



CONTRIBUTION FROM

THE CREDIT UNION DEVELOPMENT ASSOCIATION

IN RESPONSE TO

**The Central Bank of Ireland
Risk Appetite: A Discussion Paper**

1st September 2014

Introduction

CUDA (Credit Union Development Association) is a progressive representative & development association that was formed in 2003 by some of Ireland's most progressive and leading Credit Unions, in recognition of the real need for progressive credit union leadership and development in an increasingly complex financial environment.

CUDA is the only legally incorporated representative association for Credit Unions in the Republic of Ireland. Its credit union membership has over 250,000 members.

We would be happy to elaborate further on any points made in this document, if required. Please do not hesitate to contact us in this regard. Contact details are listed at the end of this submission.

Following consultation with our member Credit Unions we have collated the inputs and have some general comments on the subject and we also address the questions set out in the Discussion Paper.

General Commentary

CUDA welcomes the opportunity to put forward its comments to the Central Bank of Ireland on the subject of risk appetite and its linkage with organisational strategy. As a Credit Union representative body we have focused on the importance of this subject to Credit Unions.

It is important at the outset to note that Credit Unions are legislated for under The Credit Union Act 1997 (as amended) and the Credit Union and Co-operation with Overseas Regulators Act 2012 [CUCORA]. Section 76A, requires Credit Union Boards of Directors to set out their Credit Union's "*strategic plan*" outlining the strategy and objectives for their Credit Union. Aligned with the strategic plan under 76B, a "*credit union shall develop, implement, document and maintain a risk management system with such governance arrangements and systems and controls to allow it to identify, assess,*

measure, monitor, report and manage the risks which it is , or might reasonably be, exposed to” .

Credit Union understanding of the subject matter is also informed by both the Central Bank Credit Union Handbook (September 2013) and Central Bank “Probability Risk & Impact System (PRISM)” (November 2011).

Acknowledging the legislative requirements that Credit Unions are bound by there is little value in us discussing a Financial Services wide approach unless it is intended to direct all institutions in a similar manner to that which applies to Credit Unions. However, we do welcome the awareness of the confusion, and resulting inconsistency, which appears to exist around language, definitions and execution. Based on our experience in designing and supporting the implementation of a risk management framework in Credit Unions, we agree with the opening statement that *“A fundamental principle underpinning both risk management and strategy formulation is that the Board must understand the risks to which the institution is exposed and to establish a RAF for the institution”*. We would also state that another fundamental principle is the importance of achieving the appropriate balance between attention to performing the business and to managing the main risks associated with that business.

Credit Unions are required to have a risk management policy that describes their policy for the management of risk within their Credit Union. It forms part of the overall management framework of the Credit Union. The incorporation of risk management within the organisation aims to support and minimise risk to the Credit Union strategy and objectives.

The background comments to the paper draw attention to the challenge for organisations to assess what is the prevailing culture and whether it is consistent with the organisation’s risk appetite. To help manage this important risk, the approach we have taken in assisting Credit Unions understand is to extract and assess risk culture in the credit union before devising a complimentary and consistent RAS. The Credit Union business model is, relative to full service financial institutions, very straight forward – people become owner members of their Credit Union by depositing savings, which are shares in the Credit Union, and thereby create a pool of funds for members to

borrow from. The Board of Directors set the risk appetite for the Credit Union and the risk governance framework to be adopted. The governance framework includes the delegated authorities of the Risk Management Committee, Management team, and the areas of policy for which they are responsible.

This drives the continual enhancement and cultural awareness of risk management in all aspects and areas of the business operation.

This is why we see, and expect to see, different statements, as it reflects the variance that can exist in business models and in particular, where Boards and Management have really questioned and understood the relevance of the RAS. Guidance on this can be difficult as it is understandable, as the paper states, the need to avoid a ‘boilerplate’ approach, whereas in practice what is required is an iterative process [not an event] that ensures conduct of business and management of the associated risks are understood, transparent and proportionate.

We agree with the statement that effective Risk Appetite Frameworks need to be “actionable and measureable”, and we welcome the expectations of the Central Bank as set out in Chapter 18¹ of the Central Bank’s *Credit Union Handbook*. Without this structure there is a danger of the risk management framework, and its component parts, evolving into a pure academic exercise. The guidance states “A credit union’s risk management system should include policies, processes and controls that provide adequate, timely and continuous identification, assessment, measurement, monitoring, management and reporting of risks that the credit union is, or might reasonably be exposed to, through its current activities and the external environment”. It goes on to state that “The credit union should ensure that the risk information collected is appropriate, complete and in a standardised format that will facilitate a complete examination of risks across the credit union. A risk register provides a standardised format for the management of information relating to identified risks”. Furthermore it identifies that the risk management

¹ <http://www.centralbank.ie/regulation/industry-sectors/credit-unions/Documents/CU%20Handbook%20-%20Risk%20Management%20and%20Compliance.pdf>

officer² should provide reports on a monthly basis to the board of directors (or risk committee where one exists), that cover at a minimum:

- significant risks and the effectiveness of systems and controls;
- any risk events that have occurred and the actions taken or proposed to mitigate the risk;
- likely or actual deviations from risk tolerance levels or established systems and controls and should include the timeframe and status of any activities that are proposed to address these;
- any negative trends in higher risk areas and any recommended changes to risk management activities;
- any new risks including their risk assessment, risk rating and systems and controls;
- any material emerging risks and recommended course of action;
- updates on risk management actions arising from previous reports that have been approved by the board of directors (or risk committee where one exists); and
- any recommended remedial action required.

While we do not have significant empirical evidence at this point in time, as this is relatively new and processes are still emerging within Credit Unions, we have noted that there may a gender balance influence on views to risk appetite and risk management, which is an area that we would welcome the opportunity to learn the lessons and experience from other Financial Services sectors.

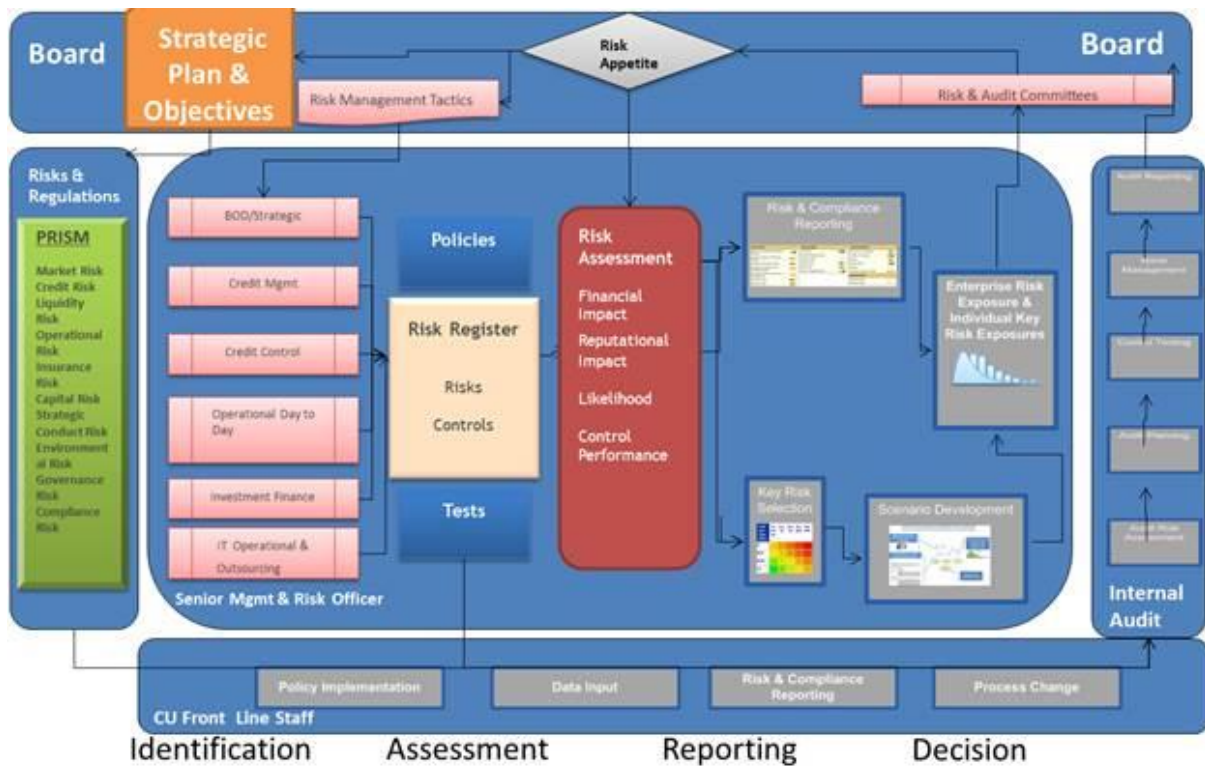
As stated above, we agree with the papers assertion to the risk of creating 'boilerplate' statements, we believe there is merit in Credit Unions adopting a template for the content which is quite different. It is our belief that risk management is about having knowledge of your business, the drivers and the threats. The risk appetite statement then clearly articulates the 'red line issues' or 'riding instructions' for executives to conduct the business of the organisation. This is particularly important now for Credit Unions as we are implementing the newly defined segregation of responsibilities between the Board and Management as set out in CUCORA 2012.

² Appointed under Section 55(1)(e) the appointment of a manager, risk management officer and compliance officer and the approval of the appointment of any other member of the management team;

Questions on Risk Appetite Statements

1. Should all organisations have a risk appetite framework? Please explain your answer.

Risk Management, when done well, is a dynamic process that commits the credit union, to continuous improvement and change that requires time, resources and planning. We believe a risk appetite framework should provide a consistent application and common language by which risks can be managed. The approach we have encouraged is depicted in the diagram below:



In order to appropriately delegate and coordinate risk management in an efficient and effective manner this framework adopts the well-known **3 Lines of Defence Model**, with each line of defence having a distinct role within the business wider governance framework. In accordance with Credit Union Act Section 76C and 76D, Credit Unions are obliged to implement a second line of defence in the form of a Risk Management Officer, and a Compliance Officer, with the third line being enhanced by an Internal Audit function. These functions operate with a degree of independence from the first line role in how they report to the Board of Directors.

The Credit Union is exposed to a variety of risks as it strives to achieve the objectives set out in its Strategic Plan. These risks will be identified, managed and assessed within the risk management framework as depicted above.

In addition to creating a general risk appetite statement, the Credit Union Handbook, published by the Central Bank, identifies the minimum broad risk categories to be addressed in the Credit Union's risk management framework. The Board [or Risk Committee where one exists] will review annually its risk appetite and risk tolerances for the various risks. Qualitative elements, quantitative measures, and risk tolerances within the risk appetite framework are included. This facilitates risks being regularly measured and breaches are reported when risk measures are exceeded.

2. What led to your organisation putting a formal RAF in place?

Legislative requirements.

Section 76B the Credit Union Act, 1997

(1) In this section—

...

'risk management system', in relation to a credit union, means the sum of those components that provide the basis (including organisational arrangements) for designing, implementing, monitoring, reviewing and continually improving risk management processes throughout the credit union;

'systems and controls', in relation to a credit union, means a set of arrangements designed to provide reasonable assurance regarding the achievement of objectives in relation to the effectiveness and efficiency of operations, reliability of financial reporting and compliance with all legal and regulatory requirements.

(2) A credit union shall develop, implement, document and maintain a risk management system with such governance arrangements and systems and controls to allow it to identify, assess, measure, monitor, report and manage the risks which it is, or might reasonably be, exposed to.

(3) The risk management system–

(a) shall be clearly set out and documented, and

(b) shall clearly set out the related tasks and responsibilities within the credit union.

(4) A credit union shall develop, adopt, implement, monitor, document and maintain systems and controls to manage and mitigate the risks identified by the risk management system.

...

Section 55 – Functions of board of directors

(1) Without prejudice to the generality of section 53(1), the functions of the board of directors of a credit union shall include the following:

...

(l) reviewing and approving all elements of the risk management system on a regular basis, but at least annually and, in particular-

(i) assessing the appropriateness of the risk management system,

(ii) taking account of any changes to the strategic plan including the credit union's resources or the external environment, and

(iii) taking measures necessary to address any deficiencies identified in the risk management system;

...

(o) approving, reviewing and updating, where necessary, but at least annually, all plans, policies and procedures of the credit union, including the following:

...

(xv) risk management policy;

...

(3) The board of directors shall implement a risk management process that ensures that all significant risks are identified and mitigated to a level consistent with the risk tolerance of the credit union.

3. How are risk appetite and strategy related?

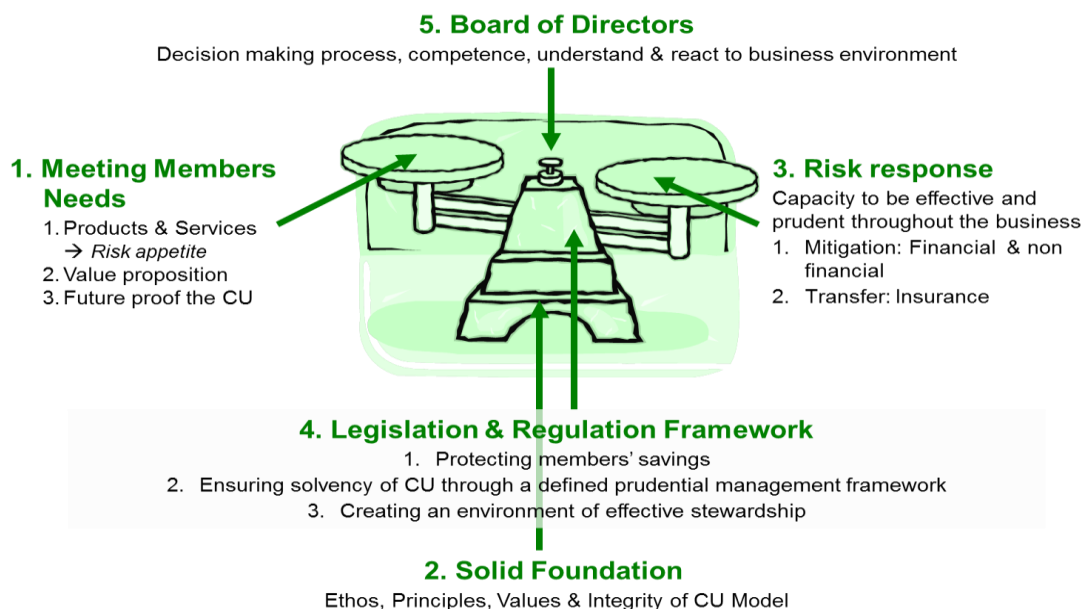
See response to question 1 above.

4. In your opinion would it be desirable for the Central Bank to facilitate a forum, comprising participants with experience in the financial services industry to develop a range of good practices with respect to the preparation and monitoring of Risk Appetite Statements?

Yes. However, it is important that any such forum respects the uniqueness of Credit Unions and is cognisant of the prescriptive legislative requirements that Credit Unions are bound by in this area.

Risk appetite

We agree that “Setting a risk appetite is not about elimination of all risks”. In our response to CP76, The Central Bank of Ireland’s Consultation on the Introduction of a Tiered Regulatory Approach for Credit Unions, we spoke of the “weighing scales” approach to regulation - offering a wide range of consumer lending products is simply part of what even relatively small credit unions do in other advanced countries, the key is to get the balance right...meeting member needs, managing the risks involved and having the appropriate governing framework. We depicted this approach by way of the diagram below:



The scales become unbalanced if too much weight is placed on any one component. We firmly believe that the strategic direction and associated decision making power rests with the Boards of Directors and not, for example through regulating to eliminate risks, as this inadvertently could create a concentration risk leading to more “risky” responses as the credit union seeks to maintain sustainability and viability. It was our belief that the proposed approach, contained in CP76, contained the potential to reduce the decision making process by attempting to eliminate risk, rather than manage it, and thus would have restricted Credit Union business models. This can have a crucial negative impact on a Board’s ability to manage a viable business.

We concur with the paper that “An effective risk appetite statement is empowering in that it enables the decisive accumulation of risk in line with the strategic objectives of the organisation while giving the board and management confidence to avoid risks that are not in keeping with the strategic objectives”. We believe that this is the ‘selling point’ for an organisation to have a RAS.

Establishing a common risk language in the organisation

Here we also agree with the Discussion Paper’s identification of the need for clear and meaningful articulation of risk appetite. While the paper states that “the Central Bank does not currently define what is meant by risk appetite”, it is worth noting that the Central Bank does state in its Credit Union Handbook that “A credit union should document its risk tolerance statement, setting out the quantified level of risk that the credit union is willing to accept in various risk areas in pursuit of its strategic objectives.”

The paper contains excellent explanations and definitions of key terms and where they should fit into the RAF. This is helpful and welcomed, as we have noted that there is a potential exposure for Credit Unions who may use generic risk management software applications in isolation of developing a well thought out risk appetite statement first that this may lead to deficiencies in their approach to the subject.

Questions on Risk Appetite, Risk Tolerance and Risk Limits

1. What definition of risk appetite does your organisation consider to be appropriate?

The amount of each category of risk that the Credit Union is willing to accept to achieve its objectives.

2. In your view, how are risk appetite, risk tolerance and risk limits related to one another?

Risk appetite, in the positive sense, will promote taking on manageable risk, risk tolerance sets out the threshold levels of risk exposure that, with appropriate approvals, can be exceeded, but which when exceeded will trigger some form of response e.g. reporting the situation to senior management / board for further consideration and action, while the risk limit sets the ordinary acceptable boundary measures. We would add that while the tolerance level allows some flexibility around the limits, it remains cognisant of risk capacity i.e. where / when will the lights go out?

3. How does your organisation use risk limits and risk tolerances around those limits?

As we are at the early stages of development and implementation of an appropriate RAF the concept of separate limits and tolerances is not commonly used. Rather, at this stage of culturally embedding risk management in a meaningful manner, we see a focus on establishing the RAS for each key category, with appropriate metrics and limits. This then forms the basis for reporting.

4. How does your organisation facilitate early warning reporting of potential breaches of risk appetite?

The Risk Management Framework report comprises a suite of reports based primarily on the guidance provided by the Central Bank in the Credit Union

Handbook. In the list of minimum coverage for reports it specifically states that likely or actual deviations from risk tolerance levels or established systems and controls are to be reported, and should include the timeframe and status of any activities that are proposed to address these. This duty is performed by the RMO and is reviewed on a monthly basis with the Risk Committee and formally quarterly with the Board.

Responsibility and Risk Culture

The commentary at 4.1 of the paper concerning culture is essential to effective risk management. For when we speak of risk management, context is extremely important and will require a comprehensive understanding of both external and internal change that will impact achievement of objectives. The pace of change is also significant. In the credit union context “external” will relate to legislative and regulatory change, financial sector change, technologies and location. While “Internal” will mainly relate to the culture within the credit union, formal and informal structure, relationships between stakeholders and processes deployed. Risk management creates a culture that recognises uncertainty and supports considered risk-taking. For risk management to add value, we believe the credit union culture must be created which recognises that to manage risk appropriately means taking calculated chances. Zero risk is neither possible, nor desirable, and a tolerable level of risk that matches the appetite for the credit union’s activity is needed.

Again, the legislation governing Credit Unions recognises this and includes in the responsibilities of the Risk Management Officer the following:

-
- *supporting the board of directors in promoting a culture of risk awareness, identification and management at every level within the credit union.*

Questions on Risk Culture and responsibility

1 How does your organisation assess risk culture?

We are not aware of a specific mechanism for the assessment of risk culture itself, rather we see the Credit Union focus being on the systematic application of

policies, procedures, methods and practices to the tasks of identifying and assessing risks, and then planning and implementing risk responses. This is what the RMO reports on and we believe it is providing a disciplined environment for proactive decision-making.

2 What are the challenges that organisations face in terms of communicating risk culture to stakeholders?

Lack of understanding of risk culture, leading to unwillingness and \ or an inability, to articulate clearly and meaningfully, their risk culture. This can be further compounded by a sense that there may not be a need, or indeed benefit, to communicating risk culture. As mentioned before, this is the early stages of implementation and as the requirements to identify inherent risk, and control measures more personnel will realise that they will already have risk management practices imbedded and these are already part of the culture in credit union operations.

Expressing risk appetite

It is welcomed to see the interpretation of the characteristics of an effective risk appetite statement, in particular we agree with the “Brevity and Clarity” and that it is possible to communicate the appetite concisely in an understandable form. It is very important that the RAS is clear, concise and practical. Therefore, we would caution to the dangers of attempting to pack too much into the RAS and thereby rendering it ineffective. Our preference is to see it as a high level statement, and the more operational issues be managed within the overall risk management framework, with detail contained in Policy and Procedures. Examples of these are the timelines, escalation and mitigation details.

Questions on expressing risk appetite

- 1 The Central Bank has suggested characteristics of an effective risk appetite statement. How would you improve this?**

This is likely to be the last step in implementing an effective risk management system within the Credit Union, as there will then be a clear understanding of the risk appetite and then an appropriate statement can be articulated. This statement will evidence that the Board, CEO and senior management team have linked the overall strategy of the credit union with how much risk it is willing to take and how it wants to balance risks and opportunities. This will include the amount and type of risk a credit union is able to support in pursuit of its business objectives, while balancing this with its regulatory reserve requirements.

2 How does your organisation determine the metrics that are most appropriate for your business?

Section 76B (2) CUCORA 2012 states... *A credit union shall develop, implement, document and maintain a risk management system with such governance arrangements and systems and controls to allow it to identify, assess, measure, monitor, report and manage the risks which it is, or might reasonably be, exposed to.* Guidance is provided to Credit Unions by the Central Bank [in the Credit Union Handbook] which states that reports should cover the following at a minimum:

- significant risks and the effectiveness of systems and controls;
- any risk events that have occurred and the actions taken or proposed to mitigate the risk;
- likely or actual deviations from risk tolerance levels or established systems and controls and should include the timeframe and status of any activities that are proposed to address these;
- any negative trends in higher risk areas and any recommended changes to risk management activities;
- any new risks including their risk assessment, risk rating and systems and controls;
- any material emerging risks and recommended course of action;
- updates on risk management actions arising from previous reports that have been approved by the board of directors (or risk committee where one exists); and
- any recommended remedial action required.

It is clear that metrics will relate to **capacity** in each area ensuring liquidity, solvency and/or Credit Union reputation are not diluted by eroding member value through adoption of risk elimination strategies or excessive short-termism. This is arrived at by assessing all risks, including those arising from “risk mitigation plan” as highlighted by Central Bank inspectors.

3 How has the use of metrics changed in your organisation?

As this is a new area for Credit Unions it is not a case of how the metrics have changed, rather how a new set of metrics are guiding Boards and Management to view their business with an added perspective – one which considers probability and impact, both in terms of financial impact and reputational damage.

We look forward to any additional queries you may have in relation our comments and we are happy to provide the Central Bank with any additional information that may be of assistance.

Again, thank you for the opportunity to contribute to your discussion on Risk Appetite.



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