Managing Risk at the Bank and Across the System

When you're the nation's central bank, effectively managing risk throughout the organization is a top priority. Indeed, managing risk from a broader perspective has become a hot topic both inside and outside the Fed.

Managing risk is not a new concept for companies and corporations. However, lately, risk management has taken on a new aspect: incorporating risk management principles across the entire organization. Donna Franco, chief financial officer at the Philadelphia Fed, puts it this way: "Corporations have been managing risk for many years. What ERM adds is an organization-wide view." A large institution like the Federal Reserve System is no exception. Like other organizations, the Fed is subject to operational, credit, market, strategic, and reputational risks. To deal with risk issues, the System developed an ERM framework several years ago, and two years ago, the Federal Reserve Bank of Philadelphia established the Enterprise Risk Management (ERM) Department.

Donna Franco, Chief Financial Officer, and Spyro Karetsos, Assistant Vice President, Enterprise Risk Management

The Philadelphia Fed's and the System's involvement with ERM dates back to 2002, when the general auditor of the Philadelphia Reserve Bank led a System work group that produced a white paper that became the basis for implementing ERM in the Federal Reserve System.

Why is managing risk at a broader

level so important? The interconnected nature of the Fed is one reason. If a risk-related issue arises at one Reserve Bank, it may well have implications for the other Reserve Banks.

Spyro Karetsos, assistant vice president, Enterprise Risk Management, notes that sometimes company managers and officers have made decisions about risk-taking informally. By formalizing the decision-making process, Karetsos says, ERM "increases the awareness of risk and the potential impact certain decisions may have." Furthermore, he says, it allows managers and others to understand a decision's effect not just on one business area but on other stakeholders as well.

Other Aspects of ERM

Another valuable aspect of ERM, Karetsos observes, is that "it compels entities to develop a common language. Having everyone use the same terminology to talk about risk reduces the need to 'translate' risk concepts." Karetsos adds that a formal ERM program also gives organizations a tool for monitoring risk: "Initially, a company may determine the amount of risk associated with a certain action. But ERM gives you ways to monitor your actual risk level *after* you've carried out the decision. It's really a system of checks and balances."

One good feature about the System's ERM framework is its flexibility, Karetsos says. It provides standards that allow a Systemwide perspective, but each Bank's ERM processes can be customized to fit that Bank's culture.

Other Reserve Banks also have ERM programs, and one goal is to share best practices across the System. One venue for doing so is the System's annual ERM meeting, which Philadelphia has hosted for the past three years. Importantly, at the 2005 meeting, it was clear that a "community of interest" has emerged within the Federal Reserve. One piece of evidence is that these meetings no longer rely on outside speakers to fill the agenda; presenters now come from within the System in addition to external presenters.

For the Philadelphia Bank, sharing ERM ideas sometimes means moving beyond the Fed's walls and even beyond U.S. borders. In August 2005, Karetsos published an article on the topic in the *RMA Journal*, a publication of the Risk Management Association. ERM has also taken on an international scope. In 2005, the central bank of Spain toured various central banks because it wants to implement an ERM program. As a result of its contact with the Philadelphia Fed, the Banco de España has developed a relationship with the ERM staff here. In early 2006, Franco flew to Madrid to share ideas with her peers from other central banks. She has also been asked to co-chair a consortium of central banks that will meet annually to discuss common risk-management concerns.

Ultimately, ERM is an umbrella that covers an organization's activities and business lines. ERM also acts as a lens that allows a company to view existing information from a risk perspective. No organization can entirely eliminate risk, Karetsos notes, but "if we know what the risks are and align resources appropriately, we can reduce inherent risks to a level within our tolerance range."

"If we know what the risks are and align resources appropriately, we can reduce inherent risks to a level within our tolerance range."

— Spyro Karetsos