

Enterprise Risk Management: A Brief for Credit Unions

INTRODUCTION

Credit Unions are in the risk taking business. With every transaction, a Credit Union takes credit, market, corporate and/or operational risk. Money is made by taking risk and money is lost by not managing risk. Credit Unions have a significant duty to the depositor members when using deposits to fund other member transactions. Credit Union Management and Boards are looking for tools to assist them in undertaking effective oversight and management of risk. Enterprise Risk Management (ERM) is an important tool.

Enterprise Risk Management represents an approach to managing all risks that are inherent to the business. The complexity of the inherent risk profile of a credit union is increased in breadth and depth by its internal characteristics such as: number of products and services delivered, business strategies employed, the size of the employee workforce, extent of capital employed, number of points of contact for sales, geographic coverage and stakeholder accountabilities. There are also external characteristics which impact the credit union's risk profile such as: the regulatory environment, political environment, economic environment, and competitive forces.

A credit union can provide for its sustainability and success into the future using an integrated Enterprise Risk Management methodology.

THE CONCEPT: What is Risk and What is ERM?

Risk is generally defined as an event or activity which could prevent an organization from achieving its goals. Risks can cause financial loss, damage to a credit union's reputation within the business community and with its members, and/or could cause an organization to miss an opportunity in the marketplace.

Enterprise Risk Management (ERM) involves a strategic analysis of risk across the credit union. The view is a corporate one rather than in silos – it cuts across business units and departments and considers end to end processes.

ERM will not eliminate risk but rather provide a framework in which an organization can effectively identify and manage risks or exposures.

ERM enables a credit union to identify and evaluate its risk profile. Thereafter, the Board and Management can determine appropriate responses to the risk profile, given the business environment and the organization's objectives and priorities.



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The ERM process ensures that the people who are stewards of the credit union and the depositors' funds are explicitly recognizing the risks that they are charged with managing and overseeing. This recognition allows more attention to be given to areas of highest risk.

Risks are represented in the external environment in which the organization chooses to operate, as well as those in the internal environment. Those in the external environment and generally outside of the organization's direct control include the political environment and public policy, world events, the economy, regulator's actions, natural geographic challenges, social policy changes, and the competition. Risks that are within an organization's control include reputation, safety of employees, business strategies taken, safeguarding of assets, ethics and culture.

Why Adopt ERM?

Credit Unions that choose to adopt an enterprise risk management view do it to be informed. By being informed, the Board of Directors, senior management, and unit management can operate in an informed status and be proactive in managing the multitude of risks.

There are numerous benefits to implementing ERM. To identify a few:

- Permits alignment of risk and strategy
- Achieves clarity of accountability
- Identifies all risks including those that have been traditionally overlooked
- Allows for informed choices and decisions
- Allocates greatest resources to areas of greatest risk
- Streamlines costs and capital.

Eight Step Process

The steps involved in implementing ERM are:

1. Identify
2. Assess
3. Measure
4. Response
5. Responsibility
6. Monitor
7. Report
8. Inform.

If ERM is to be successful in a credit union, there must be clear support at the Board and CEO level. Some organizations have demonstrated this through the appointment of a Chief Risk Officer (CRO), the establishment of a Risk Management group, and/or by providing risk education across the organization and involving staff in the implementation process. This is important to create a risk aware culture in the credit union and for all staff to see their role in managing risk.

Risk Analysis (Identify, Assess, Measure)

In undertaking a risk analysis, the credit union will identify the variety of risks that it is exposed to. Credit Unions will typically categorize risks under headings such as credit risk, market risk, operational risk, and corporate risk (sometimes referred to as regulatory risk), for ease of cataloguing and assigning responsibility for managing.

Risk management cannot be achieved without the risk analysis and assessment stage being completed. Until an organization knows what risks it is exposed to, it cannot effectively develop a prudent risk management response.

EXHIBIT II



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Each risk can be assessed in terms of likelihood of the risk occurring and the degree of impact in the event that the risk does occur. For those risks that rank as high likelihood and high degree of impact, an aggressive risk management response can be adopted. This best equates resources to areas of greatest risk. It can also identify where the credit union may be allocating excess resources to low risk areas. This filtering of risks permits the Board to identify where it needs to set policy and what areas need monitoring at the governing level.

Indicators of Risk

There are certain events that will represent times of heightened risks in an organization. Some indicators would include:

- Change – e.g. mergers, restructuring, the implementation of new systems – during times of change there can be confusion and lack of familiarity by staff with processes providing a high risk environment – a higher chance of error or even fraud.
- Multiple points of access – the greater the number of points of access by the member into the organization increases the challenge of monitoring all and safeguarding access.
- Evolving business and products – introducing new business or new products can introduce new inherent risk to an organization which has not been managed before
- Concentration of business and/or reach of business – offering one product to a restricted type of member base can create an undue concentration of risk; the further operations are from head office the greater the potential risk for less adherence to company practice.

These characteristics may change over an organization's business cycle. Therefore, it is important that management stay attuned to changes in the business. These changes could be external and/or internal. When there is change in the risk profile, the risk analysis and assessment should be reconsidered and a conscious decision taken on the appropriate risk response.

The Risk Profile Of A Credit Union

The concept of managing risk is not new for credit unions. The very nature of operating any financial institution is to manage risks. A credit union is the compilation of risks inherent to the operating and managing of a financial institution, i.e.:

- **Credit risk:** risk of financial loss resulting from the failure of a counterparty to honour its obligation to the credit union.
- **Market risk:** presented through valuation of loan portfolio and deposits: risk of financial loss resulting from changes to values of assets or liabilities of the credit union. Includes interest rate risk and foreign exchange risk.
- **Liquidity risk:** risk that the credit union is unable to meet its financial obligations as they fall due. Also entails sufficiency of the deposit base and/or other funding sources to maintain the asset base.
- **Operational risk:** presented through daily operations: risk that the credit union may not be able to offer its products and services to members or perform vital functions required for the conduct of its business, in a cost-effective manner. Includes technology risk.
- **Corporate risk:** risk that arises from failure to develop and adhere to a set of principles and values that direct and guide actions of the credit union, its directors, officers and staff. Includes indiscriminately placing the credit union in danger of unnecessary costs, financial loss, or damaging its reputation. Includes failure to comply with regulatory requirements.

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Credit unions are very familiar with the need to explicitly manage credit, market and liquidity risk. There generally are policies, underwriting procedures, careful thought into derivative transactions and placement of investments. However management of operational risk and corporate risk has generally been less organized and instead is often managed through an adhoc collection of procedures.

If it is thought that, subconsciously, management and staff know what the risks are and processes have simply evolved over time, there may not be an efficient integrated risk management structure in place. If risks are identified and evaluated, then the organization can efficiently allocate resources to those areas of higher risk, and also focus attention by line personnel and in supervision and oversight actions.

Risk Management Response and Responsibility

A risk response can be chosen for each risk and a person can be delegated responsibility for the risk. Exhibit III defines the four risk responses that can be selected to deal with any given risk: avoid, accept, transfer, mitigate.

Exhibit III

Avoid	this response is to not accept the risk, e.g. exit the business
Accept	this response is to accept the level of risk and take no action to minimize it further, e.g. establish reserves
Transfer	this response is to transfer the risk to someone else, e.g. purchase insurance
Mitigate	this response is to take action to manage the risk generally through a system of policy setting, internal controls, monitoring and reporting

The appropriateness and adequacy of the response to a risk needs to be decided in the context of the severity of the risk (i.e. degree of likelihood and degree of impact). The risk response for each credit union will be different and will vary in response to the organization's culture and risk tolerance level.

The actual actions of managing the risk will occur at different levels within the credit union, at the governing level, senior management level, business unit level, and process level. For example, the Board of Directors establishes governing policies, senior management sets operating policy, line management and front office personnel set out procedures for implementation, the business unit manager establishes monitoring procedures such as exception reporting to monitor for compliance to policy and procedures, and controls such as segregation of duties are established within processes.

Risk management also requires ongoing monitoring so that the risks continue to be managed through the chosen risk response. This can be conducted through annual reviews of the risk response strategy, exception reporting on specific events, as well as through monitoring vehicles such as internal audit.

Monitor, Report and Inform

After implementation of the risk responses and management techniques, the managers then monitor the actual activities to ensure that the identified risk stays within an acceptable threshold. Other units within the credit union may take on a monitoring role. Some organizations have adopted centralized risk management groups who have a responsibility to determine risk parameters and monitor actual results to ensure that the established parameters are met. Internal

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Audit also becomes part of the monitoring process assuming the function is utilizing a risk-based internal audit approach.

The Board and senior management will require information to be reported that allows them at their level of concern to be aware of the integrity of managing risks across the organization. Managers should determine the form of reporting necessary to best inform the oversight body. Additionally Internal Audit needs to structure their reporting to follow a risk focus.

Information from the reports can be used to inform the annual update of the risk analysis process as well as the updating of risk responses and policies.

SUMMARY

Enterprise Risk Management can be a powerful tool for Boards and management. It can greatly enhance both the effectiveness of managers and sustainability of the credit union.

Adopting an Enterprise Risk Management process is a shift in philosophy from dealing with risk on an adhoc basis to an organized and explicit basis. This requires a shift in thinking from focusing on only one or two dominant risks, to a proactive, well thought out, and well planned program designed to deal with all inherent risks. Adopting an ERM framework permits an organization to be in control, organized, and to fully utilize all information sources because the structure is appropriate and the environment that results is one that empowers the staff of the organization to make the changes that are necessary, and permits the organization to take full advantage of opportunities as they present themselves.



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We hope this advisory has been informative but please **note** that this is a brief explanation of a broad methodology. Booker & Associates would be pleased to meet with you to discuss this further.

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