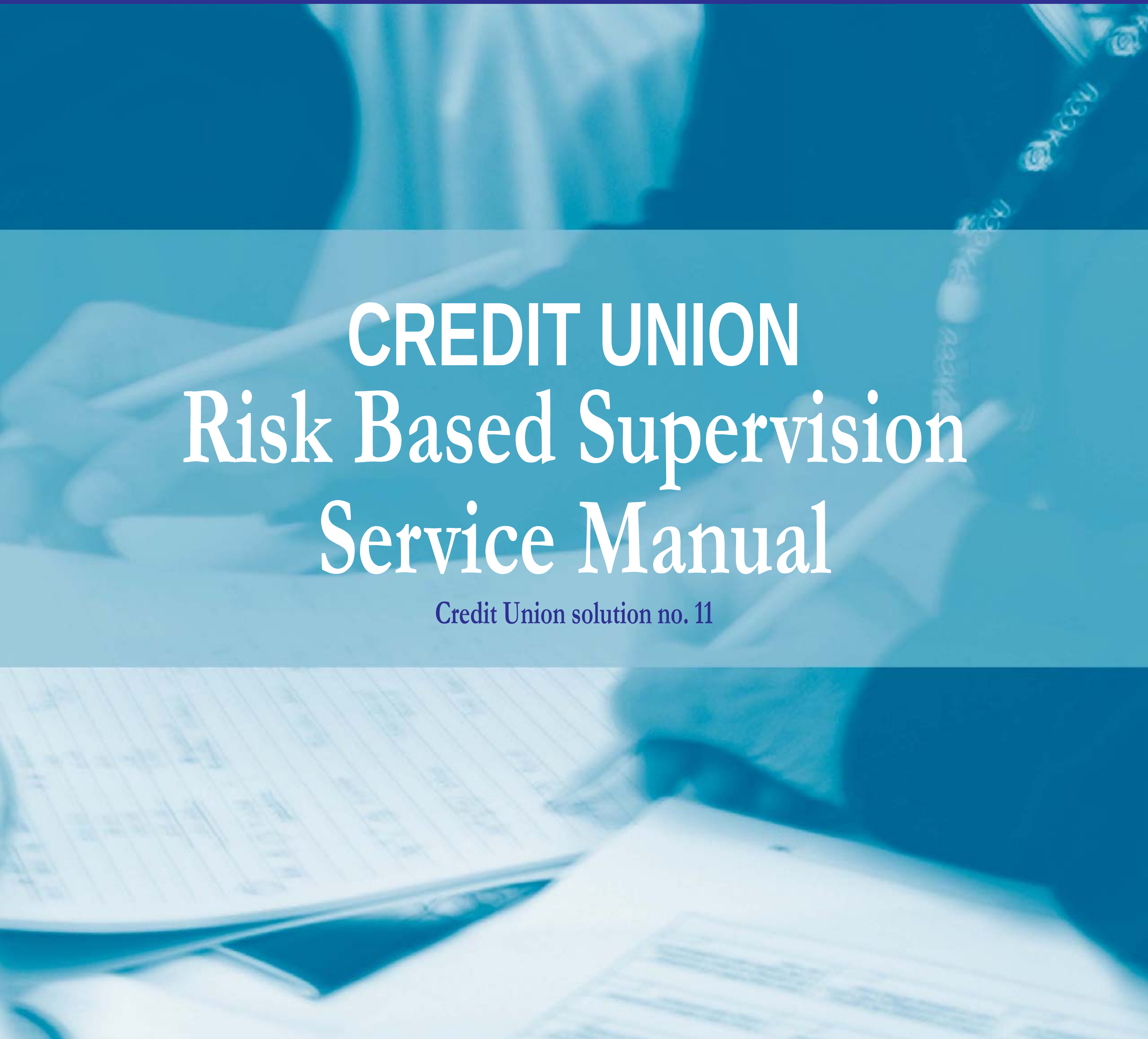

CREDIT UNION
Risk Based Supervision Service Manual

Credit Union solution no. 11

ASSOCIATION
OF ASIAN CONFEDERATION OF CREDIT UNIONS

Preface

ACCU has been operating as the regional representative body for Credit Unions since 1971 with the sole mission of promoting and strengthening Credit Unions and similar Cooperative financial institutions to enable them to fulfill their potential as effective instruments for the socioeconomic development of their members.

One of the strategic moves in ACCU Strategic Plan 2004-2009 is the Credit Union Monitoring Standardization Strategy. Adopting benchmarks to assess the performance of credit unions is a very important aspect of prudent management. The credit union industry has a standard but it has to be strictly followed reach the standards at a reasonable time possible. An institution independent of the credit and achieved. It should be the basis for planning and the goals of each credit union are to union should enforce the industry standards. In Asia context, the Cooperative Department has the role to do so.

The combined work of ACCU and its member organizations brought about changes in the ways cooperative regulators support the credit union development. It was evident in the way the regulators sees the role of the national federations as partners in promoting prudential norms for credit unions. This demonstrates new development possibilities, in which the member organizations of ACCU are the leading actors. The 2nd Regulators' Conference shared the accomplishments on the development of prudential regulatory framework and identified regulations needed to ensure the safety and soundness of credit unions in Asia. The regulators reported the prudential norms adapted from PEARLS and CAMEL.

Philippines-COOP-PESOS
Bangladesh-PEARLS-GOLD
Hong Kong-GLARES plus regulation on Good Cooperative Governance
Nepal-PEARLS-HIMAL
Sri Lanka-COOP-RUPEES
Thailand-selected ratios of PEARLS

ACCU considers an urgent need to follow up the activities to promote and implement prudent operational standards for credit unions. The compulsory training for directors and CEOs, Stabilization Fund, and branding were among those identified by the member organizations of ACCU.

ACCU has moved forward to putting in place supervision mechanisms for credit union through the establishment of the Credit Union Risk Based Supervision Service at the national federation. Obviously, the service is an ‘in system’ regulation to protect the credit union system as a whole.

The traditional supervisory approach has been to review the operations of credit union to ensure that it complies with the legislation and regulations and to ensure that the financial statements meet the requirements of the reporting methodology and to ensure that the results are an accurate representation of the facts. However, the risk to which this approach is exposed is the risk that the audit process and the process that is used to select the audit criteria can miss a significant error or misstatement. This is the type of error, or risk, that any audit process can experience. This necessitates the use of a risk-based approach.

Risk-based Supervision is an object-based supervisory approach concerned with translating economic and other information into potential risk factors for a credit union. It focuses on the quality of risk-management systems and the recognition of systemic risks to the credit union system.

RBS presents a framework with which credit unions are assessed regarding the probability and impact of risks as opposed to the intuitive assessment by the traditional approach. In contrast to the traditional form of supervision which is biased in favor of risk-avoidance and hence against innovative products and services, risk-based supervision treats risks mitigating and offsetting as valid approaches to risk management.

A risk- focused supervisory process provides flexible and responsive supervision to foster consistency, coordination as well as communication among supervisors, relies on the understanding of the institution, the performance of the risk assessment as well as the development of a supervisory plan and procedures tailored to the risk profile of individual institutions. In that regard, risk-based supervision identifies, measures and controls risks; and monitors the risk management process put in place by a credit union during a supervisory period.

The manual is evolving and will ensure to incorporate the suggestions of its member organizations and other stakeholders in the Asian credit union movement.

We thank our members for the utmost support in developing this manual. Above all, we thank Cordaid of Netherlands for providing financial support in developing the manual.

ACCU

ASSOCIATION
OF ASIAN CONFEDERATION OF CREDIT UNIONS

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Chapter 5 – Credit Union's Supervisory Processes

Chapter 6 – Implementation

1 Introduction

Foundation

1. The objective of this paper is to provide a systematic description of the risk-based framework for the supervision credit unions. This paper aims to increase understanding of how national federations will conduct its supervision of credit unions under its network. It remains the ultimate responsibility of the Board of Directors of credit unions to ensure that its business is conducted in accordance with the requirements set out by the regulations and best practices on good governance.

2. The approach enables the national federation to carry out its responsibilities in protecting the credit union system by its assessment of the credit union's businesses, risk profiles and macro-economic context. The federation is also responsible in designing effective supervisory plans and making appropriate use of this supervisory tool.

3. The traditional supervisory approach has been to review the operations of credit union to ensure that it complies with the legislation and regulations and to ensure that the financial statements meet the requirements of the reporting methodology and to ensure that the results are an accurate representation of the facts. However, the risk to which this approach is exposed is the risk that the audit process and the process that is used to select the audit criteria can miss a significant error or misstatement. This is the type of error, or risk, that any audit process can experience. This necessitates the use of a risk-based approach.

4. One of the limitations of the transactions-based method is its inability to address the future performance of individual credit unions including their managements' ability to deal with banking businesses they engage in and the economic environment over which they may have little or no control.

Risk-Based Supervision

5. Risk-based Supervision is an object-based supervisory approach concerned with translating economic and other information into potential risk factors for a credit union. It focuses on the quality of risk-management systems and the recognition of systemic risks to the credit union system.

6. RBS presents a framework with which credit unions are assessed regarding the probability and impact of risks as opposed to the intuitive assessment by the traditional approach. In contrast to the traditional form of supervision which is biased in favor of risk-avoidance and hence against innovative products and services, risk-based supervision treats risks mitigating and offsetting as valid approaches to risk management.

7. A risk- focused supervisory process provides flexible and responsive supervision to foster consistency, coordination as well as communication among supervisors, relies on the understanding of the institution, the performance of the risk assessment as well as the development of a supervisory plan and procedures tailored to the risk profile of individual institutions. In that regard, risk-based supervision identifies, measures and controls risks; and monitors the risk management process put in place by a financial institution during a supervisory period.

8. The main objective of risk-based supervision is to sharpen supervisory focus on credit unions that pose the greatest risk to the credit union system.

9. Risk based supervision is a structured approach to:

- identify the key risks to which the industry and individual credit union are exposed;
- assess the risk mitigation techniques that are used to manage these risks;
- assess the net risk exposure that emerges in terms of its level and volatility; and
- focus the supervisory effort on the most significant of these net risk exposures.

10. The basic objective of the process is to identify as efficiently as possible the areas of the credit union’s operation that present the greatest financial risk to its continued viability.

11. Effective Risk Management is the hallmark of successful financial institutions like credit unions. Due to the nature of the business, the success of credit unions depends on the security, privacy, and reliability of services backed by robust operational practices.

12. Effective risk management strategies can be implemented by integrating effective management, operational supervision and market discipline. It is also imperative for credit unions to update their risk management practices in accordance with prevalent legislation and regulatory environment.

13. Basel 2 was devised to improve the soundness of the financial system by aligning regulatory capital requirement to the underlying risks of the banking industry. This step was taken due to the vulnerability of the financial industry. As one of the players in the financial market, credit unions must also take an aggressive stance to ensure that the credit union system is addressing and mitigating risks for safety and soundness.

14. The Regulators Conference organized by ACCU in 2003, 2005 and 2007 served as platform for regulators to exchange experience and introduce enabling regulatory framework for Asian credit unions. The combined work of ACCU and its member organizations brought about changes in the ways cooperative regulators support credit union development. This was evident in the way regulators see the role of the national federations as partners in promoting prudential norms for credit unions and demonstrates new development possibilities, in which member organizations of

ACCU are the leading actors. Prudential norms developed in five countries are a tangible impact.

- Bangladesh-PEARLS-GOLD
- Hong Kong-GLARES plus regulation on Good Cooperative Governance
- Nepal-PEARLS-HIMAL
- Sri Lanka-COOP-RUPEES
- Thailand-selected ratios of PEARLS

15. Recognizing that the credit union system should initiate the in-system protection measures, the Credit Union Risk Based Supervision Service (CURBSS) is introduced to the national federation of credit unions. CURBSS carry out review of the status of risk management architecture and initiate measures to bridge the gaps. The requirements of risk based supervision model in this respect are:

- The risk-based supervision will not be transaction based – it will be systems based inspection by CURBSS team
- The supervisor will go into details of the systems and procedures for managing and controlling risks.
- Need to review and develop systems and procedures for undertaking transactions and the reporting and the controlling systems
- Need to properly document systems and procedures

16. The introduction of risk based supervision (RBS) would require credit unions to reorient their organizational set up towards RBS and put in place an efficient risk management architecture, adopt risk focused internal audit, strengthen the management information system, and set up compliance units. The credit unions would also be required to address HRD issues like personnel planning, selection and deployment of staff and their training in risk management and risk based audit. It is evident that change management is a key element in RBS and the credit unions should have clearly defined standards of governance, well-documented policies and efficient practices in place to demarcate the lines of responsibility and accountability so that they align themselves to meet the requirements of RBS.

Benefits

17. Among the important attributes and potential benefits of risk-based supervision is that it:

i. Provides a framework that offers two distinct advantages:

  – Establishes common terminology and approaches to evaluate risk and risk management in credit unions;
  – Is flexible enough to be applicable to all financial products and services;

- Unlike traditional supervision, which focuses on the internal operations of a single institution, risk-based supervision considers external factors affecting not only individual credit unions but also the credit union system as a whole;

- Provides an ‘in-system’ regulatory environment in which credit unions are not just pushed to avoid risks but can also mitigate and offset risks as acceptable risk-management practices.

- National federation will have better allocation of supervisory resources according to perceived risk, i.e. focusing resources on the credit union's highest risk or devoting more supervisory efforts to those credit unions that have a high-risk profile. It will, therefore, enable the national federation to target and prioritize the use of available resources.

- The national federation will be better placed to decide on the intensity of future supervision and the amount and focus of supervisory action in accordance with the perceived risk profile of the credit union

- The national federation may also focus more attention on credit unions whose failure could precipitate systemic crisis.

18. The National Federation's supervisors gain a better understanding of the quality of management, the characteristics of the business and the risks a credit union faces. It also enables national federation to display more consistency in carrying out its supervisory function and to assess more systematically whether credit unions continue to meet the minimum criteria of the national and international prudential standards as well as ACCESS Brand.

19. The credit unions should benefit from the improved focus of the national federation's supervision and from the specific targeting of the tools of supervision, such as specialist on-site visits and reporting accountants' reports on internal controls, to the areas of greatest risk and concern in individual credit union.

20. The more explicit linking of the tools of supervision to areas of risk or concern should mean that credit unions' management understand why a supervisor has used a particular supervisory tool. As a credit union's management and supervisors have a common interest in ensuring that risks are properly identified and that adequate and effective control systems are established, the supervisory work commissioned should be of value to both parties.

21. A risk assessment will involve the commitment of resources by both the supervisors and a credit union's management. In particular, the supervisors need to spend time on-site discussing the issues with senior credit union management. The time taken to perform this work will vary from credit union to credit union depending on the size and complexity of the institution. However, following a risk assessment, the supervisor will be better placed to decide on the intensity of the future supervision having obtained a better understanding of a credit union's risk profile. The intensity of supervision and the amount and focus of supervisory action will increase in line with the perceived risk profile of a credit union. One advantage this has for credit unions is that the cost of supervision, in terms of management time or through direct costs (e.g. reporting accountants' fees), should be more directly related to its risk.

22. From the national federation's perspective, the allocation of its own resources according to risk - devoting more supervisory effort to those credit unions that have a high-risk profile - will be more efficient.

Coverage

23. CURBSS will be available to all credit unions under the network of the national federation as ‘in-system’ protection.

24. In undertaking its supervision, the national federation will not seek to set higher standards as set by the regulatory body. This is to ensure that credit unions will be more prepared for the government supervision. The national federation will liaise as necessary with relevant regulatory body to provide information for them to understand CURBSS approach to supervision, including the extent to which supervision is carried out.

Definitions

25. For ease of reference and unless otherwise stated, the use of the word ‘credit union’ throughout this paper refers to financial cooperative institutions. Thus, this refers to:

- Credit Cooperatives
- Savings and Credit Cooperatives (SACCOS)
- Thrift and Credit Cooperative Society (TCCS)
- Savings and Credit Cooperative (SCC)
- People’s Credit Fund (PCF)
- Village Bank
- Community Based Financial Institution (CBFI)

26. In some circumstances, risk based supervision is also applicable to Multi-Purpose cooperatives wherein financial services represent more than 80% of its business.

2 CURBSS Framework

Synopsis

27. An overview of CURBSS framework is shown in Figure 1. This describes the CURBSS process into risk assessment, supervision tools execution and appraisal.

28. In practice, the process is not self-contained but rather is dynamic because new information will be received throughout the process, which may require adaptation or revision of supervisory actions and initiatives at any stage.

29. Each of the phases takes place during a 'supervisory period', which is then length of time between undertaking formal risk assessments on a particular credit union. The period will vary according to the business and control risk profile of the credit union concerned. From six months for a credit union, whose overall risk profile is low and whose business and control framework are stable. For a credit union whose overall risk profile is classified as very high or for a credit union undergoing major change, up to two years, or possibly longer.

30. In each supervisory period, CURBSS will undertake a formal **risk assessment** using ____ evaluation factors. This assessment will be performed by analyzing information, which the CUBRSS already has available and from a series of meetings (which will normally take place in a short, discrete period), with senior management of the credit union. The objective of this phase is to identify, in a systematic manner, the business or inherent risks of a credit union and to assess the adequacy and effectiveness of its controls, organization structure and management in order to establish the supervisory program. Through this risk-based approach to supervision, national federation's CURBSS will be well placed to judge whether a credit union meets the minimum criteria for authorization.

31. After each risk assessment, CURBSS will feed back its views on the credit union's risk profile in a letter to the credit union and. The letter will also contain details of any remedial action CURBSS requires the credit union to take, and of the supervisory program comprising the **tools of supervision,** which the CURBSS intends to apply. These tools will be targeted at areas considered to be of higher risk and will be used to investigate other potentially higher risk areas identified during the risk assessment. The results of the tools will be examined as they become available, which may require CURBSS to reassess the risk profile of the credit union, require the credit union to take remedial actions or for the CURBSS to take appropriate supervisory action.

Table 1

RISK ASSESSMENT	SUPERVISORY TOOLS EXECUTION	APPRAISAL
P **E** **A** **R** **L** **S** **B** **C**	**Off-Site** Reporting **On-Site** Credit Review Visit Prudential Meetings Ad Hoc Meetings	(internal in CURBSS) • Review of risk profile of the credit union (before and after) • Review of the progress made against CURBSS objectives • Review the successful completion of remedial measures of the credit union

32. During the course of the supervisory period, CURBSS will constantly evaluate the information it receives. In addition, CURBSS will undertake a formal **evaluation** to ensure that the credit union has implemented any agreed remedial actions, that CURBSS has completed its original work plan; that the findings of the supervisory tools have been acted upon and to assess the effectiveness of its own supervision. The conclusions from the evaluation will be a key input into the next risk assessment.

33. Where either CURBSS identifies significant concerns from the risk assessment or at any time during the supervisory period, it will seek appropriate and timely remedial action from the credit union.

34. Actions available to the CURBSS include:

i. *Increasing the credit union's institutional capital requirement* – CURBSS can require an increase in the institutional capital requirement of the credit union.

ii. *Suspension of any officials or key staff* – such action may be deemed necessary by CURBSS if the continuation of the services of such officials due to the widespread misconduct or mismanagement in the past and future operations.

iii. *Abolition of a financial product* - CURBSS may cancel a financial product (s) from the service of offering of a credit union if such product is creating consistent financial failure to the credit union and its continuation may cause significant risk in the safety and soundness of a credit union.

iv. *Formal supervisory action under the regulation of Stabilization Fund* - such action may be in the form of restrictions on the credit union's business, either formal or informal, or revocation of a credit union's membership if there is reasonable uncertainty as to whether the credit union is engaging in unacceptable business practices.

3

a step by step guide

35. In each supervisory period, CURBSS will perform a risk assessment, take appropriate supervisory action, apply the tools of supervision and undertake a formal evaluation. Although these are described in this, paper as discrete phases, there will be considerable interaction among them.

36. CURBSS will determine the length of the supervisory period after completing each risk assessment. During the supervisory period, credit union's management should be proactively contacting CURBSS to explain any significant changes to the business risk profile or control environment. In addition, CURBSS will use the tools of supervision to ensure that it is aware of significant developments and changes to the credit union's risk profile, business or control structure. CURBSS may alter the length of the supervisory period at any time.

Introduction of the Risk Assessment Framework

37. As designed, it establishes statutory/supervisory objectives and identifies the individual institutions' risks that may threaten these objectives and outlines the supervisory tools to mitigate them.

38. The framework involves a series of structured stages that are designed to:

- focus the supervisor's attention on the risks that threaten the achievement of supervisory objectives; and
- enable the supervisor devise a risk mitigation program to address those risks.

39. The Framework is premised on the following main supervisory objectives:

i) Promoting stability and soundness of the credit union system;
ii) ensuring consumer protection; and
iii) reducing financial crimes.

Description of the Framework

40. The framework is in six stages as illustrated in Figure 2 below. However, at the commencement of the implementation of the Risk-Based Framework, there will be seven stages incorporating the full-scale maiden examination.

- Stage 1 - Full scope maiden examination
- Stage 2 - Impact assessment
- Stage 3 - Risk assessment
- Stage 4 - Development of risk mitigation program
- Stage 5 - Evaluation and validation
- Stage 6 - Communicating the results of the assessment and risk mitigation program
- Stage 7 - Implementation of the risk mitigation program, on-going assessment of the credit union and response to risk escalation.

Full Scope Maiden Examination

41. Full Scope Maiden Examination covering 20 risk elements (as detailed ____ will be conducted at the commencement of the risk-based supervisory process. The 20-risk elements cover the full range of risks in a credit union. This stage will be a one-off event, as subsequent examinations will depend on the CURBSS assessment and perception of the risks of individual credit union.

Impact Assessment

42. The first step at this stage is to determine the potential impact of a credit union, in the event of distress, on the entire financial system by appraising quantitatively, balance sheet items such as total assets and deposits against defined **impact thresholds.** This will indicate the scale and significance of the problem if it were to occur. The credit union will then be categorized into impact bands - Very High, High, Medium, Low and Very Low. The impact threshold is as shown in Figure 2 below.

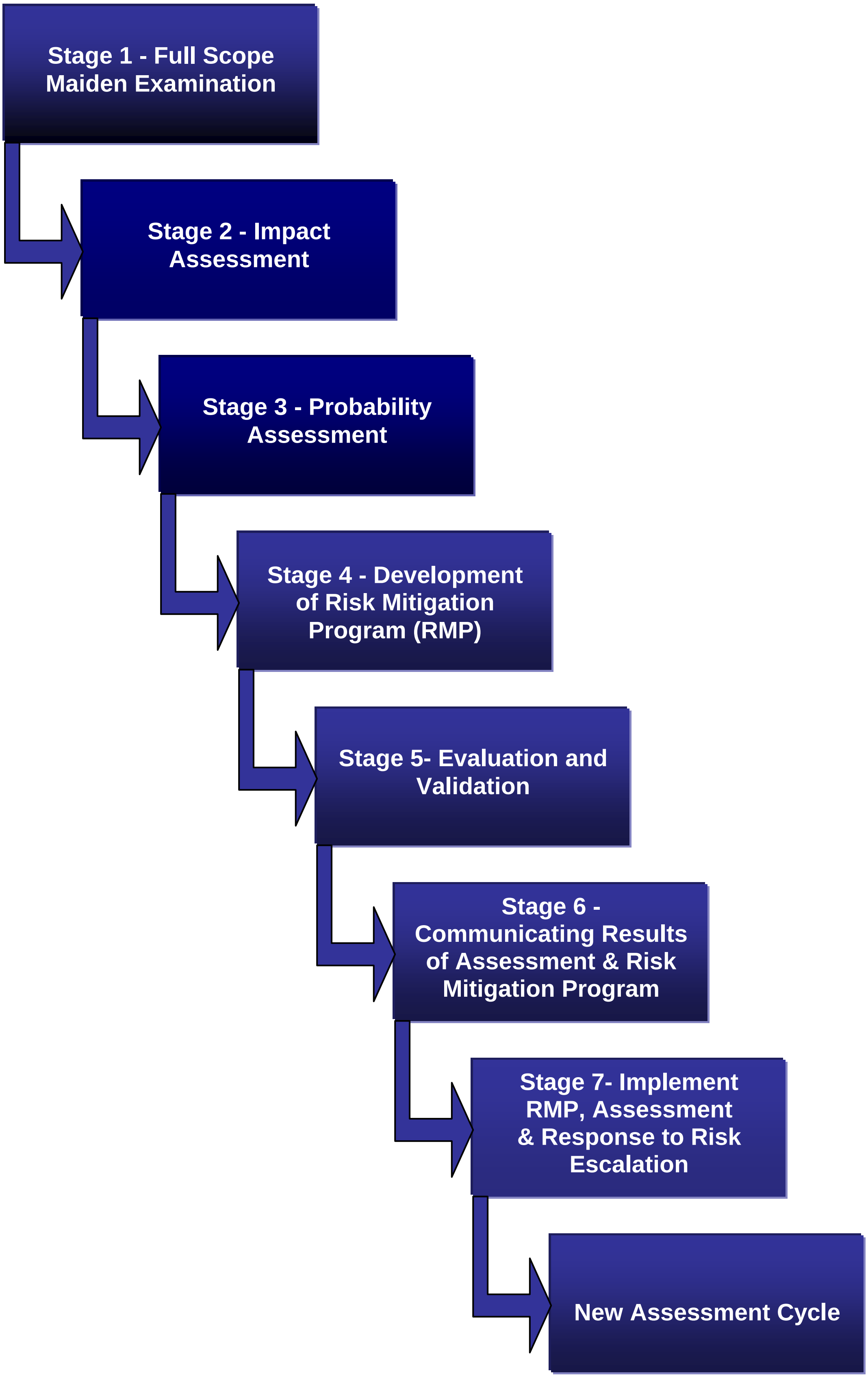
Table 2

Thresholds	Total Assets			Total Shares and Deposits		
	Million	Market Share %	Number of Credit Unions	Million	Market Share %	Number of Credit Union
Very High	Above 100			???		
High	51 – 100			???		
Medium	11 – 50			???		
Low	5 – 10			???		
Very low	< 5			???		

This will vary in different countries

A credit union's risk impact category is the higher of the two impact parameters. For example, if a credit union has "High" impact rating using the assets parameter and has a "medium" or "Low" rating using the deposits parameter, its impact classification will be "High".

Figure 1 - **The Credit Union Risk Assessment Framework**



Risk Assessment of Credit Unions

43. At this stage, the focus is to assess the likelihood of various credit union-specific risks. Credit unions will be assessed based on a risk map, which takes into account external events or threats (environmental risks) and credit union-specific risk issues and scores each of these risks in a common way. This will involve off-site assessments and on-site visits to complement available information on a credit union.

44. ***Environment Risks*** **-** These are risks that are external to the financial institution, which directly or indirectly affect the credit union's business or control risks. Environmental risks will not be assessed directly under this framework, as their effect will be captured in the assessment of credit union-specific risks and sector wide assessment.

45. ***Credit Union Specific Risk Assessment*** **-** involves determining where the risks arise and which statutory objectives they may affect. The assessment will focus on the 20 risk elements structured into four business risk groups and five control risk groups.

    i. **Business Risks** are derived from the overall philosophy of the credit union and include issues of strategy, target market, products and services, and the risk attached to the financial soundness of the institution.

    ii. **Control Risks** are the risks arising from the failure and/or inadequacies of systems, processes and procedures as well as organization and culture.

46. The main business and control risk elements adopted include the risks described in Table below:

Table 4

	Risks	Description of Risks
A. BUSINESS RISKS		
1	**Strategy**	
i)	Quality of corporate strategy or Nature of Business	The risks arising from the overall strategy of the credit union. These include the quality of the strategic planning process, the achievability of the strategy, the implications of the strategy, particularly for risk appetite, and the record of accomplishment of implementation. Also it involves risks arising from the characteristics of the business that the credit union is targeting going forward, such as risks from credit union's products, services and members and users as well as the interrelationships between them.
2	**Market, Credit and Operational Risk**	
ii)	Credit Risk	The risks arising from the type and nature of credit activities undertaken by a credit union. These include the risk appetite of the credit union, the nature of counterparty exposures involved in the credit union's products and services, portfolio characteristics and the nature and extent of credit risk mitigation. The challenges posed to a credit union under this risk area: – Default probability and low recovery rate of the loan – Loan pricing – Loss reserve/provision – Diversification of loan portfolio

	Risks	Description of Risks
iii)	Market Risk	The risk of losses in on and off balance sheet positions arising from movements in market prices. These include the risk appetite of the credit union, the nature of market risk exposures involved in the credit union's products and services, and portfolio characteristics arising from adverse movements in market rates/prices, interest rates, foreign exchange or equity prices. This would apply in savings, loans and financial investments.
iv)	Operational Risk	The risks arising from the type and nature of operational risk involved in the credit union's activities. These include direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
v)	Litigation/Legal Risk	The risks arising from the type and nature of the credit union's contractual agreements. These include the risk that contracts may not be enforceable under applicable law and that the nature of the product/service may render the credit union particularly vulnerable to litigation.
3	**Financial Risk**	
vi)	Protection of Assets	The risk arising from inadequate protection of assets measured by the adequacy of the allowances for loan losses against the amount of delinquent loans and the allowances for investment losses with the total amount of non-regulated investments. Inadequate loan loss protection produces two undesirable results: inflated asset values and fictitious earnings. Most credit unions are not anxious to recognize loan losses, and much less, to charge them off against earnings. That unwillingness leads to widespread abuse of the principles of safety and soundness. Reported net income is overstated, asset values are inflated, provisions for loan losses are inadequate, and member savings are not adequately protected.
vii)	Effective Financial Structure	The risk arising from the imbalance of fund sources and asset investment may result to liquidity problem, reduced income, and slow growth. Credit unions are encouraged to maximize productive assets as the means to achieve sufficient earnings. Since the loan portfolio is the most profitable asset of the credit union, maintaining 70-80% of total assets in the loan portfolio is recommended. Excess liquidity is discouraged because the margins on liquid investments (e.g., savings accounts) are significantly lower than those earned on the loan portfolio. Non-Earning assets are also discouraged because once purchased, they are often difficult to liquidate.
viii)	Assets Quality	The risk arising from a non-productive or non-earning asset that does not generate income for the credit union. An excess of non-earning assets affects credit union earnings in a negative way.
ix)	Rates of Return and Costs	The risks arising from the nature of earnings of the credit union and its capacity to meet the financial costs and operating expenses. The volatility of revenues could pose risks to credit union operation in the future.

	Risks	Description of Risks
x)	Liquidity	The risk of loss due to inability of a credit union to meet cash obligations. Effective liquidity management becomes a much more important skill as the credit union shifts its financial structure from member shares to more volatile deposit savings.
xi)	Signs of growth	The risk that a credit union may not maintain its asset values if a strong, accelerated growth of assets, accompanied by sustained profitability is not achieved. Growth by itself is insufficient. CURBSS will link the growth to profitability, as well as to the other key areas by evaluating the strength of a credit union.
4	**Members**	
xii)	Type of members	The risks arising from the characteristics of the current members' base.
B. CONTROL RISKS		
1	**Treatment of Members**	
xiii)	Service delivery, training, recruitment, remuneration and security of members	The risks arising from the recruitment quality and training procedures for customer service, remuneration scheme for employees and controls over customers' monies and assets when transacting with the credit union.
xiv)	Disclosure and adequacy of product literature	The risks arising from the nature of product advertisement issued by the credit union.
2	**Organization**	
xv)	Clarity of ownership/group structure[1]	The risks arising from the structure of the credit union and the relationship among entities. These include the nature of the legal and ownership structure, management arrangement, reliance on centralized functions, financial health and activities of subsidiaries and affiliates.
3	**Internal Systems and Controls**	
xvi)	Risk management system	The risks arising from the nature and effectiveness of the systems and procedures in place to identify, measure, monitor and control the risk of the business in an appropriate and timely manner. These include credit risk, market risk, operational risk, legal risk and new product risk.
xvii)	Information and Communication Technology	The risks arising from the nature of management information and controls over the ICT infrastructure. These include the adequacy, accuracy, relevance, timeliness, procedure for implementation and procurement and security framework as well as the effectiveness and efficiency of the ICT infrastructure.
xviii)	Compliance/Internal Audit	The risks arising from the nature and effectiveness of the compliance and internal audit functions. These include its mandate, structure, staffing, methodology and effectiveness, as well as the nature of policies, procedures and controls and their implementation

[1] This is in the case the credit union/cooperative also operates a subsidiary business under its organizations set up or even independently. However, such undertakings are funded by the credit union.

	Risks	Description of Risks
4	**Board, Management and Staff**	
xix)	Governance and Human Resources	The risks arising from the nature of the board composition, quality of top management, and human resources. These include the role and effectiveness of the board, non-executive directors and board committees, management responsibilities and delegation as well as recruitment, training, remuneration, disciplinary procedure and availability of resources for staff.
5	**Business and Compliance Culture**	
xx	Relationship with Regulators	The risks arising from the nature of the organization’s relationships with the regulator, other regulators and recent regulatory history. These include the adequacy, relevance, reliability and timeliness of financial and regulatory reporting.

Risk-to-Objectives

47. The Risk-to-Objectives (RTOs) are risk elements that threaten the achievement of supervisory objectives. The risk to the three supervisory objectives will include the following as shown in Table 4.

Table 5: Risks to Objectives

	Supervisory Objectives	Risk-To-Objectives
1	Promoting Safety and Soundness	Financial failure
		Poor corporate governance
		Widespread misconduct and mismanagement
		Financial crime, fraud or dishonesty
2	Ensuring Protection of Members Interest	Financial Failure
		Widespread misconduct and mismanagement
		Financial crime, fraud or dishonesty
		Poor corporate governance
		Inadequate member understanding
3	Reduction of financial crimes	Financial crime, fraud or dishonesty

48. In view of the fact that some RTOs are common threats to more than one supervisory objective as indicated above, it is summarized under five broad categories:

- i) Financial Failure (Objectives 1 & 2)
- ii) Misconduct and Mismanagement (Objectives 1, 2 & 3)
- iii) Poor Corporate Governance (Objectives 1 & 2)
- iv) Inadequate Member Understanding (Objective 2)
- v) Financial Crime/Fraud or Dishonesty (Objectives 1, 2 & 3)

Scoring of Credit Union-Specific Risks

49. Having identified the risk elements, the risk assessment will involve measuring the threat of each credit union's risk element against the RTO categories using the risk map, as shown in Table 5 below. The measurement will be on a scale of 1 – 5 with 1 representing the lowest risk and 5 the highest. The risk bands will be as follows:

i)	1	Very Low
ii)	2	Low
iii)	3	Medium
iv)	4	High
v)	5	Very High

50. The overall credit union specific risk score will be derived as shown in the risk matrix in Table 5. Following the identification of the risks, CURBSS assigns various attributes to each risk.

Impact Assessment: At a minimum, relevant period, impact, and probability of occurrence are assigned. Time frame is the beginning and end dates of when a risk may occur. Then CURBSS sets impact definitions. The Risk Matrix impact definitions are:

- **C (Critical):** If the risk event occurs, the program will fail. Minimum acceptable requirements will not be met.
- **S (Serious):** If the risk event occurs, the program will encounter major cost/schedule increases. Minimum acceptable requirements will be met. Most secondary requirements may not be met.
- **Mo (Moderate):** If the risk event occurs, the program will encounter moderate cost/schedule increases. Minimum acceptable requirements will be met. Some secondary requirements may not be met.
- **Mi (Minor):** If the risk event occurs, the program will encounter small cost/schedule increases. Minimum acceptable requirements will be met. Most secondary requirements will be met.
- **N (Negligible):** If the risk event occurs, it will have no effect on particular aspects of operation. All requirements will be met.

Probability - Po (%): Probability of occurrence is the team's assessment of the likelihood that a risk may happen. Estimating the probability of occurrence may be difficult in practice. Fortunately, all that matters when using Risk Matrix is the relative order of the probability estimates (which risks are more likely to occur). For this purpose, it is sufficient to estimate probabilities using a relative scale:

i.	**0 - 10%**	**:** very unlikely the risk will occur
ii.	**11- 40%**	**:** unlikely the risk will occur
iii.	**41- 60%**	**:** even likelihood the risk will occur
iv.	**61- 90%**	**:** likely the risk will occur
v.	**91- 100%**	**:** very likely the risk will occur

51. The risk ratings will be based on the following Risk Rating Scale on Table 5

Table 6 – Risk Rating Scale

Probability	Impact Category				
	Critical	**Serious**	**Moderate**	**Minor**	**Negligible**
91 – 100% - very likely the risk will occur	Very High	Very High	High	Medium	Medium
61 – 90% - likely the risk will occur	Very High	High	High	Medium	Low
41 – 60% - even likelihood the risk will occur	High	Medium	Medium	Medium	Low
11 – 40% - unlikely the risk will occur	High	Medium	Low	Low	Low
0-10% - very unlikely the risk will occur	Medium	Low	Low	Very Low	Very Low

52. Risk Map is the summary of the Business and Control Risks of the credit union. The rating is based on the Risk Rating Scale on Table 5.

Table 7 – Risk Map

		Financial Failure	**Misconduct & Mis-management**	**Poor Corporate Governance**	**Inadequate Member Under-standing**	**Financial Crime, fraud & dishonesty**
A. BUSINESS RISKS						
1	**Strategy**					
i)	Quality of corporate strategy or Nature of Business					
Strategy Score						
2	**Market, Credit and Operational Risk**					
ii)	Credit Risk					
iii)	Market Risk					
iv)	Operational Risk					
v)	Litigation/ Legal Risk					
Market, Credit & Operational Risk Average Score						
Market, Credit & Operational Risk Score						
3	**Financial Risk**					
vi)	Protection of Assets					
vii)	Effective Financial Structure					
viii)	Assets Quality					
ix)	Rates of Return &Costs					

x)	Liquidity					
xi)	Signs of growth					
Financial Risk Average Score						
Financial Risk Score						
4	**Members**					
xii)	Type of members					
Members Risk Score						
Business Risk Average Score						
BUSINESS RISK SCORE						
B. CONTROL RISKS						
1	**Treatment of Members**					
xiii)	Service delivery, training, recruitment, remuneration and security of members					
xiv)	Disclosure and adequacy of product literature					
Treatment of Members Risk Average Score						
Treatment of Members Risk Score						
2	**Organization**					
xv)	Clarity of ownership/ group structure[2]					
Organization Risk Score						
3	**Internal Systems and Controls**					
xvi)	Risk management system					
xvii)	Information and Communication Technology					
xviii)	Compliance/ Internal Audit					
Internal Systems and Controls Risk Average Score						
Internal Systems and						

2 This is in the case the credit union/cooperative also operates a subsidiary business under its organizations set up or even independently. However, such undertakings are funded by the credit union.

Controls Risk Score						
4	**Board, Management and Staff**					
xix)	Governance and Human Resources					
Board, Management and Staff Risk Score						
5	**Business and Compliance Culture**					
xx	Relationship with Regulators					
Business Compliance Risk Score						
Business Risk Average Score						
CONTROL RISK SCORE						
CREDIT UNION SPECIFIC RISK SCORE PER RTO GROUP						

53. The scores for each of the business control risks elements in the risk map are aggregated to arrive at the average risk scores.

54. The assessment of business risks as low control risks will often mitigate the overall business risks and vice versa. For instance, where the aggregate score under the business risks is Very High and the control risk Very Low, then the overall score will be Medium. Conversely, when business risk is Very Low but control risk is Very High, the aggregate rating should be considered High.

55. The overall credit union specific risk score will be derived as shown in the risk matrix in Table 7.

Table 7 – Overall Credit Union Specific Risk Score Matrix

Control	**Business**				
	Very High	**High**	**Medium**	**Low**	**Very Low**
Very High	Very High	Very High	High	Medium	Medium
High	Very High	High	High	Medium	Low
Medium	High	Medium	Medium	Medium	Low
Low	High	Medium	Low	Low	Low
Very Low	Medium	Low	Low	Very Low	Very Low

56. The next step will be to determine the overall risk. A combination of the credit union Risk to Objectives score and the impact score gives a measure of the overall risk posed to the supervisory objectives of the credit union system. The sample matrix is derived from no. 47-48 of this manual.

Table 8 – Overall Risk to Objectives Rating

No	**Supervisory Objectives**	**Financial Failure**	**Misconduct & Mis-manageme nt**	**Poor Corporate Gover-nance**	**Inadequate Member Under-standing**	**Financial Crime, fraud & dishonesty**
1	Promoting Safety and Soundness					
2	Ensuring Protection of Members Interest					
3	Reduction of financial crimes					

57. The credit union's overall risk rating will be used to take informed decisions on the type and frequency of regulatory response to be adopted.

58. Preliminary Feedback – at this stage, significant findings from the risk assessment will be discussed with the credit union board and management, following which the risk mitigation program will be adopted and formalized. The purpose of the meeting provides an opportunity for the credit union to mitigate risks and adopt a sustainable risk management program for the credit union.

59. Development of Risk Mitigation Program (RMP) – the risk mitigation programs are supervisory actions that will be taken by CURBSS and the credit union management to mitigate the risks found in the assessment. The RMP will address the nature of risks, intended outcome, and the actions to be taken by CURBSS and the credit union within a reasonable timeframe.

60. Supervisory Tools – these are the tools used to diagnose and mitigate risks. These are classified into four broad groups:

Table 9 – Supervisory Tools

Diagnostic	**Monitoring**	**Preventive**	**Remedial**
• On-site and off-site examination • Investigations • Risk assessments	• Off-site surveillance • On-site visits • External auditors • Internal auditors	• Disclosures • Member education • Public Statements • Regulatory Standards • Credit union system standards (National federation) such as ACCESS • Contingency planning • Management Tools (policies, systems and procedures)	• Compensation schemes • Complaints resolution • Disciplinary actions • Interventions • Penalties • Amalgamation • Suspension • Termination

Note: this can also be classified into CURBSS and credit union

61. The following are the uses of the supervisory tools:

- Diagnostic tools will be used mostly to identify and/or measure risks
- Monitoring tools will be used to keep track of risks on an on- going basis,
- Preventive tools are meant to mitigate or reduce risks
- Remedial tools will be used to address defined risks.

62. The selection of regulatory tools will be based on the overall rating of the credit union:

- Very High or High, remedial and preventive tools will mainly be applied
- Medium, monitoring and preventive tools will be applied
- Low and Very Low, diagnostic and monitoring tools will be mainly applied.

63. Determining the Supervisory Period - The supervisory period is the time between one formal risk assessment and another or the period for which the risk mitigation program lasts. This will vary depending on the overall risk rating of a credit union and will range between 12 and 24 months. The following are the suggested time frame for the supervisory period:

- Very High and High - 12 months
- Medium and Low - 18 months
- Very Low - 24 months

However, any credit union that is rated as a 'Very High' impact credit union should have a supervisory period of 12 months.

64. Evaluation and Validation - having completed the risk assessment and the risk mitigation program, the next stage entails conducting an internal evaluation and validation, before the results are adopted for implementation. The validation and testing process is expected to provide quality control and ensure consistency. A committee whose members will be independent of the risk assessment of a particular credit union will conduct it. The process will include the following:

Table 10 – Evaluation and Validation Procedure

Types of Review	Reviewer
A review of the risk assessment for the completeness and appropriateness of the scores assigned	Stabilization Fund Head and Consulting Department Head
A review of any business and control risks rating	Do
A review of he risk mitigation program for completeness, adequacy, proportionality and optimal allocation of resources	Do
Approval of the overall risk rating and mitigation program	CEO with the recommendation of the Stabilization Fund Head

Communicating the Results of the Assessment and Risk Mitigation Program to credit union

65. The results of the risk assessment, and the threat it poses to achieving supervisory objectives, the on-site examination report and the risk mitigation program, will be formally communicated to the credit union.

66. The letter communicating the result of the risk assessment will contain the following:

i. The credit union-specific risk scores and impacts against each objective
ii. Key findings that lead to the credit union-specific risk scores of "Very High" or "High"
iii. The length of the regulatory period
iv. A requirement that the credit union should, at all times, communicate significant events that may affect the risk assessment to CURBSS

67. The letter also, will include findings of on-site visit, which should contain the following:

i. The CURBSS' view of key environmental or external risks facing the credit union (where appropriate) that provides the context for the credit union-specific issues identified in the risk assessment
ii. The detailed comments and observations of the examiner

68. Finally, the letter will also inform the credit union of the prescribed risk mitigation program that will set out the following:

i. The issues identified by CURBSS
ii. The intended outcome CURBSS seeks to achieve for each issue
iii. The action to be taken to achieve the intended outcome, specifying whether the action is to be taken by CURBSS or the credit union
iv. The timetable of the action

69. CURBSS addresses the letter to the Board of Directors to emphasize the importance placed on the board's responsibility for setting up and operating effective internal controls and running the credit union's business in compliance with the standards set by the regulation and sound business practices.

70. The credit union will be required to respond formally to the letter confirming that it will follow the prescribed risk mitigation program (RMP).

71. If the credit union declines to carry out the actions in the RMP, CURBSS will consider the use of other supervisory tools. CURBSS also considers whether the credit union has breached any rule, principle or threshold condition and whether other formal actions, consistent with the regulation of the Federation or the Stabilization Fund, should be taken.

72. The issuance of the letter will trigger-off implementation actions, as specified in the RMP, by both the CURBSS and the credit union.

Implementation of Risk Mitigation Program, On-Going Assessment and Response to Risk Escalation

73. Where a credit union's supervisory period exceeds 12 months, an interim review will be carried out before the expiration of the supervision period to determine whether the earlier risk assessment and risk mitigation program are still applicable. The review will also determine whether there has been an escalation of the risks and the appropriateness of the risk mitigation program. The review will be an off-site assessment, covering all the risk factors, issues and the supervisory tools deployed.

74. Reviews could also be carried out when any of the following occurs:

    i. Developments in the external environment that could materially affect the credit union
    ii. Changes in the credit union's business, strategy, infrastructure or management
    iii. Where the supervisory tools deployed have not been effective
    iv. Successful achievement of desired outcomes in the RMP, which should ordinarily lead to an improvement in the risk profile of the credit union

4

Credit union's risk management process

Introduction

75. This chapter describes the risk management process of a typical credit union and proposes guidelines for developing a risk management model for a credit union. Such a model would facilitate the assessment of the risk that credit unions may pose to the overall supervisory objectives and to proactively decide on a menu of responses to such risks, should they arise.

76. The credit union's risk management model will facilitate CURBSS assessment of the effectiveness of a credit union's own risk management system and thereby determine the risk it poses to supervisory objectives.

77. It would assist in determining the degree of reliance to be placed on senior management's commitment to consider and address changes in the environment that may create new risks or change existing risks significantly.

78. Supervisory actions that would be taken will largely be driven by the adequacy of the credit union's risk management model vis-à-vis its risk appetite.

Risk Management Process

79. Risk refers to the uncertainty that surrounds future events and outcomes. It is the expression of the likelihood and impact of an event with the potential to influence the achievement of an organization's objectives. The phrase "the expression of the likelihood and impact of an event" implies that, as a minimum, some form of quantitative or qualitative analysis is required for making decisions concerning major risks or threats to the achievement of an organization's objectives. For each risk, two

calculations are required: its likelihood or probability; and the extent of the impact or consequences.

80. The risk management process involves the identification, measurement, monitoring and control of the institution's risks. It entails a proper understanding of the institution and its various activities.

81. The purpose of the Integrated Risk Management Framework is to:

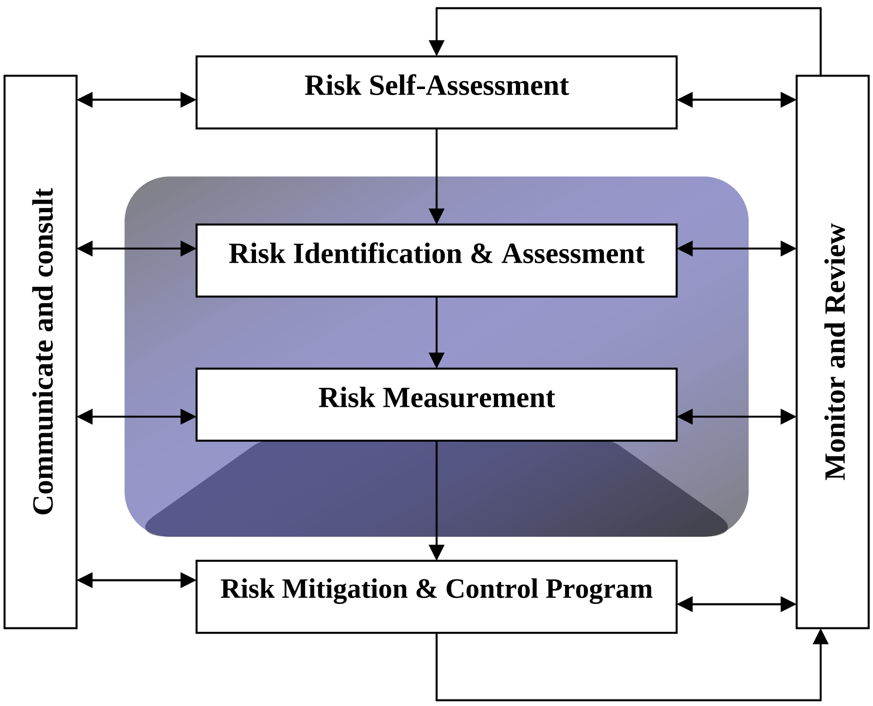
i. provide guidance to advance the use of a more corporate and systematic approach to risk management;

ii. contribute to building a risk-smart workforce and environment that allows for innovation and responsible risk-taking while ensuring legitimate precautions are taken to protect the public interest, maintain public trust, and ensure due diligence; and

iii. propose a set of risk management practices that credit unions can adopt, or adapt, to their specific circumstances and mandate.

82. The risk management process consists of a series of steps that, when undertaken in sequence, enable continual improvement in decision-making. The elements of the risk management process are summarized in Table 11:

Table 11 : Risk Management Process



83. Minimum Information Required – the various risk elements and the type of information that credit union could consider are summarized in table:

Table 12 – Minimum Information Requirement

	RISK ELEMENT	ASSOCIATED RISKS/TYPES OF INFORMATION
Business Risk Group		
1	Quality of corporate strategy	Quality of strategic planning process, implications of the strategy vis -à-vis the risk appetite and achievability of strategy, the institutions services and products, members and the inter-relationships between them.
2	Credit Risk	Type and nature of Credit risk undertaken, risk appetite of the credit union; nature of loan exposures involved in its products & services, portfolio characteristics and the nature & extent of credit risk mitigation.
3	Market Risk	Types & nature of market risk undertaken, risk appetite, nature of market risk exposures involved in its products & services and portfolio characteristics.
4	Operational Risk	Direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
5	Litigation/Legal Risk	Type & nature of contractual agreements vis -à-vis enforceability under applicable laws and the vulnerability of nature of product or service to litigation.
6	Protection of Assets	The risk arising from inadequate protection of assets measured by the adequacy of the allowances for loan losses against the amount of delinquent loans and the allowances for investment losses with the total amount of non-regulated investments. Inadequate loan loss protection produces two undesirable results: inflated asset values and fictitious earnings. Most credit unions are not anxious to recognize loan losses, and much less, to charge them off against earnings. That unwillingness leads to widespread abuse of the principles of safety and soundness. Reported net income is overstated, asset values are inflated, provisions for loan losses are inadequate, and member savings are not adequately protected.
7	Financial Structure Risk	The risk arising from the imbalance of fund sources and asset investment may result to liquidity problem, reduced income, and slow growth. Credit unions are encouraged to maximize productive assets as the means to achieve sufficient earnings. Since the loan portfolio is the most profitable asset of the credit union, maintaining 70-80% of total assets in the loan portfolio is recommended. Excess liquidity is discouraged because the margins on liquid investments (e.g., savings accounts) are significantly lower than those earned on the loan portfolio. Non-Earning assets are also discouraged because once purchased, they are often difficult to liquidate.

	RISK ELEMENT	ASSOCIATED RISKS/TYPES OF INFORMATION
8	Assets Quality Risk	The risk arising from a non-productive or non-earning asset that does not generate income for the credit union. An excess of non-earning assets affects credit union earnings in a negative way.
9	Rates of Return and Costs Risk	The risks arising from the nature of earnings of the credit union and its capacity to meet the financial costs and operating expenses. The volatility of revenues could pose risks to credit union operation in the future.
10	Liquidity Risk	The risk of loss due to inability of a credit union to meet cash obligations. Effective liquidity management becomes a much more important skill as the credit union shifts its financial structure from member shares to more volatile deposit savings.
11	Growth Risk	The risk that a credit union may not maintain its asset values if a strong, accelerated growth of assets, accompanied by sustained profitability is not achieved. Growth by itself is insufficient. .
12	Types of Members	Member base & characteristics.
13	Types of Products and services	Complexity, tenor and performance of products
Control Risk Group		
14	Service delivery, training, recruitment, remuneration and security of members	Recruitment quality and training procedures, adequacy of training plans, procedures for determining training needs and maintaining competence, remuneration policy and impact on misconduct & fraud, safety and control over members' monies and assets.
15	Disclosure and adequacy of product literature	Nature of product advertisement is sued, the content of the advertisement and product literature.
16	Clarity of ownership	Nature of Legal and ownership structure, openness of structure to regulators, jurisdiction and characteristics of shareholders or directors, nature of other group entities, management arrangements
17	Risk Management System	Nature and effectiveness of systems and procedures to identify, measure, monitor and control risk in an appropriate & timely manner.
18	Information Communication Technology	Adequacy, accuracy, relevance and timeliness as well as effectiveness and efficiency of distribution of management information; adequacy of resources to support IT infrastructure, procedures for implementation and procurement, effectiveness of security framework and appropriateness of IT platform to run the business.
19	Compliance/Internal Audit	Mandate, structure, staffing methodology and effectiveness of the compliance and internal audit functions.
20	Corporate Governance and Human resources	Role and effectiveness of the Board, non-executive directors & Board Committees; Recruitment, Training, Remuneration, disciplinary procedures & resources.
21	Relationship with regulators	Relationship with major (or lead) regulator and other regulators, including recent regulatory history.

Guidelines for Developing Individual Risk Management Model

84. In promoting a stable and sound financial system, the supervisory authorities place high priority in credit unions establishing effective risk management processes. The guideline aims at aiding that process.

85. The processes put in place for the effective management of risks in any financial institution underscores the ability of board and management of each credit union to identify, measure, monitor and control all risks inherent in its activities.

Policy Statement

86. It is the overall responsibility of the Board and Management of each credit union to ensure that adequate policies are in place to manage and mitigate the adverse effects of both business and control risks in its operations.

87. Each credit union should develop and implement appropriate and effective information systems and procedures to manage and control risks in line with the risk management policies of the credit union.

88. CURBSS will appraise the adequacy of the risk management processes of each credit union. All the facets of the risk management processes of the credit union will be reviewed as the need arises to take account of changing circumstances.

89. Each credit union should submit a copy of its Risk Management Process (and any amendments thereto) to CURBSS and the Stabilization Fund for appraisal and review.

Issues to Consider in Developing Guidelines for Risk Management Processes

90. **Self Assessment**

i. Each credit union is expected to identify significant activities, types and levels of inherent risks and the adequacy of its risk management process.
ii. Each credit union should assess itself to determine the level of risks inherent in its operations.

91. **Risk Identification and Assessment**

i. This process involves identifying the risks inherent in a credit union's business activities, which may affect its business objectives.
ii. Each credit union would need to assess the likelihood of risks crystallizing from within the credit union.
iii. The risk assessment entails the development of a risk map by credit unions, which should take into account external events and threats

92. **Risk Measurement Methods**

i. Credit unions would be required to score the risk elements identified in terms of size, duration and probability of adverse consequences.
ii. The measurement should graduate risk levels, based on the scale or significance of the activities in relation to the credit union's risk management goals and objectives.

iii. Thus, a risk element may be scored Very High, High, Medium, Low or Very Low.

93. **Risk Mitigation and Control Program**

i. The risk mitigation program is a set of self regulatory actions designed to address the impact of risks and its associate problems if and/or when they occur.
ii. The type of risk mitigation program that would be put in place would depend on the result of self-assessment carried out by the credit union.
iii. Generally, risks viewed as Very High or High would require actions to be taken to mitigate such risks.
iv. The mitigation program from the individual credit union's perspective would entail actions that are diagnostic, monitoring, preventive or remedial.
v. Actions are preventive when they are aimed at preventing the occurrence of an identified risk and remedial where they are to address crystallized risks.
vi. The risk control process involves the establishment of risk management standards. The standards to be set should be a deliberate policy of the credit union to achieve its business objectives.
vii. The objective would be to minimize the occurrence of such identified risks and contain the effects of the risks when they occur.

94. **Risk Monitoring Process**

i. Management should review the standards set for the credit union on a continuous basis, to ensure that they are appropriate to meet the set objectives. This would be achieved by appointing specific Risk Managers or designated staff who would review the adequacy or otherwise of the risk management processes across the organization.
ii. It is the duty of the Chief Executive Officer of the credit union to ensure compliance with the risk controls put in place.

5

Credit union's supervisory processes

Introduction

95. This chapter details steps in off-site surveillance and on-site examination under the new Framework. The new Framework, based essentially on risk profiling of credit unions, would be largely carried out through baseline monitoring. Through analyses of information rendered by the credit union, the supervisor would monitor, identify and deal with credit union-specific risks, and provide an insight into industry developments.

96. Since supervisory action would be risk driven, routine monitoring visits will not be a dominant feature of the new Framework.

Off-Site Surveillance

97. The off- site function will principally be pre-emptive. It will aim at preventing, controlling and mitigating risks. It will aim at early identification of problems with a view to taking prompt corrective actions, thereby minimizing overall risk in the system.

98. In line with the Framework, off-site supervisory activity will involve risk identification and assessment; implementing and monitoring on-going corrective actions; providing statistical report to operators; discussions with management and/or external auditors; collaboration with on-site Examiners and identification of high risk areas for on-site examination.

Pre Conditions for Effective Off-Site Surveillance

99. **Pre Conditions for Effective Off-Site Surveillance**

i. **Data Integrity –** The efficacy of RBS relies heavily on integrity of data upon which informed and accurate analysis of risks are based. Where information and data are either false or unreliable, assessment from the analysis conducted on such data would also be unreliable and faulty. Credit unions should adhere to financial standards that may include the proper valuation of loan portfolio, chart of accounts, and financial reporting.

ii. **Legal Protection for Compliance Officers -** The Compliance Officers of credit union will play a very significant role under a risk-based supervision regime. Accordingly, there should be adequate legal protection for them. They are to ensure that returns comply with rules and regulation before appending their signatures. They should be made to operate within minimum operating standards.

iii. **Legal Protection for Whistle Blower -** The supervisor needs to be alerted on happenings in the institutions being supervised that constitute threat to the supervisory objectives. One source of such information is the insiders of the credit unions and others whose information could be relied upon. To assure adequate protection for those providing the information, appropriate legal backing will be necessary.

iv. **Fit and Proper Persons Test -** The process of carrying out the fit and proper persons test should be reviewed to make it more effective. The Chairman of the Board should not serve as the Chairman of Board Committees while the posts of Board Chairman and Managing Director/ Chief Executive Officer should not be vested in one person.

Off-Site Surveillance Processes

i. **Impact Assessment of Credit Unions -** The off-site processes will commence with the impact assessment of credit unions. This entails determining the relative significance of a credit union to the entire system if it becomes unsafe or unsound. Balance sheet items, (i.e. total assets and total deposits) are compared against defined **impact thresholds.** This will indicate the scale and significance of the problem if it were to occur. The credit union will then be categorized into impact bands - Very High, High, Medium, Low and Very Low. The impact threshold is as shown in the table below:

Table 13 - Impact Thresholds

Thresholds	Total Assets			Total Shares and Deposits		
	Million	Market Share %	Number of Credit Unions	Million	Market Share %	Number of Credit Union
Very High	Above 100			???		
High	51 – 100			???		
Medium	11 – 50			???		
Low	5 – 10			???		
Very low	< 5			???		

ii. **Credit Union Specific Risk Assessment -** This will involve an off-site review of the credit union-specific risk elements in line with the Risk Review Guide detailed in Appendix 1. Integrating the outcome of the on-site credit union-specific risk assessment with that of the offsite will complete the credit union-specific risk review.

iii. **Development of Risk Mitigation Program -** once the credit union-specific risk assessment is completed; the Risk Mitigation Program (RMP) should be developed. The off-site and on-site Examiners as detailed below will develop this, jointly:

- The risk mitigation programs (RMPs) are actions designed to address the issues identified at the risk assessment stage. The program will address the nature of the risk, intended outcome, actions to be taken by the supervisor and/or the credit union and the timeframe within which to implement the program.

- This will involve the selection of supervisory tools, based on the severity and nature of the risk and the expected outcome.

- The tools, which consist of actions to be taken either by the supervisor or the credit union, are classified under four broad groups as shown in the table below:

Table 14 - Supervisory Tools

Diagnostic	Monitoring	Preventive	Remedial
• On-site and off-site examination • Investigations • Risk assessments	• Off-site surveillance • On-site visits • External auditors • Internal auditors	• Disclosures • Member education • Public Statements • Regulatory Standards • Credit union system standards (National federation) such as ACCESS • Contingency planning • Management Tools (policies, systems and procedures)	• Compensation schemes • Complaints resolution • Disciplinary actions • Interventions • Penalties • Amalgamation • Suspension • Termination

iv. **Evaluation and Validation -** Having completed the risk assessment and the risk mitigation program, the next stage entails conducting an internal evaluation and validation, before the results are adopted for implementation. The validation and testing process is expected to provide quality control and ensure consistency. A group whose members will be independent of the risk assessment team of a particular credit union will conduct this function. The process will include the following:

Table 15 – Evaluation and Review

Types of Review	Reviewer
A review of the risk assessment for the completeness and appropriateness of the scores assigned	Stabilization Fund Head and Consulting Department Head
A review of any business and control risks rating	Do
A review of he risk mitigation program for completeness, adequacy, proportionality and optimal allocation of resources	Do
Approval of the overall risk rating and mitigation program	CEO with the recommendation of the Stabilization Fund Head

v. **Communicating the Results of the Assessment and Risk Mitigation Program to the Credit Union -** The results of the risk assessment, and the threat it poses to achieving supervisory objectives and the risk mitigation program, will be formally communicated to the credit union.

vi. **On-Going Assessment and Response to Risk Escalation -** After communicating the results of the assessment and RMP to the credit union, the next stage is the on-going assessment and response to risk escalation. The on-going assessment will also focus on prompt corrective actions and contingency plan to curtail possible escalation of risk. Apart from the risk assessment that is carried out for each credit union during the supervisory cycle, an on- going off- site assessment of the financial soundness of the credit union will continue. The process would include off-site rating of credit unions, sending offsite reports to credit unions, and review of compliance with prudential thresholds and guidelines.

On-Site Examination Process

100. The Risk-Based Supervision will commence with a full-scope examination of a credit union. Subsequently, the on-site examination will range from a full scope examination that will cover the 20 risk elements identified to a target examination as may be determined by the supervisory program developed for each credit union.

101. On-site visitation will be required at the following stages of the Framework.

i. Risk assessment
ii. Development of RMP
iii. Implementation of the RMP
iv. Commencement of a new assessment cycle

Examination Process

102. **The** examination process will include the following phases:

i. Examination Planning
ii. Examination Program
iii. Examination Procedures

Examination Planning

103. The examination planning will include the following:

i. **Institutional Overview Report -** The starting point for RBS is an understanding of the credit union being examined. The process begins with the review of all available information on the credit union. The Examination Team will prepare a report titled "Institutional Overview Report" in the form of an executive summary that concisely describes the credit union's present condition as well as its current and prospective risk profile. The institutional Overview Report should contain, but not limited to the following:

- **Overall condition:** A general assessment of the credit union.
- **Structure:** The size, branch network and subsidiaries of the credit union and its organizational structure.
- **Strategic Initiatives:** A summary of the credit union's strategies, key business lines, product mix, market emphasis, growth areas, etc.
- **Inherent Risks:** A highlight of areas of significant risk.
- **Corporate Overview:** A description of current business activities, revenue base and future prospects.
- **Management Overview:** Comments on the level of board oversight, strengths and weaknesses of leadership, weaknesses in risk management process, policy formulation and strategic planning emphasizing the participation of key executives, the adequacy of MIS, etc.
- **Financial Overview:** A brief analysis of the financial condition and trends in earnings, asset quality, capital adequacy, liquidity ratio, ROE, ROA, etc.
- Supervisory activity performed since the previous examination.
- Considerations for future on-site visits, etc.

ii. **Developing an Examination Planning Memorandum and Entry Letter**

To define the examination activities as well as provide information for the conduct of risk-based examination, two important documents must be prepared. These are the Examination Planning Memorandum and the Entry Letter.

a. The Examination Planning Memorandum (EPM) - This document summarizes the activities to be performed during the onsite examination, as an integral part of the RBS. The document, which would be prepared before undertaking the on-site visit, should identify the specific objectives of the examination and ensure that the objectives and strategy are communicated to the team members. The focus of on-site examination identified in the EPM, should be oriented to a top-down approach that includes a review of the credit union's risk management systems and appropriate level of transaction testing. Transaction testing and asset review would be necessary to verify the integrity of the systems.

The Primary purpose of the EPM is to document and convey Examiners' conclusions regarding allocation of examination resources according to perceived risks. However, it should not serve as an off-site analysis of the institution to be examined.

The EPM includes a discussion of all CAMELS components (and in some cases, ancillary areas), regardless of the risk involved or the volume of resources anticipated to be devoted to these areas.

The EPM will also include data and discussion regarding examination hours (budgeted hours, average hours, and previous examination hours).

The EPM comments will be prepared on an "exception only" basis, according to areas of higher-than-normal or lower than-normal perceived risk. It will also encourage brief, bullet comments, not necessarily of report quality; include high-level performance ratios and financial data which will be documented in the EPM; define the deadline for submission to be the last five (5) business days prior to the commencement of the examination.

The Examination Planning process will generate concise pre-planning documents that are consistent with the stated examination objectives and detail allocation of resources according to perceived risks.

b. Entry Letter - This is a document that is used to request a credit union to supply specific information on its activities to the supervisor. It identifies information necessary for the successful execution of the on-site examination. The letter would be tailored to fit the specific character and profile of the credit union to be examined and the scope of the activities to be performed. To eliminate duplication, the letter will not request for any information that is provided on a regular basis to CURBSS, such as the various financial information.

iii. **Examination Program**

The examination program will provide a comprehensive schedule of all examination activities to be conducted on a credit union. The examination program should incorporate the following:

- A schedule of activities, commencement and conclusion dates, duration of time, staff and other resource estimates for the examination as well as output e.g. reports, sub-reports, etc.
- Areas of emphasis e.g. credit review, Board and Management, etc.
- Specialist examiners' skill required, and where necessary, the extent of their participation, etc.

iv. **Targeted Risk Areas**

These are defined as areas with more than normal risk, to which the Examiner intends to devote additional or "above normal" examination resources. Targeted Risk Areas may [but do not have to] include PEARLS components, specialty areas [e.g. e-banking], internal audit environment, internal routine and controls. Targeted Risk Areas should not include discussions of areas that are perceived to present average or moderate risk. For areas of moderate or "normal" risk, the Examiner will perform standard examination procedures. Specific discussion of these areas is therefore, not necessary.

v. **Low Risk Areas Subject to Limited Review**

Examiners will specifically discuss any areas of perceived low risk, where normal examination resources and procedures will be reduced or eliminated. Comments will include a brief explanation of why the area is considered low risk.

vi. **Loan Scope**

The Examiner will comment on the proposed loan scope, with emphasis on risk areas within the portfolio where loan file review will be concentrated. To the extent possible, Examiners will disclose the target loan penetration percentage. The Examiner will discuss loan scoping with the Off-site Examiner during the pre-examination planning contact.

vii. **Staffing**

The Examiner will prepare a schedule of duties, apportioning tasks to members of the Examination team. The job schedule should be accomplished within the specified time frame.

viii. **Documentation Methodology**

The Examiner is expected to indicate the specific examination modules which he/she anticipates using. The actual documentation methodology used may differ from that discussed in the EPM.

ix. **Submitting the Examination Planning Memorandum**

The EPM is expected to be submitted for approval not later than the last business day prior to the commencement of the examination. A copy of the EPM should also be forwarded to the CEO for comments.

Examination Procedures

104. Having developed the EPM, examination procedures will be tailored to the characteristics of each credit union, bearing in mind the size, complexity and risk profile. The procedures will be contained in Examination Manuals.

i. **Evaluation of Areas of Significant Risk**

The field work will focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor and control risks. Procedures will be completed to the degree necessary to determine whether the credit union's management understands and adequately controls the levels and types of risks that are assumed. Full-scope examinations are expected to include Examiners' evaluation of all the 20 risk elements, which usually are the common sources of significant risks. In addition, Examiners are also expected to evaluate other areas of significant sources of risk to the credit union. The Examiner should hold formal meetings with the credit union's management team to discuss and obtain commitment on their findings on each functional area.

ii. **Documentation of Findings and Conclusions**

It is important for Examiners to document their findings and overall conclusions after performing the procedures contained in the relevant examination manual. The comments are expected to be clear and well organized. The conclusions, as each relates to the functional area under review, should clearly communicate the Examiners' assessment of the risk management system, the financial condition, and compliance with laws and regulations

iii. **Exit Discussion**

At the end of the examination, the Examiners will arrange for a meeting with the credit union's management during which all findings will be discussed.

- The Examiner is expected to prepare an agenda for the exit discussion.

- The purpose of the Agenda in addition to allowing the Examiner to decide the direction of the discussion is to ensure that the attention of the credit union's management is focused on the issues to be discussed.

- The amount and order of information presented in the Agenda will depend on the proposed ratings, seriousness of issues, and causes of the problems.

- Examination findings will be presented in a logical flow, prioritized in order of importance.

- All PEARLS components should be covered.

- The exit meeting is an opportunity for the Examiners to clear any remaining questions that they may have concerning the examination. During the meeting, commitments for corrective action will be obtained or re-affirmed. The Examiner and credit union management will need to be clear as to:

  a) What was committed to be corrected, when and how?
  b) Recommended Examiner ratings (component/ composite) should be discussed.

- The credit union's management is expected to have a clear understanding of the significance of examination findings after the meeting.

iv. **Risk Report**

At the conclusion of each on-site visit, a Risk Map as detailed below will be produced. Accompanying the Risk Map, a detailed report will also be produced. It should clearly and concisely contain any supervisory issues, problems, or concerns related to the credit union. All comments regarding deficiencies noted in the credit union's risk management systems, as highlighted during the exit discussion, should be included in the Report. Accordingly, the report should detail observations under each of the risk element.

Table 16 – Risk Map

		Financial Failure	**Misconduct & Mis-management**	**Poor Corporate Governance**	**Inadequate Member Under-standing**	**Financial Crime, fraud & dishonesty**
A. BUSINESS RISKS						
1	**Strategy**					
i)	Quality of corporate strategy or Nature of Business					
Strategy Score						
2	**Market, Credit and Operational Risk**					
ii)	Credit Risk					
iii)	Market Risk					
iv)	Operational Risk					
v)	Litigation/ Legal Risk					
Market, Credit & Operational Risk Average Score						
Market, Credit & Operational Risk Score						
3	**Financial Risk**					
vi)	Protection of Assets					
vii)	Effective Financial Structure					
viii)	Assets Quality					
ix)	Rates of Return and Costs					
x)	Liquidity					
xi)	Signs of growth					
Financial Risk Average Score						
Financial Risk Score						
4	**Members**					

xii)	Type of members					
Members Risk Score						
Business Risk Average Score						
BUSINESS RISK SCORE						
B. CONTROL RISKS						
1	**Treatment of Members**					
xiii)	Service delivery, training, recruitment, remuneration and security of members					
xiv)	Disclosure and adequacy of product literature					
Treatment of Members Risk Average Score						
Treatment of Members Risk Score						
2	**Organization**					
xv)	Clarity of ownership/ group structure[3]					
Organization Risk Score						
3	**Internal Systems and Controls**					
xvi)	Risk management system					
xvii)	Information and Communication Technology					
xviii)	Compliance/ Internal Audit					
Internal Systems and Controls Risk Average Score						
Internal Systems and Controls Risk Score						

[3] This is in the case the credit union/cooperative also operates a subsidiary business under its organizations set up or even independently. However, such undertakings are funded by the credit union.

4	**Board, Management and Staff**					
xix)	Governance and Human Resources					
Board, Management and Staff Risk Score						
5	**Business and Compliance Culture**					
xx	Relationship with Regulators					
Business Compliance Risk Score						
Business Risk Average Score						
CONTROL RISK SCORE						
CREDIT UNION SPECIFIC RISK SCORE PER RTO GROUP						

6

Implementation

105. This chapter deals with the phases, issues and structures necessary or required to implement Risk Based Supervision in credit unions. Prior to commencement, the issues briefly outlined below, must be addressed in order to ensure its successful implementation.

Integrity and Reliability of Records and Information

106. The efficacy of Risk Based Supervision relies heavily on the integrity of data upon which informed and accurate analysis for assessment of risk may be conducted. Where information and data is false or unreliable, assessment from analysis conducted on such data would also be unreliable and faulty. The need for zero tolerance for data and information unreliability is critical to effective risk based supervision.

107. In order to further ascertain the quality of data received from credit unions, proper validation tests should be carried out with adequate links to examination reports.

108. In addition, appropriate incentives should be given to officers and credit unions that maintain high integrity of data and information submitted to the Stabilization Fund.

109. Generally, the sanctions and penalties for rendition of false information/statements should be robust and predicated upon prompt and timely intervention as well as varied and directed at the personnel responsible. This would entail a review of the current legal framework. In this regard, officers designated by the credit union to prepare and render specific reports, data or provide information should be held accountable and liable and denied privileges such as promotions, overseas training, etc for a specified period.

Obligation to Furnish Information to Facilitate On-Going Assessment

110. The Risk assessment process involves an on-going assessment and response to risk change in the interval between formal risk assessments. This entails the credit union providing information to the supervisor at all times and on all issues to enable the supervisor adapt the Risk Mitigation Program to accommodate changes in risk levels of the credit union on an on- going basis. Credit unions should be compelled to

supply relevant information voluntarily if such could impact upon the risk profile of their institutions.

Issuance of Risk Assessment Report and Risk Mitigation Program

111. The Risk Mitigation Program developed for a credit union is an integral part of the RBS process. Credit union should be obliged to faithfully implement the RMP for RBS to be effective. There must be legal mechanism put in place to ensure faithful implementation of the RMP.

112. CURBSS should provide for a credit union to faithfully implement the RMP. Adequate sanctions for failure to faithfully implement the RMP should be stipulated, and this could include making such failure or refusal a ground for revocation of the relevant credit union's membership at the national federation or at the Stabilization Fund.

Structural/Organizational issues

113. It would be necessary for the national federation to fashion out structures that would facilitate seamless operation of RBS in view of the relationship of CURBSS functions with the Stabilization Fund. In that regard, the national federation would need to work our modalities for evolving an appropriate institutional arrangement and controls.

Design Test Process of each Phase of the Framework

114. A simulation should be conducted to test each of the critical phases of the Framework.

   i. Risk Assessment
   ii. Supervisory Action Plan/Tools
   iii. Evaluation (including remedial measures)

Review of the Framework

115. The framework for RBS shall be reviewed to reflect relevant comments/suggestions received from the stakeholders as well as the changes in the market environment.

116. In order to ensure wide acceptance, smooth transition, as well as successful implementation of the RBS, the CURBSS would consult widely with the other stakeholders.

Training

117. The appropriate manpower training would be conducted for both supervisors and credit unions to ensure a clear understanding of the processes and procedures