

## Big Bank Ideas for Small Bank Risk Mitigation

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Long before stress testing and risk management procedures settle into best practices, they percolate in and in-between the largest banks. Large bank executives, under pressure from regulators, test out new, more involved techniques. Cross-pollinating examiners at those banks see those techniques in action and take the better ones to other banks and back to their regulator's policy experts. Eventually, those better ideas settle down into the smaller banking tiers.

What can community banks learn about risk mitigation from what's going on in the big bank risk mitigation laboratory right now? BSSA spoke with two risk consultants whose clients number among the bigger banks nationally and abroad to find out what new ideas currently being refined in the big-banking space might benefit small banks, too.

### Beyond the Quantifiable

Some kinds of risk – like credit risk – are quantifiable. Other kinds resist quantification. Naturally, banks may be inclined to spend all their time stressing and restressing for the former, but they need to get their head around the latter, too, whether they have easy numbers to put to it or not, suggests Carole Carpentier, the president of See, See Beyond . . . Creativity Consulting, Toronto and the former head of group operational risk for the Royal Bank of Canada.

“I would expect that most all banks, community banks included, would have a sense for risks that can be quantified, for how those risks can impact performance,” Carpentier says. “But it's important to look not just at the quantifiable side [of risk]. It's important to look beyond just economic shocks. There are large business or operational events that can have a big effect on a firm.”

A good example would be one still fresh in everyone's minds: Hurricane Irene. Firms located in the path of the hurricane had to make difficult decisions about the costs of evacuating people, of subways and streets being shut down.

“Organizations face many consequences, like this, that you can't necessarily put a dollar value on,” she says. “Banks have to start thinking more broadly about the impact [of a wider range of risks] on capital.”

This sort of broader risk discussion belongs in community banks, too, she argues. “Is this process easier for community banks?” she asks. “Not necessarily. It's a less complex problem to tackle, though. It's like managing a house as opposed to a hotel. It may be less complex but the principles are the same.”

So what should banks be doing? They should spend some time thinking through and planning for scenarios that may resist quantification, but could imperil a bank, nevertheless, she says.

“Community banks should be thinking not only about the impact of interest rates or a drop in market share, but also about things like: What if every member of the management team is on the same plane?” she says. “What if the plane doesn’t land? The loss of talent and leadership – it would be hard to put a number on that. The blow to the organization would be severe.”

After all, she adds, quantifiable risk is not the only type of risk that can kill a bank. “Lots of banks have fallen by the wayside, not because they had big financial losses, or anything like that, but because an event that impacted their reputation resulted in the immediate loss of confidence in them and now they’re gone.”

For example, the accounting firm Arthur Anderson counted Enron as only a small part of their business but that didn’t matter, she adds. “If there was wrongdoing on [Arthur Anderson’s] part, it was regarding a single client and was a small part of their business, but it blew them out of the water and quickly.”

It can be hard to pinpoint how likely a non-quantifiable risk event can be, but banks still need to think about likelihood and how it might respond to such an event. “Sometimes, there’s nothing you can do but be prepared to act when the time comes,” she says. “You may not be able to prevent it but there may be things you can do to cope.”

According to Carpentier, banks need to talk out these scenarios and the classic questions to ask are:

- Could this happen?
- What should we do?
- Do we accept this risk or try to mitigate it?
- Do we transfer the risk, by getting insurance, for example?
- Do we try to stop the risk?
- Do we enlist someone’s help to mitigate it?

## Perpetual Risk Assessment

How often should you be involved in assessing risk throughout your bank? Yearly? Quarterly? How about continuously.

“One of the things we’ve learned is that risk has to be baked into decision-making on a continuous basis,” says Bill Popp, the founder and CEO of POPP risk GROUP. “Risk management shouldn’t be so all-consuming that you can’t make decisions, but there are a number of things that do need to be examined on a regular basis.”

Popp recommends to his big bank clients that they should think of risk management as a year-round activity. Specifically, he suggests that banks institute a battery of risk assessment processes to take place at different regular intervals and staggered throughout the year. It’s a layered approach involving anywhere from three to eight risk tests and procedures that, once engaged in earnest, add up to a thorough and continuous risk assessment program that allows bank executives to make better risk-informed decisions.

Though he works with huge, international financial institutions on risk programs like this, Popp used to work with small banks, too. The perpetual risk assessment method applies to financial institutions of any size, he adds. The method can be scaled to individual bank risk profiles and levels of complexity, he argues. It can also start small and grow into a full-fledged, year-round endeavor.

“It runs continuously,” he says. “It sounds like a lot of work, but we don’t want to suggest that its overwhelming. We strongly recommend that banks start to implement pieces of the method into the management process and then incrementally add more so that, in a couple of years, the bank has added a lot of different pieces and it isn’t especially onerous.”

Here are a few of the tests Popp thinks all banks should fold into a layered, continuous risk assessment plan:

**Stress tests.** Due to regulatory guidance and pressure in the last few years, many banks are already conducting their own stress tests. Popp suggests running a thorough battery of stress tests once per year. “They’re an important part of risk management,” he says. “If you’re considering a potential catastrophic event, the test lets you run a system-wide or region-wide set of assumptions to see what the event might mean in terms of capital position.”

**Prioritized risks and actions.** In this process, the head of a business line and their management team meet to discuss their biggest risks, which are then ranked in order based on how big an impact a given risk can have to the bank. They

discuss the risks and establish specific mitigation activities. “This is a very hands-on activity,” Popp says. “It establishes a forum for business executives to talk about risk, specifically the risks that impact them directly” and “drives them into actions that can be tracked.” Frequency: anywhere from yearly to quarterly.

**Emerging risks.** A more forward-looking activity than stress testing, emerging risk exercises involve discussions about relevant, potential and extremely large problems that are still fairly far out on the horizon. The idea is to talk about issues that may have even more impact than those banks currently face, Popp says. Bankers should try to formulate what actions or contingency plans they may want to put into place, should an emerging risk materialize. “You do this so, once the bank sees early indications that a discussed emerging risk may actually occur, the bank has a contingency plan ready to go,” he says. Frequency: ongoing.

**Loss scenario analysis.** Designed to support the operational risk and capital risk calculation model, a loss scenario analysis produces what should be a more complete data set that, when put through your stress testing model, produces a more robust number. Frequency: yearly.

Ideally, banks will have three to eight processes in place and running throughout the year, Popp says. The aggregate process will help you to identify risks you may not know about, determine whether or not said risk fits within a bank’s risk appetite or not, and if not, allow the bank to decide what to do about them, he adds.

The layered approach can work for small banks, too, but banks would need to have an executive in place to manage the process and facilitate the flow of risk data throughout the firm, Popp says, which means that it’s probably not a viable plan for financial institutions who don’t have a CRO (Chief Risk Officer).

“Without a CRO, this would be very difficult to do,” he says. “I believe there are key subsets of these processes that the executive team should be doing. Will the bank need a CRO to drive them? Probably. There are key executives – the CEO or EVP of credit – who could do this, but they all already have full-time jobs.”

(For more on CROs and community banks, see [“Should You Hire a CRO?”](#) BSSA, August 22, 2011.)