What is ERM and Why Does it Matter?

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?

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.

ACTION

- Add Real Estate Loans in order to:
  - Increase Loan to Share Ratio
  - Increase Interest Income
  - Increase Net Margin

IDENTIFIED RISKS

- Interest Rate Risk
- Credit Risk
- Liquidity Risk
- Compliance Risk

IDENTIFIED RISKS

- Interest Rate Risk
  - Net Interest Margin at Risk (EAR)
  - Are you maximizing your Balance Sheet? (Exploit)

IDENTIFIED RISKS

- Credit Risk
  - Extended Risk
  - Expended Risk

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

- Liquidity Risk
  - Maintaining adequate cash
  - Maximizing your Balance Sheet

IDENTIFIED RISKS

- Compliance Risk
  - Forms
  - Applications
  - Rates
  - Underwriting

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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

MITIGATION

- Portfolio Management
- IRR Limits Calculation
- IRR Simulation Analysis
- Liquidity Shock Test
- Policy Review

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