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What is Your Risk Appetite?

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In January, the OCC issued proposed guidelines for the establishment and maintenance of a comprehensive risk management framework that directors of banks of all shape and sizes should review. This article will provide a high level overview of the guidelines, but more importantly, identify key takeaways for community bank directors in considering risk management at their institution. Although the guidelines directly apply to national banks with over $50 billion in assets, they provide insight into the regulators' view of appropriate ways to manage risk. While economists and pundits still debate the merits of "trickle down" economics, everyone working in the financial industry has felt the effects of trickle down regulation. It is for this reason that we believe all bank directors should take note of the guidelines, the fundamental concepts of which are scalable to any size bank.

Devising a Framework and Articulating Risk Appetite

The guidelines require that a bank establish and adhere to a formal, written risk governance framework that is approved by the board of directors. The scope of the framework must include: credit risk, interest rate risk, liquidity risk, price risk, operational risk, compliance risk, strategic risk and reputation risk. However, before designing a framework to manage this laundry list of risks, it is logical that a financial institution first articulate its acceptable level of riskiness. The guidelines require exactly such a statement of a bank's appetite for risk in both qualitative and quantitative terms, including specific maximum thresholds tied to stress testing and addressing a bank's earnings, capital and liquidity positions. To round out the stated risk appetite and risk management framework, the guidelines require a bank's CEO to develop and the board to approve a three-year strategic plan that assesses the risks currently impacting the bank, articulates an overall mission statement and strategic objectives for the bank, and includes an explanation of how the bank will update its risk management framework as the bank's risk profile evolves as the strategic plan is put in place.

Having a formalized risk management system is not necessarily new, but the guidelines are a very clear statement that each bank should be able to: (a) tell its regulator the bank's appetite for risk, qualitatively and quantitatively, (b) show how the bank is managing its risk consistent with its stated appetite, and (c) integrate its risk appetite and risk management framework with its strategic plan. Moreover, it is the board of each bank that bears the ultimate responsibility for ensuring these three pieces are working hand-in-glove.

A Layered Independent Defense

A guideline compliant risk management framework includes a layered defense system that would make any medieval castle dweller proud. Three distinct and independent levels of defense are identified, including: (1) front line units, (2) independent risk management, and (3) internal audit. Definitions and unique responsibilities of each required layer are set forth in detail, with, not surprisingly, front line units identified as the first layer of defense.

Independent risk management and internal audit provide additional defenses before a risk is allowed to reach the keep and truly threaten the bank's capital, earnings and/or liquidity. Significant time is spent in the guidelines discussing maintaining independence between all three layers, and allowing each layer direct access to the board of directors.

For community bank directors, we believe the takeaway is that a bank cannot have only one cop on the beat who rarely, if ever, attends board meetings. Rather, the regulators expect that once the board adopts the risk management framework, multiple independent players within the bank are monitoring risks and activities to keep the bank within its articulated risk tolerance. Moreover, to be most effective these multiple cops on the beat should have access directly to the board of directors.

Guideline Standards for the Board of Directors

The guidelines conclude with a set of specific standards that a bank's board must meet. Those standards include:

- Ensure an effective risk governance framework
- Provide active oversight of management
- Exercise independent judgment
- Include independent directors
- Provide ongoing training to independent directors
- Conduct self-assessments

We believe each is relevant to banks of any size, and that community bank boards should reflect on whether they meet these standards.

Conclusion

Although community bank boards might be tempted to ignore the recent OCC governance guidelines, we believe to do so is a mistake. Admittedly, many elements of the guidelines are unlikely to be required of community banks in the near future. For example, we doubt that federal regulators will require a $500 million asset bank to add the guidelines' two required "C-level" officers (a chief audit executive and a chief risk executive). However, the fundamental governance precepts that underpin the guidelines are relevant to all banks, and we believe are likely to be included in best practices recommendations from bank regulators. These underpinnings include: an ability to articulate a bank's risk appetite in both qualitative (culture, etc.) and quantitative (CRE concentration thresholds, etc.) terms, a risk governance framework that manages a bank's activities to its stated risk appetite, integration of risk appetite and management into strategic planning, a multilayered approach to managing risk, and active board involvement in developing and implementing management of risk. So, what is your risk appetite?

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