Bank Safety & Soundness Advisor

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ERM, Jr.

How to Design a Scaled-Down ERM Program and How to Know If It's Right for You

Enterprise Risk Management (ERM), particularly as it's practiced in the largest banks, can be extremely complicated, involved and expensive. As the industry – and industry regulators – discuss the need for ERM, smaller banks are asking if a simplified, scaled-down ERM program can meet their needs, both regulatory and strategic, or if they need to swallow a Bank-of-America-sized program whole.

Is ERM scalable? Can less involved ERM programs work well for smaller banks? Yes, experts say, but design matters. Some elements of a functional ERM program can be left out. Others can't. And just as important, banks need to know if a scaled-down program still allows them to manage their risk effectively.

A smaller, less sophisticated, more affordable program may be a smart idea for a smaller bank as long as it's done right, says Dan Borge, a director and risk consultant with LECG in New York, N.Y.

"It's important to prioritize," he says. "Smaller banks have people coming in, saying, 'We'll sell you ERM packages with bells and whistles.' But that may be too complicated and it might not fit their business. Yes, there's a burden on management and the board to make sure that someone's watching [risk]. They just need to know that they have the bases covered."

For many small banks, their enterprise-wide risk isn't particularly knotty or large. "A smaller bank just doesn't need a highly complex system," he adds. "Those banks need to prioritize the risk they're actually taking and that's mostly credit risk in some form or another. Having a good credit risk discipline is 80% of the battle."

Asset Size and ERM

If you're considering a smaller-scale ERM program, keep your eyes on the right metrics, cautions Marcus Faust, an SVP and ERM consultant with RP Financial, Arlington, Va. Banks with smaller asset sizes and tiny staffs may be inclined to think that they should use a small-scale ERM program, too, but asset size isn't a particularly relevant metric when it comes to calibrating an ERM program, Faust argues. Banks that want to make sure they're using an ERM program that makes sense for their bank should look to complexity rather than asset size.

"You can have a $1.5 billion plain vanilla slow growing bank with a balance sheet that's not particularly diverse, a bank that doesn't get involved in construction lending or with money service businesses," says Faust. "That's a bank I'd describe as relatively simple. For the purposes of ERM it could be considered small. On the other hand, you have a $500 million dollar bank that's growing rapidly, opening branches rapidly and doing things like ACH origination, construction lending and deals with money service business; that's a much more complex operation and, from an ERM perspective, it should have a more sophisticated program."

How can banks gauge complexity? It all comes down to two factors, says Orlando Hanselman, the education programs director for Fiserv Risk & Compliance in Johnstown, Pa.

Balance sheet complexity. Rather than getting hung up on metrics, like asset size or staff size, Hanselman counsels banks to assess the balance sheet. Look at the term structure of the investments and deposits,

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he says. Are durations short, intermediate or long? Is there a significant mismatch between assets and liabilities? Does the portfolio lean towards fixed rate or variable rate loans? How much optionality has your bank embedded in the balance sheet?

Questions like this can help a bank determine the general level of complexity in the balance sheet, he says. The more complexity there is, the more consideration a bank should give to a thorough, more involved ERM program.

Capital philosophy. If your bank follows a relatively conservative business model and holds a lot of additional capital, a smaller ERM program can be fine, Hanselman says. Banks with daring business plans – i.e., banks that want to deploy as much capital as they can and hug regulatory capital minimums – just can't rely on a simple ERM program, he adds.

"If you want a [simple] ERM program, you have to approach capital with an abundance of caution," Hanselman says. "You have to have a clearly excessive capital position."

The reason, Hanselman says, is that a simple, beginners' ERM program won't help a bank quantify risk and without that information, the bank can't anticipate and plan for changes in environmental effects. Banks with less sophisticated ERM programs can save money on staff, analytical costs and tech costs, but they'll be hard pressed to track their capital-at-risk. Those banks can't afford to run on lower capital levels and that, whether banks realize it or not, is the hidden cost in going simple with ERM, he adds.

With simple ERM programs, banks will need to "over-insure" by maintaining capital levels well in excess of regulatory minimums, he says. Banks that plan to keep capital high can get away with using a more basic ERM program.

"Bankers do have the choice about how much effort they want to put into ERM to a degree," he says. "It's continuum of choice."

Base-Level ERM

If you are a smaller plain vanilla bank and want a smaller scale, less-involved ERM program, you can design one that can be useful. It doesn't need to be expensive and it doesn't need to involve complicated analytics, either, says Faust.

"In its smallest form, ERM doesn't take much in the way of effort or resources," Faust says.

Here, according to Faust, is what a bare-bones, small-institution ERM program should look like at the outset:

1. A formal reporting structure. Collect a small group of C-level executives – typically the chief lending officer, the chief credit officer, the compliance officer, the internal audit head and the heads of the various lines of business – and

establish an ERM management committee. This group should hold regular meetings to talk about risk as it impacts the entire organization, Faust adds.

2. A risk committee charter. Establish the objectives for risk mitigation, says Faust. Look at it from a portfolio perspective. The idea is to look for risk factors that impact the entire organization, grade the risk as low moderate or high and determine the direction of the risk (stable, increasing, or decreasing).

3. A risk policy. This can be simple and short – only around four pages, Faust says. The document should include simple objectives for the committee and should set a meeting schedule. Make sure to keep minutes for the meetings, he adds.

For a lot of banks, getting started on these three elements can be "a giant step forward," Faust says. When bank executives get together regularly and talk about risk, they're no longer thinking about risk in silos, he adds. They are now looking at the entire portfolio of risk.

Should you appoint a chief risk officer, too? Even with a basic program, it makes sense to do so, Faust says. Typically, banks in this scenario will tap the chief credit officer (CCO) to take on the role. "If that CCO is separate from the chief lending officer, which would have to be the case for this to make sense, then the CCO is the most objective executive in the group," Faust says. "The CCO is, almost by definition, independent."

But don't forget the need to have some independent look at the effectiveness of your ERM program, Faust adds. That's what the regulators will be looking for regardless of the bank's asset size.

What's Next?

For banks interested in a slightly more sophisticated ERM program, the next step is an independent assessment, Faust says. Consultants providing third-party ERM assessments devote all their time to evaluating bank risk profiles and they've been through a lot of different banks. That expertise can be invaluable to risk committees, particularly inexperienced ones. "The purpose is to guide [a nascent ERM program], to point out the risks that the bank should hone in on," he says.

Has the bank's risk committee missed anything considerable? Is the bank's informal ERM process functioning? These are the questions an independent assessment can answer, he says.

These reviews can give an ERM committee an objective look at the bank's enterprise risk profile and how well the risk is managed, says Faust. The more reviews a bank has, the more the committee learns about the way it functions, the evolving risk profile of the bank, and the mistakes the bank may have made in looking at its risks. "It's a learning process," Faust says.

How often should a bank hold an independent risk assessment? There's no prescription, but in general, the frequency of assessments should depend on the profile of the bank, Faust says. A faster growing company should have independent reviews more often, since its risk profile could be changing quickly. A bank like this may want a yearly assessment. Banks on a less dynamic path will probably be fine with an independent assessment once every two years. ■

De Novos and ERM

De novo banks tend to have fewer assets, smaller staffs and – at least these days – more regulatory scrutiny. Those banks may be wary about investing time and money in an ERM program, but, whether they realize it or not, an ERM program may be much easier for them to implement than it would be for an older bank, says David Sidon, an ERM consultant with The Navis Group in Gloucester, Mass.

When investors apply for a de novo charter, they've already had to think through and plan for risk in an ERM-like way, Sidon says. "In doing so, they've already put together a lot of the puzzle. They're much closer [to ERM] than their established peers. They're closer to a pure ERM system than anyone." ■