Getting Started with Your Risk Appetite Statement

Regulators say banks are adjusting their risk appetites in the face of rugged market conditions. Have you updated or reviewed your risk appetite statement? Do you have a risk appetite statement?

More and more, regulators seem to be requiring it, as banks go longer on risk in pursuit of happier returns. What’s more, experts say the process of developing and communicating a risk appetite can be a boon to the culture of an organization, and head off troubles down the road.

But there remains skepticism. A 2013 Towers Watson Risk and Finance Manager survey found that one in five respondents had not set any risk appetite level. Formulating an explicit, written statement of risk appetite “is not as simple as it sounds,” acknowledged Comptroller of the Currency Thomas Curry, in a speech this spring about heightened risk-management standards for large banks.

For community banks, the exercise should be less daunting, and more than likely, considerably rewarding. It does not have to be complex and difficult. There are different models

Regulators Push for More Formalized Risk Appetite Statement

Hungry for revenue and earnings growth, more banks are increasing their appetite for risk. That’s understandable, given the slow economic times and continuing low interest rates. But have you carefully thought about your attitude towards risk and the implications of taking on more of it? More importantly, can you articulate and explain that to regulators?

Those regulators are increasingly concerned. In its latest Semiannual Risk Perspective, the OCC uses the term “risk appetite” more than a dozen times, in the context of banks increasing it on a wide range of products, services and investments. The report also cited concerns by the agency’s National Risk Committee, a group of senior agency officials that monitors emerging threats to the safety and soundness of the banking system: a group of key indicators the NRC monitors is “starting to show some movement toward an increased risk appetite, following several years of risk aversion.”

The concern is putting new focus on the utility of a formalized risk appetite statement as a vehicle for articulating board and management vision for an institution – as well as a way of keeping the regulators at bay. The idea of a risk appetite statement might strike some as a sort of New-Age exercise that has little relation to operations.

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How to Manage Regulatory Expectations with Bank-Owned Life Insurance

Bank-owned life insurance – or BOLI – has had a somewhat checkered past. A decade ago the idea of banks taking out life insurance on their employees was portrayed in the media as corporate greed. Even if the proceeds were often used to fund employee retirement benefits, the idea that banks were benefitting from the deaths of their employees, some of whom were never told about the insurance, was controversial.

Today, with new laws and new regulations, including new disclosure obligations, the image of the BOLI community is much improved. Nearly 3,500 community banks have BOLI, and the numbers are growing. Regulators endorse the idea, with some caveats.

“BOLI offers many benefits to a community bank, but it is not without risk. BOLI may fund employment benefits to company executives, provide

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But experts say it can be a vital tool to ensure that boards and
managements are on the same page
at a time when risks seem to be
multiplying. And it can set a kind of
baseline for other metrics that can be
used to guide bank-wide risk
management.

“There needs to be a formal
framework, and that’s the real
problem. Most organizations do not
truly try to identify and understand
what their risk appetite is and what
it means to them,” says Tony Ferris,
partner with The Rochdale Group,
Overland Park, Kan. “It’s done more
as a by-product of the planning and
budgeting cycle versus a desire to
truly understand what risks are being
leveraged.” He and other experts said
regulators are right to be concerned.

“There are two times when people
end up chasing risk inappropriately.
One is when the money is really
flowing and you follow the dollars,
like we saw with the housing bubble.
The other is when peoples’ backs get
up against the wall,” Ferris said. “You
have seen financial institutions cut all
the expenses they possibly can over
the last five years. They have to come
up with other ideas. The only way to
increase business is to take on more
risk. … Risk appetite is something
that can be easily ignored and missed,
to your error, or easily made too
confusing and complex, to your error.”

OCC is already setting minimum
guidelines for broad risk management
for the largest banks. Among the
central elements in the “heightened
expectations” proposal earlier this
year: a comprehensive written
statement that articulates the
bank’s risk appetite, including
both qualitative and quantitative
components. OCC says the
guidelines do not apply to community
banks.

But experts point out that
determining how much risk a bank is
willing to take on to achieve its goal
is a decision that banks of all sizes
have to make. And OCC says in the
latest risk-perspective report that it
will be giving heightened supervisory
attention to bank’s strategic planning
in coming months including what
new risks are being assumed and how
they are being managed.

“I would have to think, from a
regulatory perspective, having a
discussion about your risk appetite
is just good business practice,” said
Mark Zmiewski, Director, Enterprise
Risk and Product Management, for
the Risk Management Association.

“While it may not be required, it
certainly is a sound practice and
makes a lot of sense to do.”

“Most institutions have addressed
the question, ‘What is our mission?
What is our vision? What are our
values?’” Zmiewski said. Developing
a risk appetite is a similar exercise.

“It is a natural flow from that
type of perspective,” Zmiewski
says. “It is a natural dynamic of a
healthy organization to have that
conversation.” (RMA publishes a
“Risk Appetite Workbook” that helps
banks understand and develop an
appropriate risk appetite statement.)

“The beauty from the community
bank perspective, particularly on the
smaller side, is that, while they are
operating in a complex environment,
they typically have a simple business
model by the very definition of being
a community bank,” Zmiewski said.
“So their footprint and the products
and services they are offering tend to
be a lot simpler than a JP Morgan.”
Developing a risk appetite, as a result, becomes more straightforward. “It is a simpler conversation to have,” Zmiewski says. “Clearly you are going to have credit risk and operational risk. How granular do you want to get? The key there is not trying to boil the ocean.”

“The thing that is so profoundly important about defining risk appetite is that it is the glue that ties strategy to the operations,” says Eric Holmquist, managing director with Accume Partners, New York.

“Thematically, that is what the regulators have been saying: Have a clear understanding of strategy and a clear understanding of risk appetite,” Holmquist said. “Those are the most important guiding principles for everything the bank does. It does not matter if you are a $100 million community bank or a $10 billion multi-national. It is the same concept for everybody.”

Holmquist says regulators are looking for two things: Do you have consensus among senior management and the board as to what your risk appetite is? Do you have the tools to properly and truly assess the products you are offering and the underwriting criteria you are using to know what the risks are? Regulators are looking for documentation – rather than the vague assurances of your chief credit officer.

“What is happening in a lot of cases is that management and the board are not on the same page,” Holmquist said. “What the regulators are saying is that to run a bank in a safe and sound way you have to have all this on the table -- you have to have the tools to assess and you have to make sure you are all on the same page. … From my perspective, this is a really good thing.”

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compensation to a company in the event of an executive’s death, and offer tax advantages not generally available in other investment alternatives,” Cynthia L. Course, a CPA with the Federal Reserve Bank of San Francisco, wrote in the latest issue of Community Banking Connections, a Federal Reserve newsletter. “However, the purchase of BOLI or any other insurance product should be aligned with the objectives of bank management, director-approved risk guidelines, and the bank’s risk profile. It is imperative that management understands both the benefits and risks of its insurance decisions and that it appropriately identifies, quantifies, and actively manages all risks.”

Those risks include new risk-based capital rules going into effect next year under Basel III that will require more capital at institutions that hold what is known as separate account BOLI that is supported by segregated investments as opposed to the general obligation of an insurance company. Banks with a substantial investment in separate account BOLI may need to hold additional capital under the new risk-based capital rules.

“It is a good product, but it is complex, especially when it is layered onto Basel III,” said Cliff Stanford, a lawyer and chair of the bank regulatory group at Alston & Bird in Atlanta. “The capital implications for a bank, and the complexities of how that plays out with separate account BOLI, creates an additional due diligence requirement.”

“Banks have to be prepared for the call reports that are going to require them to articulate very carefully what kind of risk weighting they have and how that flows through to their capital,” Stanford said. All this comes into play January 1, he noted.

Along with the credit risk from the underlying assets or obligor, concentrations of BOLI investments at some institutions are also significant, Course observed. Some 363 institutions had policies with cash surrender value (CSV) greater than 25% of the sum of Tier 1 capital and ALLL at year-end 2013 – a level that the banking agencies consider significant for concentration risk purposes and which will lead to increased examiner scrutiny. Twenty of those institutions, including 18 community banks with assets of less than $50 million, reported CSV greater than 50% of Tier 1 capital and ALLL.

Proponents say, in many cases, the heightened concentrations simply reflect strong-performing BOLI assets at a time when capital growth at the banks is otherwise slowing or declining. Banks also appear to be purchasing new BOLI policies to obtain a higher tax-equivalent yield than is available on other securities and loans.

In an email to Bank Safety & Soundness Advisor, officials at Equias Alliance, a provider and administrator of BOLI plans to banks, said the primary reason for growth last year was that banks with $1 billion to $10 billion in assets had excess liquidity and saw BOLI as a good alternative to investments with a similar risk profile. But Course cautioned that the growth also “may raise supervisory concerns if banks do not understand the associated risks or do not have adequate risk

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management processes in place.”

According to call report data, at
year-end 2013, 3,467 community
banks had life insurance balances of
$28.9 billion, compared with 3,418
banks with $26.8 billion a year earlier.
(Banks with over $10 billion in assets
reported $108.5 billion in insurance
assets last year.)

The tax favored nature of BOLI
policies – the growth of the cash
surrender value is tax deferred, and
proceeds are tax-free at death – are
certainly attractive. The policies
currently have enviable effective
yields of between 5% and 6% with no
mark-to-market balance sheet risk.

Banks with BOLI own the policy,
bear the risk of investment losses
and receive proceeds from the death
benefit. IRS rules limit participants
to the top 35% of wage earners; each
must give express consent to the
arrangement, a change in federal law
that eliminates a perceived abuse that
employees were being kept in the
dark about the insurance.

There are two primary types of
BOLI. General account BOLI is a
relatively straightforward product
with minimum guaranteed rates.
Separate account BOLI is more
complex with variable returns and
more sophisticated features such as
stable value protection wraps.

Historically, the general account
product has been the most popular,
with over 90% of banks using it as a
funding vehicle, according to Equias
Alliance. The number of banks
holding a general account product
increased 10.3% from 1,077 in 2012 to 1,188 banks in 2013.

According to Shoemaker: “The
reason for the popularity of this
product is that it combines many of
the best features of a General
Account product, such as an
interest rate guarantee, with the
best features of a Variable Separate
Account product, such as protection
of the bank’s assets in the event
of a carrier’s insolvency, while
also offering multiple investment
portfolios.”

Here are some of the risks of
investing in BOLI as Course sees
them and her mitigation strategies:

Credit Risk

The insurance company’s financial
condition and ability to pay must
be reviewed regularly over the life
of the contract, just like a bank
would review a borrower’s financial
condition and ability to pay on a
regular basis. General account BOLI
is an unsecured obligation of the
insurance company. A bank with
special account BOLI primarily
faces credit risk from the underlying
holdings in the separate account.

Credit risk exposure also
raises concentration concerns.
Management should establish
appropriate policy limits on
exposures to insurance companies
taking into consideration regulatory
capital concentration thresholds,
state legal lending limits, and any
applicable state restrictions on BOLI
holdings.

But David Shoemaker, a principal
at Equias, said the fastest growing
type of BOLI product last year,
in terms of the number of banks
holding it, was a hybrid combining
features of both the general and
separate accounts. According to
FDIC, he said, the number of banks
using a Hybrid Separate Account
product increased 10.3% from 1,077
in 2012 to 1,188 banks in 2013.

Market or Interest Rate Risk

General account BOLI turns on the
insurance company’s own investment
results, which are often longer-term
and which may fluctuate significantly
when long-term rates change.
Separate account BOLI is not unlike
market risk exposure in the bank’s
own investment portfolio although the
bank has no control over the special
account assets. Stable Value Protection
wraps can be used to hedge against
special account declines.

Liquidity Risk

According to Course, the cash
surrender value of BOLI is one of
the least liquid assets on a bank’s
balance sheet. The bank generally
receives no cash until the death of the
insured. Extracting money before then
has severe tax consequences. Bank
management and the board should
consider institution liquidity profile
when purchasing BOLI.

Legal Risk

Purchase and retention of BOLI
exposes a community bank to a
variety of legal and compliance risks
including myriad state insurance
laws. The purchase of BOLI also
introduces employment law, tax law
and reporting considerations. Federal
Reserve regulations addressing
transactions with insiders and
affiliates may also apply.

Reputational risk

Banks must actively manage and
mitigate potential perception issues
that could arise from benefitting from
the death of an employee. Course
recalls that in the early 2000s BOLI
was derisively tabbed “janitor’s
insurance” because companies
were purchasing insurance on very
junior-level employees without their
knowledge, prompting changes in
federal law.

Before the contract is issued, banks
should notify the insured in writing that the employer intends to procure insurance coverage, including the maximum face value for which the person could be insured; obtain the insured’s written consent to the coverage and to the possible continuation of the coverage after the insured terminates employment; and inform the insured in writing that the employer will be the contract beneficiary.

“...To mitigate reputational risk and potentially significant adverse tax consequences, management and the board of directors must ensure that each covered employee has given informed consent before the institution purchases the insurance,” Course wrote. “...Passive disclosures through employee handbooks or newsletters are not sufficient."

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and approaches. But they all have the same aim: ensuring that your organization is on the same page when it comes to risk and putting some tangible limits on what you view as acceptable. They serve as guiding principles for developing strategic plans and operational processes. They set the tone for whether your bank has a risk-managed culture.

How to begin? At least as important as having a risk-appetite statement is having a conversation about risk that includes risk management and line personnel on the one hand, and senior management and the board on the other.

“So the real issue there is, ‘Is the CEO and the board engaged? Are they having conversations around the risk profile of the institution?’” said Mark Zmiewski, head of enterprise risk and product management for the Risk Management Association. “My gut feeling is, while they may not have committed it to a formal piece of paper and called it a risk appetite statement, in many ways, shapes and forms, community banks are having those conversations.”

Zmiewski says the conversation should address:

- What are we trying to accomplish?
- What is that range of acceptable activities that we want to do?
- What do we want to do – and what do we not want to do?
- Have we had a discussion that is consistent in terms of expectations of risk and line of business?

Is it consistent across the organization in terms of growth expectations and risk expectations? (An expectation to double the size of the bank, for example, seems inconsistent with a risk appetite and expectation of zero losses.)

“Have that conversation. Bring those people together to have the dialogue,” Zmiewski said. “To the extent it results in something that is memorialized and something that is percolated in your policies and procedures that is your next step.”

Tony Ferris, of The Rochdale Group, Overland Park, Kan., advocates a two-part approach to including a quantifiable element that focuses on developing metrics around such risks as budget variances and other “things that are really important to me and can get me into trouble.” The other prong is more cultural, focused on organizational behavior and management towards risk.

The latter answers such questions as: Where are our priorities? What are the rules we can and cannot break? How aggressive do we tell people to be? How aggressive do we want them to be in terms of underwriting – or pushing the envelope with the regulators?

Some experts question the value of a risk appetite statement without a large quantitative component and a large dose of rigor.

“We believe that risk appetite should really be defined by metrics,” said Scott Polakoff, executive managing director, FinPro Inc., Liberty Corner, NJ.

The firm urges banks to set acceptable thresholds of risk for such things as delinquent and non-performing loans; every major risk then has a mitigation strategy associated with it. Those elements are tied together in a seven-step process that includes strategic and capital planning, internal control and corporate governance.

“These are absolutely mandatory analyses that have to be done on a regular basis,” Polakoff says. “This is (continued on page 6)
“The regulators have an incredibly difficult job. They are on the road a lot. They parachute in for a couple of weeks. They take a snapshot. They try to understand your policies and procedures,” Polakoff said. “The best way to achieve a positive outcome to an examination is to have all these procedures and steps already done so you can show the examiners. It becomes a win-win situation.”

Eric Holmquist, managing director, Accume Partners has a framework that looks at 20 different risk categories and has clients develop risk appetite statements for each. They include the eight categories that the OCC uses for supervision purposes such as interest rate, operational, or compliance risk. They also include a range of business-level risk categories including growth and capital and even governance and social responsibility. Risk-appetite statements within even broad categories are easier to turn into actionable decisions and strategies than a single bank-wide statement, according to Holmquist.

“We found it helpful for banks to define risk appetite in broader terms—such as appetite for risking earnings or capital or growth,” he says. “Those factor into strategic decisions like, ‘How do we want to grow? How aggressively do we want to go after our strategy?’”

The risk appetite statements serve as guiding principles; clients also set more concrete “risk tolerances” for each category that serve as boundaries in which the business must operate.

Here are some examples of risk appetite and risk tolerance statements Holmquist cited at a recent presentation before a group of bankers in New York:

**Capital**

Risk Appetite: The bank maintains a low risk appetite relative to capital both to support existing operations and potential growth, whether organic or through strategic acquisitions. The bank remains well capitalized which is a high priority to the board and senior management.

Risk Tolerance

Risk Appetite: Tier 1 leverage capital will be maintained at no less than 8% of assets. Risk-based capital will be no less than 9% of assets. Total risk-based capital will be no less than 10% of assets.

**Business Model**

Risk Appetite: The bank’s overall business model is conservative, consisting of traditional banking products and services.

Risk Tolerance

The bank will not engage in more than one major strategic acquisition during a 12-month period. The bank will not offer any product or service that scores higher than a 40 on the bank’s product risk assessment model.

**Strategic Initiatives**

Risk Appetite: The bank has a low risk appetite for strategic risk. The bank does not have plans for any strategic acquisitions or any high risk product or service offerings.

Risk Tolerance: No strategic initiative shall require more than 2% of capital.

**Corporate Governance**

Risk Appetite: The bank has a low risk appetite for corporate governance and will at all times maintain suitable levels of policies, procedures and management oversight to ensure safe and sound operations.

Risk Tolerance: All bank policies will be reviewed and updated at least annually.

**Growth**

Risk Appetite: The bank has a low to moderate risk appetite for growth, largely organically. The bank does not have plans for any strategic acquisitions at this time.

Risk Appetite: Asset growth will not exceed 15% per year.

Holmquist assures it is all not as complicated as it might sound (though he says many banks find it useful to bring in an objective third-party to moderate). His advice: “Keep it simple. Keep it meaningful. This is not complicated. This is not rocket science. It is very intuitive. Focus on all the different types of risk. Just identify good appetite statements and good tolerance metrics.”  ■