

# RISK MATRIX DEFINITIONS \*

The following definitions were taken from Federal Reserve and OCC documents regarding risk-focused examinations. (See end of document for specific sources.)

## I. RISK CATEGORIES

- **Credit** risk arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- **Market** risk is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- **Liquidity** risk is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").
- **Operational** risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- **Legal** risk arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization.
- **Reputational** risk is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.
- **Strategic** risk is the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation.

## II. INHERENT RISK

Inherent risk assesses the nature, complexity, and volume of the activities giving rise to the risk in question. It is important to remember that this assessment of risk is made without considering management processes and controls; rather, these factors are considered in evaluating the adequacy of the institution's risk management systems. Inherent risk is described as high, moderate, or low, as follows:

- **High inherent risk** exists where the activity is significant or positions are large in relation to the institution's resources or to its peer group, where there are a substantial number of transactions, or where the nature of the activity is inherently more complex than normal. Thus, the activity potentially could result in a significant and harmful loss to the organization.
- **Moderate inherent risk** exists where positions are average in relation to the institution's resources or to its peer group, where the volume of transactions is average, and where the activity is more typical or traditional. Thus, while the activity potentially could result in a loss to the organization, the loss could be absorbed by the organization in the normal course of business.
- **Low inherent risk** exists where the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

## III. ADEQUACY OF RISK MANAGEMENT

When assessing the adequacy of an institution's risk management systems for identified functions or activities, primary consideration is placed on findings related to the following key elements of a sound risk management system:

- Active board and senior management oversight;
- Adequate policies, procedures, and limits;
- Adequate risk management, monitoring, and management information systems; and
- Comprehensive internal controls.

Taking these key elements into account, the examiner should assess the relative strength of the risk management processes and controls for each identified function or activity. Relative strength should be characterized as strong, acceptable, or weak as defined below:

- **Strong risk management** indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide the necessary information and analyses to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.
- **Acceptable risk management** indicates that the institution's risk management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.
- **Weak risk management** indicates risk management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

## IV. COMPOSITE RISK

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk management systems for that activity. The following grid provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related management processes and internal controls:

### Composite Risk for Significant Activities

RISK MANAGEMENT SYSTEMS	INHERENT RISK OF THE ACTIVITY		
	Low	Moderate	High
	Composite Risk Assessment		
Weak	Low or Moderate	Moderate or High	High
Acceptable	Low	Moderate	High
Strong	Low	Low or Moderate	Moderate or High

To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided below:

- A **high composite risk** generally would be assigned to an activity where the risk management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition, even in some cases where the systems are considered strong. For an activity with moderate inherent risk, a risk management system that has significant weaknesses could result in a high composite risk assessment because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.
- A **moderate composite risk** generally would be assigned to an activity with moderate inherent risk where the risk management systems appropriately mitigate the risk. For an activity with a low inherent risk, significant weaknesses in the risk management system may result in a moderate composite risk assessment. On the other hand, a strong risk management system may reduce the risks of an inherently high risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.
- A **low composite risk** generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk where internal controls and risk management systems are strong and effectively mitigate much of the risk.

## **Assess Overall Composite Risk**

Once the examiner has assessed the composite risk of each identified significant activity or function, an overall composite risk assessment should be made.

## **V. TREND**

**Trend** of risk is the probable change in the bank's risk profile over the next 12 months and is characterized as decreasing, stable, or increasing.

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### **\* SOURCES OF DEFINITIONS:**

- I. **RISKS** – “Strategic risk” definition was taken from Appendix B of OCC-CH-BSEP - Community Bank Supervision, Bank Supervision And Examination Process, Comptroller's Handbook, August 1998. Remainder of risk definitions in this section were taken from Federal Reserve Board’s “Framework For Risk-Focused Supervision Of Large Complex Institutions,” August 8, 1997.
- II. **INHERENT RISK** - Definitions in this section were taken from Federal Reserve Board’s “Framework For Risk-Focused Supervision Of Large Complex Institutions,” August 8, 1997.
- III. **ADEQUACY OF RISK MANAGEMENT** - Definitions in this section were taken from Federal Reserve Board’s “Framework For Risk-Focused Supervision Of Large Complex Institutions,” August 8, 1997.
- IV. **COMPOSITE RISK** - Definitions in this section were taken from Federal Reserve Board’s “Framework For Risk-Focused Supervision Of Large Complex Institutions,” August 8, 1997.
- V. **TREND**- “Trend” definition was taken from the “Direction of Risk” definition in OCC-CH-BSEP - Community Bank Supervision, Bank Supervision And Examination Process, Comptroller's Handbook, August 1998.