# Credit Risk Ready Podcast

## Host Linda Keith CPA With Tim Harrington CPA

## *Risk Appetite: How the Board Decides, Defines, and Communicates Their Choice*

Hi, this is Linda Keith CPA with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk.

Risk appetite is a phrase with a meaning, but I always wondered how exactly that gets decided, defined, and communicated. How should directors think independently of the credit union or bank management on the subject? How do they monitor if the management is actually sticking to the diet?

Well, to help us with this, we have Tim Harrington, president of TEAM Resources. That's a firm providing consulting, strategic planning and training to credit unions. He is also the author of a credit union guide to strategic governance, and for five years was chairman of the board of $150-million credit union in Tucson, Arizona. Prior to that, Tim was a partner with the nation's third-largest auditor of credit use known today as CliftonLarsonAllen. Tim knows a lot about this subject and I'm so happy to have you.

Welcome to the podcast, Tim.

**Tim Harrington:**
Well, Linda, so glad to be part of this, too. So glad to be visiting with you. We've been friends for a long, long time.

**Linda Keith:**

We have. We have. So, let's just start out with a definition, Tim. What is risk appetite?

**Tim Harrington:**

Well, it's the amount of risk that a group is willing to take and/or the fear of risk, which is just as evident, I think, sometimes. We try to measure it through a survey process. It's not really measurable. But we try to identify throughout this measurement process, “Is there a difference between members of a team, so

it can be members of the management team or members of the board of directors, and is there a difference between those two teams? Are they thinking about risk differently?"

**Linda Keith:**

Do you think that when someone wants to be a director or elected as a director in the first place is there any attempt to like try to recruit people that actually have a risk appetite that's similar? Or is it actually a good thing to have a variation in risk appetite in your board?

**Tim Harrington:**

You know, most people as they're recruiting or nominating new directors don't have as part of their checklist, "What is the person's risk appetite?" I think that is discovered once they're on board. By that time, I suppose, it's too late if it's an extremely different risk appetite.

**Linda Keith:**

Right.

**Tim Harrington:**

But the other part is if we all think the same, we don't need both of us. It's never a bad thing to have some differences of opinion. But it is important that the groups do agree at some point in a broad-spectrum risk appetite. Either they're going to be really aggressive on growth and change or moderately aggressive on growth and change. Or they're risk averse and they're aware of that and the consequences of it. But it does help if they agree on that.

Now, it doesn't mean over time that's not going to change or someone who might be an outlier becomes the dominant voice of the group. You could have a very risk-averse organization. There's an outlier who thinks, "We better get more aggressive or we're going to disappear." And that outlier might become the dominant voice at some point.

So, what it is is it's a map. The map just tells you where you are. Sometimes if management is struggling with ideas, trying to get the board to agree on funding certain ideas, it really helps to have this map say "Oh, my goodness. This is why they're struggling with it. We're on very different maps of this risk appetite. We're way over here on aggressive risk. They're way back here on 'Let's not risk our capital at all.' Now we've got to come to terms with that."

Linda, the survey itself is really just a conversation starter.

**Linda Keith:**

Right.

**Tim Harrington:**

It's done in a room with the whole group of, you know, seven management team people and seven directors. Once they talk about it, they come to agreement on most areas. Some of the areas you find,

"Well, boy, there's a real difference here and they have some more work to do." But mostly just in a couple of hours session, you can go through the entire risk appetite survey, at least those where there's a big difference between the two groups, and come either to a center where they both agree somewhere in the middle, or one group convinces the other group of their point of view.

**Linda Keith:**

Well, does this relate to what type of lending we're going to do? Or what type of demographics are we going to go after? Or are we going to quit doing a particular kind of lending all together? Is it all about lending? Or what else is it about?

**Tim Harrington:**

So lending is one element of it. Member, or customer, and what they get out of their relationship with the credit union or bank is another element of it. The processes in place, which include technology and so that's where technology fits in. I think that probably has the most questions of all of them. Financial liquidity… I'm looking at the questions here as we're going along. The financial liquidity question you have, which is about concentrations and how aggressively they want to build loans. How aggressively they want to take risk, maybe non-prime borrowers or weaker commercial borrowers, whatever it might be. And the compliance issues, you know. Where do they want to push the envelope on regulatory issues, or an issue according to GAAP, where they're going to take a different stance on some kind of accounting principle? And the last one is personnel, the people they have involved. How willing are they to jettison some of the people in the organization who indicate they're unwilling to move forward? And how much they recognize the need to have the right people on the bus as we move forward?

**Linda Keith:**

So, are you saying that if the risk appetite is too different between the board and the management, one of the questions for the board would really be, "Is this person that's in management, in that position, not the right person for us because we simply are too divergent on our risk appetite?"

**Tim Harrington:**

It would be that. Obviously… We teach governance, too, and one of the things we teach in governance is the board has no authority over who the CEO hires or fires. However, the board can have their favorites. They can have people who they really would not like to leave the organization. They might love the status quo where the CEO is really dying to make a change. It's important to find that out. "Are these your favorite children over here? Because they're not fitting the direction we're going. " So board doesn't have that authority if they follow an appropriate governance method. It doesn't mean they don't make it clear that they would like something to happen or not to happen.

**Linda Keith:**

They have influence even without authority.

**Tim Harrington:**

They do. Honestly, they have all of the authority in the organization til it gives it over to the CEO. One of the things they really should give to the CEO is all hiring and firing authority. But they can overstep their own policies, or their own agreements, if they want to because they have that much power.

**Linda Keith:**

Right. I remember once I was on the board of directors of a national professional association. I even read some of the governance books. I was really trying to understand governance. Because like many bank and credit union directors, you know, we're business owners, or we work in government, or whatever it is, and then we come into this director position and it takes some time to figure out what in the world is this actual role? And so, I'd come to that decision that we advise. The CEO has to actually execute. He wanted to get rid of some people. I thought it was a big mistake. But I thought, "Okay, that's his responsibility. He knows what we want him to accomplish."

**Tim Harrington:**

Right.

**Linda Keith:**

Well, it was a little bit of a disaster. It was almost like he started experimenting. He'd been the CEO for 20 years, so a long time. That was a part of the impetus to give him a lot of credit, right? It was like, "Oh, well he's got 20 years here. He knows." But there was a point where it just felt like we kind of gave him permission because he was the CEO. And then one after another, I just go, "My gosh, what is he thinking?"

**Tim Harrington:**

Right.

**Linda Keith:**

We never reeled him in because we never quite figured out how to do it, or whether maybe he still was right. We just didn't understand what he needed to do to accomplish what the goals of the organization were.

**Tim Harrington:**

Right. Then you find out you have the wrong CEO. That's the role of the board is to determine if it's the right CEO. Not what's the right vice president of finance, the right vice president of lending, or the right whatever.

**Linda Keith:**

Right, right.

**Tim Harrington:**

You know, going back to the risk appetite survey, too. One of the things that's really important is in the banking and credit union world, stability and conservatism do have a very important place at the table. Because we have lots of other people's money under our protection. We have a lot of regulatory expectations that we're going to take good care of those deposit dollars that we have. At the same time, going into a highly digital environment, which is requiring massive changes in an organization, taking new risks has become very important and having a system that will honor and reward risk taking, which hasn't been the nature of banking probably forever.

There are people in banking who've been really risk aggressive. Whether it's a credit union or a bank, they tend to often cause a lot of loan losses somewhere in the future. Then there are those who are risk averse who, you know, you talk about a stale organization. What we're always trying to find is and use the term with our clients is ‘risk intelligence.’ You have to use risk intelligence.

**Linda Keith:**

Right.

**Tim Harrington:**

Risk intelligence means that we know when to take a risk. We know that we have to be able to live with the consequences of failure of those risks.

**Linda Keith:**

Right.

**Tim Harrington:**

And rewarded. Because if you don't reward failure, if you punish failure, you wipe out the incentive to try something new. That's a very hard thing for boards to learn typically, especially if they're an older board, and for seasoned management teams for the most part. Because the banking world's changing right under their noses. These senior management teams aren't necessarily adapting quickly enough with the changes. So, they have lived in a world where they have avoided risk. Now they have to live in a world where they have to embrace risk. It's a tough thing. It's really, really difficult.

Brett King, one of the people who says, “You can't make the digital change with the management team that you have in any bank or credit union anywhere. You have to change a lot of the people to make the changes.” Just because we are so fixed in our thinking of security and stability.

**Linda Keith:**

Well, when I talk with chief credit officers when I'm preparing to do training on tax return analysis for the lending and credit professionals that are sort of in the frontline, sometimes they'll like brag about their really low loan losses.

**Tim Harrington:**

Right.

**Linda Keith:**

Or sometimes I’ll be talking to directors who will brag about their low loan losses. And my first thought is, I wont be somebody to say it, but my first thought is, “What loans could you have made that you didn't in either the community bank or the credit union space where you actually – you're in part in business to support your members or customers?”

**Tim Harrington:**

Yeah.

**Linda Keith:**

“If you have a low enough loan losses, then my guess is that some of the folks that you could have said yes to and supported their family or business's financial needs, you said no. Maybe they didn't know they could go somewhere else and get it. They just didn't do something that they could have done if you had not been quite so risk averse.”

**Tim Harrington:**

With yields so low right now, if you just stay with prime borrowers, there's not a whole lot of revenue coming into your system. If you get crazy and loan out to all non-prime borrowers, or sub-prime borrowers, that'll hurt you in the long run. You're trying to find that balance between the two.

How can we learn to loan to and serve those who are a little farther out on the edge? That's a learning process, because most people pay it back. People with lower credit scores just pay you back with less discipline. How do you keep them disciplined is really what it is.

One of the things we also, and this is thought the risk appetite to some degree because it's not part of the survey, but we really push our clients to evaluate their lenders, and report by department and by portfolio. It's a report of yield by risk tier. If you use a standard A plus A, B, C, D, E, F, show the volume in there, the net yield, the loan losses, and the gross yield. Most management teams, once they begin to do it who have never done it before, and then share it with the board, they're shocked at how well they tend to do in their really small portfolios of DNA loans, CDA. I can add C in there too. Often the most profitable, I'm sure most lenders who are listening to this know this, but the most profitable tier is the C tier. Because if you get to the good Cs and loan to them, you get a better yield and your loan losses aren't that much higher than your weaker As.

**Linda Keith:**

And, you know, you're focused on credit unions frequently. I feel this way about community banks though, too. I don't think there's much of a difference between them as opposed to really large banks. But if I'm a member, don't I have a right to a loan if I can qualify? I mean, I'm a member for goodness sakes

sake. It feels like credit unions, as a type of organization, should go even further to say, “If we could make this loan and do it in a safe fashion, why would we not?”

**Tim Harrington:**

Well, Linda, I believe in purpose-based organizations. You can be a purpose-based bank. You can be a purpose-based credit union. Though credit unions tend to be more amenable to that. Less stake or shareholder value, more purpose based. But one of those purposes that's often expressed is to help the financial wellbeing of our entire membership. And so, yeah, if that's the case, if that is part of your purpose, then you should find ways to get loans into people's hands who others might not make loans

to. But you still have to get paid back. You have to get paid back. You have to get paid back about what 99% of the time or you go under.

Yet there's a learning process. You can't just make loans in a riskier fashion. You can't just become more risk aggressive. You can't just take your risk appetite, of conservative, cautious, stable risk and throw it away and say, “We're going to change.” It is a process that you have to go through and you have to learn along the way. Because you're going to make some mistakes that are wise mistakes, and you're going to make some mistakes that were foolish mistakes. The more experience you have in taking risks, the more you recognize, “Oh, I think this will get us into a foolish territory. This is a wise risk territory.”

**Linda Keith:**

Right. And then you're actually going to, over time, actually learn the difference between wise and foolish as you start taking small steps. And then make them into bigger steps once you learn those.

**Tim Harrington:**

You do.

**Linda Keith:**

Yeah.

**Tim Harrington:**

You should. If you are good at learning from your mistakes, you should.

**Linda Keith:**

Yeah. And just for the bankers who are listening, my experience is that community banks feel the same obligation to support the individuals and the businesses in their communities that I believe most credit unions feel toward their members.

**Tim Harrington:**

Yeah. There's two thoughts that come to mind. One is from a bank and, well from an investment company, but it's Schwab. Years ago, I think they have abandoned it since then and I don't know why, but Schwab used it as part of their annual rewards to their employees. They had the Best Bad Idea award. It was a pretty large amount of money. $50,000 or something.

**Linda Keith:**

Wow.

**Tim Harrington:**

They were looking for ideas-that it-seemed-like-a-good-idea-at-the-time ideas, that went south. That didn't work. But they wanted to reward that thinking. I think that's really important. We have to reward

the different thinking here, because sameness isn't going to differentiate us. Sameness isn't going to push us into the future. So, we have to reward divergent thinking.

The other part of it is, there's a term that I learned from another consultant that I love to work with, and it's 'feedback, not failure.' So, take the feedback, learn from it as fast as you can. Retool this and go forward again. It's feedback, not failure. If the same person keeps making similar mistakes, the feedback is that this isn't the right person for that position. That is one of the pieces. But most often, it means we simply learned, we've adjusted, and we've moved on.

**Linda Keith:**

Well, to wrap this one up, Tim, would you just run through one more time those factors within your survey that we look at in terms of appetite? Then follow that up with that idea, "What is risk intelligence?" And how does a board and a management improve their ability to function in that area?

**Tim Harrington:**

Okay. So, the areas that we covered in our risk appetite survey are the effects on members and customers. What will these things that we're doing, what will the effect be on these. The processes, which includes manual as well as digital processes and new technologies. Lending, the lending area, what's important there as far as risk. Financial and liquidity compliance, which is regulatory and accounting principles. And the people, the personnel in our organization. So, it's a series of questions in all of these areas on a one-to-10 scale.

**Linda Keith:**

Okay.

**Tim Harrington:**

We're matching or comparing board-to-management and we're comparing members of board to each other. And then members of management to each other. See if there's divergent thinking, either negatively or positively, within these two teams.

**Linda Keith:**

Then if we decide to move up in sort of the aggressive scale, that's where we need to do it. Step-by-step, really reevaluate, and just not jump off a cliff without good preparation.

**Tim Harrington:**

You bet. So, risk intelligence often requires a couple of things. One is due diligence. Do you know what you're getting into? Have you done your homework? Have you learned as much as you can about this area before you go into it?

It requires a feedback mechanism so that you can see if it's working or not as quickly as possible. And then the analysis process. We got the feedback. What do we think of it? Have we done well? Have we

done poorly? Let's move on. What's that called, the virtuous cycle? Just keep going through that process.

**Linda Keith:**

Does that process happen at the management level and at the director level? Is it synergistic? How does that work?

**Tim Harrington:**

It would happen routinely at the management level. That should be part of the process brought into the culture. It is a routine process with everything you're doing.

It would have to come back to the board at some point, more like in presentation most likely. In a strategic planning session, you might bring it in on something to say, "We tried this. Here's what we learned from it." But typically, the board is kind of one level above that. They most likely see their results in the reports than typically making those decisions themselves.

**Linda Keith:**

Sure. But isn't it their decision to decide whether the CEO is carrying out or sticking with sort of the risk appetite diet that they've expressed?

**Tim Harrington:**

Absolutely, yeah. That's why it's so important for the CEO to be on the same risk appetite wavelength as his or her employer.

**Linda Keith:**

Right.

**Tim Harrington:**

Because if they're way off in different directions, someone's going to have sleepless nights or maybe finds him- or herself unemployed.

**Linda Keith:**

Exactly. Somebody's got to leave or change their thinking. Right?

**Tim Harrington:**

And sometimes it's the board. One of the things we're seeing right now is the importance for more risk-intelligent directors. There's a change in the guard from the baby boomers to Gen X and Gen Y. So, it's to some degree an age change, as well. People who are more familiar with digital technology and the risks that that entails.

**Linda Keith:**

Right. Well, Tim, thank you so much. I actually do feel much better that I have a sense of what that term 'risk appetite' means. Now I can add to that 'risk intelligence.'

Thank you so much for helping us out with this today.

**Tim Harrington:**

Linda, thanks very much for having me on.

**Linda Keith:**

Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound.

Take care.

## *Resources*

- Book: *A Credit Union Guide to Strategic Governance*: https://forteamresources.com/products/books/
- Book: *Eisenhower on Enlightened Leadership*:

  https://forteamresources.com/products/books/
- Blog:

  https://forteamresources.com/tims-blog/
- Lenders' Tax Analyzer Software:

  https://forteamresources.com/products/lenders-tax-analyzer/

# Credit Risk Ready Podcast With Tim Harrington

***Risk Appetite: How the Board Decides, Defines, and Communicates Their Choice***

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## *About Tim Harrington*

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Author, consultant, and international speaker, Tim Harrington has worked with credit unions in all 50 states, Canada, Mexico, Jamaica, the Dominican Republic, the US Virgin Islands, and Puerto Rico. His progressive ideas and broad knowledge of credit union issues has made Tim a valuable resource for credit unions nationwide. Tim has spoken to tens of thousands of credit union volunteers and staff and continues to inspire them to improve their credit unions.

Since 1996, Tim has been President of TEAM Resources, a firm providing consulting, strategic planning, and training to credit unions from coast to coast. TEAM Resources' clients range from a few million to the billions in assets.

Tim is the author of several books including *Eisenhower on Enlightened Leadership* and co-author of *A Credit Union Guide to Strategic Governance*. His books inspire boards and leadership teams to lead effectively with high integrity.

From 2001 to 2006, Tim was the chairman of the board of a $150 million credit union in Tucson, Arizona. He was appointed to the board of this troubled credit union in 2001 and served until 2006. During his tenure on the board, the credit union evolved from losing over $2 million per year to earning a profit of nearly $2 million by 2006.

Tim was formerly a partner with the nation's 3rd largest auditor of credit unions, known today as CliftonLarsonAllen. He has been working with credit unions since 1989 when he directed the internal audit of a large credit union in Tucson, Arizona. Prior to that, he was with a national accounting firm and has been practicing accounting and consulting since 1980.

Because of his knowledge, wit, and unpretentious delivery, Tim is a much sought after speaker in the credit union movement. Tim has made presentations at conferences for CEOs, directors, supervisory committees, lenders, marketers, and many more. Tim is on the faculty of the CUNA Finance for Non-Financial Managers and Volunteers School, CUNA Volunteer Certification School, and CUNA Management School.

Tucson, Arizona, has been home for Tim since 1980, but he is a native of Montana. He holds a BBA in Accounting from Gonzaga University in Spokane, Washington. He has also attended universities in Morelia, Michoacan, Mexico and Florence, Italy, and speaks several languages.

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## *Risk Appetite: How the Board Decides, Defines, and Communicates Their Choice*


Contact Information

Timothy Harrington, CPA

President, TEAM Resources

Phone: 520-290-5721 Cell: 520-906-7501 Fax: 520-290-8378,

Address: 7049 Tanque Verde, PMB 136 Tucson, AZ 85715

Tharrington@forTeamResouces.com


## *About Linda Keith*

Linda Keith, CPA, draws on her 30-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus years as CFO of the family residential construction company; and experience as an examiner with the Washington State Auditor's Office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say "yes" to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a movement afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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