CU Management
In-depth coverage for credit union leaders

Remove the Banana Peel

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Integrate ERM with strategic planning and your CU's leaders can spend more time on attaining key member service goals, rather than slipping on surprises.

With continually changing business conditions, the financial services industry still in recovery mode, and the increasing size and complexity of credit unions, the entire CU sector has good reason to move toward adopting enterprise risk management.

ERM has evolved as an integral function within many organizations because it is a process that can improve current operating results and enhance the ability to achieve future business strategies. In fact, organizations in various industries are increasingly viewing ERM as a discipline to create competitive advantage.

When ERM is deployed effectively by an organization, less management time is spent fire fighting and more on attaining core business goals, thereby strengthening regulator and membership confidence and credit union value. If ERM is integrated into a credit union's strategic business plan, then risk will be considered at times when it previously hadn't been. This in turn can reduce the number of surprises with which a CU's leaders will have to grapple.

Director Responsibility

The directors of failed financial institutions risk lawsuits based upon a claim that board members failed to carry out their fiduciary responsibilities. However, a precedent ruling as a result of a 2004 Delaware Chancery Court decision (that was reaffirmed on appeal in 2006 by the Delaware Supreme Court) articulates a pathway for directors to defend themselves.

While the Stone v. Ritter case dealt specifically with the Bank Secrecy Act, the court for the first time articulated the standard for determining whether directors can be liable for failure to exercise oversight of employees who do not comply with laws and regulations. In rejecting that a bad outcome automatically equates to bad faith, the court stated that plaintiffs now must allege that "(a) the directors utterly failed to implement a reporting information system or controls or (b) having implemented such a system of controls, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention."

One of the objectives of enterprise risk management is implementing a risk reporting information system and controls. With the Federal Reserve opining favorably to an enterprise approach to risk, there are clear signals to the directors of financial institutions: Adopt an enterprise approach to risk management. Credit unions may also wish to have other systems of risk management and reporting in place, and definitely should turn to their attorneys for specific legal advice on this issue. (Check out this blog post about director indemnity)

Establish an ERM Committee

Management's understanding of the potential benefits of the process is critical to success. Achieving ERM objectives takes a commitment of resources, a willingness to provide continuing support of the process, and an understanding that ERM must be an ongoing discipline to yield the greatest value. As such, ERM cannot be effectively implemented without direct active support of the credit union's supervisory committee.

Strong consideration should also be given to forming a standing ERM committee composed of members of the supervisory committee and top executives from across the traditional functional silos of the credit union. This committee is charged with implementing the aforementioned issues, and initiating the process at the ground level at the credit union.

The first order of business for the ERM committee is to ask the question: Why are we implementing ERM? One way of addressing that question is for the committee to develop a charter stating the vision, mission and policy of the ERM process.

The benefits of a high-level ERM committee include a broader picture of risk, an enhanced understanding of risk relationships, and the positive and negative correlations that can multiply the impact of risk on the organization. Such a committee can provide the CEO and board an internal warning system of what could be on (or just beyond) the horizon, thereby avoiding surprises that impact performance.

Based on experience and supported by the findings of numerous surveys of companies and ERM committees, the ERM committee should work on:

1. asking CU staff to identify risks by interviewing as many staff people as possible;
2. mitigating and managing known risks to the credit union;
3. gathering and providing "risk intelligence" to the CEO and board about emerging and unanticipated risks that may be on the horizon or just beyond;
4. adding new measurable value, such as helping to maintain compliance with industry trends in risk management or even reducing volatility by having fewer operational surprises;
5. creating a competitive advantage by giving another angle CUs can use to tell the story of why they are wonderful options for consumers; this would be part of their overall education plan for explaining the CU difference;
6. enhancing corporate governance by helping leaders lead since likely risks are known; and,
7. assuring that credit unions live up to risk management rules that other businesses now face, as a pathway to compliance with CU regulations if they take hold in our industry as well.

One method some organizations have used to determine if the members of the ERM committee as well as the board of directors are in sync when it comes to risk is to ask each of them to select a definition of risk from the five most common (1. uncertainty, 2. adverse event, 3. chance of loss or gain, 4. expected loss, 5. variation from expected outcome). The purpose of this deceptively simple question is to determine how aligned existing thoughts about risk are at the credit union. If there is a spread of answers it should spark a dialogue and help develop the process.

Another important issue to consider is that there is no single, cookie-cutter approach to implementation. While one credit union may already have sophisticated risk management practices in place, another may not. As a result, the "starting point" needs to be tailored to recognize the strength of existing risk management efforts.

The board is responsible for setting and defining the credit union's risk appetite (how much it is willing to risk losing in total) and risk tolerances (how much it is willing to lose in one event).

Identifying Risk

ERM committees usually set the direction for the ERM process by asking staff to conduct a basic risk identification and assessment to provide an overview (risk map) of the status quo to management and the board. The straightforward approach is to create an online questionnaire as a tool to gather initial information and then conduct one-on-one interviews to follow up.

One aspect of the questionnaire should ask about the stated or perceived "risk appetite" and "risk tolerance" at the credit union. The terms are not synonymous and actually quite different. An example of risk appetite could be the amount of capital committed to a given new project; the risk tolerance is the amount of tolerable loss (outcome) at any given moment associated with that project that the organization is prepared to accept. However, risk appetite and risk tolerance go far beyond pure financial calculations and cut across various functions within an organization, such as strategic, legal and human resources.

The board is responsible for setting and defining the credit union's risk appetite (how much it is willing to risk losing in total) and risk tolerances (how much it is willing to lose in one event). Said another way, the board is responsible for defining the organization's acceptance of variability around risk outcomes. Informal understandings based on past history are not sufficient. The purpose of establishing risk appetite and tolerance is to ensure that the board and employees of the credit union have a clear understanding of what outcomes are acceptable to the business and what outcomes are not.