STATE OF MICHIGAN

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DEPARTMENT OF LICENSING AND REGULATORY AFFAIRS
OFFICE OF FINANCIAL AND INSURANCE REGULATION
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COMMISSIONER

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DATE: April 30, 2012

LETTER NO.: 2012-CU-01

TO: The Board of Directors and Management of Michigan State-Chartered Credit Unions

SUBJECT: OFIR Credit Union Division Examination Process: Disclosure of CAMEL and Risk Analysis Matrix During the Onsite Examination.

The purpose of this letter is to explain changes in the Office of Financial and Insurance Regulation (OFIR) Credit Union Division examination process relating to the disclosure of draft CAMEL ratings and Risk Analysis assessments.

These changes were implemented to formalize communication of the examiner's draft assessments in a consistent format. The documents will outline the draft CAMEL Evaluation (see Exhibit 1) and the underlying Risk Assessment used to derive those ratings (see Exhibit 2). Both documents will include summary narrative providing key points used to justify the ratings.

The CAMEL Evaluation document will continue to utilize the standard FFIEC CAMEL component and composite definitions. The Risk Assessment will utilize the five-tier system outlined in Credit Union Division Policy 10040 – Risk Matrix and Ratings Definitions (Exhibit 3). The Risk Assessment will communicate the regulatory perspective of inherent risk levels and the adequacy of risk management processes used as a basis for the CAMEL ratings.

These documents will not replace of the finalized Examination Report which will continue to be reviewed and transmitted from the Lansing office. However, all information provided as part of the examination process, including these new documents, should continue to be treated with the same confidentiality awareness outlined within the Michigan Credit Union Act.

OFIR believes these documents will improve communication of OFIR's initial assessments in a standard format and provide a basis for examination exit meetings.

To comply with the policy Credit Union Division examiners must provide the CAMEL rating assessment and the Risk Assessment to executive management at least one day prior to the scheduled exit meeting. I strongly encourage credit union management to utilize this information in preparation for the exit meeting to understand the examiner perspective and fully discuss the basis for the provided ratings.

The implementation of the policy places procedural requirements on Division staff and provides no additional regulatory burden upon the industry.

The board of directors of each Michigan state-chartered credit union should review and retain a copy of this letter, which is also posted on the OFIR website at:

https://www.michigan.gov/dif s/industry/credit-unions/
credit-union-examination-survey/credit-union-letters

Questions regarding this letter may be directed to the Credit Union Division at 517-373-6930.

Sincerely,

John J. Kolhoff,
Deputy Commissioner
Credit Union Division

Office of Financial & Insurance Regulation

CAMEL Evaluation

Credit Union Name: Examiner In Charge: Effective Date:	OFIR EXAMINER RATING
CAPITAL ADEQUACY	
Component Rating	
Reasons/Factors on Capital Adequacy Rating	
ASSET QUALITY	
Component Rating	
Reasons/Factors on Asset Quality Rating	
MANAGEMENT	
Component Rating	
Reasons/Factors on Management Rating	
EARNINGS	
Component Rating	
Reasons/Factors on Earnings Rating	
LIQUIDITY/ASSET-LIABILITY MANAGEMENT	
Component Rating	
Reasons/Factors on Liquidity/Asset-Liability Management Rating	
COMPOSITE RATING	
Final Composite	
Reasons/Factors on Composite Rating	

EXHIBIT 1

This CAMEL Evaluation is strictly confidential pursuant to section 207(6) of the Michigan Credit Union Act. The credit union shall, under no circumstances publish, or make public in any manner, this CAMEL Evaluation or any portion thereof. It is provided in draft form and is subject to further review by the Office of Financial and Insurance Regulation.

Office of Financial & Insurance Regulation

RISK ANALYSIS

Credit Union Name:				
Examiner in Charge:				
Effective Date:				
Risk Factors:	Inherent Risk	Risk Management	Composite Risk	Trend
Credit				
COMMENTS:				
Interest Rate				
COMMENTS:				
Liquidity				
COMMENTS:				
Transactional/Operational				
COMMENTS:				
Compliance/Legal				
COMMENTS:				
Strategic				
COMMENTS:				
Reputation				
COMMENTS:				

EXHIBIT 2

This Risk Analysis is strictly confidential pursuant to section 207(6) of the Michigan Credit Union Act. The credit union shall, under no circumstances publish, or make public in any manner, this Risk Analysis or any portion thereof. It is provided in draft form and is subject to further review by the Office of Financial and Insurance Regulation.

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. This policy provides definitions for the seven risk categories, inherent risk, risk management, composite risk, and risk trends.

II. PRIMARY REFERENCES

1. Credit Union Division Policies and Procedures
   a. 10060 Database Input Workbook

III. DEFINITIONS

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.

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

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.

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, monitoring, and management information systems; 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 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 that 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 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 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 that 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, that require substantial improvement in internal controls or accounting procedures, or improved adherence to supervisory standards or requirements. The risk management 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, as such, 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.

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.

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.

IV. ATTACHMENTS / FORMS

1. Sample: Database Input Workbook