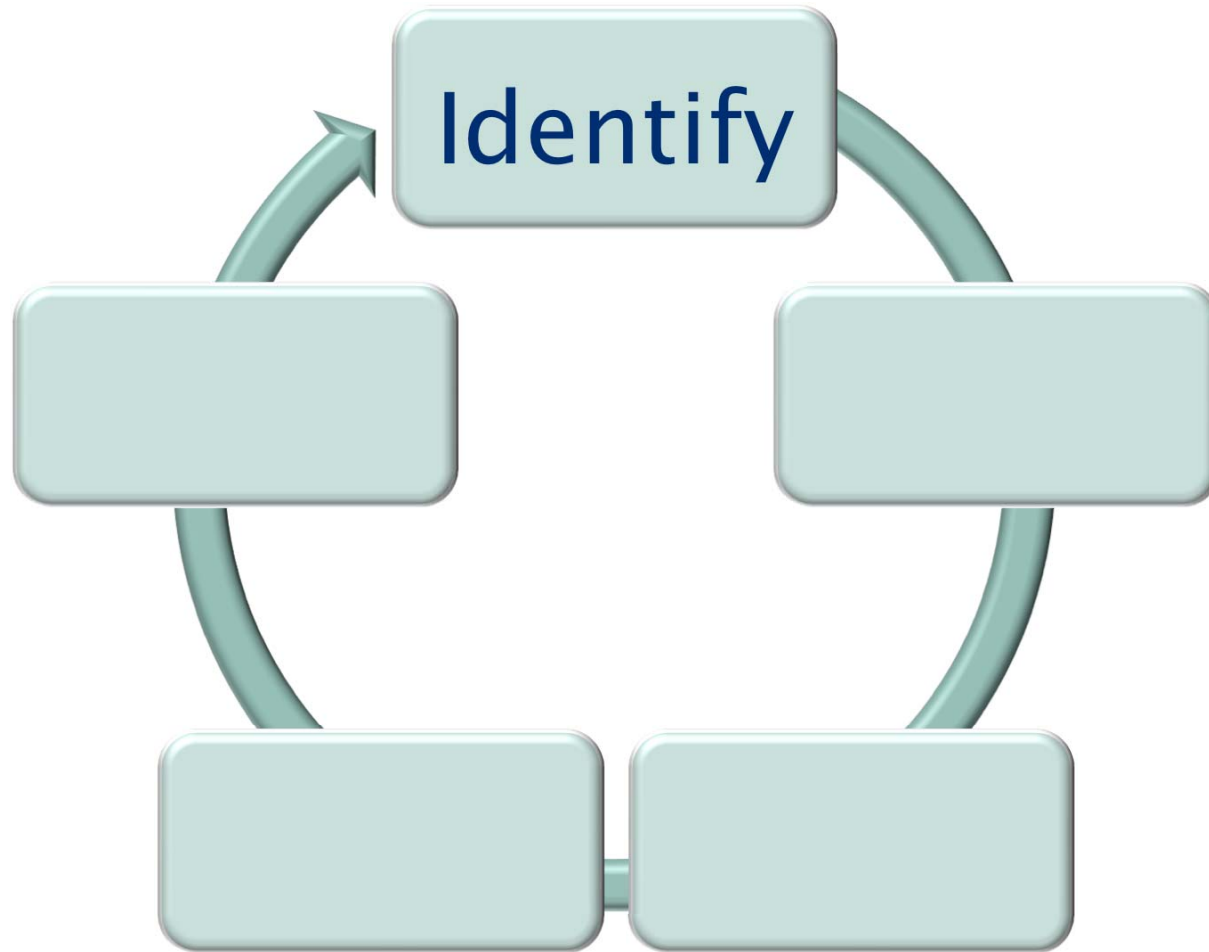
No matter what the size or complexity of the bank might be, starting to look at risk on an ERM—enterprise risk management view point will allow the bank to scale its systems within the organization taking into consideration a holistic approach to enterprise risk.

# RISK MANGEMENT

---



# IDENTIFY



# IDENTIFY



- Recognize existing risk and risk that may arise
- Risk that may come from external market conditions
- Regulatory risks
- Risk that are interdependent and correlate across portfolios

# IDENTIFY



A bank could begin conducting their Enterprise Risk Assessment using **CAMELS** or a simple Risk Matrix's

Your decision as to the methodology of your Risk Assessment should be based on your:

- Bank's risk profile
- Size of the Bank
- Complexity of the Bank

# IDENTIFY



**A straightforward question for banks to ask themselves might be: What are the five key correlation risk we face as an enterprise, have we stress tested them using the latest quantitative techniques, and are the results reasonable from a intuitive perspective...”**

**“It is critical that banks isolate the most potentially threatening financial risk factors dependencies, given its business model, and use sophisticated quantitative stress tests to explore and quantify the effects.”**

Article in Risk Monthly, 2008 SunGard Ambit Risk Management & Compliance

# IDENTIFY

## SIMPLE RISK MATRIX

*Using CAMELS*

	HIGH	MEDIUM	LOW
CAPITAL			
ASSETS			
MANAGEMENT			
EARNINGS			
LIQUIDITY			
SENSITIVITY			

# SELF ASSESSMENT OF RISK

Prioritize the risks and focus the bank on its greatest threats...

Risk	Risk Factors	Ranking	Reason
Capital	Amount of Capital	3	Capital difficult to obtain and stress by asset quality issues
Asset Quality	Loan Concentrations	3	High level of Classified Assets
Asset Quality	Increasing Classified	3	Real Estate Concentrations above Regulatory guideline
Management	Succession	2	Executive Officers at age of retirement
Earnings	Asset Quality	3	Elevated funding of ALLL impacting earnings
Earnings	Interest Margin	3	Deposits cost high due to bank condition
Liquidity	Wholesale Funding	1	Limited broker deposits
Liquidity	Deposit demand	1	Bank conditions increased deposit rates
Sensitivity	Deposit demand	3	Deposit pricing reducing margins
Legal/ Regulatory	Reg. Action	3	Consent Order
Reputation	Shareholder Value	3	Poor performance – stock price reduced

# EVEN MORE GRANULAR RISK MATRIX

	HIGH	MEDIUM	LOW
<b>ASSETS</b>			
Loans			
Commercial Loans			
Secured			
Unsecured			
Receivable Financing			
Real Estate Loans			
Construction:			
Residential			
Spec Building			
Owner Occupied			
Commercial			
Land:			
Commercial			
Owner Occupied			
Local Market			
Outside the market			
Income Producing			
Retail			
Office			
Residential			
Term Loans			
Rentals			
HECL			
Spec Lots			

# IDENTIFY

## Board and Management Responsibility to assess CAMELS and other Risk Factors

- Understanding where we are now?
- Should assess the banks current risk profile as to each of the components
- What risk?
  - What are the risk associated with each of the elements both internal and external
- What is the strategy to mitigate the risk?
  - What do we have in place now that mitigates the risk we have identified and what plans do we have as the risk
- Who is responsible for the risk?
  - Every employee
  - Management
  - Board
- How is the current risk profile and future changing risk reported to the Board?
  - Reports?
  - How often
  - Who makes the report
  - What should the report be?
    - Regulatory Exam
    - Internal Examinations
    - Peer Group Comparisons/local and national

# IDENTIFY – Other Risk Factors

## Legal/ Regulatory

- Compliance
- Litigation
- Insurance

## Reputation

- Local/ National Market Perception
- Investor Relations
- Human Resource
- Pricing

## Operational

- Human Resources
- Policies and Procedures
- Controls
- Audits
- IT
- Transactional Risk

## Economic

- Local/National Economy
- Market Risk

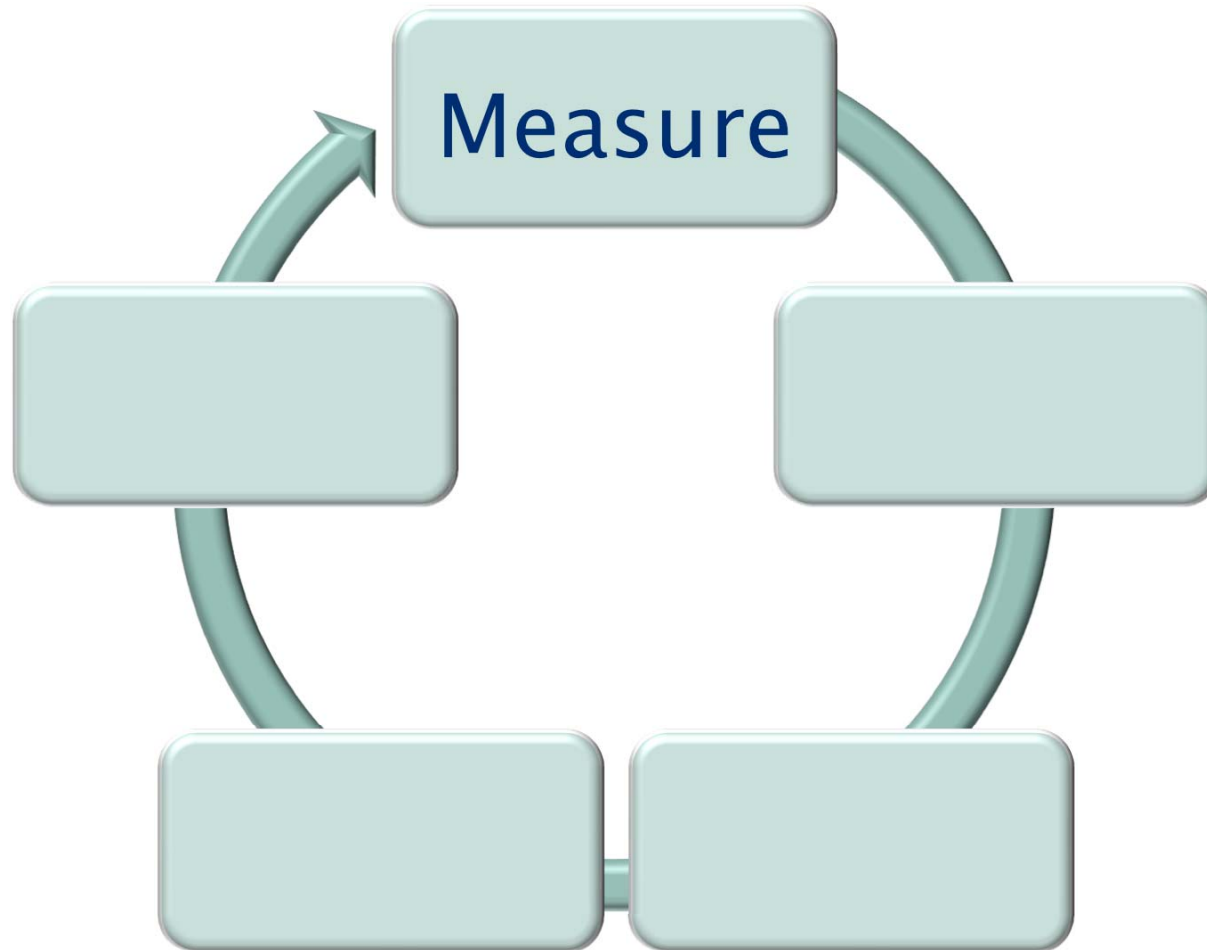
# IDENTIFY



There are many methods and methodologies to identify risk. You should choose factors that are meaningful and appropriate for your bank. You need an integrated ERM system regardless of the bank size.

The point is to identify your risks!

# MEASURE



# MEASURE



- Accurate and timely measurement of risk.
- Bank needs to have a method of measuring risk.
- Prioritize the risk factors
- Test the measurement.

# MEASURE



## Examples of Risks that need to be measured

- Liquidity Risk
- Credit Risk
- Market Risk
- Interest Rate Risk
- Compliance Risk
- Operational Risk
- Regulator Risk
- Economic Risk
- Capital Risk
- Balance Sheet Risk
- Investment
- Etc.

# MEASURE



Even a simple self assessment and measurement of your identified risk serves as a road map of the enterprises risk.

Modeling your risk under stress allows measure of the impact of the identified risk.

# MEASURE



Once you have identified a risk you will need to measure and test the risk against stress.

# MEASURE



Your bank's model for measuring risk can be simple or complex based on the risk profile.

For example:

Credit Modeling for a loan portfolio measured against historic loss levels might not be enough – forward thinking on “what might happen” is required.

# Stress testing:

*progress in improving  
assessment of risk*

There are numerous potential stress tests available. Each bank should design and develop its stress tests to its individual situation.



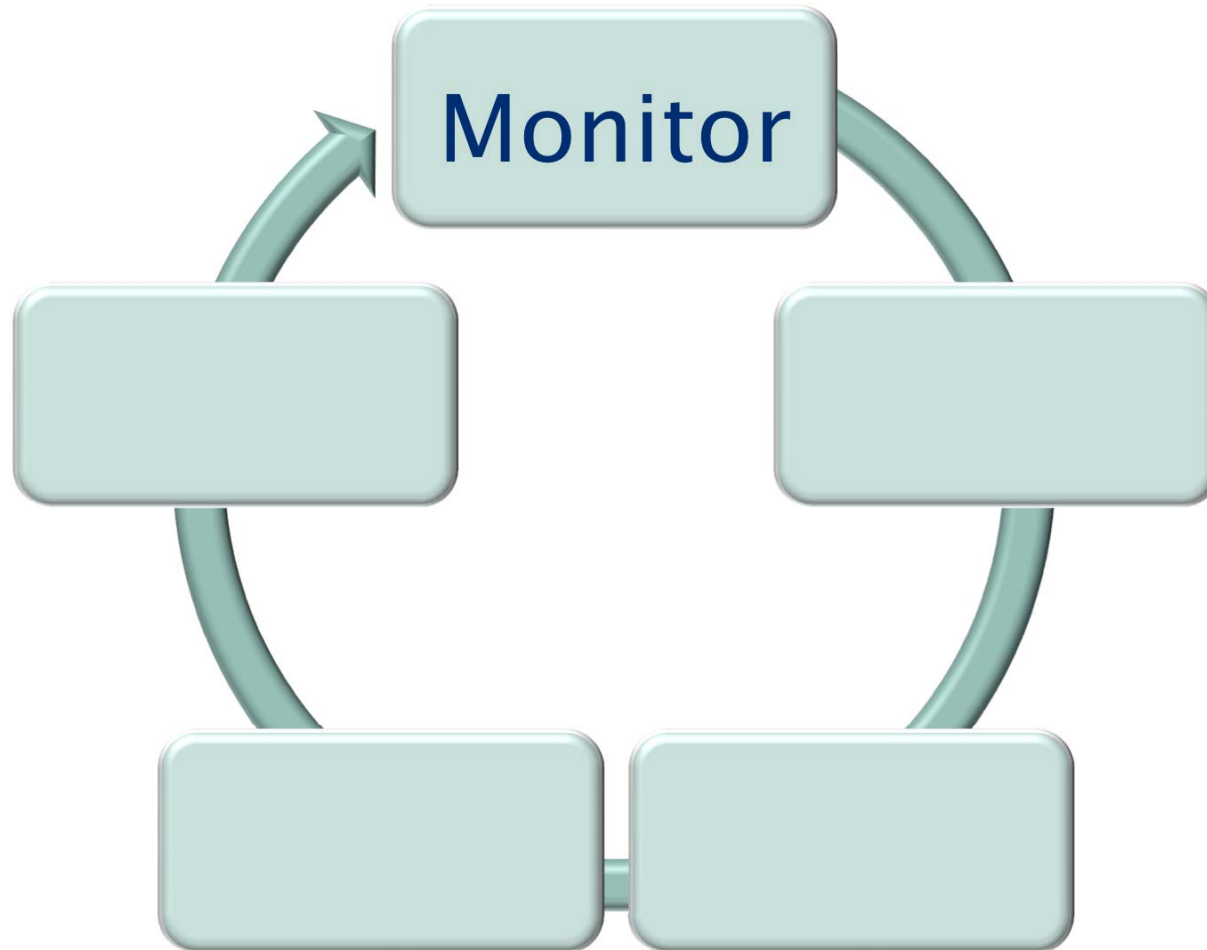
# MEASURE

## Stress Testing

Helps to quantify impact of changing economic conditions on :

- Asset Quality (Probability of Default, Downgrades)
- Earnings (Charge Offs, Reserves)
- Capital (Charge Offs, Reserves)
- Assists management to form contingency plans in the event downside scenarios occur
- Tool for use of predictive metrics as compared to lagging metrics
- Opens discussion regarding possible future trends by taking a forward looking view at portfolio risk
- Directional information that should be a part of a bank's overall credit/risk assessment process
- Enhances "Enterprise Risk Management" function
- Assist in identifying strategic opportunities

# MONITOR



# MONITOR



- Monitor risk levels
- Report should be timely, accurate and informative (Management/Board)
- Regular and consistent

# MONITOR



A systematic method of monitoring risk factors or key ratios will provide the information to management and the Board of where the bank is in relation to its established risk tolerances.

# MONITOR

## Methods to Monitor Risk

Once the Board has established Risk Policy and Procedures and tolerance guidelines the bank can be monitored by how they measure up to their own tolerance and guidance. In addition;

- Regular State and Federal Examinations
- Comparison with peer banks by review of the Uniform Bank Performance Report.
- and:

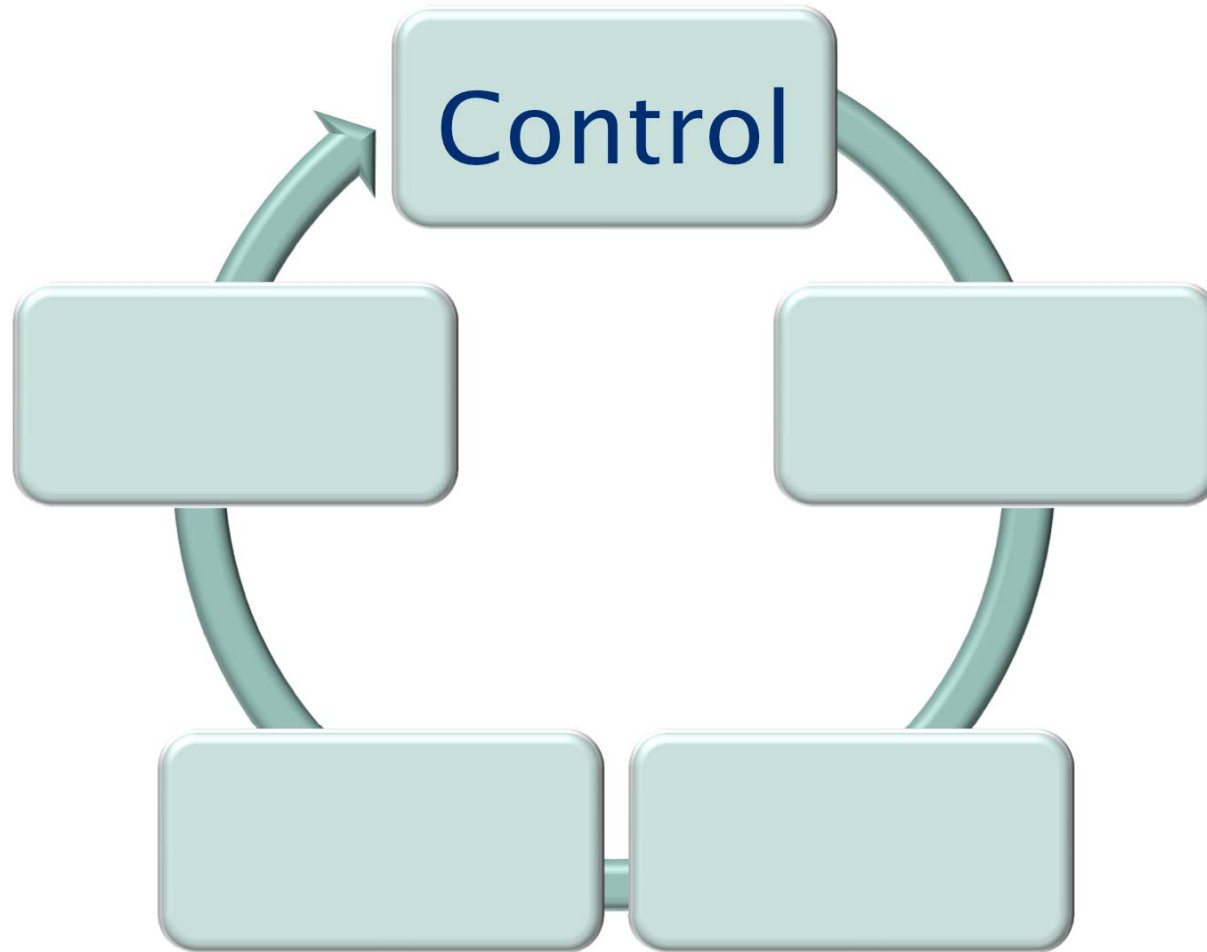
# MONITOR



## Methods to Monitor Risk–continued

- ROAA
- ROAE
- Tier 1 Core Capital Ratio
- Total Risk Based Capital Ratio
- Texas Ratio
- ALLL as a percentage of Loans
- Exception reports
- Etc.

# CONTROL



# CONTROL



- Establish and communicate risk limits
- Establish risk policy and procedures
- Define responsibilities and authorities
- Review exceptions
- Limits to control exposures to various risks

# CONTROL



The establishment of the risk tolerance for the bank is and should be reviewed on a regular basis, whether it's; monthly, quarterly, semi-annually or annually it needs to be reviewed for relevance with current bank and economic conditions.

# REPORT

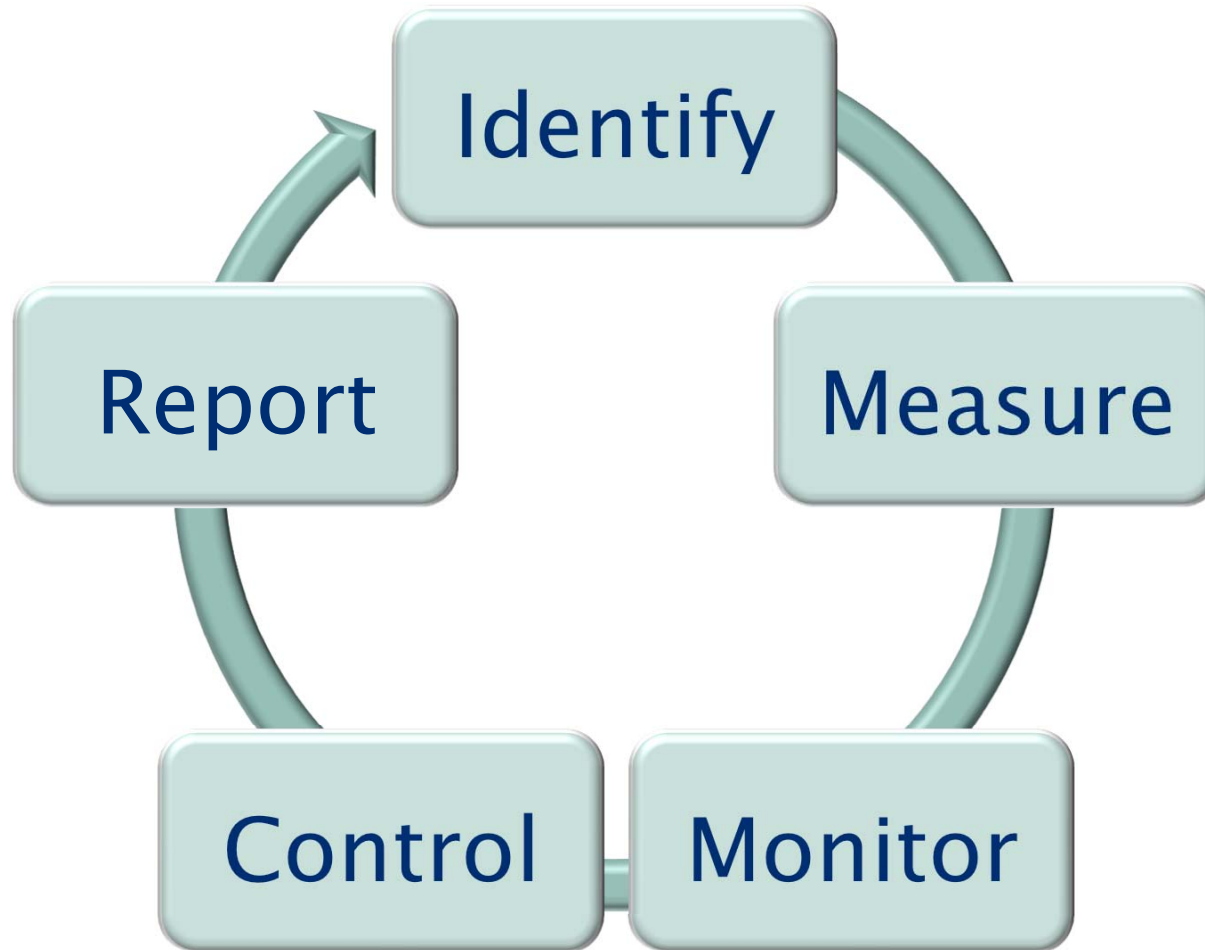


# REPORT



- Timely reporting to management/Board
- Detail sufficient to understand risk profile of the bank
- Board makes the decisions on risk limits and tolerances and management follows and reports

# RISK MANGEMENT



# GOVERNANCE



The Board needs to decide if a special Risk Committee and Risk Committee Charter is warranted for the bank.

Can the Audit Committee take on that added responsibility; and is the audit committee independent of management?

# GOVERNANCE

If a Risk Committee is established there are a few suggestions

- Membership should all be independent directors
- A formal Charter for their duties, responsibilities and authority should be approved.
- Regular meeting with an agenda, minutes would be necessary.
- Reporting to the full Board on a schedule appropriate for the bank.
- Management should be available to the committee to make reports and provide requested information as needed.

# GOVERNANCE



The Risk Committee charter can be as simple as one page, or multi-pages depending on the Board direction.

Bank of America's Risk Committee Charter is one page.

# Bank of America Corporation – Enterprise Risk Committee Charter

## BANK OF AMERICA CORPORATION ENTERPRISE RISK COMMITTEE CHARTER

As of July 28, 2010

### Purpose

The Enterprise Risk Committee (the “Committee”) of Bank of America Corporation (the “Company”) is responsible for exercising oversight of senior management’s identification of the material risks facing the Company and, except as allocated by the Board of Directors of the Company (the “Board”) to another committee of the Board, oversight of senior management’s management of, and planning for, the Company’s material risks, including market risk, interest rate risk, liquidity risk, operational risk and reputational risk. The Committee also shall oversee senior management’s responsibilities with respect to the Company’s capital management and liquidity planning.

### Membership

The Committee shall consist of no fewer than three non-management members of the Board. The members of the Committee and the chair of the Committee shall be appointed, and may be replaced, by the Board on the recommendation of the Corporate Governance Committee.

### Committee Authority and Responsibilities

In performing its oversight responsibilities as set forth above, the Committee shall oversee senior management’s establishment of policies and guidelines, to be adopted by the Board, articulating the Company’s risk tolerances as to material categories of risk, the performance and functioning of the Company’s overall risk management function, as established by the Company’s management, and senior management’s establishment of appropriate systems (including policies, procedures, management committees and stress testing) that support control of market risk, interest rate risk and liquidity risk. The Committee shall periodically review management’s strategies, policies and procedures for managing market risk, interest rate risk, liquidity risk and reputational risk, and receive and review reports from senior management (including the Chief Risk Officer and appropriate management committees) regarding compliance with applicable risk related policies, procedures and tolerances, and review the Company’s performance relative to these policies, procedures and tolerances.

In addition, the Committee shall oversee management’s activities with respect to operational risk (including review of reports from the Audit Committee on the effectiveness of the Company’s efforts at monitoring and correcting deficiencies), capital management and liquidity planning, including approval of management’s plans with respect to liquidity sources, dividends, the issuance, repurchase or redemption of equity or other securities and issuance and repayment of the Company’s debt. The Committee shall review and approve annually the effectiveness of Advanced Systems as defined by Basel II.

Upon the elimination of the Special Committee of the Company, the Committee shall assume the duties of the Special Committee and any actions reasonably incident thereto, as enumerated in the Special Committee’s charter.

The Committee’s chair shall report its findings to the Board at each regular meeting. The Committee shall review and reassess this Charter annually and recommend any proposed changes to the Board for approval and shall conduct an annual review of its own performance.

### Additional Authority

The Board delegates to the Committee, in order to further the performance of the Committee’s responsibilities, the power and authority to obtain, at its discretion, advice and assistance from internal or external financial, legal, accounting or other advisors, and to hire and compensate such external advisors at the Company’s expense.

The Committee may form, and delegate authority to, subcommittees when appropriate.

KM# 16800096

<http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MTg3NzJ8Q2hpbGRJRD0tMXxUeXBIPTM=&t=1>

For more examples  
of bank committee  
charters go to:  
[www.hkgllp.com](http://www.hkgllp.com)

H | K | G

# Midwest Bank – Board Enterprise Risk Management Committee Charter



Approved by Committee: January 26, 2010

## Board Enterprise Risk Management Committee Charter

### PURPOSE

*The Enterprise Risk Management (ERM) Committee is responsible for overseeing executive management’s responsibilities to identify potential events that may affect the bank, and manage risk within predetermined risk parameters to promote the bank’s objectives.*

### COMMITTEE MEMBERSHIP

*The Committee shall consist of at least three independent directors. The members and the chair of the Committee shall be appointed and replaced by the Board on the recommendation of the Corporate Governance Committee.*

### COMMITTEE AUTHORITY AND RESPONSIBILITIES

*I. The Committee is responsible for:*

1. coordinating the Board’s oversight of risks by working with other Committees to avoid duplication of efforts;
2. assessing risk management philosophy and risk appetite of the company;
3. oversight regarding management’s assessment of key systemic (global) risks facing the bank
4. oversight regarding management’s structure and processes established to identify, measure, monitor, and manage risks

*II. The Committee shall:*

- a. Review with management guidelines and responsibilities for assessing and managing such risks
- b. Review benchmarks for major financial risk exposures
- c. Review management’s performance against these policies and benchmarks

For more examples of bank committee charters go to:  
[www.hkgllp.com](http://www.hkgllp.com)

H | K | G

# Midwest Bank – Board Enterprise Risk Management Committee Charter



*III. The Committee's responsibility is one of oversight. The responsibility for regulatory compliance and for the management of risks rests with management of the Corporation. In fulfilling their responsibilities, it is recognized that members of the ERM Committee are not full time employees of the Corporation and are not, and do not represent themselves to be, risk management or compliance professionals.*

- a. The Committee shall have the ability to contract for any outside expertise necessary to carry out its responsibilities.
- b. The Committee shall develop a work plan and shall annually review and update its Charter and Work Plan and its performance.

### **MEETINGS**

The Committee shall meet monthly or as is deemed necessary and report to the Board on its assessment of major risks to the Bank. The Committee shall meet with management and members it's standing Risk Management Committee, periodically in executive session, with or without management present.

For more examples of bank committee charters go to:  
[www.hkgllp.com](http://www.hkgllp.com)

# GOVERNANCE



## RISK COMMITTEE/ CHIEF RISK OFFICER (CRO)/AUDIT COMMITTEE

- Based on the banks size, risk profile and complexity
- Separate Risk committee Charter
- Risk Assessment part of the Audit Committee Charter
- Chief Risk Officer for the enterprise
- Combination
- Do nothing
- Make it simple
- Ignore

# GOVERNANCE



The board should constantly be thinking of risk and its every changing character. Today's risk and today's bank balance sheet is ever changing because of internal and external factors. Be watchful of those changes.

# GOVERNANCE

## “Ten Principles of Effect Risk Oversight”

1. Understand the company’s key drivers of success
2. Assess the risk in the company strategy
3. Define the role of the full board and its standing committees with regard to risk oversight
4. Consider whether the company’s risk management system—including people and processes—is appropriate and has sufficient resources
5. Work with management to understand and agree on the types (and format) of risk information the board requires
6. Encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions
7. Closely monitor the potential risk in the company’s culture and its incentive structure
8. Monitor critical alignments—strategy, risk, controls, compliance, incentives, and people
9. Consider emerging and interrelated risks
10. Periodically assess the board’s risk oversight process: Do they enable the board to achieve its risk oversight objectives

“Report of the NCAD Blue Ribbon Commission; Risk Governance: Balancing Risk and Reward,” National Association of Corporate Directors (NCAD), Oct 2009

# GOVERNANCE



## Levels of progress on risk framework:

- Planning
- Defining limits for types of risk
- Establishing holistic risk framework
- Determining risk tolerances for business segments and consolidated entity
- Communicating, implementing and enforcing risk levels established by the BOD

# REGULATORY



- Board oversight and management implementation
- Effective credit risk management and monitoring
- Well-defined “CRE Lending Policy”
- Diversification/concentration management and controls with established risk tolerances
- Stress testing and risk monitoring
- Underwriting and documentation standards

# REGULATORY



“The presence of risk is not necessarily reason for supervisory concern. Examiners determine whether the risks a bank assumes are warranted by assessing whether the risks are effectively managed, consistent with the safe and sound banking practices.”

“Generally, a risk is effectively managed when it is identified, understood, measured, monitored, and controlled as part of a deliberate risk/reward strategy. It should be within the bank’s capacity to readily withstand the financial distress that such risk, in isolation or in combination with other risks, could cause.”

Large Bank Supervision, Comptroller’s Handbook, January 2010

# REGULATORY



- **The range of acceptable business models has narrowed considerably, making approval or acceptance difficult if the business plan triggers regulator concerns such as:**
  - Excessive growth
  - Reliance on brokered or other rate-sensitive deposits
  - Problematic asset concentrations (especially CRE)
  - Certain consumer products
  - Inadequate capital buffers
  - Out-of-area expansion
- **Regulators are looking closely at:**
  - Management qualifications and expertise
  - Number and qualifications of business, risk, controls, and compliance personnel
  - Adequacy of infrastructure and systems, including IT and MIS
- **Make sure business plan is consistent with current supervisory policy and relies upon rock-solid business assumptions**

# Regulatory Update:

Top 10 examination issues:

1	Enterprise risk management process (includes IT and MIS)
2	Commercial Real Estate Loans – Best Practices
3	Stress testing
4	Troubled debt restructurings
5	Strategic and Business plans
6	Liquidity
7	Affiliate Transactions
8	Modeling
9	Commitment to internal audit, compliance and loan review
10	Incentive compensation

# RISK MANAGEMENT

## Identify

- Recognize existing risk and risk that may arise
- Risk that may come from external market conditions
- Regulatory risks
- Risk that are interdependent and correlate across portfolios

## Measure

- Accurate and timely measurement of risk
- Bank need to have method of measuring risk
- Test the measurement

## Monitor

- Monitor risk levels
- Report such be timely, accurate and informative (Management/Board)
- Regular and consistent

## Control

- Establish and communicate risk limits
- Establish risk policy and procedures
- Define responsibilities and authorities
- Review exceptions
- Limits to control exposures to various risks

## Report

- Timely reporting to management/Board
- Detail sufficient to understand risk profile of the bank
- Board makes the decisions on risk limits and tolerances

# RISK MANGEMENT

---

