Applying ERM in Daily Operations

TCT RISK SOLUTIONS

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Defining Risk

WHAT IS RISK?

- Possibility of incurring loss
- Vulnerability to a negative outcome

Defining ERM

The process by which organizations in all industries assess, control, exploit, finance and monitor risks from all sources for the purpose of increasing the organization's short and long term value to its stakeholders.

Applying ERM

- A common thread of enterprise risk management is that the overall risks of the organization are managed in aggregate, rather than independently.
- The level of decision making under enterprise risk management is also shifted, from the insurance risk manager to the chief executive officer, or board of directors, who would be willing to address all forms of risk.

Defining Risk

Risk Categories

- Credit Risk – the risk of non-repayment where your credit union invests or loans funds.
- Interest Rate Risk – the risk that your credit union won't adequately manage changes in market rates to maintain an appropriate net interest margin.
- Liquidity Risk – the risk your credit union won't be able to liquidate assets quickly and with minimal loss in value to meet your obligations.
- Transaction Risk – the risk that fraud or errors will cause a loss to your credit union. This risk is a function of internal controls, information systems, employee integrity, and operating processes.
- Compliance Risk – the risk that failure to comply with laws and regulations, prudent ethical standards, and contractual obligations will harm your credit union.
- Strategic Risk – the risk that poor business decisions or improper implementation of strategic goals will reduce your credit union's earnings and net worth.
- Reputation Risk – the risk that your credit union's public image will be tarnished due to improper actions on the part of officials, management, or staff.

Understanding ERM

- ERM represents a return to the original roots of risk management, a field that was first developed in the 1950s.

- The first risk management text, published in 1963, was titled Risk Management and the Business Enterprise.

Understanding ERM

- As initially introduced in this text, the objective of risk management is, to maximize the productive efficiency of the enterprise.

- The basic premise of this text was that risks should be managed in a comprehensive manner, and not simply insured.

Understanding ERM

- How did we move away from comprehensive management to simply insuring against risk?

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How did we move away from Comprehensive Risk Management?

An historical review shows this process…

1. Businesses identified specific risk types
2. Risk managers developed expertise for specific risks
3. Risk managers built walls around their specialty risk areas

How can we move back to Comprehensive Risk Management?

Recognize that…

- ERM is not truly a new form of risk management.
- Risk management means total risk management, not some subset of risks.
- The process of addressing risks is not stagnant.
- Business risks increase and change as the operational environment changes.

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Three Steps of Enterprise Risk Management

The following three steps will assist Credit Union management with the implementation of ERM.

1. Create targeted actions that are part of the strategic direction of the CU.
2. Identify all risks that may accrue to the CU from each action.
3. Employ risk management tools to assess and mitigate each risk.

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Practical ERM Implementation?

A Case Study

ACTION
Describe what you plan to do

RISKS
Identify all potential risk from the action

MITIGATION
Employ tools to measure and mitigate risks

Applications

Let’s examine a case study to see how this works.

ANY CREDIT UNION

USING 5300 DATA FROM 3/31/2020

VITAL SIGNS	2018	2019	2020	Recommended TCT Solution	Target Goal with TCT Solution
Equity Ratio	12.17%	12.33%	12.07%		8.00% - 15.00%
Loan to Share	47.65%	54.40%	53.51%	Loan Pricing	80.00% - 95.00%
ROA	0.66%	0.39%	0.36%	ALM	0.75%+
Core to High Yield Deposits	520.35%	582.18%	619.05%	Deposit Pricing	95.00%+
Cost of Funds	0.22%	0.21%	0.21%	Deposit Pricing	0.25% - 0.60%
Payout Ratio	5.82%	5.43%	5.54%	Deposit Pricing	3.00% - 8.00%
Asset Growth	0.06%	1.94%	2.86%		3.00% - 8.00%
Deposit Growth	-1.09%	1.25%	3.41%	Deposit Pricing	3.00% - 8.00%
Loan Growth	16.26%	15.59%	1.72%	Loan Pricing	6.00% - 12.00%
Loan Yield	5.39%	5.00%	5.23%	Loan Pricing	5.60% - 12.00%
Investment Yield	2.16%	2.65%	2.23%		2.00% - 5.00%
Earning Asset Yield	3.68%	3.95%	3.90%		4.00% - 8.00%
Net Interest Margin	3.06%	3.17%	3.08%	Pricing	3.00% - 8.00%
Operating Expense	4.51%	4.87%	4.67%		3.00% - 5.00%
Net Fee Subsidy	-1.45%	-1.69%	-1.60%	Pricing	0.00% - 2.00%
Deliquency Ratio	0.44%	0.24%	0.22%	Credit Migration	0.40% - 1.00%
Charge Off Ratio	0.22%	0.05%	-0.09%	Credit Migration	0.40% - 1.00%

ACTION

Add a combination of Loans in order to:

- Increase Loan to Share Ratio
- Increase Interest Income
- Increase Loan and Asset Yield
- Increase Net Margin
- Reduce Net Fee Subsidy
- Accept potential increase in DQ and C/O

Audit Actions

Auditors can provide invaluable support to the credit union by:

- Understanding each of these steps
- Monitoring that the steps have been implemented
- Reporting to management and board on the process

Audit Actions

- As we progress through the case study, we will identify specific actions in which auditors may engage to support and reinforce ERM at credit unions.

MITIGATION

- Policy Review
- Loan Pricing
- IRR Limits Calculation
- Liquidity Shock Test
- Portfolio Management

IDENTIFIED RISKS

Compliance Risk (Policy Creation and Maintenance)

- Forms
- Applications
- Rates
- Underwriting

Audit Actions

Has the credit union applied statistical analysis to:

- Identify the key factors that affect credit risk
- Provide updated policy underwriting guidance that links to risk
- Assured that applicable state and federal requirements have been addressed

IDENTIFIED RISKS

Credit Risk

- Extended Risk
- Expended Risk

Audit Actions

Has the credit union applied statistical analysis to:

- Identify the key factors that affect extended credit risk
- Regularly and consistently monitor exposure
- Take actions when risk is exceeded

Validating Costs

"The key to successful risk-based lending is to ensure that ***prices (rates) correctly reflect the risk and costs involved.***"

NCUA Guidance Letter - 174 August 1995

Validating Costs

A statistically valid pricing system requires:

Identification of costs

- Cost of Funds
- Loan Operations (Activity Based Costing)
- Collections
- Charge-offs

Accurate measurement of costs

Application of costs to loan volume

Set rates that will cover all costs and feed equity.

IDENTIFIED RISKS

Let’s see how this works in the real world…

Audit Actions

Has the credit union applied statistical analysis to:

- Quantify and monitor all loan related costs
- Adopt rates that accurately reflect costs and risk
- Validate the profitability of all loan rates

IDENTIFIED RISKS

Interest Rate Risk

- Establish NII and Equity and Risk Limits
- Apply those limits to planned actions

IDENTIFIED RISKS

Let’s see how this works in the real world…

IDENTIFIED RISKS

Interest Rate Risk

- Net Interest Margin at Risk (EAR)
- EAR facilitates SIMULATIONS that help control this risk.
- Are you maximizing your Balance Sheet? (Exploit)

IDENTIFIED RISKS

Let’s see how this works in the real world…

Audit Actions

Has the credit union applied statistical analysis to:

- Create IRR limits that maximize return and exploit the balance sheet
- Simulate the impact of new loans and other programs
- Provide the board with up to date analysis

IDENTIFIED RISKS

Liquidity Risk

- Credit Unions remain in business because of TRUST.
- Losing that trust can be a DISASTER!
- Testing liquidity can assure that we maintain the trust.

IDENTIFIED RISKS

Liquidity Risk

- Maintaining adequate cash
- Maximizing your Balance Sheet

IDENTIFIED RISKS

Let’s see how this works in the real world…

Audit Actions

Has the credit union applied statistical analysis to:

- Measure and monitor the balance sheet cushion
- Prepare consistent reports on balance sheet cushion
- Provide the board with up to date analysis of liquidity

IDENTIFIED RISKS

Credit Risk

- Loan Losses are a significant challenge for credit unions
- Are you maximizing the portfolio to control risk of loss?

Who Is Putting the Credit Union At Risk?

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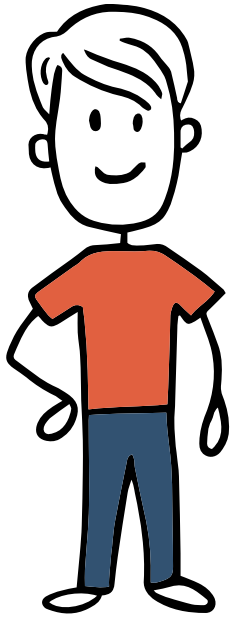
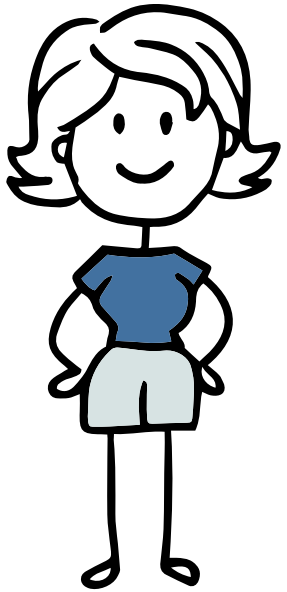
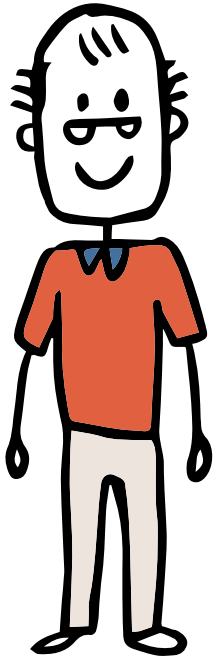


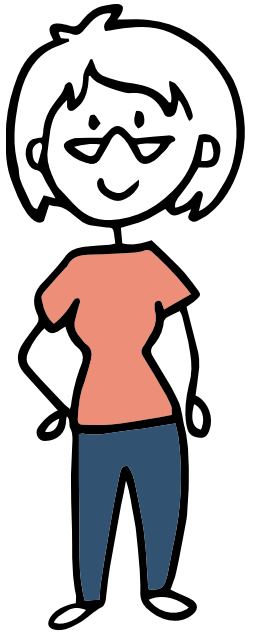
In this presentation we will tell the story of four individuals that represent all the members of your credit union.



Understanding their stories will help us improve loan management better serve our members.



Sit back and enjoy the story of CREDIT MIGRATION



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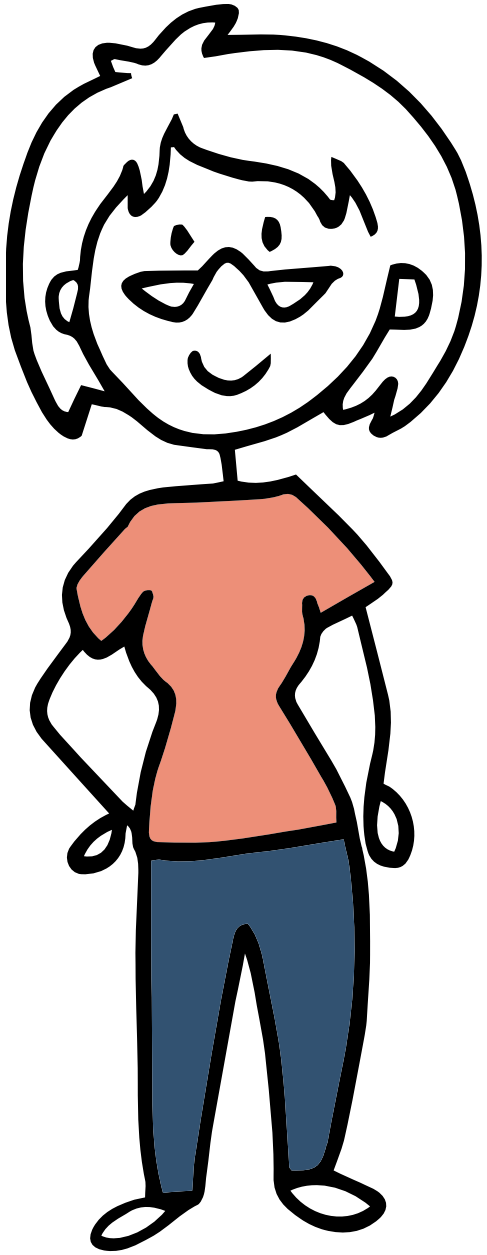

Ruth

Good ole' Ruthie has a high B credit score. She never gets too wild. She buys the same things month after month, she never overspends. Good Ole' Ruthie is still a high B today!

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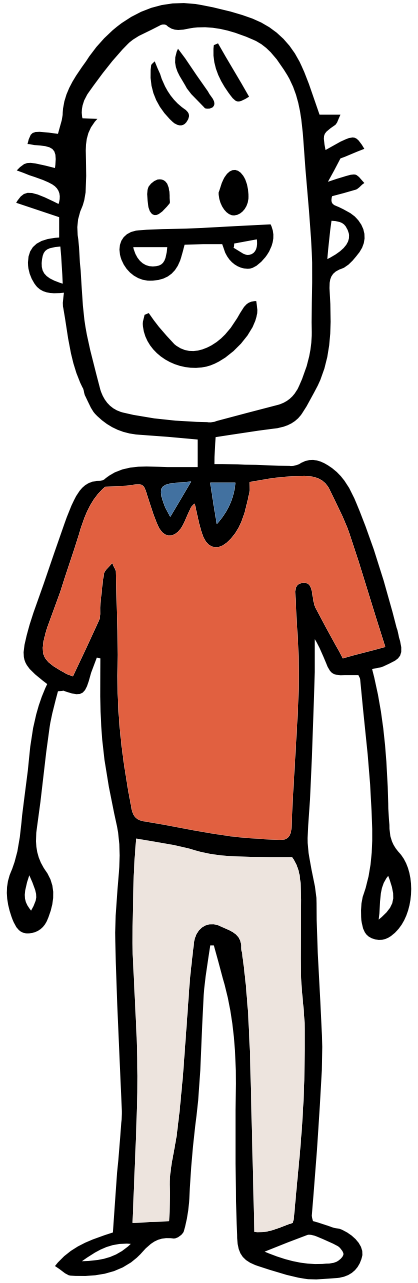

Henry

When Henry first came to your Credit Union, he had A+ credit. Several months ago, Henry lost his job, but he didn't change his lifestyle. He started living off of credit cards and today his credit score is a D.

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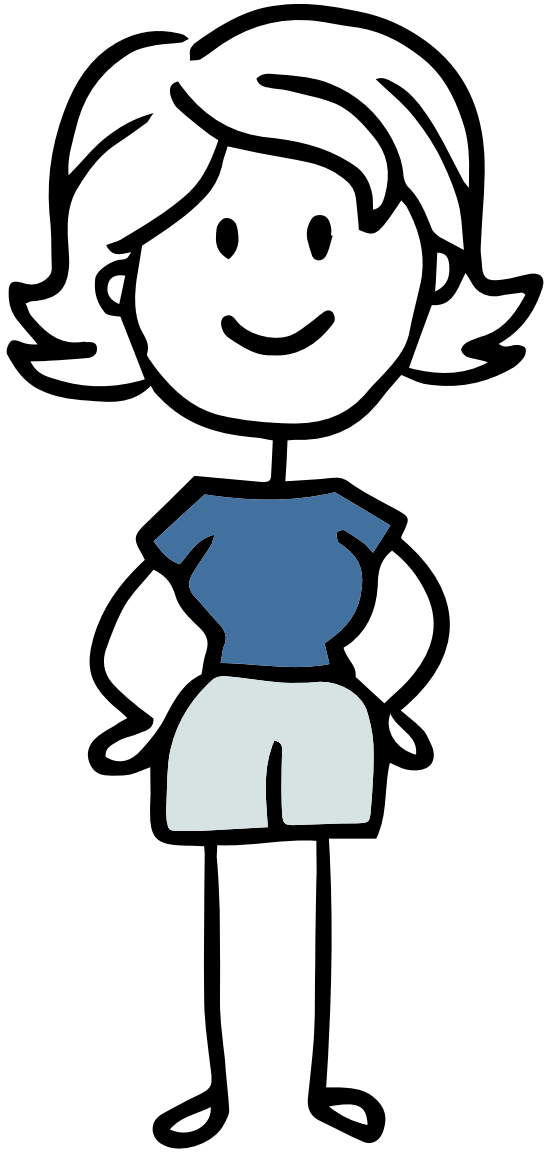

Liz

Liz is a credit newbie. Your credit union decides to take a chance and approve her for a car loan. Over the past few months she has built her credit up to an impressive A+.

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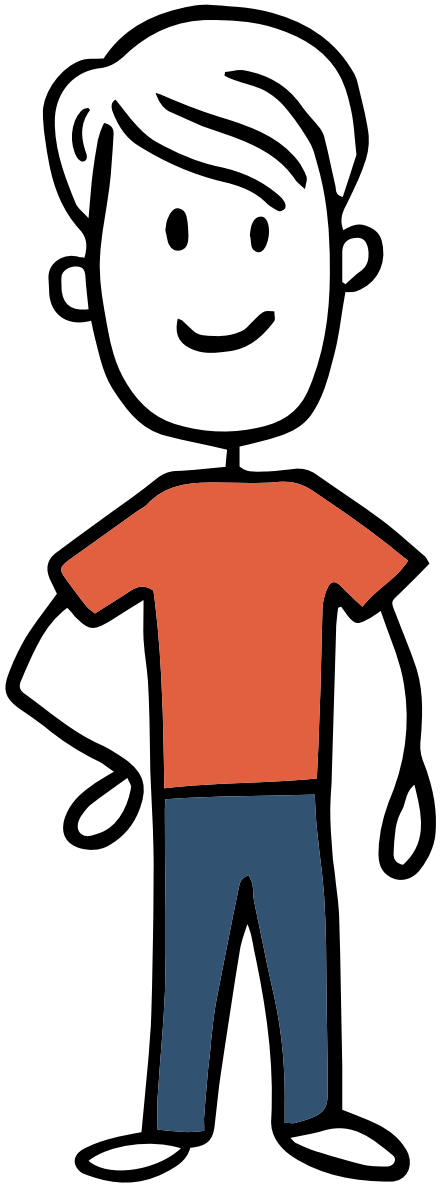

John

Was down on his luck when your credit union financed a car loan for him. His credit was a D. However, his luck turned around and he was able to find a job, make payments on time and even save a buck or two. Today his credit score is an A.

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Audit Actions

Has the credit union applied statistical analysis to:

- Identify members with increasing risk exposure to the credit union
- Take action to limit credit risk
- Identify members with decreasing risk exposure to the credit union
- Take action to expand offerings to these members

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Contact Us |208.939.8366 | djensen@tctrisk.com

100+ CREDIT UNIONS SERVED IN 22 STATES

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