 <b>Office of Credit Unions</b> <b>Policies and Procedures</b>	<b>POLICY NUMBER</b>
	<b>10051</b>
<b>EXAMINERS MANUAL - GENERAL</b>	<b>EFFECTIVE DATE</b>
	<b>11/01/2018</b>
<b>SUBJECT</b>	<b>REVISION DATE</b>
	<b>11/01/2018</b>
<b>7 Key Risk Categories - Defined</b>	<b>PAGE(S)</b>
	<b>Page 1 of 6</b>

## I. PURPOSE

This policy provides guidance on the definitions used within the Risk Analysis sheet within the Database Input Workbook for full and follow-up examinations. The definitions for the seven risk categories, inherent risk, risk management, composite risk, and risk trends are as explained here.

## II. SEVEN RISK CATEGORIES

### Credit Risk


Credit risk is the current and prospective risk to earnings or capital arising from an obligor's failure to meet terms of any contract with the credit union or otherwise fail to perform as agreed. Credit risk exists in all activities where the credit union invests or loans funds with the expectation of repayment.

### Interest Rate Risk

Interest Rate Risk is the risk that changes in market rates will adversely affect a credit union's capital and earnings. Interest rate risk arises from (1) differences between the timing of rate changes and the timing of cash flows (repricing risk); (2) changing rate relationships among different yield curves affecting credit union activities (basis risk); (3) changing rate relationships across the spectrum of maturities (yield curve risk); and (4) interest-related options embedded in credit union products (options risk). Not only can a move in interest rates affect the price of investments, it also has an effect on the value of the loan portfolio and on fee income, which is sensitive to changes in interest rates. The assessment of interest rate risk should consider risk from both an accounting perspective (i.e., the effect on the credit union's accrual earnings, including held-to-maturity and available-for-sale accounts) and the economic perspective (i.e., the effect on the market value of the credit union's loans and investments.) In some credit unions, the broader category of market risk captures interest rate risk.

### Liquidity Risk

Liquidity risk is the current and prospective risk to earnings or capital arising from a credit union's inability to meet its obligations when they come due, without incurring material costs or unacceptable losses. Liquidity risk includes the inability to manage funding sources, including unplanned decreases or changes. Liquidity risk also rises from the credit union's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

 <b>Office of Credit Unions</b> <b>Policies and Procedures</b>	<b>POLICY NUMBER</b>
	<b>10051</b>
	<b>EFFECTIVE DATE</b>
	<b>11/01/2018</b>
<b>EXAMINERS MANUAL - GENERAL</b>	<b>REVISION DATE</b>
	<b>11/01/2018</b>
<b>SUBJECT</b>	<b>PAGE(S)</b>
<b>7 Key Risk Categories - Defined</b>	<b>Page 2 of 6</b>

### **Transactional/Operational Risk**

Transaction Risk is the risk to earnings or capital arising from fraud or error that results in an inability to deliver products or services, maintain a competitive position, and manage information. This risk is a function of internal controls, information systems, employee integrity, and operating processes. The risk can also arise from operational problems or unforeseen catastrophes that may result in unexpected losses.

### **Compliance Risk**


Compliance Risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards. Compliance risk may also arise in situations where ambiguous or untested laws or rules govern certain credit union products or activities of the members. Compliance risk exposes the credit union to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, limited opportunities, reduced field of membership expansion potential, and lack of contract enforceability. Compliance risk goes beyond a failure to comply with consumer protection laws. It encompasses all laws as well as prudent ethical standards, contractual obligations, and exposure to litigation. Compliance risk can blend into operational risk, transaction processing, and even legal risk.

### **Strategic Risk**

Strategic Risk is the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of a credit union's strategic goals, the business strategies developed to achieve those goals, the resources deployed to accomplish these goals, and the quality of implementation. The tangible and intangible resources needed to carry out business strategies include communication channels, operating systems, delivery networks, monitoring systems, and managerial capacities and capabilities.

### **Reputation Risk**

Reputation Risk is the current and prospective risk to earnings or capital arising from negative public opinion or perception. Reputation risk affects the credit union's ability to establish new relationships or services, or to continue servicing existing relationships. This risk, which occurs in activities such as asset management decisions and transactions, can expose the credit union to litigation, financial loss, or a decline in membership base. Reputation risk exposure appears throughout the credit union organization. The officials, management, and staff must accept

 <b>Office of Credit Unions</b> <b>Policies and Procedures</b>	<b>POLICY NUMBER</b>
	<b>10051</b>
<b>EXAMINERS MANUAL - GENERAL</b>	<b>EFFECTIVE DATE</b>
	<b>11/01/2018</b>
<b>SUBJECT</b>	<b>REVISION DATE</b>
	<b>11/01/2018</b>
<b>7 Key Risk Categories - Defined</b>	<b>PAGE(S)</b>
	<b>Page 3 of 6</b>

responsibility to exercise an abundance of caution in dealing with members and the community.

### III. INHERENT RISK

Inherent risk assesses the nature, complexity, and volume of the activities giving rise to the risk in question. It is important to remember that this assessment of risk is made without considering management processes and controls; rather these factors are considered in evaluating the adequacy of the institution's risk management systems. Inherent risk is described as **High, Considerable, Moderate, Limited,** or **Low.**


**High Risk** exists where the activity is significant or positions are large in relation to the institution's resources, where there are a substantial number of transactions, and/or where the nature of the activity is inherently more complex than normal. Thus, the activity potentially could result in a significant and harmful loss to the organization.

**Considerable Risk** exists where the positions are above average in relation to the institution's resources, where the volume of transactions is above average, and/or where the activity is more complex than normal. Thus, the activity potentially could result in a significant loss to the organization; however, the resulting loss, while significant, would not threaten the long-term health or viability of the organization.

**Moderate Risk** exists where positions are average in relation to the institution's resources, where the volume of transactions is average, and where the activity is more typical or traditional. Thus, the activity potentially could result in a significant loss to the organization; however, the resulting loss, while significant, would not threaten the long-term health or viability of the organization.

**Limited Risk** exists where the volume, size, or nature of the activity is such that, even if the internal controls have weaknesses, the risk of loss is small, and, even if a loss were to occur, it would unlikely have a significant impact on the institution's overall financial condition.

**Low Risk** exists where the volume, size, or nature of the activity is such that, even if the internal controls have weaknesses, the risk of loss is remote, or, if a loss were to occur, it would have little material negative impact on the institution's overall financial condition.

 <b>Office of Credit Unions</b> <b>Policies and Procedures</b>	<b>POLICY NUMBER</b>
	<b>10051</b>
	<b>EFFECTIVE DATE</b>
	<b>11/01/2018</b>
<b>EXAMINERS MANUAL - GENERAL</b>	<b>REVISION DATE</b>
	<b>11/01/2018</b>
<b>SUBJECT</b>	<b>PAGE(S)</b>
<b>7 Key Risk Categories - Defined</b>	<b>Page 4 of 6</b>

#### IV. ADEQUACY OF RISK MANAGEMENT


When assessing the adequacy of a credit union's risk management systems for identified functions or activities, primary consideration is placed on findings related to the following key elements of a sound risk management system:

- Active board and senior management oversight;
- Adequate policies, procedures, and limits;
- Adequate risk management, systems, and monitoring; and
- Comprehensive internal controls

Taking these key elements into account, the examiner should assess the relative strength of the risk management process and controls for each identified function or activity. Relative strength should be characterized as **Strong**, **Satisfactory**, **Fair**, **Marginal**, or **Unsatisfactory** as defined below:

**Strong risk management** effectively identifies and controls all major types of risk posed by the credit union's activities. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward-looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and are understood, reviewed, and approved by the board. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide management and the board with the information and analysis that is necessary to make timely and appropriate decisions in response to changing conditions. Risk management practices and the organization's infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient experience, expertise, and depth to manage the risks assumed by the institution. Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with the standards of safety and soundness, and in accordance with internal and supervisory policies and practices.


**Satisfactory risk management** is largely effective, but lacking in some modest degree. Management demonstrates a responsiveness and ability to cope successfully with existing and foreseeable risks that may arise in carrying out the institution's business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are in the

 <b>Office of Credit Unions</b> <b>Policies and Procedures</b>	<b>POLICY NUMBER</b>
	<b>10051</b>
	<b>EFFECTIVE DATE</b>
	<b>11/01/2018</b>
<b>EXAMINERS MANUAL - GENERAL</b>	<b>REVISION DATE</b>
	<b>11/01/2018</b>
<b>SUBJECT</b>	<b>PAGE(S)</b>
<b>7 Key Risk Categories - Defined</b>	<b>Page 5 of 6</b>

process of being resolved. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Risks are controlled in a manner which does not require more than normal supervisory attention. The credit union's risk management practices and infrastructure are satisfactory and generally are adjusted appropriately in response to changing industry practices and current regulatory guidance. Staff experience, expertise and depth are generally appropriate to manage the risks assumed by the institution. Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

**Fair risk management** practices are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management (active board and senior management oversight; adequate policies, procedures, and limits; adequate risk management monitoring and management information systems; comprehensive internal controls) is considered less than acceptable, and has precluded the institution from fully addressing one or more significant risks to its operations. Certain risk management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control all significant risks to the institution. Also, the risk management structure may need to be improved in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. In addition, management's response to changing industry practices and regulatory guidance may need to improve. The internal control system may be lacking in some important aspects, particularly as indicated by continued control exceptions or by a failure to adhere to written policies and procedures. The risk management weaknesses could have adverse effects on the safety and soundness of institution if corrective action is not taken by management.

**Marginal risk management** is defined as deficit risk management practices which fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management is deficient and requires immediate and concerted corrective action by the board and management. The institution may have serious identified weaknesses, such as an inadequate separation of duties, which require substantial improvement in internal controls or accounting procedures, or improved adherence to supervisory standards or requirements. The risk management

 <b>Office of Credit Unions</b> <b>Policies and Procedures</b>	<b>POLICY NUMBER</b>
	<b>10051</b>
<b>EXAMINERS MANUAL - GENERAL</b>	<b>EFFECTIVE DATE</b>
	<b>11/01/2018</b>
<b>SUBJECT</b>	<b>REVISION DATE</b>
	<b>11/01/2018</b>
<b>7 Key Risk Categories - Defined</b>	<b>PAGE(S)</b>
	<b>Page 6 of 6</b>

deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

**Unsatisfactory risk management** is defined as critical absence of effective risk management practices with respect to the identification, monitoring, or control over significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address these deficiencies. Internal controls are critically weak and could seriously jeopardize the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and the potential for losses if corrective measures are not taken immediately. Deficiencies in the institution's risk management procedures and internal controls require immediate and close supervisory attention.

#### **V. COMPOSITE RISK**

The composite risk for each significant activity is determined by balancing the overall level of the activity with the overall strength of the risk management systems for that activity. Once the examiner has assessed the composite risk of each of the seven risk categories, an overall composite risk assessment of the entire credit union shall be made.

#### **VI. RISK TREND**

The trend of risk is the probable change in the credit union's risk profile for each of the seven categories of risk and the overall composite risk within the next examination cycle. The trend is characterized as decreasing, stable, or increasing.