Remarks by

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Good afternoon, it's a pleasure to be here today. In this period following the financial crisis, banks—and supervisors—are thinking about the challenges and opportunities ahead, and how to position our organizations for an uncertain and changing environment. As you share experiences with your peers and participate in the workshops, there's one thought I hope you take away from this conference. *Managing risk is not just about identifying, assessing, and monitoring all the things that could go wrong. It also is about understanding all the things that need to go right for a bank to achieve its mission and objective of safely and profitably serving its customers and community.*

Today, I am going to focus on three key messages:

1) You are likely already doing some form of "Enterprise Risk Management" or ERM,
2) There are important links from ERM to other key planning activities in your bank—primarily strategic planning and capital planning, and
3) There are important reasons to improve your risk management capacity—including making your organization more competitive.

However, before getting into more detail, let me set the stage or the backdrop on what we are seeing in the banking industry more broadly.

The environment is challenging right now. The economic recovery has been slow and conditions in Europe contribute to our domestic headwinds. Narrow margins are pressuring earnings, equity capital formation, and shareholder returns. The regulatory landscape continues to evolve. Cyber attacks on the critical national infrastructure, including banks themselves, are a persistent threat. Competitive pressures are prompting a reassessment of strategy, product offerings, and business processes. With all this uncertainty, boards and management are looking for information and tools that can help them chart the way through troubled waters.

One item I'd like to highlight for you that may help improve your understanding the risk landscape is the OCC's Semiannual Risk Perspective. Available on our Web site, it's been designed to help increase awareness and understanding of a whole array of risks facing the banking system, and it promotes an *integrated* view of those risks. The report also highlights a number of positive aspects of the environment. Our banking system is safe and sound and conditions are improving. The number of troubled banks with the most severe conditions (rated 4 or 5) appears to be stabilizing. The level of significant criticisms identified in reports of examination—we refer to these as Matters Requiring Attention—is declining. Financial health measurements, such as capital and liquidity, are strengthening. And, the volume of problem assets continues to decline.

For community banks, an environment of change—regulatory, technology, products, and strategy—presents both hazards and opportunity. And those that understand and effectively manage risk across the enterprise are the banks that will have the effective decision-making tools needed to grow and remain vibrant contributors to the communities they serve.

While there are a number of formal definitions of enterprise risk management, at its core the concepts are fairly simple and have been expected by the OCC and other supervisors for a number of years. In straight-forward terms, enterprise risk management is an integrated approach to identifying, assessing, managing, and monitoring risk in a way that maximizes business success. It involves the practices and processes the board and management use to define their business model and strategy, prioritize the associated risks and identify ways to mitigate them, use that analysis to make effective decisions, and create an organization that anticipates and adapts to the changing internal and external environments.

Enterprise risk management means that individual risks aren't considered *only* within the lines of business or by function, although the board and management can and should think about them in this way. It also means that risk and risk management are considered in total *across the institution*, as well as how different risks are interconnected and interact with one another. Often the "total" potential impact is greater than the sum of its parts. This is particularly true when the risk of reputational damage is considered. We have seen the impact reputation risk issues have had on our larger institutions and to the industry more broadly, and similar risks exist for community banks at a more local level, which can be just as significant. We have seen examples of community banks getting involved with a third party arrangement without doing sufficient due diligence relative to the partner's business practices. The consequences can be devastating for the institution's reputation with customers and the community.

In addition to reputation risk, bankers also need to consider how the use of third parties and outsourcing for the delivery of products and services, mitigates, or contributes to, the risks of strategy and operations. The use of third parties and outsourcing is an area where we are seeing more issues and concerns *now* and we expect more in the *future*. (Reference: OCC Bulletin 2001-47 *Risk Management Principles for Third Party Relationships* and we are in the process of updating it to reflect lessons learned and corresponding supervisory expectations. Stay tuned.)

So, where does ERM fit into the grand scheme of your organization?

I started off our discussion saying that most of you are already doing some form of ERM in your institutions. I'd offer to you as well, that no set of policies or procedures, whether you call it enterprise risk management or something else, will be effective if it is not integrated into the culture and governance practices of your institution and included in all facets of your decision-making processes.

How well you integrate an enterprise-wide approach to risk management into your *culture* is critical to its success. Your risk culture drives the manner in which management *sets* strategy and *makes* decisions. Your risk culture translates into how management and your employees *anticipate* and *respond* to risk. A strong risk culture drives the *assessment* and *understanding* of all the risks as part of *developing* strategic objectives and *implementing* new products and services. A strong risk culture is *proactive*. A strong risk culture supports an enterprise-wide approach to risk management by rewarding risk awareness and information sharing, discouraging a "siloed" approach, and ensuring there is the *right kind of information*, in the *right hands*, at the *right time* to manage risks collectively and to achieve strategic objectives. Finally, a strong risk culture ensures there is integrity in the process and the organization can answer "yes" to these questions:

> **Has risk ownership been well defined and does everyone understand their role?**
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> For example, we continue to see too many instances where risk management is viewed as the responsibility of a chief risk officer or a risk management function *only*. Business lines in some cases still see themselves only as a profit center. Every employee of the bank has a role in managing risk soundly.
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> **Is there consistency between our risk decisions and our strategy, risk appetite, and profit objectives?**
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> It's a cliché, but there's some truth to it. Every driver on the road thinks they are safe. It's the other drivers that are dangerous. Likewise, almost all bankers think they are conservative but still have concentrations, products, or activities that suddenly turn out to be of higher risk than expected. It's important to be candid and self-critical in assessing how well daily decisions conform to strategy and risk appetite. In order to do that, the *risk appetite* needs to be clearly defined and the *bank has to have the ability to effectively gauge potential risk exposures*.

In fact, the OCC just released guidance for community banks on stress testing—OCC Bulletin 2012-33. Some key points in the guidance include: 1) Banks need to understand their key vulnerabilities and they should conduct some type of stress test or sensitivity analysis to their loan portfolios at least annually. 2) Those results should inform the bank's risk tolerances, concentration limits and be factored into their capital analysis. The guidance sets forth that this type of analysis is an important component of sound risk management and recent experience has demonstrated the value of stress testing as a way to help quantify and manage risk. The OCC encourages community banks to adopt a stress test method that fits their unique business strategy, size, products, sophistication or complexity, and overall risk profile. This is an important message that is continually inserted into OCC guidance. I know the conference planners for this session asked me to speak to "examiners' expectations" around ERM and its concepts. You will hear me repeat a similar message—we expect you to develop your practices throughout the bank in a manner that is *effective* in achieving the desired result; and is *commensurate* with your overall risk profile. If you have higher risks, or more complexity, then we expect you to make corresponding adjustments so that your policies and practices are effective in managing risk.

Another question you may ask is "*Do our incentive and compensation programs prohibit excessive or imprudent risk taking and encourage sound risk management?"* Recently, there have been reports in the news of firms either fined or sued for selling products that weren't suitable for the customers, or promising features that weren't delivered. In some instances, this misbehavior by bank employees and third-party vendors resulted from incentive programs that unintentionally created financial and compliance risk that was not identified or managed properly.

Enterprise risk management is neither a *new* concept, nor a *new* supervisory expectation. The OCC's handbooks and guidance documents—and those of the other agencies, I might add—have long stressed the need for a comprehensive and integrated view of risk across the enterprise. What is different now is that the importance of and need for a comprehensive and integrated approach has *increased* in an environment that is *increasingly complex*. This complexity is reflected in: 1) the structure of many institutions; 2) the products and services being developed; 3) the technology being used to deliver these products and services and to interface with consumers; 4) the competition in the market place; and 5) the global presence possible for an institution to have today that was not previously imaginable. Simply put, there is a *compelling business reason* for all banks to do this *well*.

As a concept, enterprise risk management is fairly easy to understand. But implementing it can be a challenge because there is no simple roadmap. Enterprise risk management and the governance around the process have to be customized to your institution. It is not and cannot be a "one-size-fits-all" approach. The process of managing risk on an enterprise-wide basis has to be based on your corporate structure, as well as the size, scope, complexity, volume, and delivery channels of your products and services. The more complex your products and services are, the higher the volumes of transactions, the more sophisticated the delivery channels you use, the greater the need to ensure risks—individually and in the aggregate—are understood, and effectively identified, measured, monitored, and controlled.

If enterprise risk management is about understanding and managing what can go wrong, *and* about understanding all of the things that need to go right, then it is also *closely related to strategic and capital planning.* Let me explain further.

Your strategic plan is your roadmap for addressing the business environment, desirable products, customer segments, geographies in which to operate, and tactics to undertake that are consistent with your bank's strengths and weaknesses in order to achieve sustainable levels of profitability. Enterprise risk management helps your bank to align its risk appetite and strategies. In simple terms, your risk appetite involves knowing what kinds of risk and how much risk you are comfortable with, as well as the *boundaries of your bank's financial capacity to take on these risks.* An enterprise-wide view of risks gives the board and management the information needed for making sound decisions for executing your strategy.

In the same way that enterprise risk management can add value to setting your strategy and defining your risk appetite, it also can be used to strengthen your capital planning process. An effective process for identifying and evaluating risk across the enterprise is a *foundational component* of an effective capital planning process.

Earlier this year, the OCC issued Guidance for Evaluating Capital Planning and Adequacy (Bulletin 2012-16; June 2012). Even if you are not a national bank or thrift, the bulletin provides helpful guidance on developing a capital planning process appropriate for banks of all sizes. The guidance discusses the processes of identifying, measuring, monitoring, and controlling the significant risks and their importance to capital planning. These are the same elements that are used in enterprise risk management. They will help you understand your bank's overall risk profile, including vulnerabilities such as concentrations and their impact on earnings and capital; determine risk tolerance levels; assess strategic choices that affect risk and capital; and provide a forward-looking assessment of risk and capital adequacy in a changing economic and financial environment.

Together, sound management of risk across the enterprise, and good capital planning—in ways and at a depth based on your risk profile and complexity—*enhance* *the banks' ability to be competitive* and *continue serving the needs of their customers and communities*, and it *ensures ongoing viability* during difficult economic periods.

Summary

Let me wrap up now and then open up for some questions from the group. As I stated at the beginning, many of you are likely already doing some form of "Enterprise Risk Management" or ERM—*managing risks on an integrated basis across the enterprise is not new***.** We have expected banks to have sound risk management processes for as long as I can remember. Our focus, and it should be yours as well, is to ensure each bank's process *remains* commensurate with their changing complexity and evolving risk profile. That means the process must get continual assessment, enhancements, and adjustments as needed.

There are important links from ERM to other key planning activities in your bank—primarily strategic planning and capital planning. And, there are important reasons to *improve your risk management capacity,* including making your organization more competitive.

Lastly, we discussed the links between ERM, strategic planning, and capital planning and how your ability to put in place a governance framework, which includes all these foundational components, will enhance your ability to navigate the challenges and uncertainties that lie ahead. No doubt, you've heard the saying that "Information is power." In our dynamic and challenging industry, *risk information* is what will enable your institutions to make the *most* prudent and informed business decisions. By improving your risk management capacity, which includes incorporating stress testing or scenario analysis and embracing enterprise risk management as a powerful process that facilitates risk information and risk understanding, can give you a strategic and tactical advantage over your competitors. Thank you for your time today. Now, I will take some of your questions.