

How to Use This Manual

Risk management is not a new concept to bankers. After all, managing risk is a cornerstone of sound banking practices that has been a part of banking since the industry began.

What is new, however, is how your regulator applies the principles of sound risk management to day-to-day operations. Rather than continuing to look at risk management simply in relation to separate bank activities, such as lending, investments, and so on, the approach now is to measure risk on a bankwide basis.

For example, regulators see that risks in your lending area can affect other activities of your bank and, if they do, your bank's entire exposure to risk will be affected. Gone are the days when there were walls between bank activities. Now the focus is on measuring the consequences of risks on an enterprise-wide basis.

Bankers need to master the skills and tools necessary to meet regulatory expectations. *Risk Management for Banks: A Guide to Regulatory Compliance* provides these tools. The manual includes background information, forms, and checklists you'll need to bring your bankwide risk assessment, monitoring, and management efforts in line with the expectations of your examiner.

Implications of Enterprise Risk Management

The shift toward enterprise risk management has some obvious implications:

- *Systemic vs. transaction-based risk management.* Bankers need to change their risk focus from a transaction-based view of risk management to a systemic (bankwide) view. From this point of view, training, internal controls, management reports, and similar systemic tools are equally as important as your ability to handle risk on a transaction-by-transaction basis.
- *Portfolio vs. transaction-based risk management.* Risk management as a continuous, bankwide activity also requires that banks change from a transaction-based view of risk management to a portfolio view. Consider this example. Traditionally, bankers have paid significant attention to the credit risk in the bank's various loan portfolios but much less attention to interest rate and liquidity risk there. In contrast, the interest rate risk and liquidity

risk have been the primary concerns in the investment portfolios, with little attention paid to credit risk. Those priorities are logical from a transaction-oriented point of view. However, from a bankwide perspective, those priorities are incomplete at best. A bankwide perspective on risk management requires the examination of all risks from all aspects of the bank's operations.

- *The range of bank activities.* When banks begin to analyze risks from the entire range of bank activities, they find that some risk exposures offset each other. As a bank does a better job of viewing risks on a bankwide basis, it will find that some risks, especially rate risk and liquidity risk, have natural offsets that can be enhanced.

As you look at risk from a bankwide perspective, you also see that some risks can be reduced through diversification. Here the classic example is the loan portfolio that includes just one loan — a loan to an umbrella store. In this case, the bank will increase its credit risk in its portfolio if it adds a second loan to another umbrella store even if that second borrower is financially stronger than the first one. On the other hand, if the bank adds a second loan to a golf course, it reduces the credit risk in the portfolio even if the golf course is not as financially strong as the umbrella store. That result arises from the fact that the bank can expect the golf course to prosper in dry weather when the umbrella store has poor sales and vice versa. To the extent that the bank can learn more about the correlations between the risks on its balance sheet, it can manage those risks better.

Organization of the Manual

Bank regulators are primarily responsible for encouraging bankwide risk management. The Federal Reserve System (Fed) and the Office of the Comptroller of the Currency (OCC) have adopted risk-based examinations, the Fed using six separate risk management factors and the OCC nine.

This manual generally uses the OCC's nine defined risks for its structure. In Chapter 1, however, we review each of the Fed's six risks and each of the OCC's nine risks in detail. Chapter 2 includes a complete sample program of checklists for each of the individual risk management areas. It can be used to assess your current risk management efforts in each of the areas. Then in Chapters 3 through 11 and 13, each risk category is discussed in detail. We turn to some broader perspectives on risk management in Chapter 12.

Instead of quick fixes and easy answers, the risk management discussions in this manual focus on the tools necessary to build useful, long-term risk management techniques. This manual is not a

simple recipe book. Rather, we offer a solid mix of background information, descriptions of risk management tools, introductions to quantitative risk management concepts, sample checklists and procedures, and examples and suggestions of risk management techniques.

Risk Management for Banks: A Guide to Regulatory Compliance will help readers unfamiliar with bankwide, quantitative risk management tools to learn the essential elements. It will also help readers who already understand many of the concepts of enterprise risk management by providing them with new insights and broader perspectives, along with practical suggestions.