NEXT**LEVEL**SOLUTIONS RISK AND REGULATORY INSIGHTS

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CREDIT UNIONS AND REGULTORY REALITIES

From a risk management perspective credit unions have a certain levels of uniqueness that often places them in a disadvantageous position when compared to larger, more capitalized supervised financial institutions. Firstly, credit unions are small and generally do not have the ability to afford the level of sophisticated systems often observed elsewhere. Boards are often drawn from a pool of persons who are not deeply exposed to financial, risk and strategic management issues. Staffing is sometimes limited. Risk management approached differently.

Credit unions, by virtue of their bonds, have a restriction on who can participate. Most activities are based on membership, consequently there is a limitation in the universe from which talent can be drawn for boards and committees. While credit unions do have unique challenges we believe that with creative effort these issues can be managed and even overcome. This would demand proactive collective effort, openness to change and a willingness of the regulator to facilitate adjustments which may become necessary.

The switch of regulatory oversight to the Central Bank of the Bahamas creates its own set of challenges. The standards have been heightened, the approach to supervision more robust and scrutiny likely more focused than in the past. *Some Credit Unions seems to be struggling with this shift. While the issues cited are important, maybe the thing that is most critical is the pace at which some credit unions seems to be adjusting to the change.* The oversight regime will not change. The environment is getting riskier and more disruptive. Credit unions boards and senior management must adjust and adapt quickly. This is fundamental for regulatory compliance, competitive viability and success.

THE RESPONSE

At **NextLevelSolutions** we believe the approach by credit unions should be aligned with the following:

I. <u>Take a strategic approach to the situation. Regulations demand strategic shift and thinking</u>. Position or reposition your credit union to be highly aware and responsive to the "new" circumstances. Board, senior management and staff needs to <u>be fully aware of and understand the regulatory regime and requirements.</u>

II. <u>Become very knowledgeable</u> about the new regulatory environment. Take steps stay ahead of the knowledge curve. Prudently be an early adaptor and <u>use this as a strategic thrust to gain competitive advantage</u>.

III. <u>Re-define how risk management is seen</u>, using it as a strategic tool to address the vagaries of an ever changing environment. The ability to demonstrate effective control and to manage more complex risk holds significant importance for operational effectiveness. <u>The Governance-Risk-Compliance model is the way to go.</u>

IV. <u>Do not look at risk management as a burden but rather a strategic imperative</u> that facilitates the protection of, and addition to, shareholders' value. Risk Management is about reducing exposure, exploiting opportunities.

V. <u>Secure assistance as needed to help creates sound understanding, *deliver practical solutions* and work to achieve and maintains sound compliance with regulations and stay in the "good book" of the regulator.</u>

In this our second issue of the **Risk and Regulatory Insights** we draw attention to important expectations of the Central Bank, which if properly addressed, effectively implemented and managed will position the credit union to successfully comply and thrive in its new regulatory paradigm. This is not intended to be a comprehensive analysis but rather instructive in guiding outlook, informing board and senior management approach to addressing risk and regulatory concerns and engender some confidence in navigating this important path.

The following are selected question drawn from a Central Bank of The Bahamas' questionnaire sent to credit unions a few years ago. At that time the objective was to develop a risk profile of each institution. They are used here to draw attention to where Credit Union can focus in their bit to develop robust risk management and governance systems. *The main focus here is on credit unions but the following can be applied to any organization, especially regulated entities*.

	RISK QUESTION	INSIGHTS
1.	Does the risk assessment methodology of the Supervised Financial Institution's (SFI) internal audit adequately capture the risk profile?	A *risk assessment provides the basis for assessing the adequacy of an internal audit's work* by ensuring that it is adequately covering the critical risk exposures of the Credit Union. As the main risk function in Credit Unions this is fundamental. Beyond this *a risk assessment is crucial to the strategic management of an organization*. The critical take away is that all credit unions should routinely have a comprehensive risk assessment based in a robust methodology, delivering an accurate risk profile.
2.	Explain the process of tracking issues identified in the internal audit report.	Remedial action for matters identified by internal audit or other review functions must be taken in a timely manner. Additionally these matters should be tracked. *A system incapable of doing this represents a weakness in the risk management system and could ultimately lead to regulatory sanctions*, depending on the severity and length of time. *Long standing unaddressed issues, internal or externally identified, are a significant red flag for all regulators*
3.	Has the SFI had challenges meeting the statutory liquidity deposit and statutory reserve requirement of 10%?	The viability of a financial institution involved in deposit taking revolves around the ability to meet depositors demand on a timely basis. Statutory limits are set to protect the interest of not only the narrow class of depositors but also protecting the integrity of financial system. *Decisions around deposits and managing reserves holds serious implications for the profitability and should be paramount in the mind of boards and senior management*.
4.	What is the composition and quality of capital and the level of capital adequacy? Has the SFI had challenges meeting the statutory requirement of 10% for its capital ratio?	Capital is the ultimate bedrock of managing the risk of a financial institution. It is indicative of the level of risk which can be introduced to the balance sheet and the extent to which the institution is well placed to meet its regulatory obligations. *Boards of directors would pay special attention to understanding not just the quantum but also the quality of capital* and should always be cognizant of aligning business decisions with risk capacity.
5.	How effective senior management/ The Board have been in implementing strategic plans?	Before having the ability to effectively implement the strategic plans must exist. It is crucial that boards and senior management actively engage in sound planning which is informed by and informs the risk management apparatus and regime. *Risk functions should be mindful that risk management is about facilitating the institution to meet its objectives*. Consequently strategic plans and business objectives are the starting for an effective risk assessment and risk analysis and determination of risk treatment. Care should be taken to *protect against*

		operating in silos, ensuring that information is seamlessly cascaded and escalated throughout the institution.
6.	Is there a process for tracking implementation of the strategic and business plan and modifying the plans in response to changes in the business operating environment and specific events?	See above. *Modification, adjustments, re-strategizing are all outputs which are informed by risk management processes*. Importantly organizations should manage with flexibility and being respectful of the environment in which they operate. Failure or lack of urgency in being responsive to shifts, internal or external, in the operating space could result in losses, loss of competitive ground or disruption in operation leading greater exposures for the organization which could ultimately imperil its capital.
7.	Is there a process in place for setting high-level strategic objectives for the SFI and translating these into detailed shorter-term business and operating plans?	This process is in the wheelhouse of boards and senior management. It points to the need for there to be high level strategic objectives and an anticipation that these objectives must be further translated into shorter tem objective. *Failing to have a long term outlook for an organization is a weakness and handicaps planning. Failure to translate into more manage objectives complicates achievement and properly allocate resources.*
8.	Is there a structured risk-based reporting regime to ensure ongoing reporting to senior management and the Board with respect to all relevant key risk areas and subsequent tracking of matters escalated?	No organization has the ability to manage every single risk exposure with the same level of attention. *Given that risk exposures vary and have different level of importance for it is more effective and efficient for a risk based approach to be taken.* This ensures that the critical risks gets the greatest level of attention which those posing the least exposure for the entity is address at a requisite lower level or over a longer time horizon. One valuable output of a risk based approach is the ready appreciate of risk issues which must be escalated to the board or up the chain of command.
9.	The Non-Executive Director(s) of the SFI to show that they have relevant skills and background to provide adequate independence and challenge to senior management.	*Boards should be comprised of individuals who have the requisite skillset, competency and experience to provide oversight for the operational and risk management efforts of the organization*. Credit Unions often struggle in this area but we believe that as a movement and with the support of The League there are creative means of bridging this gap. Fundamentally training and effective orientation, support and consultation can assist. In the end though each director has a fiduciary responsibility and should ensure that proactive steps are taken to be able to adequately discharge board responsibilities.
10.	Does the Board undertake a comprehensive annual review to ensure that corporate governance meets its objectives and are the results of the review incorporated in the required annual attestation to the CBOB?	The attestation given to the Central Bank ought not to be a box-ticking undertaking. *Often organizations represents a level of compliance with corporate and risk management requirements which on later inspection proves to be otherwise*. It is critical for boards to ensure the accuracy of these and understand that the actual response is but an output of the state of risk management processes and should not be based on guess or assumptions. It is expected to be guided by senior management accordingly should

		hold them accountable in the same manner as the Central Bank will hold the board accountable for inaccuracies and misrepresentations.
11.	Please indicate in your response whether the annual review incorporates the review of action plans in place to remediate the adverse findings of internal and external independent reviews of controls including CBOB on site examinations.	No system or process will be perfect. At times there will be challenges. The anticipation is that organizations will be proactive and identify and lay our comprehensive remedial plans for correcting challenges. *Actions plans should be real and sound and not simply created as a means of "covering" an item.* It should be remembered that satisfaction of the regulator is only subsidiary to management objectives. *Doing the right things, doing it at a fundamental level and accurately automatically will fulfil regulatory requirements*.
12.	Please indicate in your response how the Board receives assurance from senior management that all aspects of the credit union's operations are effectively controlled and all key inherent risks in the business are effectively managed on an ongoing basis.	This assurance *should be had by means of an independent function such as internal audit*. Internal audit provides assurance and helps the boards to confidently come to a conclusion, positive or adverse. The work of internal audit as the third line of defense is not to create compliance but to opine on the state thereof. Management and the supervisory/credit committee is anticipated to provide the first two lines of defense.
13.	The various risk committees established by the SFI and indicate their areas of responsibility and composition?	All *committee should have clear charters or mandate which delineate their responsibilities, roles and obligations* to the institution, board and any other stakeholders imposed by law or regulations.
14.	Does the Board regularly review policies and procedures to ensure that proper controls and risk management processes have been put in place appropriate to the business and risk profile?	This is an obligation of the board without an expectation that the board is the entity doing the actual reviewing. Here is where it has the benefit of internal audit or other risk function. The supervisory and credit risk committee has an important role to play in this process. *This point leads back to the extent to which an adequate risk assessment is carried out, proper design and implementation of controls, effective risk management with an appropriate risk based approach having regard for inherent and residual risk and proper remedial actions for identified problems*. Risk Management can be delegated but not the associated responsibilities.
15.	Does the senior management team of the SFI have appropriate experience and skills to effectively manage the business and risk profile?	The actual day-to-day running of the institution is in the hands of senior management and *they should be competent, understand the business and know how to manage the risks involved* in meeting the business objectives of the institution.