

Introduction

All financial institutions - credit unions, banks and thrifts - are exposed to and take a variety of risks. Fundamentally taking risk is an essential element of our business model. In today's complex financial services environment, the nature and potential severity of risks to which financial institutions are exposed - no matter their size, location, or business strategy - have increased significantly. As has been dramatically demonstrated, taking risks without adequately understanding the potential consequences of those risks can have far reaching implications for the institution's future success. The risk environment has changed dramatically in the last ten years, threatening the earnings, loan quality, growth opportunities and the ongoing viability of some financial institutions. As the pressure to maintain profitability intensifies, some institutions may be accepting greater risk to maintain returns and margins. Many institutions may realize too late that too little emphasis has been placed on understanding and managing risk.

The ability of directors and executives of financial institutions to oversee risk has long been a primary concern of regulators. Regulators acknowledge that different institutions face different types of risk, depending on their business strategy, size and other variables. But they also make clear that all institutions bear risks, and the methods used by financial institutions to identify, measure, monitor and control risks will be specifically evaluated during supervisory examinations. Since the mid-1990s, all regulatory agencies have adopted a risk-based approach to examining financial institutions. Increasingly, they are holding boards of directors and management directly accountable for the quality of the institution's risk management program.

In this environment, a risk management plan is more than a "nice-to-have" document; it is a critical element of any responsible management structure. Management should assess risks inherent in the institution's business and operating environment, ensure that adequate risk management guidelines have been incorporated in the institution's policies and procedures, and establish an on-going risk management program. Boards of Directors should understand the levels of risk that are inherent in the activities they govern. By merging effective risk management practices with sound planning, institutions can reap long-term benefits and insulate themselves from unexpected problems and economic downturns. A sound risk-management culture should start with some form of early-warning-system that can be monitored regularly to observe levels and trends in a wide variety of risk elements.

Borrowing a Concept to Help Credit Unions

In late 1999, the Office of the Comptroller of the Currency (OCC) unveiled "Project Canary". Like the role of the canary in the mining industry this project was created to provide an early-warning-system to enable regulators to identify financial institutions with excessive risk. The goal of Project Canary was to develop a series of benchmark risk ratios that could be calculated from call report data and used to evaluate credit risk, interest rate risk and liquidity risk at OCC-regulated institutions. Every quarter the OCC calculates 15 risk-related ratios for each institution it regulates and compares those ratios to established benchmarks.

The results are used to prioritize the OCC's examination efforts. Those institutions with high levels of risk, indicated by exceeding several benchmarks, will likely be targeted for early or additional examination work. This methodology has been so effective, as one predictive tool that the Federal Reserve Bank, FDIC, NCUA, and the Office of Thrift Supervision have all adopted almost the same monitoring tools.

Under this early warning system, reports provide an analysis of the 15 benchmark risk ratios on a quarterly basis. The results help identify those institutions that might be growing too rapidly, accepting an immoderate level of credit risk, relying too heavily on volatile short-term funding, or exposing themselves to significant asset/liability pricing and interest rate risk. The 15 risk ratios are broken down into three categories: credit risk, interest rate risk and liquidity risk. Six ratios relate to credit risk, four to interest rate risk, and five for liquidity. These measures are static measures because they refer to an institution's risk position at a given time. If three or more benchmarks within a specific risk category are exceeded, the regulator generally assumes a severe increase in risk in that measurement area. The ratios used are a valid measurement of risk for all sizes, types and charters of financial institutions. There are certainly differences in balance sheet composition between banks and credit unions however the goal of these ratios is to indicate levels of risk no matter the type of institution.

When discussing CANARY ratios a former FDIC Chairman, Donna Tanoue, commented that, "a tornado watch does not mean that severe weather is inevitable but that conditions exist for the development of a tornado and that one needs to keep up to date on the latest weather information." Similarly, the ratios in this report can indicate conditions of increased risk exist which *might* lead to stormy weather.

So, do these ratios provide good information about underlying risk issues? Can these ratios really be useful to someone other than a financial institution examiner? Does each ratio provide adequate information for easy understanding? Do the ratios provide the information needed by management to take appropriate actions?

In practice the OCC only applies this methodology to nationally-chartered banks however we believe the ratios are useful to all institutions in analyzing risk conditions. For example, rapid loan growth or significant changes in the portfolio mix can strain underwriting and credit risk standards, as well as the capacity of credit risk management and administration processes. As loan growth rates increase, credit risk increases in tandem. Many community-based financial institutions, however, lag behind their larger counterparts when it comes to devoting resources to risk management, believing that less complex institutions do not have the same need or capacity to manage risk as do larger institutions. The reality is that institutions of all sizes face the same risks, with varying degrees of exposure, and have the same need to manage those risks.

What Filene Risk Watch Report Doesn't Do

These ratios are the simplest of analytical tools used by the regulators to assess risk.* They act as an early-warning system, or the first line of defense in identifying risky institutions. However, by their nature they are static ratios based on historic call report data and they cannot take into account future changes in balance sheet composition. They are not a substitute for simulations but, as a starting point in understanding risk and in communicating that information to non-financial leaders of the institution. It is also fair to say that certain of the measurements do not directly measure risk but rather are ratio characteristics that regulatory experts believe highly correlate to actual measures of interest rate risk. Research supports this argument and has historically confirmed that more in-depth analysis of supporting data do show the same trends that are reflected by the trends of these ratios.

A credit union can gain genuine insight into inherent risk levels by closely monitoring both risk indicators and trended risk indicators. As with any performance measurement the trend of the ratio is just as important as its level. It is important to understand that this report is *not intended to be compliance driven (comparing your credit unions operations to regulatory rules); rather it is designed to provide a thorough overview of the risks that are inherent in your balance sheet.* It is possible to be in compliance with regulations but still be incurring high levels of risk as the current economic environment clearly illustrates. This report is intended to provide a broad overview of many of those risk elements. Although credit unions tend to have higher ratios than banks in certain areas the fact that “everyone’s the same” doesn’t alleviate the inherent risk in those areas and those risks must be understood.

It is essential that, in reviewing your Filene Risk Watch Report, you bear in mind that the benchmarks represent *the regulators* assessment of risk and, by their very nature, they are conservatively structured. The regulatory agencies simply assess whether an institution is within the range of “regulatory preference” for each benchmark ratio. For the purposes of this report each benchmark is “scored” on a Red/Yellow/Green system.

- A Red score represents exceptions to regulatory preferences.
- A Yellow score is given when the institution is getting close to the regulatory preference - this allows the institution to monitor trends more closely for its Yellow ratios.
- Green represents a benchmark where the institution is well within regulatory expectations.

Also consider that credit unions operate in a sector that inherently balances risk and reward. A lowering of risk, generally speaking means a lower reward. Being too far into the green area of every ratio may provide comfort as to the level of risk you are taking but could also indicate that strategically there is insufficient focus on balancing sufficient levels risk with sufficient levels of reward. On the following pages we present your credit union's customized Filene Risk Watch Report along with a set of conclusions, recommendations and potential next steps.

* The NCUA, for example, uses approximately 170 financial ratios to assess credit union risk today.