Concepts and Realities at Credit Unions

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Background and Underlying Concepts

Enterprise risk management began appearing in the U.S. business lexicon in the late 1990s and is still a relatively new methodology for addressing credit union risks. The ERM approach is distinguished from other risk management activities by its emphasis on a broader, credit union-wide view of risk, the inclusion of risk to a CEO and board level, and the addition of risk as a strategic consideration.

Various descriptions and definitions have been put forth by regulatory and rating agencies, risk management practitioners and consultants. While there are similarities in the definitions, there are also differences that have caused some to question which is correct or which to adopt.

The important thing to remember is that ERM processes are not a fixed set of prescriptive business actions appropriate for application in the same manner across different business environments. Instead, the ERM process entails broadening the view of business risk and aligning the organization's risk-taking positions in a manner that's consistent with overall credit union philosophies, objectives and financial capacity.

Viewed this way, it is easier to see that each credit union's approach to ERM does not have to strictly align with a single definition, nor does it have to be approached in the exact same manner at each credit union. In fact, ignoring the strengths of existing risk management practices will only delay and complicate the adoption of ERM processes.

Regardless of how ERM is defined, it's important to have a realistic understanding of what ERM is and what it is not.

ERM is:

- A process, not a product.
- An approach for identifying credit union-wide risks and understanding their interrelationships.
- A methodology for aligning risk assumption consistent with strategic objectives.

ERM is not:

- An indication that all prior risk management activities were inappropriate
- A panacea for everything that could possible go wrong in business.
- A single set of rules that can be applied equally to businesses and credit unions.
- A tool that absolves management of its fundamental responsibilities to understand its business risks and capitalize on the opportunities they present.

Adoption by U.S. Business

Energy, utilities, insurance and banks were among the early business sectors to formally implement the ERM process. Until the last few years, however, corporate America has been cautious about adopting ERM, in part because of a general resistance to altering current business practices, limited resources which are already stretched razor thin, and a view that risk is being effectively managed with the existing operational structure.

However, several drivers are pushing more U.S. businesses and credit unions to implement ERM:

- The financial crisis of 2008/2009 highlighted shortcomings of existing risk management practices within many firms (particularly in the financial sector).
- Regulators and legislators alike are now focused on the importance of effective enterprise risk management.
- Credit rating agencies have incorporated an ERM view into their ratings process.
- Business executives and board members are (or will be) held to a higher standard of accountability for understanding, monitoring, and managing their organization's profile.

Traditional Risk Management vs. ERM

Risk management consists of five basic steps:
(1) Identify and assess risks;
(2) Analyze and prioritize risks;
(3) Develop risk mitigation strategies;
(4) Implement the mitigation strategies; and
(5) Monitor and report the progress.

While traditional risk management is widely practiced by organizations, these steps are often applied independently by various groups or departments, which has resulted in a fragmented effort within typical organizational structures.

For example, a credit department may apply the risk management steps as part of the process of assessing customer quality, something that a greater number of credit unions will become more deeply involved with as they move into commercial lending. The risk management department applies these same steps to address traditional insurable (e.g. vehicle or premises exposures) risks. And other business segments use the same steps within their specific area of responsibility.

In each case, however, each business segment will apply slightly different standards, view risk priorities differently, and have different risk appetites and tolerances (which may or may not be consistent with executive management's view of credit union-wide risk appetites and tolerances).

In fact, department managers may each have different perspective about the definition of risk and, therefore, will manage risk around their individual perceptions rather than in a manner consistent with credit union-wide strategy. This fragmented approach results in risk taking that is inconsistent with overall objectives, focuses almost entirely on today's known risks without contemplating emerging risks, and ignores portfolio implications that may result in risk appetites and tolerances being exceeded.

ERM is a process that employs the traditional risk management steps across the entire credit union and enables management to apply consistent risk appetites and tolerances to the credit union's overall risk profile. With this methodology, risks are viewed as interconnected business issues that must be considered in the aggregate, rather than in isolation.

Apply it to your Board Room:

1. How would you describe your credit union's current approach to risk management: traditional or enterprise-wide?
2. If your credit union currently takes a traditional approach, what benefits might your organization see in shifting to an enterprise-wide view of risk management?

For more information about ERM, read part two of this series "ERM: Initiating the Process at Credit Unions". It will provide a step-by-step approach to getting started and the role of the board of directors, the supervisory committee and ERM committee.

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