Enterprise Risk Management 2016

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What Is Risk?

Risk: Exposure of someone or something valued to danger, harm or loss. – Impairment, charge-off or missed opportunity.
“What is your business viability?”

*Toney Bland,* Senior Deputy Comptroller for Midsize and Community Bank Supervision at the Office of the Comptroller of the Currency
Dear Fellow Owners,

2008 was a tough year, and we expect 2009 to be even tougher.

The liquidity challenge I reported in last year’s letter has become a global financial meltdown. In 2008, we worked hard to keep the Company safe and to anticipate how the financial crisis would impact our businesses. In the past, I believed that our diversified portfolio would protect us in all kinds of economic cycles. But we never anticipated a global financial system failure and its continuing economic fallout.
As 2008 began, it became clear to everyone that what constituted a winning performance would be redefined and expectations would need to be reset. The year quickly became about **liquidity as opposed to earnings** as the most strategic and proactive companies were **assessing their relationships** with banks, suppliers, service providers, and even their own employees. We... recognized the consumer slowdown early on and put into place a **series of contingency plans that could be implemented quickly** if business did not turn around. The backbone of these plans centered on a **reduction in both inventory and expenses** while **working with our bank group** to exercise the **$90 million of the $100 million accordion feature** in our **line of credit**. **All three of these tactics were implemented to support our strategy of maximizing liquidity during this economic crisis.**

— Edward W. Stack, Chairman & CEO, Dick’s Sporting Goods, Annual Report, Letter to Shareholders
Even success can bring with it risk. The risk of not being able to fulfill unexpectedly high demand – or the ability to maintain business momentum that has become an exception.
“What is the right model for a community bank? Not that there is one model, but what thoughts or considerations are you giving to that?”

*Toney Bland*, Senior Deputy Comptroller for Midsize and Community Bank Supervision at the Office of the Comptroller of the Currency
Certainly any business decision is about capturing some reward. To capture it, you take certain risks. But the better question is how does the enterprise *USE RISK* to achieve its strategic, financial and value creation objectives.
The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private-sector organization comprised of the following organizations dedicated to guiding executive management and governance participants towards the establishment of more effective, efficient, and ethical business operations on a global basis.

- American Accounting Association
- American Institute of Certified Public Accountants
- Financial Executives International
- Institute of Management Accountants
- The Institute of Internal Auditors
Enterprise Risk Management

Enterprise Risk Management is a process for the measurement of risk associated with achievement of strategic objectives.

The Committee of Sponsoring Organizations – The Treadway Commission
“Enterprise risk management enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value. Value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity’s objectives.”
# ERM Risks

The risk to earnings or capital arising from:

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<th>Risks</th>
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<td>Credit Risk</td>
<td>An obligor's (e.g., borrower or counterparty) failure to meet the terms of any contract or otherwise fail to perform as agreed.</td>
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<td>Market Risk</td>
<td>Movements in interest rates (repricing risk; basis risk; yield curve risk; options risk). Changes in the value of traded portfolios of financial instruments.</td>
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<td>Liquidity Risk</td>
<td>The inability to meet obligations when they come due without incurring unacceptable losses. Changes in funding sources or market values.</td>
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<td>Operational Risk</td>
<td>Inadequate or failed internal processes, people, systems, or external events.</td>
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<td>Compliance &amp; Legal Risk</td>
<td>Violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards.</td>
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<td>Reputational Risk</td>
<td>Negative public opinion.</td>
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<td>Strategic Risk</td>
<td>Adverse business decisions, improperly implemented business decisions, or lack of responsiveness to industry changes.</td>
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Strategic risk remains an ongoing concern. Banks are several years into the risk accumulation phase of the economic cycle. The banking environment continues to evolve, with growing competition among banks, nonbanks, and financial technology firms. Banks are increasingly offering innovative products and services, enabling them to better meet the needs of their customers. While doing so may heighten strategic risk if banks do not use sound risk management practices that align with their overall business strategies, failure to innovate to meet evolving needs or financial services may place a bank at a competitive disadvantage.
ERM Balancing Risk & Reward

- Desired Reward
- Risk Appetite
- Risk Profile
- Risk Response
ERM Balancing Risk & Reward

Desired Reward

Risk Response

Context

Risk Appetite

Risk Profile
Forward:
In keeping with its overall mission, the COSO Board commissioned and published in 2004 *Enterprise Risk Management – Integrated Framework*. Over the past decade, that publication has gained broad acceptance by organizations in their efforts to manage risk. However, also through that period, the complexity of risk has changed, new risks have emerged, and boards have enhanced their awareness and oversight of enterprise risk management while asking for improved risk reporting. This update addresses the evolution of enterprise risk management and the need for organizations to improve their approach to managing risk in today’s business environment.
The Framework is a set of (23) principles organized in five interrelated components:

- Risk Governance and Culture
- Risk, Strategy, and Objective-Setting
- Risk in Execution
- Risk Information, Communication, and Reporting
- Monitoring Enterprise Risk Management Performance

You can learn more about this project at www.coso.org.
The “Corporate and Risk Governance” booklet applies to the examination of all OCC-supervised banks.

Highlights:
• This booklet discusses the board’s and management’s authority and responsibilities for governing the bank’s structure, operations, and risks.
• Explains enterprise risk management and the importance of viewing risk in a comprehensive, integrated manner.
• Discusses a risk governance framework as a means to manage a bank’s risks enterprise-wide.
• Describes risk culture and risk appetite in the context of a risk governance framework.
• Expands the discussion on risk management systems to include the three lines of defense—frontline units, independent risk management, and internal audit.
• Provides guidance to examiners on strategic, capital, and operational planning.
Risk Governance Framework

- Risk Culture
  - Risk Appetite
    - First Line of Defense: Frontline units, business units, or functions that create risk
    - Second Line of Defense: IRM, loan review, compliance officer, chief credit officer
    - Third Line of Defense: Internal Audit, including independent assurance

Risk Governance is an important element of corporate governance. Risk governance applies the principles of sound corporate governance to the identification, measurement, monitoring, and controlling of risks to ensure that risk-taking activities are in line with the bank’s strategic objectives and risk appetite.
Risk culture is the shared values, attitudes, competencies, and behaviors throughout the bank that shape and influence governance practices and risk decisions. As a subset of corporate culture, risk culture pertains a bank’s risk approach and is critical to a sound risk governance framework.
The bank’s risk appetite is another essential component of an effective risk governance framework and reinforces the risk culture. The bank’s risk appetite is the aggregate level and types of risk that the board and management are willing to assume to achieve the bank’s goals, objectives and operating plan…
“We’ve heard a few misconceptions about the original Framework since it was introduced in 2004. To set the record straight:

**ERM can be used by organizations of any size** if an organization has a mission, a strategy, and objectives – and the need to make decisions under uncertainty – then ERM can be applied.”
Jack R. Salvetti, CPA
S.R. Snodgrass, P.C.

Jack R. Salvetti is a Principal with S.R. Snodgrass, P.C., a regional accounting and consulting firm specializing in service to the banking industry. Jack assists banks throughout the United States by formulating successful strategies, improving financial performance, and implementing dynamic enterprise risk management frameworks. Jack is a frequent speaker, writer, and instructor at bank management schools and bank director programs.