



World Council of Credit Unions, Inc.

Cooperative Risk Management Tool Final Version

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WOCCU

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Introduction

The Risk Management Tool (RMT) is designed to evaluate the main risks facing credit unions and similar types of savings and credit cooperatives around the world. Much of the material presented in this document draws heavily from the methodology and experience of the World Council of Credit Unions (WOCCU) Rating Agency in Guatemala that was operational from 1999-2003. The methodology that was created and used by the Rating Agency was developed from several key inputs:

- The employees of WOCCU who worked extensively with the credit unions of Guatemala over the previous seventeen years, had acquired an intimate knowledge of the inner workings of many credit unions and were very familiar with the challenges that the Guatemalan credit union movement faced.
- The employees of the Rating Agency were primarily former employees of the Guatemalan Superintendency of Banks and brought with them considerable knowledge and field experience in the supervision and regulation of the Guatemalan banking sector. Their inputs were invaluable in the creation of the methodology.
- The PEARLS Monitoring System, which for the previous sixteen years was used extensively by WOCCU to evaluate the financial performance of credit unions throughout the world. This monitoring system provided a wealth of information and insight into the creation and use of prudential standards for the management of credit unions.
- The Basel Capital Adequacy Standards introduced a risk-based approach which further enhanced the methodology by introducing the capacity to measure the risks of a credit union and determine its capacity to deal with the challenges and uncertainties of the global marketplace.
- The inclusion of qualitative indicators which complemented the quantitative indicators of the PEARLS Monitoring System. These qualitative indicators provided a more comprehensive risk analysis of a credit union, particularly in the area of operational risk which is one of the most important qualitative areas of risk in a credit union.

The Risk Management Tool includes a total of 82 indicators in four key risk areas, with 51 qualitative indicators and 31 quantitative indicators. The indicators are all risk-weighted, so while the 31 quantitative indicators represent 38% of the number, they provide 65% of the total points possible in the risk-weighted score. The other 51 qualitative indicators represent 68% of the indicators in number, but only 35% of the total points possible in the risk weighted score. The vast majority of these 82 indicators are completely new and have never been used before. The PEARLS ratios, which are used by many credit unions worldwide represent only 11 of the 82 indicators. The product design is based on 20 years of field experience working with many different types of financial cooperatives in Latin America, Africa, Eastern Europe, and Asia.

Even though there are 82 indicators, the tool can be easily simplified by regulators or other end users if so desired.

This paper will present a conceptual framework for the development of the risk management tool. Then it will discuss the different areas of risk and a justification for each of the indicators used in their respective areas. Finally, it will present a summary of all the indicators, their type and the total points possible per indicator, along with a new format for reporting in a consolidated risk assessment report.

Conceptual Framework

The conceptual framework of the risk management tool is built around the four cornerstones of risk facing credit unions and the processes required to evaluate those risks. While there may be other risks that a credit union must deal with, these four risks are considered to be the most critical as they commonly threaten the safety and soundness of credit unions. A brief introduction of each risk area is included below, while a more detailed discussion of the indicators will follow in the next section.

1. CAPITAL RISK

Capital risk is the challenge of not being able to accumulate sufficient capital to achieve three fundamental objectives:

- A. To adequately protect the creditors and members from the loss of their assets,
- B. To bolster profitability, and
- C. To provide quality products and services that will preserve a competitive advantage in the market.

2. CREDIT RISK

Credit risk attempts to measure the ability of a financial institution to invest and diversify the member's money in earning assets that both maintain their value and generate income to build capital. This risk includes not only the loan portfolio, but also investments in short term deposits and longer term certificates of deposit offered in banks, finance companies, and investment brokerage houses.

3. LIQUIDITY RISK

Liquidity risk measures the ability to maintain adequate cash flow to fund member loans, satisfy member withdrawal requests, and pay operating expenses in a timely manner. It also looks at the adequacy of "back up" liquidity reserves whether the credit union satisfied this independently or through second tier institutions, such as central finance facilities or corporate credit unions.

4. OPERATIONAL RISK

Operational risk is the threat of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risk includes governance, as well as the vital operational processes of a credit union that must be working properly in order to avoid institutional failure.

The conceptual design and methodology of the risk management tool is divided into four operational phases:

1. INFORMATION INPUT

The most important part of the process is to capture the correct financial, demographic and statistical information, as well as to obtain copies of all of the written policies, procedures and guidelines of the credit union in order to provide accurate inputs. This phase can be the most difficult and time consuming if the solicited information is unavailable, inaccurate, or incomplete. The best approach is to solicit the required information beforehand so that a complete file and work plan can be established. The main source documents are the accounting records, including all the detailed general and auxiliary ledger accounts, the financial and statistical reports, PEARLS reports, and a series of tables showing the distribution of loans, savings accounts, and investment concentrations. A complete checklist of the required information is found in Annex 1.

2. ON & OFF SITE ANALYSIS OF INFORMATION

The next phase is a two-step process. First, an extensive in-house review of the submitted information should be conducted to insure that it is complete. If there are errors or omissions, they should be noted and addressed; if the information is unavailable, a work plan should be established to obtain this information while in the field. Second, an on-site field visit to the credit union should be conducted to review and verify the accuracy of the information submitted. During the on-site visit, all inaccurate or incomplete information should be corrected and finalized.

3. INTERPRETATION AND FINAL WRITTEN REPORTS

The next phase of the process requires the entry of all of the information into the Risk Management Tool (RMT) and then, the synthesis and interpretation of the information. The final output of the RMT is a written report with three parts:

- A. A list of all of the findings by risk area,
- B. An individual rating for each risk area, and
- C. An overall institutional rating of all of the risks expressed as a composite letter grade based on a scale of 100 points, which is an average of the ratings for the four risk areas.

4. WORK PLAN AND CORRECTIVE ACTION FOLLOW UP WITH THE BOARD OF DIRECTORS

Once the results of the risk analysis have been compiled into the final report, a formal process should be followed to communicate the results of the evaluation to the Board of Directors of the credit union. Additionally, follow up monitoring should occur to ensure that corrective actions are taken to resolve the issues and exceptions highlighted in the report.

These four areas will be covered in the Supervisory Manual which will serve as a step by step operational guide for field examiners to fully implement the risk management tool and achieve the desired operational changes and mitigation of risk.

Areas of Risk and Rationale for the Risk Indicators

This section provides a summary of each risk area and the rationale for each indicator and its corresponding prudential standard. It demonstrates how risk can be analyzed, but more importantly, it shows how risk can be mitigated through compliance with key prudential standards that are incorporated into the overall risk rating system.

1. CAPITAL RISK

There has been considerable discussion of what constitutes true risk capital in a credit union. This methodology allows for two types of risk capital: 1) institutional capital, which is the sum of retained earnings, legal surplus, specific capital reserves, and donations; and 2) member share capital which is defined by local conditions and includes an obligatory contribution from each member which cannot be withdrawn or diminished except upon permanent withdrawal from the credit union. In addition, these shares cannot be used as collateral for any loan.

The obvious advantage of cooperative institutional capital is that it is permanent capital that is indivisible and untouchable. In other words, it belongs to everyone, but no one can claim a portion of it for themselves by selling it to new investors looking for higher returns.

The objectives of this area and its indicators are as follows:

- To measure the amount of real risk capital,
- To evaluate the capacity to generate new capital, and
- To analyze the ability to maintain adequate net capital according to prudential standards.

The ten indicators that follow represent an integral view of the factors which contribute to a strong capital position. The area of capital risk is the single most important area within the entire methodology, because experience has shown that strong capital is vital for providing good service, strong earnings, and adequate protection for the member's money.

A more detailed explanation of each indicator, including its purpose, type, component parts, formula, standards, and rating points follows in the next section. The following discussion attempts to explain the rationale and importance of each indicator.

A. Net Capital Ratio

Net capital is the actual amount of real capital that the institution has available to protect member savings, improve profitability, and improve products and services. Some people have promoted the idea that net capital should not be invested in the products and services of the credit union, but rather, maintained as a cash reserve. This approach incorrectly assumes that capital has only one purpose: absorbing losses.

The risk methodology presented in this document takes a different approach. It assumes that capital has three equally important functions: 1) to provide quality products and services that members want and use, 2) to provide increased earnings capacity to generate more capital in times of accelerated growth through the expansion of new points of service, and 3) to provide protection for the member's money to cover unforeseen operational losses or losses resulting from poor credit administration practices. If such losses occur, capital must be used first to cover those losses, thus negating the other purposes mentioned above.

Net capital is different than book capital. It is calculated by subtracting any deficiency in loan provisions and any hidden junk assets that have no value even though they may appear on the balance sheet at their cost. Book capital, on the other hand, has no adjustments and assumes no hidden losses. It represents the difference between the cost of assets and liabilities.

The use of the net capital ratio is a very important indicator of risk because many times a credit union has inadequate loan loss provisions or has not written down assets that have lost their value. As a result, their true capital position is overstated. The use of this ratio will identify such problem areas.

B. Capital Ratio Stability

The concept of capital stability is new in this analysis. It is valid only for credit unions that have met the initial ten percent net capital requirement because stability implies that the capital standard has already been met. Capital stability recognizes the fact that reaching the capital standard is good but maintaining the capital standard is better.

Field experience has shown that it is difficult to consistently maintain the capital standard year after year, particularly in countries where macroeconomic variables are unstable, and where credit unions experience volatile growth rates, unpredictable delinquency rates, rising operating expenses, and high levels of non-earning assets.

A credit union that maintains its capital ratios under adverse or volatile conditions shows that its planning, pricing, and control processes are all functioning properly. It is one of the best indicators of the competence of management to safely guide the credit union through volatile conditions.

C. Capital Ratio Trend

This indicator is applicable to only those credit unions that have a capital ratio below ten percent. It is impossible to earn points for both the capital ratio trend and the capital ratio stability; points are awarded for either one or the other. The logic behind the use of the capitalization trend is that even though the net capital ratio may be below the ten percent standard, if a credit union is showing steady, positive progress towards achieving the standard, no matter how low the capital ratio, it will receive recognition for its efforts in building capital.

The capitalization trend indicator will provide incentives for those credit unions that have a level of capital below the standard. More importantly, it will help detect if improvements are not being made. Many times, management becomes complacent with their decision-making and efforts to improve their capital ratios. Stagnating capital ratios below the ten percent level represent a common, but serious weakness since capital accumulation can only occur through decisive actions made by management.

D. Total Asset Growth

The growth of total assets is included in capital risk because it is an excellent indicator used to achieve a market affirmation of the quality, pricing and value of credit union financial products and services as promoted by the newly devised Basel Standards. Even if the shares of a credit union remain at par value, a continual increase in membership usually brings increased financial resources, resulting in impressive growth in total assets.

The use of the PEARLS ratios over many years has also demonstrated that total asset growth is a fundamental indicator of change in credit unions. This sole indicator can affect the outcome of seventeen other PEARLS ratios. It is a building block of solid financial performance because, from it, the credit union can establish guidelines for optimal financial structure, peak operating efficiency, and enduring profitability.

E. Loan Book Ratio Trend

The outstanding loan portfolio is one of the most important measures of profitability because it usually represents the largest and most profitable asset of the credit union. Proper management of the loan portfolio is fundamental to the generation of net capital. When the loan to asset ratio declines, the profitability of the credit union

invariably declines and diminishes the amount of net income available for capitalization.

Many observe that one of the common challenges of a credit union with a flourishing savings program is that all of the new liquidity cannot be placed in good loans. The excess liquidity is then deposited in banks where the short term interest rate yields little or no financial margin, unless the money is pooled in a second tier central finance facility. Even then, the yield is significantly lower than what could be earned in the loan portfolio.

There is a natural tendency to be very conservative with member savings deposits as opposed to other “outside” money. A great challenge for deposit-taking credit unions is to be aggressive in capturing savings, but also, aggressive in placing the savings in good loans and then collecting it without experiencing high delinquency. A strong loan book coupled with a low delinquency rate is an excellent indicator of successful credit administration.

Another reason for the inclusion of the loan book trend in this analysis is that the loan portfolio is the only asset where the board and management have the power to set the interest rates. This is extremely important because, unlike alternative investments where the interest rates are determined by someone else, the credit union has complete control over these rates and they have a significant bearing on profitability.

F. Savings Deposit Ratio Trend

The savings deposit trend is included in the analysis of capital risk for various reasons. First, multiple studies conducted by WOCCU have shown that savings deposits are the lowest cost source of financing alternatives for a credit union. Lower financial costs translate into significant savings and increased profits, which ultimately generate more capital.

Second, savings deposits are the preferred mechanism for maximizing the financial leverage of an institution because, over time, savings deposits tend to increase in a linear (or upward) fashion, as opposed to the up and down cycles of external credit borrowings. By smoothing out these cycles, optimum leverage levels can be achieved and maintained, which likewise results in a greater earnings capacity.

Third, savings deposits create great financial independence for the credit union: the board and management do not have to rely on outside financing and unpredictable interest costs to fund the loan portfolio because they can set the interest rates on their own savings deposits, particularly where market conditions are less competitive. In addition, savings-based credit unions can pursue their own growth and operating strategies without outside interference from donors or lenders who may have other agendas which are not compatible with the long run vision of the credit union. This translates into greater responsiveness to the members’ needs and community well-being.

Finally, a strong savings program usually means that the credit union has a good image in the community and enjoys the trust of its members. All of these factors translate into significant advantages for deposit-taking institutions and foster strong capital formation.

G. Non-Earning Asset Ratio Trend

Non-earning assets are an important factor in the financial performance of a credit union, particularly if interest bearing liabilities such as savings deposits or shares are being used to finance these assets which produce no revenue. This trend is included under capital risk because as a credit union grows and improves its image, a lot of fixed expenses are incurred, such as buildings, furniture, equipment, and computer systems. These expenses can multiply with the opening of new branch offices.

Many credit unions have the tendency to overspend on the aforementioned items, significantly raising the non-earning asset ratio beyond the established guidelines. Excessive non-earning assets translate into reduced net income and net capital, thus demonstrating the importance of this trend. This ratio can help the Board of Directors or the regulators prevent serious long-term problems from occurring, because once purchased, some non-earning assets such as buildings and computer systems cannot be easily sold or returned. Hence, the only option is to grow and channel all the new growth into earning assets. This can be a long ordeal if solid growth does not come as a result of an investment in non-earning assets. This trend pinpoints the magnitude of the non-earning assets, and the length of time it takes to reduce this ratio.

H. Operating Expense Ratio Trend

There has been a great deal of debate as to how to measure the adequacy of operating expenses in the overall financial performance of credit unions, as well as other microfinance institutions or nongovernmental organizations that provide financial services. There are three alternative ways to measure operating expenses: 1) total operating expenses divided by the loan portfolio, 2) total operating expenses divided by total gross income, and 3) total operating expenses divided by total average assets.

The methodology included in this paper uses only the third approach for the following reasons:

- I. For deposit-taking institutions, the first approach is inadequate since it assumes that all expenses incurred are related to the loan portfolio. Cost studies conducted by WOCCU and other groups show that savings mobilization represents approximately 40% of total operating expenses. By using average total assets in the denominator, a more fair indication can be obtained of the adequacy of both savings and loan expenses.

- II. The second approach of using total gross income in the denominator has proven to be inadequate because it is susceptible to pricing manipulation. Since many credit unions can set their own loan and savings rates with little competition in the local market, high operating expenses can be made to look normal by charging higher loan interest rates, thus increasing the gross income and reducing the operating expense ratio. This tactic has been used to justify very high operating expenses and promote a false sense of operating efficiency. Unfortunately, raising loan interest rates to lower the operating expense ratio has the exact opposite effect; it is detrimental to efficiency.
- III. The third approach is the best way to measure the adequacy of operating expenses because total assets represent all of the financial resources in circulation, and total operating expenses represent all of the costs associated with those financial resources. In addition, by using total assets instead of gross income, the operating expense ratio cannot be manipulated as indicated above.

The inclusion of the operating expense ratio trend in this analysis is probably the single most important indicator of profitability and efficiency. Whereas the previous trend indicators of loans, savings, and non-earning assets were all linked to financial structure, the operating expense trend is directly related to the bottom line performance and has an even more dramatic effect on profitability.

I. Share Dividend Yield

According to the ideology of credit unions, their non-profit nature is reflected by limiting the return to share capital in two ways: 1) dividends are limited to the current cost of capital (i.e. the passive yield on demand deposits or bank loans), and 2) the share values cannot appreciate above the original par or book value because the retained earnings are not allowed to be sold or traded among individual members. This traditional approach has allowed management to focus on the reinvestment of profits in the goods and services of the credit union, thereby providing better quality products at more attractive rates than the competition. Hence, many times, the “dividend” is reflected in a lower interest rate on loans, or a higher interest rate on savings.

In practice, two extremes have emerged. On the one hand, some believe that share capital should not provide any return, thereby lowering the cost of capital for the credit union. On the other hand, some have wanted to treat credit union share capital like bank shares, placing no limit on dividends and thereby significantly raising the cost of capital for the credit union. The justification for this action is to create “incentives” so that members take greater ownership of the credit union and demand better financial performance. While correct incentives are important, another unfortunate practice is that sometimes these high dividend rates are offered when the net capital position of the credit union is still below the ten percent prudential standard. Such dividends create an improper image of profitability at the expense of safety and soundness.

The methodology employed in this risk management tool rejects both extremes. The prudential standard for this indicator promotes the idea that share capital should maintain its real value, which means that at a minimum, it should pay a dividend equal to the inflation rate. This will avoid inefficiencies and internal subsidies that affect members who neither borrow nor save, but who have share capital invested from previous financial transactions.

The optimum standard allows for the payment of dividends greater than the inflation rate, but only after the net capital ratio of the credit union has reached the prudential standard of ten percent. Once adequate safety and soundness standards have been met, the Board and Management may reward the members with a higher dividend, according to the stage of development and the achievement of the goals identified in the credit union's annual business plan.

Aside from the issue of yield, experience has shown that this indicator is an excellent measure of profitability and efficiency, two components needed to build capital and minimize risk. The concept of efficiency is reflected by the fact that dividends to shares are the last financial cost that a credit union incurs after covering all of its other operating expenses. If there is inefficiency in the operations, there will not be enough money left over to pay a reasonable dividend. This has shown to be a trustworthy red flag that other problems exist in the operations of the credit union.

J. Analysis of Sources and Uses of Funds by Interest Rate

WOCCU has developed a simple tool to check the funding structure of credit union assets and liabilities (see Annex 3, page 2). This was developed because some credit unions have aggressively pursued savings mobilization by paying higher interest rates to attract more savings and then are not able to invest all of the liquidity in high quality loans. The alternative is to put the excess liquidity into a bank or a second tier central liquidity fund where, many times, the savings deposit rate is inferior to the credit union savings rate. This creates a negative spread and a reduction in earnings.

This tool is very useful because it not only can signal an imbalance in the asset/liability mix, but also can indicate if all interest-bearing liabilities are properly invested in assets which generate a yield greater than the corresponding liability.

2. CREDIT RISK

The area of credit risk is almost as important as capital risk since it analyzes the decision-making capacity of the institution to disburse its resources prudently and also collect them with a minimum amount of difficulty. The area of credit risk has three main objectives:

- Measure the quality of the loan portfolio and other alternative investments,
- Determine the concentration or diversification of income-producing assets, and

- Detect poor practices in the administration and investment of assets which may affect the capacity to generate capital.

There are ten indicators in this section. A more detailed explanation of each indicator, including its purpose, type, component parts, formula, standards, and rating points is included later in this document. The following discussion attempts to explain the rationale and importance for each indicator.

A. Loan Delinquency Ratio

Loan delinquency is one of the most important areas of institutional risk. This is because loan delinquency is the most frequent problem and because it directly affects many other important measures of risk, such as net capital, loan loss provisions, loan charge-offs solvency, operating expenses, and profitability.

This methodology promotes an optimum standard of five percent of loans delinquent (portfolio at risk) over 30 days and a minimum standard of ten percent. Extensive experience has shown that credit unions that operate within these parameters are able to maintain a safe and sound institution without causing undue harm to their members. If delinquency raises higher than ten percent, a credit union starts to experience serious difficulties in its capacity to create adequate loan loss provisions to protect member savings deposits.

B. Delinquency Ratio Stability

This indicator is only valid for credit unions that have reached the standard of maintaining a delinquency rate at or below five percent at year end since stability implies that the standard has already been met. Delinquency stability recognizes the fact that reaching the delinquency standard is good, but maintaining the delinquency standard is even better. Field experience has shown that it is very difficult to consistently maintain the delinquency standard year after year. This is due to a variety of reasons such as high interest rates, unpredictable economic conditions, and lax collection policies. A credit union that consistently maintains its delinquency rate shows that it has a firm control over the entire credit administration process.

The optimum standard for this indicator is to maintain the delinquency standard for at least three consecutive years. For many credit unions, this is a challenging objective.

C. Delinquency Ratio Trend (if the delinquency rate is less than or equal to ten percent)

There are two standards associated with this indicator because of the large number of cases where delinquency rates are spread across a broad spectrum. The first tier is valid only for credit unions whose delinquency ratio is above five percent but below ten percent.

The logic behind the delinquency trend is that even though the delinquency ratio may be above the five percent standard, if the Board and Management are focused on implementing strict collection policies and the delinquency ratio is showing steady positive progress towards achieving the standard, their efforts should be recognized and rewarded since the level of risk is going down as the delinquency rate declines.

Delinquency Ratio Trend (if the delinquency rate is greater than ten percent)

The second standard is valid for credit unions whose delinquency rate is above ten percent. The qualifications for this tier change, however, because the credit union has a longer way to go to achieve the optimum standard. In order to earn points, there must be a minimum reduction in the delinquency rate of at least one percent per year, as opposed to one half percent for delinquency rates between five percent and ten percent.

The rationale for this second standard is the same as for the first: even though the delinquency ratio may be very high, if a credit union is showing steady positive progress towards lowering delinquency, its efforts should be recognized and rewarded since the level of risk is going down as the delinquency rate declines.

D. Repayment Capacity Analysis

In traditional credit unions, the most common loan approval process is based on a multiple of member shares (1:1, 2:1 or 3:1), without giving attention to other criteria such as a member's credit history, repayment capacity, and collateral guarantees. Share-based lending was an old strategy used to ration limited sources of financing in non-deposit taking credit unions. Now, as savings mobilization provides significant sources of funds, credit rationing is no longer needed. In its place, a repayment capacity approach verifies critical borrower information and substantiates the need and repayment capacity of the borrower for the requested loan based on the "Five Cs of Credit": character, credit record, conditions, capacity, and collateral.

Important evidence has now shown that a repayment capacity approach to lending can significantly reduce delinquency and also helps the borrowers meet their financial needs. This is the main rationale for its inclusion in the credit risk area.

E. Improper Restructuring or Refinancing of Delinquent Loans

One of the most common and frequently found problems in credit unions is the use of loan refinancing or restructuring to hide the true delinquency rate of the loan portfolio. This is more common in places where there is no legal framework that prohibits such actions, nor a formal regulator or supervisor to enforce compliance with such bans. This is a serious problem because not only does it disguise the true delinquency rate, but it weakens the financial position of the credit union and leaves member savings deposits completely unprotected. Hence, it is included in the risk indicators to minimize its unwelcome presence.

The best way to solve this problem is to have clear and concise restructuring and refinancing policies which establish the basis for approval of any restructured or refinanced delinquent loan. In some, specific cases, restructuring may be justified. This indicator is subjective in nature, and requires an intense and thorough revision of all delinquent loans that have been refinanced or restructured during the year to verify if proper policies were followed during the process. It is left up to the evaluator to determine if there have been improper actions followed in the restructuring process.

F. Charge-Off of Loans Delinquent Longer than Twelve Months & Charge-off Rate

The concept of loan charge-offs is included in the credit risk area because it represents an alternate strategy to reduce delinquency and contain risk. In general, there are two ways to reduce delinquency. The first is to collect the delinquent loans and the second is to charge off the delinquent loans. Both alternatives will reduce the delinquency rate, but controlling delinquency through loan charge-offs is a much riskier and costlier approach than collecting the delinquent loans. This indicator is also an excellent measure of the quality of credit administration in the credit union. Excessive charge-offs are a red flag for improper loan underwriting and collections. Such actions provide concrete evidence that the credit administration process is flawed.

G. Largest Single Loan Concentration

By evaluating the size of the largest loan outstanding we can see whether such a loan can have an adverse effect on the overall institutional capital of the credit union. In some countries, there are standards that permit a single loan size of up to 50% of the institutional capital. In other countries, the maximum loan size is 25% of total capital including shares. Such examples are excessively large. Such liberal limits can be extremely risky for a credit union that has weak credit administration practices. Field experience has shown that very large loans which become delinquent adversely affect the delinquency ratio and the adequacy of the loan loss provisions. In order to minimize this risk, the largest borrower should not have a loan outstanding greater than ten percent of the net institutional capital of the credit union.

H. Maximum Concentration of Twenty Largest Borrowers

A common practice in many credit unions to bolster sagging loan to asset ratios and improve profitability is to make larger loans. The problem with such a strategy is that if the larger loans become delinquent, the amount of loan loss provisions needed to protect the members from losses is far greater than any additional economies of scale than come from making larger loans. In addition, large borrower concentrations can quickly absorb all of the accumulated loan loss provisions and institutional capital of a credit union, thus leaving it insolvent and on the brink of bankruptcy. After looking at various case studies from various regions and evaluating the institutional capacity to mitigate the risk of larger loans, it was determined that the optimum standard for

this indicator is that any one loan should not exceed 25% of the total loan portfolio outstanding of the credit union.

I. Largest Institutional Investment Concentration Ratio

In recent years, credit unions have lost large sums of money by depositing their liquidity in financial entities of questionable strength that offer very high rates of return with no protection for member savings deposits. The purpose of this indicator is to prevent credit unions from concentrating their risk in such entities, and also to avoid investing all of their liquid resources in just two or three financial institutions. The optimum standard for this indicator is that not more than 20% of all liquid investments (excluding government securities), should be placed in any one institution, thus spreading the investment risk among at least five different financial institutions.

J. Investments Restricted to Regulated Institutions

In addition to the 20% investment limitation noted above, another excellent strategy to further mitigate credit risk is to limit all financial investments excluding government securities to institutions that are regulated by the Superintendent of Banks or another competent regulator recognized by the government. By limiting investments to only regulated financial institutions, the credit union's exposure to risk is mitigated and the burden of due diligence and in-depth investigation into the criteria and application of safety and soundness indicators for the depository institution is diminished. These benefits serve as the rationale for this requirement.

3. LIQUIDITY RISK

As a credit union's financial structure evolves from a traditional, share-based focus to a savings deposit framework, proper liquidity management becomes a critical skill. Experience has shown that an illiquid credit union is more susceptible to failure than an insolvent credit union: when people demand their money in the midst of a financial panic the credit union is contractually obligated to return those resources, even if they are invested in good quality loans with a longer term. It is for this reason that some managers are reticent to reduce the level of share capital in a credit union because shares represent a more permanent, non-withdrawable form of capital.

Yet, time and again, credit unions have demonstrated that permanent growth is linked to robust savings mobilization programs. This requires a much higher level of fund management skills to properly manage savings accounts. Proper liquidity management requires constant vigilance since short term liquidity can radically change from one moment to the next. A viable, second tier liquidity management facility can also help to mitigate a liquidity crisis.

The focus of this important risk area can be distilled into four main objectives:

- Measure the amount of average net liquidity in the credit union,

- Determine the concentration of depositors,
- Analyze the magnitude of member withdrawals and the corresponding lines of defense needed to meet those withdrawal requests, and
- Evaluate the institutional capacity to maintain proper asset-liability management.

The indicators for liquidity risk are as follows:

A. Average Net Liquidity at Ninety Days

For many years, a more simplified indicator had been used to measure the amount of net liquidity on hand and to compare it to the aggregate savings deposit balance. One of the weaknesses of this measure was that it could be easily manipulated by credit union managers who could transfer substantial sums of money into the short term accounts of the credit union; this normally would happen the day before the end of the month and the following day these funds could be transferred back into other investments. This tactic inflated the liquidity of the institution.

In order to avoid such manipulation, the indicator employed here computes the average daily balances of all short term liquid funds, accounts payable less than 30 days, and savings deposit balances for the previous 90 days and then calculates the average net liquidity. By looking at the previous 90 days instead of just the last day of the month, a more accurate picture of the institutional liquidity is obtained and the option of moving money around at the last minute is eliminated.

Ideally, the daily or monthly average net liquidity should be computed over a longer period of time instead of just one 90 day period to avoid seasonal fluctuations. Unfortunately, due to many accounting limitations, this ratio is computed on just the most recent 90 days.

B. Mandatory Liquidity Reserve

The concept of a mandatory liquidity reserve requirement in the Central Bank is commonplace in the banking sector in cases where banks want access to a variety of financial products and services offered by the Central Bank. In the cooperative sector, credit unions are typically not required to comply with the same mandatory reserve requirements. As a result, they are also not able to offer the same type of financial services as the banks, nor do they receive the same level of support from the Central Bank. This places the credit unions at a huge disadvantage.

Field experience has shown that requiring mandatory liquidity reserves through a second tier central finance facility provides a much needed source of back up liquidity in the event of a financial crisis. Also, such reserves play an essential part of any sound financial system by access to additional liquidity when needed. The rationale for this indicator is to motivate the creation of a parallel, back-up liquidity reserve for times of crisis.

Second tier central finance facilities have been very successful in some of the more advanced credit union movements around the world, such as the United States and Canada. Yet, in many developing countries, this concept has been met with resistance and skepticism, largely due to the fear that the funds would not be managed soundly. Good credit unions are unwilling to deposit their money into a collective fund to help finance weak and the poorly managed institutions. Also, interest rate pricing on these liquid funds is also an issue. Many times, individual, well-managed credit unions have been able to negotiate better rates on their liquid investments than the second tier central finance facilities can.

These issues have made it difficult to promote the creation of a central finance facility in many countries; hence, the recommendation in this paper is to have a mandatory liquidity reserve set aside in either in a bank or other appropriate second tier financial institution with back up lines of credit available to support a liquidity crisis.

C. Maximum Concentration of the Twenty Largest Depositors

This indicator has proven to be very useful because excessive concentrations of savings deposits appear to be a common problem in credit unions that are trying to grow rapidly. When there is pressure to grow, large savings deposits can achieve that objective with minimal effort, although the level of risk is much higher because such savings accounts are much more volatile than smaller savings accounts and also are contracted at higher interest rates. Given their volatility and high interest cost, such money is difficult to lend out over a reasonable period of time to achieve an acceptable profit margin. Inflating balance sheet accounts to achieve growth at the expense of profitability and safety is an unsound practice that should be detected as soon as possible. Hence, it is included in this risk-base methodology.

D. Maximum Concentration of the Next Forty Largest Depositors

The potential risk of excessive concentrations of deposits can be so dangerous that alternative back up sources of liquidity should be secured as an additional strategy to protect the credit union from a liquidity crisis. The purpose of this indicator is to evaluate those back up sources of liquidity and determine if they are adequate to cover the savings deposit balances of the next 40 largest depositors. The most common traditional back-up lines of liquidity that provide additional protection are as follows:

- Mandatory liquidity reserves held with or by second tier financial institutions,
- Stand-by lines of credit from second tier financial institutions and banks,
- Certificates of Deposit with terms greater than days that can be converted into cash, and
- Excess liquidity greater than fifteen percent of total deposits.

By evaluating the 60 largest depositors of a credit union between the two concentration-based indicators, an adequate picture can be obtained of the magnitude

of the concentrations and the availability of on-hand liquidity or back-up liquidity to cover the risk exposure.

E. Maximum Withdrawal Risk Ratio

This indicator is a new approach to an old problem: how much cash should be left on hand in the credit union to meet the withdrawal needs of the members? It is recognized that excessive amounts of cash are risky because they are subject to theft and also costly because the idle cash earns no interest. The methodology of this approach is to analyze all of the withdrawal amounts over a 90 day period and then, calculate the second standard deviation (standard deviation multiplied by two) of those daily withdrawals. The resulting figure represents the amount of cash needed to cover 95% of all withdrawal amounts. The standard deviation formula is a built-in function in the standard Excel spreadsheet (STDEV) so it is very easy to calculate and then multiply by two.

Ideally, the daily or monthly averages on withdrawals should be computed instead of just one 90 day period to avoid seasonal fluctuations, but due to many credit union accounting limitations, this ratio is computed on just the most recent 90 days. Once the second standard deviation is computed, the average daily cash on hand should be compared to this amount to verify that adequate cash is available. If there are any withdrawal requests greater than the second standard deviation (which would represent only a five percent probability), they should be covered by the back up lines of liquidity identified in the previous indicator.

F. Maximum Asset/Liability Management (ALM) GAP at Ninety Days

The matching of assets and liabilities is a relatively new technique for many credit unions in the developing world. Its purpose is to determine how well the term periods (1-90 days) of assets and liabilities are matched together over the same period. This specific time frame is used because in a large number of developing countries, there normally exists a large mismatch of assets and liabilities in this short term category. This is particularly important since adequate liquidity in this timeframe can make or break a financial institution. The main reason for this mismatch is that there are few financial instruments available to properly structure the assets and liabilities and there is normally no secondary capital market available where investors are willing to bear the risk of financial instruments with longer maturity dates.

The inclusion of an asset liability management indicator in this risk based assessment is very important since few institutions practice serious asset liability management (ALM) techniques. Large interest rate gaps between assets and their corresponding liabilities are not normally a serious problem because of the widespread use of variable interest rates. There may be a sizable gap, however, between the maturity dates of liabilities and their corresponding assets. This is mainly due to imbalances in the macroeconomic environment where it is very rare to find long term liabilities greater than one to three years. Perhaps inflation and devaluation are the real culprits

which destroy investor confidence in the financial marketplace. An example of an ALM analysis is found in Annex 3, page 2.

4. OPERATIONAL RISK

The area of operational risk, as included in the new Basel II Capital Accords, is perhaps one of the most significant changes that directly affect credit unions. Operational risk is defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people or systems, or from external events. Credit unions are very vulnerable to operational risks partly because of their organizational structure and operating ideology.

The Risk Management Tool attempts to accomplish three main objectives in the area of operational risk:

- Identify and evaluate the vital business processes of a credit union that may be susceptible to failure,
- Evaluate the capacity for good governance and monitor the most common areas of poor governance, and
- Review the legislative and regulatory framework and its impact on reducing operational risk.

There are 56 total indicators in the area of operational risk. Of this amount, 51 are qualitative and only 13 are quantitative. The high incidence of indicators in this section is due to the large number of issues that need to be reviewed and evaluated to ensure operational risks are mitigated.

The Risk Management Tool breaks down operational risk into the following three areas:

- Vital institutional processes,
- Governance, and
- Legislation and supervision.

Each of these areas will be discussed below:

A. Vital Institutional Processes

The business of financial intermediation is subject to a variety of internal institutional processes, some of which repeat themselves frequently during the course of a fiscal year. As these processes repeat themselves, if there is not a sound policy framework, adequate controls, or competent human resources, the process can breakdown and fail repeatedly, thus precipitating a serious problem. This risk management tool attempts to identify the key institutional processes which are vital to the success of the credit union, and monitor their performance. There are seven vital business processes that will be discussed below:

I. Executive Human Resource Administration Process

One of the most common problems facing credit unions is finding and keeping qualified people on staff. In the absence of specific job requirements, there is a tendency to hire unqualified personnel, including family and friends, to fill vacant positions. Many credit unions also do not conduct job performance evaluations at least annually to hold employees accountable for their performance. When the Board of Directors interferes with these processes, problems become even more serious.

Without a profile for each executive level position, including job qualifications and job descriptions, and a process to evaluate performance, credit unions will continue to have substandard performance in this vital area.

II. Institutional Planning Process

The institutional planning process is one of the first areas that must be addressed in the modernization of credit unions. Weak planning and monitoring are common problems that need improvement. WOCCU has designed a business planning methodology that incorporates a long run strategic plan with short term business goals to improve performance. It links prudential standards to actual financial performance and highlights key areas of weakness that need improvement.

The business planning process is the means whereby poor performance and weak financial indicators can be changed through systematized planning and methodical implementation. Where performance is measured and monitored, results dynamically improve.

III. Savings Mobilization Process

A robust savings program is one of the most important cornerstones of a successful credit union. It is a key driver for growth in terms of both members and their financial resources. It also represents an important way to measure the level of community trust in the credit union. Some have erroneously thought that savings mobilization is simply about creating a savings product with an attractive interest rate that is sufficient. Research has shown that members are looking for safety, liquidity, and yield in the savings products they buy.

Another reason for the savings mobilization process is that it allows a more in-depth evaluation of the need for external credit. Some have commented that they cannot mobilize sufficient savings and need external credit to survive, but it is more likely that other factors are involved in the breakdown of the savings mobilization process. This process will be a tremendous help in mitigating the risk associated with the mobilization of savings.

IV. Liquidity Management Process

The inclusion of liquidity management as a vital process is the result of having a successful savings mobilization program. One of the key disciplines of savings mobilization is to have sufficient liquidity on hand to meet the withdrawal requests of members. This is a process that is frequently repeated. It is a fundamental shift from the traditional credit union which is funded only with member shares that are non-withdrawable. Excess liquidity frequently occurs in credit unions that cannot disburse all of the liquidity into good quality loans. The main disadvantage of excess liquidity is that the yields are much lower than on the loan portfolio.

Unfortunately, in recent years many credit unions have lost more money in poor quality investments than in the loan portfolio. This is because they have sought higher yields to compensate for the significant loss in opportunity cost associated with these investments. The loss in yield is significant and the irony is that sometimes the risks are much higher. The liquidity management process will help minimize these risks by analyzing the entire process that the credit union follows to manage its liquidity, minimize its costs, and maximize its earnings.

V. Credit Administration Process

Unquestionably, the process of credit administration from the analysis, approval and disbursement to the final collection is one of the most important processes in the credit union. Ironically, the core business of lending is also one of the riskier processes and subject to failure. Delinquency control is a challenge that never subsides, even in the best credit unions.

In response to this, conservative attitudes tend to dominate the loan approval process, particularly when member savings deposits are the source of financing. It seems that for many, the answer to low delinquency rates is to reduce the loan to asset ratio and deposit the excess liquidity in government securities with zero risk.

The credit administration process is focused on helping to reduce the risks associated with loan-making and maximizing the amount of liquidity that is recirculated back into the community as loans.

VI. Internal Control Process

Internal controls establish proper checks and balances in the management of cash resources. The most common form of fraud in a credit union originates from the inside, among the employees. Strong procedures should be in place to discourage this behavior. In many credit unions, this is one area that functions well: the

internal control systems in place have been tried and tested over many years to prevent the improper handling of cash.

In addition to internal control mechanisms to prevent fraud, the internal audit is an excellent mechanism to detect the breakdown of other key processes and procedures in a credit union. As the Risk Management Tool becomes more operational, the internal auditor will play a major role in monitoring the areas identified herein, and will be able to detect and correct problems before they become serious.

VII. Information Technology Systems Control Process

In recent years, information technology (IT), along with its associated hardware and software, has taken on a significant role in the vital institutional processes of credit unions. It is mentioned last, not because of its diminished importance, but because it ties many of the other processes together through a network.

The implications of this level of connectivity to other vital processes makes it imperative that adequate security levels are in place to prevent unauthorized access and to provide trustworthy back up information in the event of a systemic loss. The greatest weaknesses of IT processes are that few people have the technical understanding needed to safeguard them from abuse. Recent experience has shown that without a proper back-up mechanism and audit trail, software programs can be hacked into and vital information changed or erased leaving little or no apparent evidence.

The inclusion of this process is important to insure that the integrity of data files so that member financial information is not compromised and effective communications strategies exist to prevent major disruptions in the time of crisis.

B. Governance

Cooperative governance has long been recognized as an area of weakness within the overall cooperative ideology by both cooperative leaders and their critics. Some suggest that the cooperative structure is outdated, intrinsically flawed, and should be categorically discarded in favor of more effective organizational structures that provide a stronger framework of incentives and controls. Others, however, including WOCCU, believe that the problem is not in the ideology or the structure, but rather, in the transparency, regulatory framework, and supervision of cooperative entities.

Over many years, WOCCU has had first hand experience in dealing with governance challenges in different regions of the world and the vast majority of the governance problems stem from inadequate regulation and supervision. The insights gained from that experience and numerous others form the basis for the concepts presented in this section. It is important to note, however, that ample evidence suggests that many

non-cooperative organizations, including for-profit financial institutions, are also prone to experience many of the same governance challenges.

I. Conceptual Framework

The problems of cooperative governance can be traced directly to some of the original principles found in the cooperative ideology. Many of these principles have existed for over 150 years and, as such, merit careful consideration when providing solutions to the cooperative governance conundrum. Some of the most relevant principles that affect governance are as follows:

- a. *Open Membership*: The ability to join (affiliate) or leave (disaffiliate) without major constraints and with minimum capital requirements. Membership also brings automatic ownership in the cooperative.
- b. *Democracy*: The voting power of control is allocated by one member, one vote, instead of the traditional allocation of one share, one vote.
- c. *Non-Profit*: The standard cooperative mission statement says: “Not for profit, nor for charity, but for service.” Instead of pursuing profit maximization strategies, the cooperative is charged with providing the best quality products and services at the lowest possible prices, consistent with full cost recovery principles.
- d. *Duality*: All members of the cooperative have dual roles as owners as well as end-users of the goods and services for sale.
- e. *Limited Returns*: Cooperative dividend rates are limited to the current market rates for the long term certificates of deposit for savings accounts.
- f. *Collective Capital*: The capital reserves of the cooperative are held in common for the benefit of all members and are indivisible. If a member leaves the cooperative, no claim for withdrawal can be made against this capital and it remains part of the permanent institutional reserves. Member shares, however, may be redeemed at par upon departure from the cooperative.

The aforementioned principles are very powerful mechanisms producing positive social and economic impact in community-based cooperatives if they are implemented correctly. Paradoxically, these same principles can also create serious negative consequences which directly impact the quality of the governance of the institution. The principles themselves are not inherently flawed, as some would say, but rather, depend upon their usage. In order to illustrate this point, the same principles discussed above in a positive context are shown below in a negative context:

- a. *Open Membership*: Easy membership rules allow anyone to affiliate without requiring significant capital contributions or commitments. Minimal membership requirements attract people who are not interested in promoting the common good and who look for opportunities to satisfy their own selfish interests. When members have nothing to lose and are only interested in themselves, their actions and behavior are often incongruent with sound business principles.
- b. *Democracy*: The concept of one member, one vote can sometimes breed apathy among members because they feel one vote or a small group of votes has little or no impact or consequence. Ironically, this apathy, coupled with little capital and no commitment, can create a vacuum of leadership, giving way to small interest groups directing and managing the cooperative to satisfy their own selfish interests.
- c. *Non-Profit*: The principle of not for profit but for service breeds a feeling that profit is a dirty word and it should be minimized or eliminated. This attitude eclipses sound business judgment because it effectively eliminates the motivation to be profitable and efficient. When there is no pressure to ensure a good bottom line, poor decisions are more likely to be made with little concern for their consequences.
- d. *Duality*: The concept of duality creates an inherent conflict of interest among those who lead the credit union. Since cooperative leaders are both owners and end users, personal interests arising from the use of specific products frequently take precedence over the group interests (i.e. a director who is a net borrower is more concerned with keeping loan interest rates low than raising interest rates on savings or dividend rates on shares).
- e. *Limited Returns*: Some have erroneously interpreted this principle to mean that no dividends should be paid on shares, thus creating a large internal subsidy and imbalance within the membership. Such an imbalance is particularly acute for those who have no loans outstanding. Ironically, their shares, which have limited or no return, are used to finance other members' loans at lower than market interest rates. The absence of competitive dividends also breeds complacency and inefficiency within the cooperative structure.
- f. *Collective Capital*: The concept of collective capital can give rise to the saying, "it belongs to everyone, but no one can claim it." Many members are completely oblivious to its existence and since they can never divide or distribute it among themselves, they don't pay attention to it. Such apathy is dangerous, particularly since the Board of Directors and management can make poor decisions which may precipitate huge operating losses that reduce this capital. This can happen without anyone ever asking what happened. A

common result of this lack of accountability is that leadership and management can make significant mistakes without being held accountable.

The most devastating consequence of these negative impacts is that they are usually cumulative in nature. In other words it is not uncommon for a cooperative to experience many or all of the above mentioned issues at once. For example, the following scenario could easily take place in a cooperative institution:

A person with questionable motives enters the cooperative by paying the \$5.00 membership fee. They apply for and receive a loan with a preferential interest rate and no collateral guarantee and then run for a position on the Board of Directors with no experience or qualifications (perhaps being a friend or family member of someone who already works at the credit union). As a board member, he or she could authorize the payment of high honorarium fees and lavish travel expenses for the board, resulting in higher operating expenses. They also could refuse to raise interest rates on loans to cover such expenses and refuse to pay any dividend on shares. Furthermore, they authorize the expenditure of excessive non-earning assets (such as the construction of a new building) beyond the financial capacity of the credit union. This results in large operating losses that diminish the collective reserves of the members. Finally, the individual leaves the credit union by withdrawing any remaining shares or savings, all with no consequence!

The typical response to these scenarios is to suggest that a radical change is needed in the organic structure of a cooperative, including a shift towards more traditional, for-profit banking schemes that theoretically may promote better incentives and controls to avoid such pitfalls. Some common recommended reforms are:

- ◆ Changing the voting rights from one member, one vote to a traditional capitalistic scheme of one share, one vote
- ◆ Dividing the institutional capital among the shareholders and allowing the member shares to fluctuate or appreciate in value according to external market conditions and net earnings
- ◆ Issuing preferred equity shares that create two classes of members with different dividend rates and voting rights based on class
- ◆ Adopting profit maximization schemes where average costing and cross subsidies are replaced by pricing models set to equate marginal costs with marginal revenues
- ◆ Allowing non-members to patronize the products and services of the cooperative in order to build volume and boost profit through greater economies of scale, even though the process to join is not difficult

These changes strike at the very essence of what a cooperative is and completely divest the cooperative of its unique non-profit ideology. Perhaps, for those so inclined, it would be better to demutualize and become a bank or other for-profit

financial intermediary. Yet, consider the following scenario which is also possible based on the same cooperative principles:

A poor person with limited resources and income who has been rejected by the traditional banking sector can become a member of the cooperative with only a \$5.00 membership fee. The average costing methodology of the credit union allows this person to immediately open a savings account without the minimum balance fee the bank charges. This member can deposit and withdraw money freely, thus alleviating the need to hide the money in an unprotected or unsafe place. In addition, the credit union pays a higher savings and dividend rate because it is well managed and efficiently operated. As a direct result of the non-profit ideology, the cooperative offers its membership an international remittance product at one half the cost of the competition, thus resulting in larger savings in a short period of time. As a member-owner, this poor person can likewise become a member of the Board of Directors and receive educational classes and training to help him or her prepare to carry out the role of Director with integrity. Finally, the collective capital of the credit union can be invested in new technologies such as debit and credit cards and shared networks to provide better quality service at a much lower cost because the resources are pooled and do not bear an excessively high cost of capital as they do in the bank.

These real world examples help us bring sharply into focus the pros and cons of the cooperative ideology and its potential impact on governance. Instead of discarding the cooperative principles, a more appropriate course of action would be to find solutions that promote the positive impacts of cooperative principles, while simultaneously designing strategies to minimize the possible negative consequences of such principles.

The methodology presented herein uses the aforementioned cooperative principles to form a strong foundation upon which an effective cooperative governance framework can be designed and implemented. The ultimate litmus test for this methodology will be if through its use the advantages of the cooperative ideology can be maximized to their full potential and their disadvantages minimized.

II. Common Problem Areas in Cooperative Governance

From 1962 to 2005, the World Council of Credit Unions carried out development projects in 64 countries around the world with a total cost of \$285 million dollars. These activities have yielded a rich history of observation and experience in cooperative governance, both positive and negative. Over the past fifteen years, several consistent patterns have emerged that make it easy to pinpoint the main problem areas of governance in savings and credit cooperatives. Inasmuch as cooperative leaders and employees cannot get rich from the traditional incentives of the trading and appreciation of cooperative stock (since such activity would jeopardize its non-profit status), alternative incentives have proven effective

surrogates for personal gain and consistently have appeared in different cooperative environments around the world.

This risk management tool is intended to probe the most common areas where governance problems occur, and capture vital information which can pinpoint and substantiate the magnitude of poor governance decision-making. While this list is not all-inclusive, the vast majority of observed deficiencies can be found in three key areas: use of power, use of financial resources, and use of products and services. The proposed solution to these problems is discussed individually in each problem area that follows:

a. Use of Power

The temptation to misuse power is rooted in the absence of clearly defined responsibilities and accountability for both the board of directors and management. When there are no clearly defined rules, the “cooperative culture” cannot be institutionalized and a predefined path cannot be established that is unaffected by changes in personnel and leadership.

Without such clarity, institutional cultures may change with each change in key personnel. When people with strong personalities join the Board of Directors they can define their own rules, irrespective of what has happened in the past. Such chaos can be likened to a coup d'état of government authorities. Such practices become so engrained in the mentality of the members that when a new board of directors assumes control, it is expected they will set their own rules, regardless of whether such rules follow the best practices of previous administrations.

Depending upon the personalities involved, the democratic principles of decision-making can be turned upside down by three forms or levels of autocratic decision-making:

- ◆ Board of Directors where the Chairman and/or other directors assume control
- ◆ CEO where the General Manager assumes control
- ◆ Insider Cliques where small informal groups assume control

When autocratic decision-making prevails, nepotism and cronyism seem to flourish. It is not uncommon under such scenarios to find that many employees and/or directors are family members, close relatives, or good friends. These people are often ill prepared to lead and manage the cooperative.

These problems lead to another area of great tension between the principles of democracy and good governance. Currently, it is a common practice that anyone who is a member of the cooperative can join the board of directors if they want to serve and if they are voted into office by the members. All too

often, would-be directors are not qualified to serve in such a capacity nor can they provide the necessary leadership and direction required in today's highly competitive marketplace.

The poor use of power can be checked by establishing a clear set of rules, authorities, and accountabilities, and also by creating job qualifications and profiles for the board of directors and for each executive level position within the cooperative. While there is still little empirical evidence at this time to support the thesis that good governance is predicated upon having proper academic credentials and a requisite level of experience, the Risk Management Tool will gradually provide this type of data.

The Risk Management Tool attempts to capture and evaluate essential information on how leaders and members use their power in daily practice. There are 21 key qualitative indicators under this area and they are divided into the main governing and administrative groups as follows:

1) Annual General Meeting

i. Definition of Role for the Annual General Meeting (AGM)

There has been great confusion over the correct role of the AGM. For many years, the AGM served as the "ultimate decision-maker" for both strategic and operational matters. One of the most antiquated responsibilities of the AGM under traditional bylaws has been the setting of interest rates on loans, savings, and shares.

In the current marketplace of great volatility of interest rates, such a function is clearly impossible for an AGM to do, because they would have to be meeting at least once a month to review the interest rate changes.

This reality underscores the need to reform the bylaws and place such operational decisions in the hands of the Board and Management. The AGM should elect its leaders, approve important policies affecting the membership, and demand accountability of its leaders by requiring transparent reporting to the members. By delegating these operational matters into the hands of the Board and Management, the credit union can have the much needed flexibility to adapt and compete in a volatile and highly competitive marketplace.

2) Board of Directors

i. Definition of Role for Board of Directors

One of the greatest problem areas in the management of a credit union is the lack of clearly defined roles for board and management, and the blurring of responsibilities and authorities. In some areas, board members completely manage the credit union and the “manager” has no authority to make decisions without board approval.

The high incidence of this type of interference is one of the main reasons why credit unions suffer from governance problems. Without clear rules, responsibilities, and accountabilities, the risk of failure in the vital institutional processes is very high. A clear definition of the role of the Directors and the limits of their authority and involvement is essential to good governance.

ii. Profile and Job Description for Members of the Board of Directors

As credit unions grow and become more sophisticated financial institutions, the need for qualified board members becomes more acute. Traditionally, anyone could become a board member if they were voted in. Now, it is imperative that a proper profile is created of the ideal board member, along with a job description so that the membership is aware of the requirements for appointment. Required skills and experience should be clearly stated.

Some credit unions carry this one step further. They require potential board members to pass through various volunteer committees and training functions if they are to be eligible for appointment to the Board. Such “filters” have proven to be very effective in weeding out persons with ulterior motives or private agendas that do not benefit the membership in general.

iii. Academic Credentials

In addition to job skills and experience in key areas, regulators and others have started to impose educational requirements on would-be directors. This is broken down to two levels:

- Directors who have a high school degree
- Directors who have a college degree

This new initiative is being met with resistance, particularly in rural areas where the educational diplomas are not readily accessible. In such cases, exceptions may be needed. While academic credentials may not be a reliable predictor of the quality of decision making, it is

nevertheless an important step forward in trying to raise awareness for the need for proper education and preparation to serve on the Board of Directors.

iv. Percentage of Net Savers on the Board of Directors

Experience has shown that cooperative members with a net savings balance are more prudent and fiscally responsible Directors than those who have net loan balances. The reason for this difference should be obvious: net savers are more concerned about the safety and soundness of the credit union as a trusted depository for their precious savings as opposed to those who only borrow and are not worried about fiscal matters.

As credit unions transition from credit-only institutions to savings and credit institutions, the membership demographics have also understandably changed, and surprisingly, there are many more net savers than net borrowers in savings-oriented credit unions. Studies have shown that there can be four to five times as many savers as borrowers.

There are two reasons behind this indicator. First, if it is true that there are many more savers than borrowers, then they should have a majority representation on the Board. Second, if the Board of Directors is dominated by net borrowers, then there should be greater oversight in monitoring key financial indicators such as the delinquency rates and loan interest rates.

v. Appropriate Election of Board Members According to Bylaws

In a democratic institution such as a credit union, there is an excellent chance to provide service opportunities for the members to serve in leadership positions. Most bylaws impose limits on the length of time that any one person can serve on the Board of Directors (usually two terms of two or three years each), although the “resting period” between appointments may vary.

In more cases than not, directors who have served long periods of time may be more prone to create some of the governance problems noted in this paper because they tend to believe that their service has given them certain privileges, or others think that the credit union belongs to them, instead of the members.

On the opposite end of the spectrum, there may be continual turmoil on the Board with premature resignations or dismissals for various reasons. High turnover can signal some of these problems. The

purpose of this indicator is to detect any of these occurrences and provide a warning to further investigate any anomalies.

3) Senior Management Team (SMT)

i. Definition of the Role of the General Manager

The position of general manager is the most important operational position in the credit union and thoughtful effort should be given to defining their role to avoid unpleasant and counter-productive conflicts with the Board. The manager should be delegated decision-making powers over 100% of all of the operational matters of the credit union, including the management of the budget, and should be held accountable by the Board for the implementation of all goals, activities, policies, and results.

The absence of clarity in the role and responsibilities of the general manager will raise red flags in the risk management profile because this creates significant potential for conflict with the Board. Where the Board intervenes in the day to day operations and makes management decisions, it cannot rightfully hold the manager accountable. This is the worst possible scenario for a complete governance meltdown.

ii. Profile and Job Description for Senior Management Team Members

In connection with the appropriate delegation of authority and responsibility to the general manager, the risk profile cannot be complete without a profile of each job description and requirements for all senior management positions to insure that only qualified people are hired.

The absence of job descriptions and requirements creates a situation where cronyism and nepotism can take hold in the credit union. It is not uncommon to see family and friends working in positions that clearly require a greater level of professional preparation. This indicator will help to minimize such abuses unless policy guidelines are violated. This will be detected in the vital institutional processes.

iii. Academic Credentials

The need for strong academic credentials is more acute among the members of the senior management team because most of the job responsibilities are related to operational activities and processes that are repeated on a daily basis. Advanced education beyond high school is also a more rigorous requirement for senior management team

(SMT) members because many of the vital institutional processes have become more sophisticated with the arrival of information technology and its far-reaching impact. It is also necessary to have the proper academic foundation to be able to grasp the concepts quickly and implement more sophisticated financial management tools in a shorter period of time.

The academic requirements are similar to those of the Board of Directors (although there is a higher percentage requirement for college education) and are broken down into two levels:

- SMT members who have a high school degree
- SMT members who have a college degree

iv. Percentage of SMT Members with a Specialized Degree in a Business-Related Field

Stronger academic credentials for SMT members also require that college degrees be specialized in a business-related field such as accounting, finance, economics, or business administration. While there is no doubt that the rigors of a college degree can help prepare an individual better than just a high school diploma, specialization in certain key business areas will also provide more relevant training and preparation for their positions.

v. Average Tenure of SMT Members at Credit Union

One of the key weaknesses noted in many credit unions is the absence of seasoned SMT members who have worked in the credit union for a period of time longer than five years. Experience plus academic training make a good combination, but seasoned professionals with long employment in the credit union add another dimension of stability to the risk profile.

Initially, the tenure of all SMT members were included in this indicator, however it was found that the general manager tended to have the longest tenure, and in many cases, it distorted the average tenure for the SMT. By excluding the tenure of the general manager, a more realistic profile can be developed, particularly since in most cases, the tenure of the manager will far exceed the average tenure of the other SMT members. If needed, the tenure of the manager can be compared to the other SMT members.

vi. Annual Employee Turnover Ratio

The annual employee turnover ratio is included in this section because it is an excellent indication of the level of morale in the organization.

If there are problems with the use of power or financial resources, the employees will be the first to know. This will directly impact the employees and likely harm morale. Experience has shown that a high employee turnover ratio indicates that something is amiss in the cooperative. By including this indicator in this section, it is being used as a check or verification of problems in other areas.

4) 360° Feedback

i. Anonymous Internal and External Lines of Communication

The inclusion of the concept of 360° feedback is a safety mechanism which allows for the reporting of improper activities that may otherwise go unreported or undetected because of fear, intimidation, reprisal, or because such activities may be imperceptible to a majority of the people. The rationale for this indicator is that when anonymous communications are facilitated with the entities that are responsible for supervision, the needed feedback can happen without the fear of reprisal.

The advent of internet and cell phone technology makes this indicator even more feasible. Instantaneous anonymous communications can be sent at a moments notice and regulators or internal auditors can be apprised of wrongful practices in a timely and forthright manner.

b. Use of Financial Resources

Among the problem areas of cooperative governance, the misuse of financial resources is perhaps the most common. Problems can typically occur at three different institutional levels: the annual general meeting, the board of directors, and the senior management team.

Excessive financial expenditures or the improper use of financial resources for personal gain can be tempting for the cooperative's leaders and management. Perhaps this is so common because the people in power might erroneously believe that such expenditures are allowable in their position.

The Risk Management Tool includes a set of five quantitative indicators which will measure the magnitude of the expenses incurred at each of the three levels and will relate them to the overall operating expenses of the cooperative. By capturing this information over different geographical regions of the world and over various time periods, it is anticipated that these indicators will create greater awareness and prudence in the management and use of the collective resources. When leaders knows that these expenses will be reviewed and evaluated, they will be more careful and circumspect in their spending habits.

1) Annual General Meeting (AGM)

i. **Total Annual Expenses of the AGM as a Percentage of Total Operating Expenses**

Some leaders and managers purposely try to discourage active member participation in the AGM for fear of losing control of the meeting or the institutional objectives they are pursuing. The time and place of the AGM may be purposely set at an inconvenient hour and under uncomfortable conditions. Under this scenario, limited resources are spent to inform the members of the performance of the cooperative. At the other end of the spectrum, lavish facilities may be provided with expensive gifts for all of the members in order to entice them to come to the meeting. Significant sums of money can be spent to present an image of “well-being,” when in reality, serious financial problems may exist.

The use of this indicator will help establish prudential standards for the normal and acceptable expenses incurred in an AGM. Where extremes occur at both ends of the spectrum, they will be easily detected and investigated.

2) Board of Directors

i. **Average Number of Monthly Board Meetings**

This is an important indicator because many times, the Board meets too frequently. This happens because the honorariums paid to Board members can sometimes eclipse the salaries earned in normal jobs, or even the salary expenses of the general manager and the SMT members. If no honorarium is paid, other “incentives” may explain the reason for such behavior, as discussed below. Unless there are extenuating circumstances, it is rare that a Board of Directors should meet more frequently than twice a month.

ii. **Total Annual Expenses of the Board as a Percent of Total Operating Expenses**

The inclusion of an indicator which measures the Board expenses is long overdue in credit unions. Many times, Board expenses are hidden among general operating expenses and it is very difficult to quantify. In the field work conducted, it was discovered that many times, the credit union chart of accounts does not include all the needed line items for Board expenses.

When the Board of Directors are not paid an honorarium for their service, they may justify other forms of compensation such as international and domestic travel, training workshops, and forums and seminars as opportunities for personal growth and relaxation. While such activities may be justified on a case-by-case basis, the real problem is the magnitude of those expenses as a percentage of the total operating expenses of the cooperative.

3) Senior Management Team (SMT)

i. **Ratio of the General Manager's Salary to the Average SMT Salary**

There is a trend in many corporate businesses to lavishly compensate the CEO with various forms of compensation. The gap between the salary of the CEO and the rest of the senior management team seems to be widening at an alarming rate. Sadly, this practice also seems to be taking root in the credit union sector, where the non-profit ideology is being supplanted with profit maximization strategies to boost individual remuneration schemes that are based on net profit.

The intent of this indicator is to raise awareness and establish a ceiling between the compensation of the general manager and the rest of the SMT. Under any scenario, individual for-profit remuneration schemes that are common in the banking sector should be limited in the credit union sector to give recognition to the value of the team approach and the cooperative ideology.

ii. **Total Annual Expenses of the General Manager as a Percentage of Total Operating Expenses**

The general manager is a key person who usually has complete control over the budgeting process and the corresponding expenditures. At times, this absolute control can lead to excessive spending, so the General Manager should be accountable by providing a detailed report of all expenses from his or her department. Unfortunately, some accounting systems cannot easily track all of the general manager's expenses by line item. Care should then be taken to accurately tabulate these expenditures by computer or by hand, so that on a monthly basis, they can be reported and reviewed.

Typical non-salary operating expenses where problems may occur are as follows:

- Transportation Expenses – The purchase and use of vehicles and tickets for airplanes, trains, buses, etc.
- Telecommunication Expenses – The use of cell phones, pagers, PDAs, computers, etc.

- Travel Expenses – Hotel and per diem or actual meal expenses
- Entertainment Expenses – Paying for the lodging, meals, and entertainment of others
- Training Expenses – Payment for workshops, seminars, or training inscription fees

While these line items are all legitimate operating expenses, the intent of this indicator is to measure the magnitude of these expenses relative to the asset size and revenue-generating capacity of the cooperative.

c. Use of Products and Services

The financial products and services of a credit union are another common way in which the directors, officers, staff and related individuals (DOSRI) can avail themselves of preferential treatment and benefits through the positions of leadership and trust that they hold. This risk management tool includes three qualitative indicators that evaluate these problems. Since these measures require subjective judgment, a separate DOSRI journal should be kept for all applicable DOSRI members and extra time must be invested to review all of the respective files instead of just a case by case sampling. All improper activities should be documented and brought to the attention of the proper regulatory authorities and the internal auditor. Problems can often occur in the following areas:

1) Loan Approval, Disbursement and Collection Activities

Sometimes, lending policies are violated in order to accommodate special situations that are driven by board and management requests. Loan purpose, loan amounts, and collateral requirements may likewise be circumvented to accommodate special needs. Finally, loan delinquency, loan restructuring and refinancing, and lenient collection practices are also common governance problems linked to the DOSRI members.

As this indicator is evaluated, the main question to ask is: “Was there any preferential treatment given to insiders in the approval, disbursement or collection of loans?” By reviewing all of the DOSRI member loan files, careful attention can be given to the compliance of all established policies and procedures in the credit administration process.

2) Loan and Savings Interest Rates

The credit union usually has a set of standardized loan and savings products and rates for all members. The risk management tool compares the average loan interest rate of the loan portfolio with the individual loan interest rates of each DOSRI account to see if there are any preferential rates given. The same analysis would apply to savings deposit rates.

In the fieldwork conducted, significant interest rate disparities have been noted, and in some cases directors or employees have received zero interest loans or higher than market interest rates on their savings accounts. This type of problem can be easily detected and automated if the accounting software can look at individual loan and savings accounts and make the comparisons. If not, each account must be reviewed manually.

3) Disposal of Non-Performing Assets to the DOSRI members

When member loans are delinquent and the collateral (real property) is foreclosed and sold to cancel outstanding loan balances, a delicate conflict of interest can occur. In some cases, DOSRI members have purchased foreclosed real estate at liquidation auctions for prices well below stated appraisal values. This action not only is ethically wrong, but could also affect the image of the cooperative in the community and should be strictly prohibited.

Even if a “fair market price” is paid, that price could be well below what the property was originally worth and the sale could fall short of canceling the balance of the outstanding principal and interest of a delinquent members’ loan. The DOSRI should avoid any potential conflict of interest (perceived or real), particularly where personal gain may come at the expense of a member who cannot pay.

The inclusion of this indicator is to prevent such conflicts of interest from happening, and to minimize the reputation risk for possible improper behavior in such compromising situations.

C. Legislation and Supervision

The final area of operational risk deals with the external environment in which the credit union operates and the impact it can have on the operations. In many areas of the world, there are no external rules or regulators, so credit unions are left to operate by themselves and sometimes do so under very risky conditions. Based on its experiences, WOCCU has seen the need to promote specific legislation and regulation for credit unions around the world. Self-regulation has not proven to be a viable alternative, particularly in situations where there are problems to resolve and difficult decisions to make to protect member savings. Since credit unions are cooperatives, many times they are included under the general laws governing cooperatives. These laws have repeatedly proven to be inadequate for the specialized financial operations of a credit union.

This section is divided into two parts, one dealing with legislation and the other with the enforcement of legislation through external supervision. The most successful

credit union movements around the world have enjoyed the benefits of both specific legislation for credit unions and regulators that specialize in supervising credit unions.

I. Legislation

The main question that is analyzed in this area is, “Do credit unions operate under a legal and regulatory framework that is specific to their financial institution?” Specific legislation for credit unions is promoted here because there are many critical areas of financial intermediation that require special treatment and are unique to savings and credit cooperatives. As such, they are not covered in the general laws governing the establishment and operations of cooperatives, nor do they fit well within existing banking regulations.

The rationale of this indicator is to promote what has worked very well in the developed credit union movements around the world: a specific law governing the operations of a credit union which respects its ideology and organizational structure and fosters fair competition among all financial institutions.

II. Supervision

The topic of external supervision has generated great debate. The leaders of traditional credit unions have preferred to be excluded from any formal external supervision and to rely wholly on the merits of self-regulation. The capitalized experience in this area has repeatedly shown that few leaders with vested interests in their credit unions are capable of regulating their institutions without external help, particularly if there are conflicts between their personal interests and those of the membership at large. When problems arise, it is impossible to be objective in determining solutions because no one can effectively play the role of judge and jury.

The intent of this indicator is to promote the establishment of an in-country regulator that is responsible for the examination and regulation of credit unions.

Description of Indicators

The following pages contain a more detailed synopsis of each indicator in the Risk Management Tool including its purpose, its type, its component parts, its formula, its proposed financial standards, and finally, a qualification table to help allocate the final number of points possible.

The qualification table found under each indicator is comprised of a minimum and maximum standard, and a corresponding number of points possible, depending on the results. The range divides the standards into an equal number of steps between the minimum and the maximum ratios, and allocates points according to the level of effort. The level of effort recognizes the fact that to move from the minimum amount one step at a time to the maximum amount, requires different levels of effort, and so the greater the effort, the more points are awarded.

These concepts can best be shown in the Net Capital Ratio, which is the first indicator in Capital Risk Area. The minimum standard is 5% of total assets, while the maximum amount is 10%. The steps in the range between 5% and 10% increase equally 1% at a time, however the level of effort is different. To move from 5% to 6% requires a 20% effort ($1/5=20\%$) while the effort required to move from 9% to 10% is only 11.11% ($1/9=11.11\%$). Hence, the number of additional points earned by going from 5% to 6% is 3.30 ($21.30 - 18.00 = 3.30$) while the amount of points earned by going from 9% to 10% is only 1.80 ($30.00 - 28.20$). All of the qualification tables in this section follow the same logic.

A summary of the risk rating indicators is found in Annex 2. It includes the indicators in each area, the maximum and minimum standards, the number of points possible for each area and each indicator, and finally, the number indicators in each area, classified by whether they are quantitative or subjective.

CAPITAL RISK					
No. of Indicators					
Quantitative	9	Subjective	1	Total	10

1 Net Capital Ratio

Purpose: To measure the real level of risk capital after subtracting potential losses and adjusting the allowances for risk assets to meet the net capital prudential standards.

Risk Capital: Defined as two separate categories:

- 1) Institutional capital (e.g., the sum of all legal and non-distributable reserves, capital donations, the portion of the current year's surplus that will be retained as a legal or non-distributable reserve): these institutional reserves cannot be sold and no member may present an individual claim against them.
- 2) Mandatory share capital of each member: this share capital shall be defined by local conditions and cannot be withdrawn except by permanently leaving the credit union nor be pledged as loan collateral. If such conditions are not met, then share capital is not considered in the formula.

Type: Quantitative

Components:

- a. Institutional capital at latest year end
- b. Mandatory shares (defined by local conditions and must be non-withdrawable and not pledged as loan collateral) at latest year end
- c. Allowances for risk assets at latest year end
- d. Balance of delinquent loans greater than 12 months at latest year end
- e. Balance of delinquent loans between 1 and 12 months at latest year end
- f. Problem assets (losses that will be liquidated) at latest year end
- g. Total assets at latest year end

Formula:
$$\frac{\{(a + b + c) - [d + .35e + f]\}}{g}$$

Standard:	<u>Optimum</u> ≥ 10%	<u>Minimum</u> ≥ 5%
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Total Points:	<u>Optimum</u> 30	<u>Minimum</u> 18
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Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	$\geq 10\%$	$\geq 9\%$	$\geq 8\%$	$\geq 7\%$	$\geq 6\%$	$\geq 5\%$
Level of Effort	100%	94%	87%	80%	71%	60%
Points	30.00	28.20	26.10	24.00	21.30	18.00

2 Capital Ratio Stability (Applicable if Net Capital Ratio $\geq 10\%$)

Purpose: To measure the stability of net capital for the past 3 years in maintaining the prudential capital standards. In order to qualify for points, the net capital ratio must be at least $\geq 10\%$ for one, two, or three years.

Type: Quantitative

Components: a. Net Capital – latest year end

Formula: Number of years $a \geq 10\%$

Standard:	<u>Optimum</u>	<u>Minimum</u>
	3 Consecutive Years	Any 1 Year out of 3

Total Points:	<u>Optimum</u>	<u>Minimum</u>
	9.0	5.40

Qualification Table:	Optimum	Step 1	Minimum
Range	3 Consecutive Years	Any 2 Years	Any 1 Year
Level of Effort	100%	80%	60%
Points	9.00	7.20	5.40

3 Capital Ratio Trend (Applicable if Net Capital Ratio $\leq 10\%$)

Purpose: To measure the capitalization trend for the past three years towards achieving the net capital standards. The formula is structured to give the most weight to the current year, and then reducing with each successive year. The advantage of weighting this trend is that it creates a greater incentive to achieve the optimum standard more quickly since the most recent year will have a greater impact on the points possible, than two or three years ago.

Type: Quantitative

- Components:**
- a. Net capital latest year end
 - b. Net capital previous Year 1 end
 - c. Net capital previous Year 2 end
 - d. Net capital previous Year 3 end
 - e. Percentage of growth in net capital each year end
 - f. Weighted factor (60%, 30% or 10%)

Formula:

$$a - b = e_1 \quad \text{If } (e_1) \text{ is } \geq 0.5\% \Rightarrow \text{then } (e_1) * 60\% = f_1$$

$$b - c = e_2 \quad \text{If } (e_2) \text{ is } \geq 0.5\% \Rightarrow \text{then } (e_2) * 30\% = f_2$$

$$c - d = e_3 \quad \text{If } (e_3) \text{ is } \geq 0.5\% \Rightarrow \text{then } (e_3) * 10\% = f_3$$

$$\sum f_1, f_2, f_3$$

Standard:

<u>Optimum</u>	<u>Minimum</u>
$e \geq 1\%$	$e \geq 0.5\%$

Total Points:

<u>Optimum</u>	<u>Minimum</u>
9.0	5.40

<i>Qualification Table:</i>	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
<i>Range</i>	$\geq 1.0\%$	$\geq 0.9\%$	$\geq 0.8\%$	$\geq 0.7\%$	$\geq 0.6\%$	$\geq 0.5\%$
<i>Level of Effort</i>	100%	94%	87%	80%	71%	60%
<i>Points</i>	9.00	8.46	7.83	7.20	6.39	5.40

4 Total Asset Growth

Purpose: To measure the real institutional growth by comparing the annual growth rate of total assets to the annual inflation rate

Type: Quantitative

- Components:**
- a. Total assets at latest year end
 - b. Total assets as of the previous year end

Formula:

$$\left(\frac{a}{b} \right) - 1 * 100$$

Standard:

<u>Optimum</u>	<u>Minimum</u>
Inflation + (10%)	Inflation

Total Points:

Optimum
9.0

Minimum
5.40

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	Inflation +10%	Inflation + 8%	Inflation + 6%	Inflation + 4%	Inflation + 2%	Inflation
Level of Effort	100%	94%	88%	81%	72%	60%
Points	9.00	8.46	7.92	7.29	6.48	5.40

5

Loan Book Ratio Trend

Purpose: To evaluate the trend of the net loan portfolio outstanding and its relationship to total assets for the past three years, seeking constant improvement toward the optimization of the financial structure. The formula is structured to give the most weight to the current year, and then reducing with each successive year. The advantage of weighting this trend is that creates a greater incentive to achieve the optimum standard more quickly since the most recent year will have a greater impact on the points possible, than two or three years ago.

Type: Quantitative

Components:

- a. Total gross loan portfolio outstanding at latest year end
- b. Total allowance for loan losses at latest year end
- c. Total assets at latest year end
- d. Percent of net loans
- e. Weighting factor (60%, 30% or 10%)

Formula:

Current Year $\frac{(a - b)}{c} = d_1 \Rightarrow \text{then } (d_1) * 60\% = e_1$

Previous Year 1 $\frac{(a - b)}{c} = d_2 \Rightarrow \text{then } (d_2) * 30\% = e_2$

Previous Year 2 $\frac{(a - b)}{c} = d_3 \Rightarrow \text{then } (d_3) * 10\% = e_3$

$\sum e_1, e_2, e_3$

Standard:

Optimum
 $80\% \geq d \geq 70\%$

Minimum
 $d \geq 50\%$

Total Points:

Optimum
9.0

Minimum
5.40

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	$70\% \leq \leq 80\%$	$\geq 66\%$	$\geq 62\%$	$\geq 58\%$	$\geq 54\%$	$\geq 50\%$
Level of Effort	100%	93%	86%	78%	69%	60%
Points	9.00	8.37	7.74	7.02	6.21	5.40

6 Savings Deposit Ratio Trend

Purpose: To evaluate the trend of the total savings deposits outstanding and their relationship to total assets for the past three years, seeking improvement toward the optimization of the financial structure. The formula is structured to give the most weight to the current year, and then reducing with each successive year. The advantage of weighting this trend is that creates a greater incentive to achieve the optimum standard more quickly since the most recent year will have a greater impact on the points possible, than two or three years ago.

Type: Quantitative

Components:

- Total savings deposits at latest year end
- Total assets at latest year end
- % savings deposits
- Weighting factor (60%, 30% or 10%)

Formula:

Present Year $\frac{a}{b} = c_1 \Rightarrow \text{then } (c_1) * 60\% = d_1$

Previous Year 1 $\frac{a}{b} = c_2 \Rightarrow \text{then } (c_2) * 30\% = d_2$

Previous Year 2 $\frac{a}{b} = c_3 \Rightarrow \text{then } (c_3) * 10\% = d_3$

$\sum d_1, d_2, d_3$

Standard:

<u>Optimum</u>	<u>Minimum</u>
$c \geq 70\%$	$c \geq 50\%$

Total Points:

<u>Optimum</u>	<u>Minimum</u>
9.0	5.40

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	≥ 70%	≥ 66%	≥ 62%	≥ 58%	≥ 54%	≥ 50%
Level of Effort	100%	93%	86%	78%	69%	60%
Points	9.00	8.37	7.74	7.02	6.21	5.40

7 Non-Earning Asset Ratio Trend

Purpose: To evaluate the trend of the non-earning assets and their relationship to total assets for the past three years; seeking constant improvement towards the optimization of the financial structure. The formula is structured to give the most weight to the current year, and then reducing with each successive year. The advantage of weighting this trend is that creates a greater incentive to achieve the optimum standard more quickly since the most recent year will have a greater impact on the points possible, than two or three years ago.

Type: Quantitative

Components:

- Total non-earning assets at latest year end
- Total assets at latest year end
- % non-earning asset
- Weighting factor (60%, 30% or 10%)

Formula:

Present Year $\frac{a}{b} = c_1 \Rightarrow \text{then } (c_1) * 60\% = d_1$

Previous Year 1 $\frac{a}{b} = c_2 \Rightarrow \text{then } (c_2) * 30\% = d_2$

Previous Year 2 $\frac{a}{b} = c_3 \Rightarrow \text{then } (c_3) * 10\% = d_3$

$\sum d_1, d_2, d_3$

Standard:

<u>Optimum</u>	<u>Minimum</u>
$c \leq 5\%$	$c \leq 10\%$

Total Points:

<u>Optimum</u>	<u>Minimum</u>
9.0	5.40

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	≤ 5%	≤ 6%	≤ 7%	≤ 8%	≤ 9%	≤ 10%
Level of Effort	100%	90%	81%	73%	66%	60%
Points	9.00	8.10	7.29	6.56	5.94	5.40

8 Operating Expense Ratio Trend

Purpose: To evaluate the trend of the operating expenses and their relationship to total assets for the past three years, seeking constant improvement towards greater operating efficiencies. The formula is structured to give the most weight to the current year, and then reducing with each successive year. The advantage of weighting this trend is that creates a greater incentive to achieve the optimum standard more quickly since the most recent year will have a greater impact on the points possible, than two or three years ago.

Type: Quantitative

Components:

- Total operating expenses (exclusive of provisions for loan losses)
- Total assets at latest year-end
- Total assets at latest year-end
- Percent of operating expenses
- Weighting factor (60%-30%-10%)

Formula:

Present Year $\frac{a}{\left[\frac{(b+c)}{2} \right]} = d_1 \Rightarrow \text{then } (d_1) * 60\% = e_1$

Previous Year 1 $\frac{a}{\left[\frac{(b+c)}{2} \right]} = d_2 \Rightarrow \text{then } (d_2) * 30\% = e_2$

Previous Year 2 $\frac{a}{\left[\frac{(b+c)}{2} \right]} = d_3 \Rightarrow \text{then } (d_3) * 10\% = e_3$

$\sum e_1, e_2, e_3$

Standard:	<u>Optimum</u>	<u>Minimum</u>
	$d \leq 5\%$	$d \leq 10\%$
Total Points:	<u>Optimum</u>	<u>Minimum</u>
	9.0	5.40

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	≤ 5%	≤ 6%	≤ 7%	≤ 8%	≤ 9%	≤ 10%
Level of Effort	100%	90%	81%	73%	66%	60%
Points	9.00	8.10	7.29	6.56	5.94	5.40

9 Share Dividend Yield

Purpose: To evaluate the capacity of the credit union to pay dividends and also, measure the yield on member shares and its impact on the ability of the institution to accumulate sufficient net capital.

Type: Quantitative

Components:

- Total dividends paid on member shares at latest year end
- Total insurance premium paid on member shares at latest year end
- Total taxes paid by credit union on dividends on shares at latest year end
- Total member shares as of current year-end
- Total member shares as of last year-end

Formula:
$$\frac{(a + b + c)}{\left[\frac{(d + e)}{2} \right]}$$

Standard: Optimum
> Inflation Rate
if Net Capital =10% Minimum
Inflation Rate

Total Points: Optimum
9.0 Minimum
5.40

Qualification Table:	Optimum	Minimum
Range	> Inflation Rate	Inflation Rate
Level of Effort	100%	60%
Points if Net Capital ≥ 10%	9.00	5.40
Points if Net Capital ≥ 5%	4.00	2.40
Points if Net Capital < 5%	2.00	1.20

10 Analysis of Sources and Uses of Funds by Interest Rate

Purpose: To stratify all the sources and uses of funds by interest rate yields and evaluate whether all interest-bearing liabilities and share capital are invested in assets which generate profits to cover the marginal costs associated with the various funding alternatives.

Type: Subjective

Components:

- Liabilities and/or share capital, starting with the lowest cost first at latest year end.
- Assets starting with the lowest yielding accounts first at latest year end.

Formula: For each account of the financial statement:

If the marginal cost of $a \leq$ the marginal yield of b , the structure is balanced. If the marginal cost of $a > b$, the structure is imbalanced.

Procedure:

- All the sources of funding (liabilities, share capital, and institutional capital) should be listed in ascending order, according to their cost of funds.
- All of the uses of funds (assets) should be listed in ascending order of yield, beginning with the non-earning assets first, until all of the uses of funds have been accounted for.
- A manual revision and linking of the sources and uses of funds should be conducted to insure that all of the liabilities and capital are invested in assets that earn at least as much as their respective cost of funds
- By following this revision and linking procedure, if all the liabilities and share capital are invested in higher yielding assets, the funding structure is balanced. If higher cost liabilities or share capital are used to finance lower yielding assets, the structure is imbalanced.

Standard:	<u>Optimum</u> Yes	<u>Minimum</u> None
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Total Points:	<u>Optimum</u> 7	<u>Minimum</u> None
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Qualification Table:	Optimum	Minimum
Range	Yes	None
Level of Effort	100%	Not Applicable
Points	7.00	0

CREDIT RISK					
No. of Indicators					
Quantitative	7	Subjective	3	Total	10

1 Loan Delinquency Ratio

Purpose: To measure the delinquency rate of the gross loan portfolio, following the best practice of using the outstanding delinquent loan balances instead of accumulated delinquent loan payments.

Type: Quantitative

Components: a. Sum of all delinquent loan balances (>30 days) at latest year end
b. Total (gross) loan portfolio outstanding at latest year end

Formula: $\frac{a}{b}$

Standard: Optimum $\leq 5\%$ Minimum $\leq 10\%$

Total Points: Optimum 30 Minimum 18

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	$\leq 5\%$	$\leq 6\%$	$\leq 7\%$	$\leq 8\%$	$\leq 9\%$	$\leq 10\%$
Level of Effort	100%	90%	81%	73%	66%	60%
Points	30.00	27.00	24.30	21.90	19.80	18.00

2 Delinquency Ratio Stability

Purpose: To measure the time over the past three years that the delinquency rate has remained at a stable level of no more than 5% of the loan portfolio outstanding at year end.

Type: Quantitative

Components: a. Loan delinquency at year end for past three years

Formula: Number of years $a \leq 5\%$

Standard: Optimum Minimum
3 Consecutive Years Any 1 Year

Total Points: Optimum Minimum
9.0 5.40

Qualification Table:	Optimum	Step 1	Minimum
Range	3 Consecutive Years	Any 2 Years	Any 1 Year
Level of Effort	100%	80%	60%
Points	9.0	7.20	5.40

3 Delinquency Ratio Trend

Purpose: To evaluate the trend of the delinquency rate for the total loan portfolio outstanding over the past three years, seeking a constant improvement towards the achievement of the optimal standard of 5%. The formula is structured to give the most weight to the current year, and then reducing with each successive year. The total sum of the three years represents the weighted average trend.

Type: Quantitative

Components: a. Loan delinquency at latest year end
b. Loan delinquency previous Year 1 end
c. Loan delinquency previous Year 2 end
d. Loan delinquency previous Year 3 end
e. Percentage decrease in loan delinquency per year
f. Weighting factor (60%-30%-10%)

Formula: $a - b = e_1$ If $(e_1) \geq 0.5 \Rightarrow$ then $(e_1) * 60\% = f_1$
 $b - c = e_2$ If $(e_2) \geq 0.5 \Rightarrow$ then $(e_2) * 30\% = f_2$
 $c - d = e_3$ If $(e_3) \geq 0.5 \Rightarrow$ then $(e_3) * 10\% = f_3$

$$\sum f_1, f_2, f_3$$

Standard: Optimum Minimum
1st Tier If Loan Delinquency is $\leq 10\%$
 $e \geq 1\%$ $e \geq 0.5\%$

5 Improper Restructuring/Refinancing of Delinquent Loans

Purpose: To document the existence of poor credit administration practices where manipulation is used to circumvent loan policy and hide problems and understate the true delinquency rate. This is subject to the judgment of the evaluator and the existence of one problem does not necessarily mean that the entire process is flawed.

Type: Subjective

Components: a. Improper Restructured or Refinanced Delinquent Loans

Formula: If (a) is = No \Rightarrow then receive points

Standard:

<u>Optimum</u>	<u>Minimum</u>
No improper actions as determined by evaluator	None

Total Points:

<u>Optimum</u>	<u>Minimum</u>
9	0

Qualification Table:	Optimum	Minimum
Standard	No	None
Level of Effort	100%	Not Applicable
Points	9.00	0

6 Charge-Off of Loans Delinquent More Than 12 Months & Charge-Off Rate

Purpose: To determine if the credit union follows the discipline of charging off all loans delinquent more than twelve months, and if so, to calculate the loan charge off rate as a percent of the loan portfolio.

Type: Quantitative

Components:

- Charge-off of loans delinquent more than 12 months at latest year end
- Loan charge-offs at latest year end
- Gross loan portfolio (excluding allowances) at latest year end

Formula: If a = Yes & $\frac{b}{c}$

Standard:

Optimum
If a = Yes & $\frac{b}{c} \leq 0.20\%$

Minimum
If a = Yes & $\frac{b}{c} \leq 1\%$

Total Points:

Optimum
9.0

Minimum
5.40

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	Yes & $\leq 0.20\%$	Yes & $\leq 0.36\%$	Yes & $\leq 0.52\%$	Yes & $\leq 0.68\%$	Yes & $\leq 0.84\%$	Yes & $\leq 1.00\%$
Level of Effort	100%	87%	78%	71%	65%	60%
Points	9.00	7.83	7.02	6.39	5.85	5.40

7

Largest Single Loan Concentration Ratio

Purpose: To measure the risk of excessive loan size concentration by comparing the largest single loan outstanding to the total credit union net capital.

Type: Quantitative

Components: a. Largest Loan at latest year end
b. Net Capital at latest year end

Formula: $\frac{a}{b}$

Standard:

Optimum
 $\leq 10\%$

Minimum
None

Total Points:

Optimum
9.0

Minimum
0

Qualification Table:	Optimum	Minimum
Range	$\leq 10\%$	None
Level of Effort	100%	Not Applicable
Points	9.00	0

8 Maximum Concentration Ratio of 20 Largest Borrowers

Purpose: To measure the risk of excessive loan size concentration by comparing the sum of the largest 20 borrowers' loans outstanding to the total loan portfolio.

Type: Quantitative

Components: a. 20 largest borrowers' loans outstanding at latest year end
b. Total (gross) loan portfolio outstanding at latest year end

Formula: $\frac{a}{b}$

Standard: Optimum Minimum
 $\leq 25\%$ None

Total Points: Optimum Minimum
9.0 0

Qualification Table:	Optimum	Minimum
Range	$\leq 25\%$	None
Level of Effort	100%	Not Applicable
Points	9.00	0

9 Largest Institutional Investment Concentration Ratio

Purpose: To measure the risk of excessive investment concentration by comparing the total investments placed in any one financial institution, (excluding government guaranteed securities) with the total investment portfolio.

Type: Quantitative

Components: a. Total investments (excluding government guaranteed securities) placed in each financial institution (liquid and financial investments or savings deposits) at latest year end
b. Total investments (excluding government guaranteed securities) placed in all financial institutions (liquid and financial investments or savings deposits) at latest year end

Formula: $\frac{a}{b}$

Standard: Optimum $\leq 20\%$ Minimum None

Total Points: Optimum 9.0 Minimum 0

Qualification Table:	Optimum	Minimum
Range	$\leq 20\%$	None
Level of Effort	100%	Not Applicable
Points	9.00	0

10 Investments Restricted to Regulated Institutions

Purpose: To review the entire portfolio of investment placements (excluding government guaranteed securities) and verify that all the investments have been made with financial institutions that are regulated by the Superintendency of Banks or its equivalent.

Type: Subjective

Components: a. Total Investments (excluding government guaranteed securities) placed in regulated institutions at latest year end

Formula: If $(a) = 100\% \Rightarrow$ then receive points

Standard: Optimum Minimum
100% None

Total Points: Optimum Minimum
7 0

Qualification Table:	Optimum	Minimum
Range	100%	None
Level of Effort	100%	Not Applicable
Points	7.00	0

LIQUIDITY RISK					
No. of Indicators					
Quantitative	4	Subjective	2	Total	6

1 Average Net Liquidity Ratio @ 90 Days

Purpose: To evaluate the adequacy of the credit union liquid cash reserves and investments on hand over a 90 day period by comparing the net cash on hand (after paying all short term debts <30 days) to the total amount of Saving Deposits.

Type: Quantitative

Components:

- Average daily balance of total earning liquid investments during the last 90 days from latest year end
- Average daily balance of total non-earning liquid assets during the last 90 days from latest year end
- Average daily balance of total short-term payables of less than 30 days during the last 90 days from latest year end
- Average daily balance of total savings deposits during the last 90 days from latest year end

Formula:
$$\frac{(a + b - c)}{d}$$

Standard: Optimum
≥ 15% Minimum
≥ 10%

Total Points: Optimum
30 Minimum
18

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	≥ 15%	≥ 14%	≥ 13%	≥ 12%	≥ 11%	≥ 10%
Level of Effort	100%	93%	86%	78%	69%	60%
Points	30.00	27.90	25.80	23.40	20.70	18.00

2 Mandatory Liquidity Reserve Ratio

Purpose: To determine the existence of an obligatory liquidity reserve fund and measure the amount of liquid reserves invested in the fund, as a percentage of the total savings deposits.

Type: Quantitative

- Components:**
- a. Total liquid reserves in fund at latest year end (earning assets)
 - b. Total liquid reserves in fund at latest year end (non-earning assets)
 - c. Total savings deposits at latest year end

Formula:
$$\frac{(a+b)}{c}$$

Standard:

<u>Optimum</u>	<u>Minimum</u>
10%	None

Total Points:

<u>Optimum</u>	<u>Minimum</u>
15	0

Qualification Table:	Optimum	Minimum
Range	10%	None
Level of Effort	100%	Not Applicable
Points	15.00	0

3 Maximum Concentration Ratio of the Twenty Largest Depositors

Purpose: To measure the risk of excessive savings deposit concentrations by comparing the savings deposits of the 20 largest depositors to the total amounts savings deposited in the credit union.

Type: Quantitative

- Components:**
- a. Total savings of 20 largest depositors at latest year end
 - b. Total savings deposits at latest year end

Formula:
$$\frac{a}{b}$$

Standard:

<u>Optimum</u>	<u>Minimum</u>
10% of Total Savings	15% of Total Savings

Total Points:

<u>Optimum</u>	<u>Minimum</u>
15	9

Qualification Table:	Optimum	Step 1	Step 2	Step 3	Step 4	Minimum
Range	≤ 10%	≤ 11%	≤ 12%	≤ 13%	≤ 14%	≤ 15%
Level of Effort	100%	91%	82%	74%	67%	60%
Points	15.00	13.65	12.30	11.10	10.05	9.00

4 Maximum Concentration Ratio of the Next Forty Largest Depositors

Purpose: To evaluate the risk of excessive savings deposit concentrations by comparing the savings deposits of the next 40 largest depositors with the credit union's back up sources of liquidity to determine its adequacy in satisfying unanticipated withdrawal requests.

Type: Subjective

Components: a. Savings balance of next 40 largest depositors at latest year end
b. Back up sources of liquidity at latest year end

Back up Sources of Liquidity: Excess liquidity from a lower loan/asset ratio, emergency lines of credit from a mandatory liquidity reserve fund, stand-by lines of credit from another financial institution, or financial investments with maturities greater than 90 days that can be converted to cash upon demand.

Formula: If $a < b \Rightarrow$ then meets standard

Standard: Optimum Minimum
 $a < b$ None

Total Points: Optimum Minimum
15 0

Qualification Table:	Optimum	Minimum
Range	$a < b$	None
Level of Effort	100%	Not Applicable
Points	15.00	0

5 Maximum Withdrawal Risk

Purpose: To compare the anticipated withdrawal amount (second standard deviation of all daily cash withdrawals over the previous 90 day period from year end) with the average amount of available cash on hand.

Type: Quantitative

Components: a. Second standard deviation (2σ) of all daily cash withdrawals over the previous 90 day period from latest year end
b. Average daily liquidity over the same 90 day period

Formula: If $a \leq b \Rightarrow$ then meets standard

Standard: Optimum Minimum
 $a \leq b$ None

Total Points: Optimum Minimum
10 0

Qualification Table:	Optimum	Minimum
Range	$a \leq b$	None
Level of Effort	100%	Not Applicable
Points	10.00	0

6 Maximum Asset/Liability Management GAP Ratio @ 90 Days

Purpose: To classify all liabilities and capital (sources) and all assets (uses) by their maturity dates from 1 to 90 days and measure any timing gap or mismatch between the funding sources and their corresponding uses.

Type: Subjective

Components: a. Assets classified by their maturity dates from 1 to 90 days at latest year end
b. Liabilities and Capital classified by their maturity dates from 1 to 90 days at latest year end

Formula: $\frac{(a-b)}{b}$

Standard: Optimum Minimum
 $\geq -20\%$ None

Total Points: Optimum Minimum
15 0

Qualification Table:	Optimum	Minimum
Range	≥- 20%	None
Level of Effort	100%	Not Applicable
Points	15.00	0

OPERATIONAL RISK					
No. of Indicators					
Quantitative	11	Subjective	45	Total	56

1. VITAL INSTITUTIONAL PROCESSES

1.A Executive Human Resource Administration Process

Purpose: To evaluate the quality of the Human Resource (HR) administrative process and review the hiring, training, empowerment, and accountability of key employees of the senior management team (SMT) to achieve the results identified in the business plan.

Type: Subjective

Questions:

- Does there exist a job description and qualifications profile for each position on the SMT and does the credit union hire employees on the SMT according to the established profiles?
- Are there measurable criteria to evaluate the performance of the SMT and is it done at least once a year?

Formula: If (a) = Yes, then meets standard
If (b) = Yes, then meets standard

Standard:

<u>Optimum</u>	<u>Minimum</u>
2 Yes Answers	1 Yes Answer

Total Points:

<u>Optimum</u>	<u>Minimum</u>
7	4.2

Qualification Table:	Optimum	Minimum
Range	2 Yes Answers	1 Yes Answer
Level of Effort	100%	60%
Points	7.00	4.20

1.B Institutional Planning Process

Purpose: To evaluate the quality of the business planning process and the implementation and follow up of critical activities that will affect the achievement of key strategic goals.

Type: Subjective

Questions:

- Does the credit union have a Strategic Plan (long term vision) and a Business Plan (short term vision) designed by SMT and approved by the Board of Directors?
- Does a complete Business Plan exist that is based on a technical methodology that links financial discipline, operating efficiency, and interest rates together, and also, contains realistic institutional goals, activities and time deadlines?
- Is a monitoring system in place and functioning that can evaluate the implementation and progress of approved plans?
- Does there exist a reporting format which periodically reviews the advances made against the established plans?
- Is there a procedure established to review and adjust existing business plan goals and activities?

Formula:

If (a) = Yes, then meets standard
If (b) = Yes, then meets standard
If (c) = Yes, then meets standard
If (d) = Yes, then meets standard
If (e) = Yes, then meets standard

Standard:	<u>Optimum</u>	<u>Minimum</u>
	5 Yes Answers	3 Yes Answers

Total Points:	<u>Optimum</u>	<u>Minimum</u>
	7	4.2

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers	4 Yes Answers	3 Yes Answers
Level of Effort	100%	80%	60%
Points	7.00	5.60	4.20

1.C Savings Mobilization Process

Purpose: To evaluate the quality of the savings mobilization process and the strategies used by the credit union to build member trust, improve security and provide high quality savings products to the membership.

Type: Subjective

- Questions:**
- Does the physical building and its location foster member trust and facilitate savings mobilization?
 - Does adequate security exist to mobilize savings safely (safe, security guards, alarm systems)?
 - Do adequate policies and controls exist to properly detect and eliminate money laundering activities?
 - Does a pricing methodology exist that ties the aggregate interest rate on savings in the business plan to the individual savings products?
 - Does the credit union have a master marketing plan that includes all of its individual product plans, market niches, market studies, and the tools to measure its success?

Formula:

If (a) = Yes, then meets standard
If (b) = Yes, then meets standard
If (c) = Yes, then meets standard
If (d) = Yes, then meets standard
If (e) = Yes, then meets standard

Standard:

	<u>Optimum</u>	<u>Minimum</u>
	5 Yes Answers	3 Yes Answers

Total Points:

	<u>Optimum</u>	<u>Minimum</u>
	7	4.2

<i>Qualification Table:</i>	Optimum	Step 1	Minimum
<i>Range</i>	5 Yes Answers	4 Yes Answers	3 Yes Answers
<i>Level of Effort</i>	100%	80%	60%
<i>Points</i>	7.00	5.60	4.20

1.D Liquidity Management Process

Purpose: To evaluate the quality of the liquidity management process by reviewing all of the written policies and tools used to properly monitor the fluctuating cash flows and preferred levels of liquidity within the credit union.

Type: Subjective

- Questions:**
- Are there any liquidity management tools used for monitoring (cash flow projections, ALM projections, concentrations of borrowers and savers, etc.), and is there any evidence that they are being properly utilized and implemented?
 - Does a cash management policy exist to keep daily cash balances at a minimum?
 - Does the credit union have adequate insurance and fidelity bonding to cover external and internal losses from robbery, assault, and employee fraud?
 - Do adequate investment policy guidelines exist that contain criteria to be followed in the selection of suitable institutions and investment instruments?
 - Do the liquidity management policies require the establishment of back up sources of liquidity and do they provide adequate protection in the case of unanticipated withdrawals?

Formula:

If (a) = Yes, then meets standard
 If (b) = Yes, then meets standard
 If (c) = Yes, then meets standard
 If (d) = Yes, then meets standard
 If (e) = Yes, then meets standard

Standard:

<u>Optimum</u>	<u>Minimum</u>
5 Yes Answers	3 Yes Answers

Total Points:

<u>Optimum</u>	<u>Minimum</u>
7	4.2

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers	4 Yes Answers	3 Yes Answers
Level of Effort	100%	80%	60%
Points	7.00	5.60	4.20

1.E Credit Administration Process

Purpose: To evaluate the quality of the credit administration process including loan applications, underwriting, disbursements, and collections, as well as the written policies and procedures for each area.

Type: Subjective

Questions: *Loan Approval & Disbursement*

- a. After interviewing the staff responsible for lending activities, is there a clear congruence between the written credit policies and the daily activities identified by the lending department staff?
- b. After reviewing a random sampling of recently approved loans, are the written credit policies being followed in daily practice?

Administrative Collections:

- c. After interviewing the staff responsible for loan collections, is there a clear congruence between the written credit and collections policies and the daily activities identified by the collections staff?
- d. After reviewing a selective sample of efforts to collect delinquent loans, are the written collection policies being adequately followed in daily practice?

Judicial Collections:

- e. Do there exist written policies regarding the follow-up of delinquent loans in judicial foreclosure and is there a person assigned to provide the necessary follow-up?
- f. After reviewing a selective sample of loans in judicial foreclosure, are the written policies being followed in daily practice?

Formula: If (a) = Yes, then meets standard
If (b) = Yes, then meets standard
If (c) = Yes, then meets standard
If (d) = Yes, then meets standard
If (e) = Yes, then meets standard
If (f) = Yes, then meets standard

Standard: Optimum Minimum
6 Yes Answers 4 Yes Answers

Total Points: Optimum Minimum
7 4.2

Qualification Table:	Optimum	Step 1	Minimum
Range	6 Yes Answers	5 Yes Answers	4 Yes Answers
Level of Effort	100%	80%	60%
Points	7.00	5.60	4.20

1.F Internal Control Process

Purpose: To evaluate the quality of the internal control process to insure that proper controls are in place as a safeguard against internal fraud and external vulnerabilities.

Type: Subjective

Questions:

- Is there an independent department or person responsible for internal control?
- Does a methodology and scope of work exist to promote checks and balances through the use of internal audits?
- Is there a checklist of proper reporting and disclosure requirements that should be made by the SMT and the Board of Directors to the auditors, regulators, and general membership?
- Are the internal audit reports sent to an external entity independent of management?
- Does there exist evidence that proper follow up is given to the internal audit reports?

Formula:

If (a) = Yes, then meets standard
If (b) = Yes, then meets standard
If (c) = Yes, then meets standard
If (d) = Yes, then meets standard
If (e) = Yes, then meets standard

Standard:	<u>Optimum</u>	<u>Minimum</u>
	5 Yes Answers	3 Yes Answers

Total Points:	<u>Optimum</u>	<u>Minimum</u>
	7	4.2

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers	4 Yes Answers	3 Yes Answers
Level of Effort	100%	80%	60%
Points	7.00	5.60	4.20

1.G Information Technology Systems Control Process

Purpose: To determine the security, integrity, dependability, and continuity of all electronic database systems and their timely reporting and data retrieval capabilities.

Type: Subjective

- Questions:**
- Are there different levels of security clearance required to access the information systems database?
 - Are the various information databases (including accounting) being managed to achieve transparency and trust?
 - Does there exist a backup of the database information systems both internally and externally to protect against unforeseen damage or destruction?
 - Do strategies exist to provide timely access to the database information in the event of systemic failures or power outages?
 - Do effective communications strategies exist to maintain timely contact with Branch offices?

Formula:

If (a) = Yes, then meets standard
 If (b) = Yes, then meets standard
 If (c) = Yes, then meets standard
 If (d) = Yes, then meets standard
 If (e) = Yes, then meets standard

Standard:

<u>Optimum</u>	<u>Minimum</u>
5 Yes Answers	3 Yes Answers

Total Points:

<u>Optimum</u>	<u>Minimum</u>
7	4.2

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers	4 Yes Answers	3 Yes Answers
Level of Effort	100%	80%	60%
Points	7.00	5.60	4.20

2	GOVERNANCE
2.A	USE OF POWER
Annual General Meeting (AGM)	

2.A.1) Definition of Role for the AGM

Purpose: To determine if the approved bylaws clearly define the powers, limitations, and functions of the AGM and whether its role is adequately described.

Type: Subjective

- Components:**
- Do the bylaws define the role for the AGM?
 - Are the bylaws adequate and being followed?

Formula: If (a) = Yes and (b) = Yes then meets standard

Standard: Optimum Minimum
Yes None

Total Points: Optimum Minimum
17.0 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

Board of Directors (BOD)

2.A.2) Definition of Role for BOD

Purpose: To determine if the approved bylaws clearly define the powers, limitations, and functions of the BOD and whether its role is adequately described

Type: Subjective

Components: a. Do the bylaws define the role for the Board of Directors
b. Are the bylaws adequate and being followed?

Formula: If (a) = Yes and (b) = Yes then meets standard

Standard: Optimum Minimum
Yes None

Total Points: Optimum Minimum
17.0 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.A.3) Profile and Job Description for BOD Members

Purpose: To determine if an officially approved document exists which clearly defines the profile, job requirements, and job description for the BOD and whether this document provides adequate guidance for daily operations.

Type: Subjective

Components: a. Does a written and approved document exist that defines the profile, job requirements, and job description for the BOD?
b. Is this document adequate and being followed?

Formula: If (a) = Yes and (b) = Yes then meets standard

Standard: Optimum Minimum
Yes None

Total Points: Optimum Minimum
17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Standard	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.A.4) Academic Credentials

This indicator is divided into two parts:

a. % of Board of Directors Members with a High School Degree

Purpose: To measure the percentage of the BOD members who are high school graduates.

Type: Quantitative

Components: a. The accumulated number of years of completed high school studies for each member of the BOD as of the report date.
b. The total time (years) typically required to complete all high school studies and qualify for graduation.
c. The total number of BOD members as of the report date.

Formula:
$$\frac{\sum a}{b * \sum c}$$

Standard: Optimum Minimum
100% None

Total Points: Optimum Minimum
17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.0	13.60	10.20

b. % of Board of Directors Members with a College Degree

Purpose: To measure the percentage of the BOD members who are college graduates.

Type: Quantitative

Components: a. Total number of BOD members who have a college degree as of the report date.
b. Total number of BOD members as of the report date.

Formula:
$$\frac{\sum a}{\sum b}$$

Standard: Optimum Minimum
≥ 25% None

Total Points: Optimum Minimum
17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.A.5) % of Net Savers on BOD

Purpose: To measure the percentage of the BOD members who are net savers.

Net Saver: Defined as any member who has a positive net savings balance after subtracting any loans outstanding.

Type: Quantitative

Components: a. Total number of BOD members that are net savers as of the report date.
b. Total number of BOD members as of the report date.

Formula:
$$\frac{\sum a}{b}$$

Standard: Optimum Minimum
 $\geq 60\%$ None

Total Points: Optimum Minimum
17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2. A. 6) Election of Board of Directors

Purpose: To verify that the Directors are elected to the BOD according to the terms specified in the Bylaws.

Type: Subjective

Components: a. Are Directors elected to the BOD according to the terms specified in the Bylaws?

Formula: If (a) = Yes then meets standard

Standard: Optimum Minimum
Yes None

Total Points: Optimum Minimum
 17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

Senior Management Team (SMT)

2.A.7). Definition of General Manager's Role

Purpose: To determine if the approved bylaws clearly define the powers, limitations, and functions of the general manager and whether his or her role is adequately described.

Type: Subjective

Components: a. Do the bylaws define the role for the general manager?
 b. Are the bylaws adequate and being followed?

Formula: If (a) = Yes and (b) = Yes then meets standard

Standard: Optimum Minimum
 Yes None

Total Points: Optimum Minimum
 17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.A. 8) Profile and Job Description for SMT Members

Purpose: To determine if an officially approved documents exists which clearly define the profile, job requirements, and job description for each member of the SMT and whether the documents provides adequate guidance for daily operations.

Type: Subjective

Components: a. Does a written and approved document exist that defines the profile, job requirements, and job description for each member of the SMT?
b. Is this document adequate and being followed?

Formula: If (a) = Yes and (b) = Yes then meets standard

Standard: Optimum Minimum
Yes None

Total Points: Optimum Minimum
17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.A.9) Academic Credentials

This indicator is divided into two parts:

a. % of SMT Members with a High School Degree

Purpose: To measure the percentage of SMT members who are high school graduates.

Type: Quantitative

Components: a. The accumulated number of years of completed high school studies for each member of the SMT as of the report date.
b. The total time (years) required to complete all high school studies and qualify for graduation.
c. The total number of SMT members as of the report date.

Formula:
$$\frac{\sum a}{b * \sum c}$$

Standard: Optimum Minimum
100% None

Minimum
10.20 points for Section II.1

<i>Qualification Table:</i>	Optimum	Step 1	Minimum
<i>Range</i>	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
<i>Level of Effort</i>	100%	80%	60%
<i>Points</i>	17.0	13.60	10.20

b. % of SMT Members with a College Degree

<i>Qualification Table:</i>	Optimum	Step 1	Minimum
<i>Range</i>	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
<i>Level of Effort</i>	100%	80%	60%
<i>Points</i>	17.00	13.60	10.20

2.A.10) % of SMT Members with a Specialized Degree in a Business-Related Field

- Components:**
- SMT members who possess a college degree in economics, finance, accounting, business administration or a related field.
 - SMT members who possess a college degree

Formula: $\frac{a}{b}$

Standard: Optimum Minimum
 $\geq 50\%$ None

Total Points: Optimum Minimum
 17 points for Section II.1 10.20 points for section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.A.11) Average Tenure of SMT Members

Purpose: To measure the average amount of time that SMT members have been employees of the credit union (excluding the manager)

Type: Quantitative

- Components:**
- Total number of years that all SMT members have been employees of the credit union.
 - Total number of years that the general manager has been an employee of the credit union.
 - Total number of SMT members (excluding the general manager) as of the report date.

Formula: $\frac{a - b}{c}$

Standard: Optimum Minimum
 ≥ 5 Years None

Total Points: Optimum Minimum
 17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.A.12) Annual Employee Turnover Ratio

Purpose: To measure the annual percentage of employee turnover.

Type: Quantitative

Components: a. Total number of employees who resigned in the past 12 months.
b. Total number of employees during the past 12 months.

Formula: $\frac{a}{b}$

Standard: Optimum $\leq 10\%$ Minimum None

Total Points: Optimum 17 points for Section II.1 Minimum 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

360° Feedback

2.A.13) Anonymous Internal and External Lines of Communication

Purpose: To determine if the credit union has an anonymous mechanism to provide feedback to internal and/or external entities regarding governance issues or other problems employees identify.

Type: Subjective

Components: a. Do anonymous lines of communications exist between employees and internal and external units or supervisory entities?

Formula: If (a) = Yes, then meets standard

Standard: Optimum Minimum
Yes None

Total Points: Optimum Minimum
17 points for Section II.1 10.20 points for Section II.1

Qualification Table:	Optimum	Step 1	Minimum
Range	13 Yes Answers for Section II.1	10 Yes Answers for Section II.1	8 Yes Answers for Section II.1
Level of Effort	100%	80%	60%
Points	17.00	13.60	10.20

2.B USE OF FINANCIAL RESOURCES

Annual General Meeting (AGM)

2.B.1) Annual General Meeting Expense Ratio (total annual expenses of the AGM as a percentage of total operating expenses)

Purpose: To compare the total cost of the AGM to the total operating costs of the credit union.

Type: Quantitative

Components: a. Total annual expense of the AGM during the past 12 months.
b. Total operating expenses of the credit union during the past 12 months.

Formula:
$$\frac{\sum a}{\sum b}$$

Standard: Optimum Minimum
 $\leq 2\%$ None

Total Points: Optimum Minimum
14 points for Section II.2 8.40 points for Section II.2

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers for Section II.2	4 Yes Answers for Section II.2	3 Yes Answers for Section II.2
Level of Effort	100%	80%	60%
Points	14.00	11.20	8.40

Board of Directors (BOD)

2.B.2) Average Number of Monthly BOD Meetings

Purpose: To calculate the average number of monthly meetings held by the BOD during the past 12 months.

Type: Quantitative

Components: a. Total number of meetings held during the past 12 months.
b. Number of months analyzed per year (12)

Formula: $\frac{a}{b}$

Standard: Optimum
 ≤ 2 Minimum
None

Total Points: Optimum
14 points for Section II.2 Minimum
8.40 points for Section II.2

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers for Section II.2	4 Yes Answers for Section II.2	3 Yes Answers for Section II.2
Level of Effort	100%	80%	60%
Points	14.00	11.20	8.40

2.B.3). Board of Directors Expense Ratio (total annual expenses of the BOD as a percent of total operating expenses)

Purpose: To compare the average expenses of the BOD in relation to the total operating costs of the credit union during the past 12 months.

Type: Quantitative

- Components:**
- Annual expenses of the BOD during the past 12 months.
 - Annual credit union operating expenses during the past 12 months.

Formula:

$$\frac{\sum a}{\sum b}$$

Standard:

<u>Optimum</u> ≤ 2.50%	<u>Minimum</u> None
---------------------------	------------------------

Total Points:

<u>Optimum</u> 14 points for Section II.2	<u>Minimum</u> 8.40 points for Section II.2
--	--

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers for Section II.2	4 Yes Answers for Section II.2	3 Yes Answers for Section II.2
Level of Effort	100%	80%	60%
Points	14.00	11.20	8.40

Senior Management Team (SMT)

2.B.4) Ratio of the General Manager's Salary to the Average SMT Salary

Purpose: To compare the general manager's salary to the average salary of the other SMT members.

Type: Quantitative

- Components:**
- Salary of the general manager during the past 12 months.
 - Total salaries of the SMT (excluding manager) during the past 12 months.
 - Total number of SMT members (excluding manager) during the past 12 months.

Formula:

$$\frac{a}{\left(\frac{b}{c}\right)}$$

Standard:

<u>Optimum</u> ≤ 2 times	<u>Minimum</u> None
-----------------------------	------------------------

Total Points:

<u>Optimum</u> 14 points for Section II.2	<u>Minimum</u> 8.40 points for Section II.2
--	--

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers for Section II.2	4 Yes Answers for Section II.2	3 Yes Answers for Section II.2
Level of Effort	100%	80%	60%
Points	14.00	11.20	8.40

2.B.5) General Manager Expense Ratio (total annual expenses of the general manager as a percentage of total operating expenses)

Purpose: To compare the total annual expenses incurred by the general manager to the total operating costs of the credit union over a 12 month period.

Type: Quantitative

Components:

- Annual expenses of the manager during the past 12 months.
- Annual operating expenses of the credit union during the past 12 months.

Formula: $\frac{a}{b}$

Standard: $\frac{\text{Optimum}}{\leq 3\%}$ $\frac{\text{Minimum}}{\text{None}}$

Total Points: $\frac{\text{Optimum}}{14 \text{ points for Section II.2}}$ $\frac{\text{Minimum}}{8.40 \text{ points for Section II.2}}$

Qualification Table:	Optimum	Step 1	Minimum
Range	5 Yes Answers for Section II.2	4 Yes Answers for Section II.2	3 Yes Answers for Section II.2
Level of Effort	100%	80%	60%
Points	14.00	11.20	8.40

2.C USE OF PRODUCTS AND SERVICES

Purpose: To document the existence of any preferential treatment given to the Board of Directors, senior management or staff (a.k.a. “insiders”), as a result of improper dealings related to any financial products, services, or daily activities of the credit union.

Type: Subjective

- Components:**
- Was there any preferential treatment given to insiders in the approval, disbursement, or collection of loans?
 - Was there any preferential treatment given to insiders related to the interest rates charged on loans and paid on savings deposits, or in the payment of dividends?
 - Was there any preferential treatment given to insiders regarding the sale or disposition of foreclosed assets?

Formula:

If (a) = No, then meets standard
 If (b) = No, then meets standard
 If (c) = No, then meets standard

Standard:

<u>Optimum</u>	<u>Minimum</u>
3 No Answers	2 No Answers

Total Points:

<u>Optimum</u>	<u>Minimum</u>
14 points for Section II.3	8.40 points for Section II.3

Qualification Table:	Optimum	Minimum
Range	3 No Answers for Section II.3	2 No Answers for Section II.3
Level of Effort	100%	60%
Points	14.00	8.40

3 LEGISLATION AND SUPERVISION

3.A. Legislation

Purpose: To determine if there is specific legislation and regulation governing the safe and sound operation of credit unions in each country where credit union operates and manages the savings and credit resources of their members.

Type: Subjective

Components:

- Do credit unions operate under a legal and regulatory framework that is specific to their financial institution?

Formula: If (a) = Yes, then meets standard

Standard:

<u>Optimum</u>	<u>Minimum</u>
1 Yes Answer	None

Total Points: Optimum Minimum
 6 points for Sections III.1 & III.2 3.6 points for Sections III.1 & III.2

Qualification Table:	Optimum	Minimum
Range	2 Yes Answers for Section III	1 Yes Answer for Section III
Level of Effort	100%	60%
Points	6.00	3.60

3.B. Supervision

Purpose: To determine if there is a regulatory entity responsible for the examination and supervision of credit unions in each country where credit unions operate and manage the savings and credit resources of their members.

Type: Subjective

Components: a. Is there a specific in-country regulator that is responsible for the examination and regulation of credit unions?

Formula: If (a) = Yes, then meets standard

Standard: Optimum Minimum
 1 Yes Answer None

Total Points: Optimum Minimum
 6 points for Sections III.1 & III.2 3.6 points for Sections III.1 & III.2

Qualification Table:	Optimum	Minimum
Range	2 Yes Answers for Section III	1 Yes Answer for Section III
Level of Effort	100%	60%
Points	6.00	3.60

FINAL RISK RATING REPORT

Once the analysis of all the risk areas has been completed, the results are then formatted into a risk rating report. This report was created to consolidate and simplify the final risk rating into a five page document which enables the end-user to see the total score as well as the individual component scores, by risk area. Additional detail is also provided to help clarify specific areas of strength or weakness which support the final rating. A sample copy of the report is found in Annex 3.

The first page of the report is a complete summary of all of the indicators in the risk management tool. There are a total of 100 points possible for each of the four areas which facilitate a quick summary judgment of each risk area. For example, the sample credit union in the annex scored only 36.52 points in the area of capital risk, 9 points in credit risk, 55 points in liquidity risk, and 26.80 points in operational risk. When the scale of points is set to 100, simple math gives a quick reckoning.

The final score of 31.83 points was calculated by adding the points from the four individual risk area scores and dividing by 4. This simple average is purposely not weighted, allowing the end-user set the final score by applying local criteria to emphasize the areas of greatest need.

The second page contains supplementary information to the reader regarding some indicators found in the capital risk, credit risk, and liquidity risk areas. For example, the first table shows a detailed breakdown of the sources and uses of funds by interest rate. The second table shows the concentrations of the institutional investments, and the ones which are in non-regulated financial institutions. The third table shows all of the backup sources of liquidity and the maximum withdrawal risk. The final table shows the maximum ALM gap by maturity. All of these tables provide greater details to their respective indicators on the first page.

The third and fourth pages show the answers to all of the individual questions for each of the seven vital institutional processes and the fifth page provides feedback for all of the twenty-one governance indicators. With these five summary pages any board member, manager, supervisor, or regulator can have an in-depth understanding of the main

In Annexes 4A-4C of this paper is presented a case study comparing a standard PEARLS analysis with a risk-based analysis, including all of the indicators in this paper. The comparison was made with the intent of providing a side-by-side analysis to show the added benefits of the RMT.

CONCLUSION

In conclusion, the RMT is a comprehensive tool which looks at the four key risk areas of a credit union. This paper was written with the intent of introducing a new group of performance indicators for credit unions that will assist managers, boards of directors, supervisors and regulators to focus on a broader array of risk-based issues.

We hope that the additional transparency provided by this risk management tool will set a new standard for disclosure and accountability and will motivate credit unions around the world to improve their financial and social performance.

ANNEX 1: Risk Management Tool Required Information

1. Financial Statements for the past 3 years
2. Distribution of Net Income approved by the AGM for the last 3 fiscal years
3. Demographic information about the breakdown of the membership during the last 3 fiscal years, classifying the information as follows:

Description	Total
Men	
Women	
Children	
Others	
Total	
4. Delinquency Tables for the past 3 years,

Description	# of Cases	Amount in US \$
Current Loan Portfolio		
Delinquent Loan Portfolio		
≥1 day - ≤30 days		
> 30 days - ≤ 60 days		
> 60 days - ≤ 90 days		
> 90 days - ≤180 days		
> 180 days - ≤ 365 days		
> 365 days		
5. Information regarding the number and volume of all loans charged off during the last 3 years
6. Information regarding the number and volume of charged-off loans that were recovered during the last 3 years
7. Information regarding the number and volume of delinquent loans that were refinanced, restructured, or renewed during the last fiscal year
8. Information regarding the largest 20 borrowers of the credit union as of the latest date possible, including the following information:
 - Membership Account Number
 - Loan Number
 - Loan Balance Outstanding
9. Information regarding all the investments of the credit union (demand deposits, certificates of deposit, government securities, shares, stock etc.) as of the date of reference, along with the following information:
 - Name of the institution where the investments are located
 - The document or account number
 - The date of investment (if applicable)
 - The maturity date (if applicable)
 - The interest rate
 - The reinvestment of interest (if applicable)
 - The last date interest was paid
 - The balance or outstanding amount of the investment as of the reference date

10. If non-financial investments exist, require the accounting for those investments for the last two years
11. Average Daily balances for the last 90 days from the reference date of the following accounts:
 - Cash and Cash Equivalents (demand deposits & short term deposits whose maturity date is <90 days
 - Accounts payable ≤ 30 days
 - Savings Deposits
12. Report of the largest 60 savers in the credit union as of the reference date, along with the following minimum information:
 - Member number
 - Type of Account
 - Balance outstanding
13. Information regarding the “lines of defense” that the credit union has secured in order to safeguard against future liquidity problems. At a minimum, the following information is needed:
 - Description of the particular line of defense
 - The name of the institution where the protection is located
 - The amount of protection available to cover liquidity shortfalls
14. Consolidated Report of all daily savings account deposits and withdrawals during the last 90 days from the date of reference. The report should include the following information:
 - The specific chart of account affected
 - The type of account
 - The amount of the withdrawal (debit)
 - The amount of the deposit (credit)
 - The daily balance
15. Report of the ALM gap between assets and liabilities as of the reference date
16. Report of evaluation of the key business processes and their condition
17. Bylaws of Credit Union
18. Profile and Job Descriptions for BOD Members & SMT Members
19. Academic Credentials for BOD & SMT members
20. Payroll and Length of Service for SMT members
21. Report of annual AGM Expenses, Board of Directors Expenses, Manager’s Expenses

RISK RATING INDICATORS

Annex 2

Description of Risk Area		Indicator		Points Possible				Type of Indicator	
		Minimum	Optimum					Quantitative	Subjective
CAPITAL RISK				100.00	E9 < 5%	E9 >= 5%	E9 >= 10%	9	1
1	Net Capital Ratio	≥ 5%	≥ 10%	30.00				Q	
2	Capital Ratio Stability	Any 1 Year	3 Consecutive Years		0.00	0.00	9.00	Q	
3	Capital Ratio Trend	≥ 0.5%	≥ 1%		9.00	9.00	0.00	Q	
4	Total Asset Growth	Inflation	Inflation + 10%	9.00				Q	
5	Loan Book Ratio Trend	≥ 50%	≥ 70% & ≤ 80%	9.00				Q	
6	Savings Deposit Ratio Trend	≥ 50%	≥ 70%	9.00				Q	
7	Non-Earning Asset Ratio Trend	≤ 10%	≤ 5%	9.00				Q	
8	Operating Expense Ratio Trend	≤ 10%	≤ 5%	9.00				Q	
9	Share Dividend Yield	Inflation Rate	>Inflation & Net Capital ≥10%		2.00	4.00	9.00	Q	
10	Analysis of Sources and Uses of Funds by Interest Rate	None	Yes	7.00					S
CREDIT RISK				100.00	A1 <= 5%	A1 <= 10%	A1 > 10%	7	3
1	Loan Delinquency Ratio	≤ 10%	≤ 5%		30.00	0.00	0.00	Q	
2	Delinquency Ratio Stability	Any 1 Year	3 Consecutive Years		9.00	0.00	0.00	Q	
3	Delinquency Ratio Trend	≥ 0.5%	≥ 2%		0.00	9.00	9.00	Q	
4	Repayment Capacity Analysis	None	Yes	9.00					S
5	Improper Restructuring/Refinancing of Delinquent Loans	None	No	9.00					S
6	Charge-Off of Delinquent Loans > 12 Months & Charge-Off Rate	Yes & ≤ 0.20% / yr. of Loan Portfolio	Yes & ≤ 1% / yr. of Loan Portfolio	9.00				Q	
7	Largest Single Loan Concentration Ratio	None	≤ 10%	9.00				Q	
8	Maximum Concentration Ratio of 20 Largest Borrowers	None	≤ 20%	9.00				Q	
9	Largest Institutional Investment Concentration Ratio	None	≤ 20%	9.00				Q	
10	Investments Restricted to Regulated Institutions	None	100%	7.00					S
LIQUIDITY RISK				100.00				4	2
1	Average Net Liquidity @ 90 Days	≥ 10%	≥ 15%	30.00				Q	
2	Mandatory Liquidity Reserve Ratio	None	10.0%	15.00				Q	
3	Maximum Concentration of the 20 Largest Depositors	15% of Total Savings	10% of Total Savings	15.00				Q	
4	Maximum Concentration Ratio of the next 40 Largest Depositors	None	< Backup Sources of Liquidity	15.00					S
5	Maximum Withdrawal Risk Ratio	None	2nd Std Deviation of daily cash withdrawals @ 90 days ≤ Avg. Liquidity @ 90 days	10.00				Q	
6	Maximum Asset/Liability Management GAP Ratio @ 90 Days	None	≥ - 20%	15.00					S
OPERATIONAL RISK				100.00	No. of Questions			11	45
1	VITAL INSTITUTIONAL PROCESSES	Positive (Yes) Answers		49.00		33			33
	Executive HR Administration Process	1	2	7.00		2			S
	Institutional Planning Process	3	5	7.00		5			S
	Savings Mobilization Process	3	5	7.00		5			S
	Liquidity Management Process	3	5	7.00		5			S
	Credit Administration Process	4	6	7.00		6			S
	Internal Control Process	3	5	7.00		5			S
	IT Systems Control Process	3	5	7.00		5			S
2	GOVERNANCE			45.00		21		11	10
	USE OF POWER	8 Yes Answers	13 Yes Answers	17.00		13			
	ANNUAL GENERAL MEETING (AGM)								
	Definition of Role for AGM	None	Yes						S
	BOARD OF DIRECTORS (BOD)								
	Definition of Role for BOD	None	Yes						S
	Profile and Job Description for BOD Members	None	Yes						S

RISK RATING INDICATORS

Annex 2

Description of Risk Area		Indicator		Points Possible				Type of Indicator		
		Minimum	Optimum					Quantitative	Subjective	
OPERATIONAL RISK				No. of Questions						
	Academic Credentials for BOD	None	High School = 100% & College ≥ 25%					Q		
	% of Net Savers on BOD	None	≥ 60%					Q		
	Proper Election of Board Members	None	Yes						S	
	SENIOR MANAGEMENT TEAM (SMT)									
	Definition of Role for General Manager	None	Yes						S	
	Profile and Job Description for SMT Members	None	Yes						S	
	Academic Credentials for SMT	None	High School = 100% & College ≥ 75%					Q		
	% of SMT with a specialized degree in a business-related field	None	≥ 50%					Q		
	Average Tenure of SMT Members at Credit Union	None	≥ 5 years					Q		
	Annual Employee Turnover Ratio	None	≤ 10%					Q		
	360° FEEDBACK									
	Anonymous Internal and External Lines of Communication	None	Yes						S	
	USE OF FINANCIAL RESOURCES	3 Yes Answers	5 Yes Answers	14.00		5				
	AGM									
	Total Annual Expenses of the AGM as a % of Total Operating Expenses	None	≤ 2.00%					Q		
	BOARD OF DIRECTORS (BOD)									
	Average Number of Monthly BOD Meetings	None	≤ 2					Q		
	Total Annual Expenses of the BOD as a % of Total Operating Expenses	None	≤ 2.50%					Q		
	SENIOR MANAGEMENT TEAM (SMT)									
	Ratio of the General Manager's Salary to the Average SMT Salary	None	≤ 2 Times					Q		
	Total Annual Expenses of the General Manager as a % of Total Operating Expenses	None	≤ 3%					Q		
	USE OF PRODUCTS AND SERVICES	2 No Answers	3 No Answers	14.00		3				
	Was there any preferential treatment given to insiders in the approval, disbursement, or collection of loans?	None	No						S	
	Was there any preferential treatment given to insiders related to the interest rates charged on loans and paid on savings deposits, or in the payment of dividends?	None	No						S	
	Was there any preferential treatment given to insiders regarding the sale or disposition of foreclosed assets?	None	No						S	
3	LEGISLATION AND SUPERVISION	1 Yes Answer	2 Yes Answers	6.00		2			2	
	Do credit unions operate under a legal and regulatory framework that is specific to their financial institution?	None	Yes						S	
	Is there a specific in-country regulator that is responsible for the examination and regulation of credit unions?	None	Yes						S	
TOTAL				400.00					31	51

RISK RATING REPORT

Annex 3

Sheet No. 1/5

Description of Indicator	Indicators					Qualification Points					
	Level		Dec-04	Dec-05	Dec-06	Optimum Level	Dec-04	Dec-05	Dec-06		
	Minimum	Optimum									
CAPITAL RISK			No. Indicators	10				100.00	0.00	0.00	36.52
Net Capital Ratio	≥ 5%	≥ 10%			1.89%	30.00				0.00	
Capital Ratio Stability	Any 1 Year	3 Consecutive Years			0	9.00				0.00	
Capital Ratio Trend	≥ 0.5%	≥ 1%			0.00%					0.00	
Total Asset Growth	Inflation	Inflation + 10%			19.82%	9.00				8.46	
Loan Book Ratio Trend	≥ 50%	≥ 70% & ≤ 80%			72.35%	9.00				8.37	
Savings Deposit Ratio Trend	≥ 50%	≥ 70%			53.53%	9.00				5.40	
Non-Earning Asset Ratio Trend	≤ 10%	≤ 5%			6.36%	9.00				7.29	
Operating Expense Ratio Trend	≤ 10%	≤ 5%			14.82%	9.00				0.00	
Share Dividend Yield	Inflation Rate	>Inflation & Net Capital ≥10%			7.62%	9.00				0.00	
Analysis of Sources and Uses of Funds by Interest Rate	None	Yes			Yes	7.00				7.00	
CREDIT RISK			No. Indicators	10				100.00	0.00	0.00	9.00
Loan Delinquency Ratio	≤ 10%	≤ 5%			25.21%	30.00				0.00	
Delinquency Ratio Stability	Any 1 Year	3 Consecutive Years			0	9.00				0.00	
Delinquency Ratio Trend	≥ 0.5%	≥ 2%			0.07%					0.00	
Repayment Capacity Analysis	None	Yes			No	9.00				0.00	
Improper Restructuring/Refinancing of Delinquent Loans	None	No			Yes	9.00				0.00	
Charge-Off of Delinquent Loans > 12 Months & Charge-Off Rate	Yes & ≤ 0.20% / yr. of Loan Portfolio	Yes & ≤ 1% / yr. of Loan Portfolio			No 0.23%	9.00				0.00	
Largest Single Loan Concentration Ratio	None	≤ 10%			32.47%	9.00				0.00	
Maximum Concentration Ratio of 20 Largest Borrowers	None	≤ 25%			5.61%	9.00				9.00	
Largest Institutional Investment Concentration Ratio	None	≤ 20%			59.19%	9.00				0.00	
Investments Restricted to Regulated Institutions	None	100.00%			No	7.00				0.00	
LIQUIDITY RISK			No. Indicators	6				100.00	0.00	0.00	55.00
Average Net Liquidity Ratio @ 90 Days	≥ 10%	≥ 15%			32.40%	30.00				30.00	
Mandatory Liquidity Reserve Ratio	None	10.00%			0.00%	15.00				0.00	
Maximum Concentration Ratio of the 20 Largest Depositors	15% of Total Savings	10% of Total Savings			15.48%	15.00				0.00	
Maximum Concentration Ratio of the next 40 Largest Depositors	None	< Backup Sources of Liquidity			No	15.00				0.00	
% of coverage of backup sources of liquidity					96.77%						
Maximum Withdrawal Risk Ratio	None	2nd Std Deviation of daily cash withdrawals @ 90 days ≤ Avg. Liquidity @ 90 days			Yes	10.00				10.00	
% of coverage of average liquidity					355.07%						
Maximum Asset/Liability Management GAP Ratio @ 90 Days	None	≥ - 20%			-14.73%	15.00				15.00	
OPERATIONAL RISK			No. Indicators	56				100.00	0.00	0.00	26.80
Vital Institutional Processes			Positive (Yes) Answers				49.00				
Executive HR Administration Process	1	2			1	7.00				4.20	
Instutional Planning Process	3	5			2	7.00				0.00	
Savings Mobilization Process	3	5			1	7.00				0.00	
Liquidity Management Process	3	5			0	7.00				0.00	
Credit Administration Process	4	6			0	7.00				0.00	
Internal Control Process	3	5			0	7.00				0.00	
IT Systems Control Process	3	5			4	7.00				5.60	
Governance			Positive (Yes) Answers				45.00				
Use of Power	8	13			9	17.00				9.00	
Use of Financial Resources	3	5			4	14.00				8.00	
Use of Products and Services	2	3			1	14.00				0.00	
Legislation and Supervision			Positive (Yes) Answers								
Legislation and Supervision	1	2			0	6.00				0.00	
Total Indicators			82								
FINAL QUALIFICATION					F		100.00	0.00	0.00	31.83	

RISK RATING REPORT

Credit Union
Complementary Information

Sheet No. 2/5

CAPITAL RISK

Analysis of Sources and Uses of Funds by Interest Rate

Miles of US\$.

ASSETS				LIABILITIES AND CAPITAL				Balance Available or (To Cover)	To Comply (Yes or No)
Income Rate	Accounts	Balance to Cover	Balance Covered	Expense Rate	Accounts	Balance to Use	Balance Used		
0.0%	Non-Earning Assets	178	178	0.0%	Non-Interest Bearing Liab	218	178	40	Yes
0.0%	Non-Financial Investments	160	40	0.0%	Non-Interest Bearing Liab	40	40	(120)	Yes
0.0%	Non-Financial Investments	120	120	0.0%	External Credit	635	120	515	Yes
0.0%	Financial Investments	30	30	0.0%	External Credit	515	30	484	Yes
0.8%	Liquid Investments	614	484	0.0%	External Credit	484	484	(130)	Yes
0.8%	Liquid Investments	130	130	0.0%	Transitory Capital	163	130	33	Yes
36.6%	Loans	2,685	33	0.0%	Transitory Capital	33	33	(2,652)	Yes
36.6%	Loans	2,652	61	0.0%	Institutional Capital	61	61	(2,591)	Yes
36.6%	Loans	2,591	462	7.6%	Member Shares	462	462	(2,129)	Yes
36.6%	Loans	2,129	1,667	9.2%	Savings Deposits	1,667	1,667	(462)	Yes
36.6%	Loans	462	462	0.0%	Allowances	462	462	0	Yes

CREDIT RISK

Institutional Investments Concentration

Miles of US\$.

Investment Concentration in Non-Regulated Institutions

Miles of US\$.

Institution	Balance	% of Total Investments	% of Net Capital	Institution	Balance	% of Total Investments	% of Net Capital
Entity A	18,877	59.19%	31171.56%	Entity A	18,877	100.00%	31171.56%
Entity B	3,247	10.18%	5361.55%	Entity B	0	0.00%	0.00%
Entity C	3,000	9.41%	4954.01%	Entity C	0	0.00%	0.00%
All others (number of entities)	6,767	21.22%		All others (number of entities)	0	0.00%	
Total	31,890			Total	18,877		

LIQUIDITY RISK

Backup Sources of Liquidity

Miles of US\$.

Maximum Withdrawal Risk Analysis

Miles of US\$.

Description	Dec-04	Dec-05	Dec-06	Description	Dec-04	Dec-05	Dec-06
Loans Based in Mandatory Reserves Liqui			0	Maximum Withdrawal Amount			68
Loans Stand By			0	Avg. Cash and Equivalents @ 90 Days			240
Investments > 90 days, that can be cancel			133	% of Coverage			355.07%
Liquidity (L1) > 15% only the difference			6				
Others			0				
Total Backup Sources of Liquidity	0	0	139				
Concentración Siguientes 40 Mayores Depositantes			143				
% de Cobertura de Líneas de Defensa			96.77%				

Maximum Asset/Liability Management (ALM) GAP @ 90 Days

Miles of US\$.

Accounts	≤ 30 Days	≤ 60 Days	@ 90 Days	@ 180 Días	@ One Year	> One Year	No Definite Maturity	Total
Cash and Banks	3,242	-	3,242	3,242	3,242	-	-	3,242
Mandatory Reserves Liquidity	-	-	-	-	-	-	-	-
Loans (Gross)	1,785	3,449	5,235	10,427	20,008	19,712	2,309	42,029
Adjustment by Delinquency (x %)	(98)	(189)	(287)	(572)	(1,098)	(1,082)	-	-
Liquid and Financial Investment	3,012	1,409	4,421	4,431	4,431	-	-	4,431
Accounts Receivable (Gross)	-	403	403	403	403	-	107	510
Adjustment by Delinquency (x %)	-	(14)	(14)	(14)	(14)	-	-	-
Investments in Stocks or Shares	-	-	-	-	-	-	169	169
Fixed Assets Gross	-	-	-	-	-	-	5,281	5,281
Other Assets	-	24	24	24	24	-	282	306
Allowances	-	-	-	-	-	-	-	(8,648)
TOTAL ASSETS	7,942	5,082	13,023	17,941	26,996	18,630	8,147	47,319
Regular Savings	772	1,545	2,317	4,634	9,267	-	16,770	26,037
Term Savings	4,129	7,000	11,129	8,188	8,407	0	(51)	8,356
Other Savings	-	-	-	-	-	-	51	51
External Credit	-	-	-	-	-	-	-	-
Accounts Payable	429	1,214	1,642	1,642	1,642	-	-	1,642
Other Liabilities	-	186	186	186	186	-	-	186
Shares	-	-	-	-	-	-	6,550	6,550
Transitory Capital	-	-	-	-	-	-	3,376	3,376
Institutional Capital	-	-	-	-	-	-	1,120	1,120
TOTAL LIABILITIES AND CAPITAL	5,329	9,944	15,274	14,650	19,502	0	27,817	47,319
DIFFERENCE (Assets - Liabilities & Capital)	2,612	(4,862)	(2,250)	3,291	7,494	18,630	(19,670)	0
GAP (Difference / Liabilities and Capital)	49.02%	-48.90%	-14.73%	22.47%	38.43%	5174870.13%		

RISK RATING REPORT

Credit Union
Vital Institutional Processes

Sheet No. 3/5

Description of Indicator	Indicator					Qualification			
	Positive Answers		Dec-04	Dec-05	Dec-06	Optimum Level	Dec-04	Dec-05	Dec-06
	Minimum	Optimum							
VITAL INSTITUTIONAL PROCESSES						49.00	0.00	0.00	9.80
Executive HR Administration Process	1	2			1	7.00			4.20
Does there exist a job description and qualifications profile for each position on the SMT and does the credit union hire employees on the SMT according to the established profiles?					Yes				
Does there exist measureable criteria to evaluate the performance of the Management Team and is it done at least once a year?					No				
Institutional Planning Process	3	5			2	7.00			0.00
Is there a Strategic Plan (long term vision) and a Business Plan (short term vision) designed by SMT and approved by the BOD					Yes				
Does a complete Business Plan exist that is based on a technical methodology that links financial discipline, operating efficiency, and interest rates together, and also, contains realistic institutional goals, activities and time deadlines?					Yes				
Is a Monitoring System in place and functioning that can evaluate the implementation and progress of approved plans?					No				
Does there exist a reporting format which periodically reviews the advances made against the established plans?					No				
Is there a procedure established to review and adjust existing plans, goals, activities and budgets?					No				
Savings Mobilization Process	3	5			1	7.00			0.00
Does the physical building and its location foster member trust and facilitate savings mobilization?					No				
Does adequate security exist to mobilize savings safely (safe, security guards, alarm systems)?					No				
Do adequate policies and controls exist to properly detect and eliminate money laundering activities?					No				
Does a pricing methodology exist that ties the aggregate interest rate on savings in the business plan to the individual savings products?					No				
Does the CU have a master marketing plan that includes all of its individual product plans, market niches, market studies, and the tools to measure its success?					Yes				
Liquidity Management Process	3	5			0	7.00			0.00
Are there any liquidity management tools used for monitoring (cash flow projections, ALM projections, concentrations of borrowers and savers, etc.), and is there any evidence that they are being properly utilized and implemented?					No				
Does a cash management policy exist to keep daily cash balances at a minimum?					No				
Does the CU have adequate insurance and fidelity bonding to cover external and internal losses from robbery, assault, and employee fraud?					No				
Do adequate investment policy guidelines exist that contain criteria to be followed in the selection of suitable institutions and investment instruments?					No				
Do the liquidity management policies require the establishment of back up sources of liquidity and do they provide adequate protection in the case of unanticipated withdrawals?					No				

RISK RATING REPORT

Credit Union
Vital Institutional Processes

Sheet No. 4/5

Description of Indicator	Indicator					Qualification			
	Positive Answers		Dec-04	Dec-05	Dec-06	Level Optimum	Dec-04	Dec-05	Dec-06
	Minimum	Optimum							
Credit Administration Process	4	6			0	7.00			0.00
Loan Approval & Disbursement									
After interviewing the staff responsible for lending activities, is there a clear congruence between the written credit policies and the daily activities identified by the lending department staff?					No				
After reviewing a random sampling of recently approved loans, are the written credit policies being followed in daily practice?					No				
Administrative Collections									
After interviewing the staff responsible for loan collections, is there a clear congruence between the written credit and collections policies and the daily activities identified by the collections staff?					No				
After reviewing a selective sample of efforts to collect delinquent loans, are the written collection policies being adequately followed in daily practice?					No				
Judicial Collections									
Does there exist written policies regarding the follow-up of delinquent loans in judicial foreclosure, and is there a person assigned to provide the necessary follow-up?					No				
After reviewing a selective sample of loans in judicial foreclosure, are the written policies being followed in daily practice?					No				
Internal Control Process	3	5			0	7.00			0.00
Is there an independent department or person responsible for internal control?					No				
Does a methodology and scope of work exist to promote checks and balances through the use of internal audits?					No				
Is there a checklist of proper reporting and disclosure requirements that should be made by the SMT and the Board of Directors to the Auditors, Regulators, and General Membership?					No				
Are the internal audit reports sent to an external entity, independent of Management?					No				
Does there exist evidence that proper follow up is given to the internal audit reports?					No				
IT Systems Control Process	3	5			4	7.00			5.60
Are there different levels of security clearance required to access the information systems database?					Yes				
Are the various information databases (including accounting) being managed to achieve transparency and trust					No				
Does there exist a backup of the database information systems both internally and externally to protect against unforeseen damage or destruction?					Yes				
Do strategies exist to provide timely access to the database information in the event of systemic failures or power outages?					Yes				
Do effective communications strategies exist to maintain timely contact with Branch offices?					Yes				

RISK RATING REPORT

Credit Union

Analysis of Governance and Legislation and Supervisor

Sheet No. 5/5

Description of Indicator	Indicator					Qualification			
	Level		Dec-04	Dec-05	Dec-06	Optimum Level	Dec-04	Dec-05	Dec-06
	Minimum	Optimum							
GOVERNANCE						45.00	0.00	0.00	17.00
USE OF POWER (Positive Answers)	8	13			9	17.00			9.00
Annual General Meeting (AGM)									
Definition of Role for AGM	None	Yes			Yes				
Board of Directors (BOD)									
Definition of Role for BOD	None	Yes			Yes				
Profile and Job Description for BOD Members	None	Yes			Yes				
Academic Credentials for BOD	None	Yes			Yes				
• Have all of the Board of Directors graduated from High School?		100%			100.0%				
• % of the Board of Directors that have a College Degree		≥ 25%			86.0%				
% of Net Savers on BOD	None	≥ 60%			14.0%				
Are Directors elected to the BOD according to the terms specified in the Bylaws	None	Yes			Yes				
Senior Management Team (SMT)									
Definition of Role for General Manager	None	Yes			Yes				
Profile and Job Description for SMT Members	None	Yes			No				
Academic Credentials for SMT	None	Yes			Yes				
• Did all Management Team Members graduate from High School?		100%			100.0%				
• % of the SMT that have a College Degree		≥ 75%			83%				
% of SMT with a specialized degree in a business-related field	None	≥ 50%			58%				
Average Tenure of SMT Members at Credit Union	None	≥ 5			8				
Annual Employee Turnover Ratio	None	≤ 10%			4.0%				
360° Feedback									
Anonymous Internal and External Lines of Communication	None	Yes			No				
USE OF FINANCIAL RESOURCES (Positive Answers)	3	5			4	14.00			8.00
Annual General Meeting (AGM)									
Total Annual Expenses of the AGM as a % of Total Operating Expenses	None	≤ 2.00%			1.79%				
Board of Directors (BOD)									
Average Number of Monthly BOD Meetings	None	≤ 2			1.00				
Total Annual Expenses of the BOD as a % of Total Operating Expenses	None	≤ 2.50%			3.75%				
Senior Management Team (SMT)									
Ratio of the General Manager's Salary to the Average SMT Salary	None	≤ 2 Times			1.85				
Total Annual Expenses of the General Manager as a % of Total Operating Expenses	None	≤ 3.00%			1.14%				
USE OF PRODUCTS AND SERVICES (Positive Answers)	2	3			1	14.00			0.00
Was there any preferential treatment given to insiders in the approval, disbursement, or collection of loans?	None	No			Yes				
Was there any preferential treatment given to insiders related to the interest rates charged on loans and paid on savings deposits, or in the payment of dividends?	None	No			Yes				
Was there any preferential treatment given to insiders regarding the sale or disposition of foreclosed assets?	None	No			No				
LEGISLATION AND SUPERVISION						6.00	0.00	0.00	0.00
LEGISLATION AND SUPERVISION (Positive Answers)	1	2			0	6.00			0.00
Do credit unions operate under a legal and regulatory framework that is specific to their financial institution?	None	Yes			No				
Is there a specific in-country regulator that is responsible for the examination and regulation of credit unions?	None	Yes			No				

ANNEX 4: PEARLS vs RMT Case Study

The Pearls Monitoring System was created in 1990 as a means to quickly monitor the financial performance of credit unions. It is comprised of 45 quantitative indicators and covers six important areas of financial management: 1.) Protection, 2.) Effective Financial Structure, 3.) Asset Quality, 4.) Liquidity, and 5.) Signs of Growth. PEARLS is very efficient because all of the indicators are quantitative and can be computed without any subjective judgment or on-site field visits. The cost-savings of this advantage are substantial. Sometimes however, the financial information is not reliable and false conclusions can be reached result unless there is an on-site field visit.

In the attached case study, the delinquency numbers were incorrect, and so some of the other numbers and ratios were also affected. The main problem was the delinquency rate was reported to be 14.1% but was really 25.21%. The higher delinquency ratio affected the net capital position which was reported to be 8.90% but was really 1.89%. Notwithstanding this problem, there were other problem areas detected that were correct: high operating expenses, low dividend rate on shares, inadequate net income and return on assets (ROA), and decreasing membership. The overall conclusion was the same.

The Risk Rating Report found in Annex 4C is comprised of 82 indicators, of which only 11 indicators are the same as PEARLS. While PEARLS looks only at financial performance, the RMT looks are four critical risk areas: Capital Risk, Credit Risk, Liquidity Risk, and Operational Risk. Since 62% of the RMT indicators are subjective, an on-site inspection and analysis is required. This means more time and more cost, but also, more opportunity to dig deeper and uncover hidden problems.

The value added of the RMT is best seen in the same case study. While PEARLS detected a high delinquency ratio and low capital ratio, the RMT uncovered more serious problems that most likely explain why the delinquency ratio is higher. For example, in the area of credit risk, the credit union only scored 8 points out of a total of 100. Besides, delinquency, there is a serious problem with repayment capacity analysis, improper restructuring of delinquent loans, and large loan concentrations. These issues add a much greater dimension of risk than just the delinquency rate.

In the area of liquidity risk, PEARLS detected the absence of a mandatory liquidity reserve fund, while the RMT uncovered concentrations of large depositors and no back-up sources of liquidity in the event of a accelerated withdrawals. The total score for liquidity risk was only 55 points out of 100 possible.

In the area of Operational Risk, PEARLS was silent while the RMT analyzed the vital institutional processes and governance. The consolidated score for operational risk was only 26.80 points out of 100. There were serious problems with 6 out of 7 of the vital institutional processes. The credit union scored only 8 correct answers out 33 questions. In summary, the RMT and PEARLS complement each other. PEARLS is fast and easy while the RMT takes longer and is more difficult, but the additional risk profiles produce a more comprehensive assessment.

ANNEX 4B

Based on US\$

P-E-A-R-L-S RATIOS

Annual Goal

P-E-A-R-L-S RATIOS

Goals (Excellence)

Dec-01

Dec-02

Dec-03

Dec-04

Dec-05

Dec-06

P PROTECTION

1 Loan Loss Allowances / Delinq. >12 Mo.	100%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
2 Net Loan Loss Allow. / WOCCU Allow. Required for Delinq. 1-12 Mo.	35%	46.38%	37.65%	37.12%	36.65%	203.07%	86.55%
2X. Net Loan Loss Allow. / User Allow. Required for Delinq. 1-12 Mo.	100%	132.50%	107.57%	106.06%	104.71%	580.21%	247.29%
3 Complete Loan Charge-Off of Delinquency > 12 Mo.	Yes	Yes	Yes	Yes	Yes	Yes	No
4 Annual Loan Charge-offs / Average Loan Portfolio	Minimized	-14.72%	0.41%	1.38%	-0.05%	0.15%	0.23%
5 Accum. Charge-Offs Recovered / Accum Charge-Offs	>75%	19.57%	23.10%	16.28%	22.77%	22.83%	28.94%
6 Solvency	>=111%	123.74%	119.96%	111.13%	116.90%	125.53%	123.77%

E EFFECTIVE FINANCIAL STRUCTURE

1 Net Loans / Total Assets	70-80%	84.32%	78.43%	76.62%	79.76%	73.59%	70.50%
2 Liquid Investments / Total Assets	<=16%	8.80%	12.15%	17.13%	12.94%	14.95%	18.44%
3 Financial Investments / Total Assets	<=2%	1.25%	1.07%	0.85%	0.77%	0.68%	0.92%
4 Non-Financial Investments / Total Assets	0%	0.00%	0.00%	0.00%	0.00%	2.42%	4.80%
5 Savings Deposits / Total Assets	70 - 80%	59.45%	65.63%	70.46%	70.28%	54.90%	50.06%
6 External Credit / Total Assets	0-5%	2.14%	0.16%	0.00%	0.00%	10.26%	19.06%
7 Member Share Capital / Total Assets	<=20%	12.63%	9.35%	8.00%	2.58%	13.49%	13.87%
8 Institutional Capital / Total Assets	>=10%	14.94%	9.81%	5.57%	9.44%	9.24%	4.17%
9 Net Institutional Capital / Total Assets	>=10%	15.72%	9.98%	5.65%	9.50%	15.61%	8.90%

A ASSET QUALITY

1 Total Delinquency / Gross Loan Portfolio	<=5%	7.81%	7.57%	4.77%	4.88%	4.66%	14.10%
2 Non-Earning Assets / Total Assets	<=5%	5.64%	8.35%	5.41%	6.53%	8.36%	5.34%
3 Net Zero Cost Funds / Non-earning. Assets	>=200%	471.19%	299.60%	399.98%	416.38%	531.65%	406.68%

R RATES OF RETURN AND COSTS (ANNUALIZED)

1 Net Loan Income / Average Net Loan Portfolio	Entrepreneurial Rate	1.54%	31.85%	31.89%	28.66%	35.17%	35.59%
2 Liquid Inv. Income / Avg. Liquid Investments	Market Rates	0.08%	1.35%	1.12%	1.22%	1.13%	0.84%
3 Fin. Investment Income / Avg. Fin. Investments	Market Rates	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
4 Non-Fin. Inv. Income / Avg. Non-Fin. Investments	>=R1	NA	NA	NA	NA	0.00%	0.00%
5 Fin Costs: Savings Deposits / Avg. Savings Deposits	Market Rates, > Inflation	0.30%	8.22%	9.04%	8.86%	8.79%	9.21%
6 Fin Costs: External Credit / Avg. External Credit	Market Rates	0.37%	7.06%	0.00%	NA	0.00%	0.00%
7 Fin Costs: Member Shares / Avg. Member Shares	Market Rates, > R5	0.42%	50.21%	48.22%	84.10%	6.39%	7.62%
8 Gross Margin / Average Assets	^E9=10%	1.08%	15.49%	14.65%	12.59%	21.55%	20.88%
9 Operating Expenses / Average Assets	<=5%	0.44%	9.48%	9.68%	9.82%	17.46%	14.33%
10 Provisions for Risk Assets / Average Assets	^P1=100%, ^P2=35%	0.06%	0.68%	1.06%	0.24%	1.99%	4.86%
11 Other Income or Expense / Average Assets	Minimized	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
12 Net Income / Average Assets (ROA)	^E9=10%	0.58%	5.34%	3.92%	2.54%	2.11%	1.69%
13 Net Income / Avg. Inst. Cap (ROC)	>Inflation	4.53%	34.66%	35.32%	23.77%	18.14%	15.74%

L LIQUIDITY

1 Liquid Assets - ST Payables / Total Deposits	15-20%	14.93%	18.58%	24.37%	18.54%	17.85%	32.40%
2 Liquidity Reserves / Total Savings Deposits	10%	10.00%	10.18%	17.22%	14.57%	0.00%	0.00%
3 Non-Earning Liquid Assets / Total Assets	<1%	0.08%	0.06%	0.05%	0.09%	0.27%	0.43%

S SIGNS OF GROWTH (Year-To-Date Growth Rates)

1 Net Loans	^E1=70-80%	-97.38%	47.85%	48.79%	35.91%	7.96%	14.78%
2 Liquid Investments	^E2<=16%	-97.04%	119.54%	114.68%	-1.33%	35.11%	47.85%
3 Financial Investments	^E3<=2%	-94.74%	36.54%	21.14%	17.71%	4.09%	60.39%
4 Non-Financial Investments	^E4=0%	0.00%	0.00%	0.00%	0.00%	100.00%	137.84%
5 Savings Deposits	^E5=70-80%	-97.18%	75.50%	63.50%	30.23%	-8.60%	9.25%
6 External Credit	^E6=0-5%	-99.38%	-88.25%	-100.00%	0.00%	100.00%	122.73%
7 Member Shares	^E7<=20%	-97.77%	17.68%	30.33%	-57.82%	510.52%	23.22%
8 Institutional Capital	^E8>=10%	-92.33%	4.42%	-13.63%	121.40%	14.50%	-45.95%
9 Net Institutional Capital	^E9>=10%	-92.12%	0.89%	-13.82%	119.81%	92.14%	-31.69%
10 Membership	>=15%	19.26%	40.47%	95.37%	41.45%	3.76%	-34.46%
11 Total Assets	>Inflation + 10%	-97.32%	58.96%	52.30%	30.56%	17.00%	19.82%

#NAME?

> Greater Than

< Less Than

^ Amount Needed

Inflation Rate (Annualized) 10% in 2006

RISK RATING REPORT

Description of Indicator	Indicator					Qualification					
	Level		Dec-04	Dec-05	Dec-06	Optimum Level	Dec-04	Dec-05	Dec-06		
	Minimum	Optimum									
CAPITAL RISK			No. Indicators	10				100.00	0.00	0.00	36.52
Net Capital Ratio	≥ 5%	≥ 10%			1.89%	30.00				0.00	
Capital Ratio Stability	Any 1 Year	3 Consecutive Years			0	9.00				0.00	
Capital Ratio Trend	≥ 0.5%	≥ 1%			0.00%					0.00	
Total Asset Growth	Inflation	Inflation + 10%			19.82%	9.00				8.46	
Loan Book Ratio Trend	≥ 50%	≥ 70% & ≤ 80%			72.35%	9.00				8.37	
Savings Deposit Ratio Trend	≥ 50%	≥ 70%			5.53%	9.00				5.40	
Non-Earning Asset Ratio Trend	≤ 10%	≤ 5%			6.36%	9.00				7.29	
Operating Expense Ratio Trend	≤ 10%	≤ 5%			14.82%	9.00				0.00	
Share Dividend Yield	Inflation Rate	>Inflation & Net Capital ≥10%			7.62%	9.00				0.00	
Analysis of Sources and Uses of Funds by Interest Rate	None	Yes			Yes	7.00				7.00	
CREDIT RISK			No. Indicators	10				100.00	0.00	0.00	9.00
Loan Delinquency Ratio	≤ 10%	≤ 5%			25.21%	30.00				0.00	
Delinquency Ratio Stability	Any 1 Year	3 Consecutive Years			0	9.00				0.00	
Delinquency Ratio Trend	≥ 0.5%	≥ 2%			0.07%					0.00	
Repayment Capacity Analysis	None	Yes			No	9.00				0.00	
Improper Restructuring/Refinancing of Delinquent Loans	None	No			Yes	9.00				0.00	
Charge-Off of Delinquent Loans > 12 Months & Charge-Off Rate	Yes & ≤ 0.20% / yr. of Loan Portfolio	Yes & ≤ 1% / yr. of Loan Portfolio			No 0.23%	9.00 9.00				0.00	
Largest Single Loan Concentration Ratio	None	≤ 10%			32.47%	9.00				0.00	
Maximum Concentration Ratio of 20 Largest Borrowers	None	≤ 20%			5.61%	9.00				9.00	
Largest Institutional Investment Concentration Ratio	None	≤ 20%			59.19%	9.00				0.00	
Investments Restricted to Regulated Institutions	None	100.00%			No	7.00				0.00	
LIQUIDITY RISK			No. Indicators	6				100.00	0.00	0.00	55.00
Average Net Liquidity Ratio @ 90 Days	≥ 10%	≥ 15%			32.40%	30.00				30.00	
Mandatory Liquidity Reserve Ratio	None	10.00%			0.00%	15.00				0.00	
Maximum Concentration Ratio of the 20 Largest Depositors	15% of Total Savings	10% of Total Savings			15.48%	15.00				0.00	
Maximum Concentration Ratio of the next 40 Largest Depositors	None	< Backup Sources of Liquidity			No	15.00				0.00	
% of coverage of backup sources of liquidity					96.77%						
Maximum Withdrawal Risk Ratio	None	2nd Std Deviation of daily cash withdrawals @ 90 days ≤ Avg. Liquidity @ 90 days			Yes	10.00				10.00	
% of coverage of average liquidity					355.07%						
Maximum Asset/Liability Management GAP Ratio @ 90 Days	None	≥ - 20%			-14.73%	15.00				15.00	
OPERATIONAL RISK			No. Indicators	56				100.00	0.00	0.00	26.80
Vital Institutional Processes	Positive (Yes) Answers										
Executive HR Administration Process	1	2			1	7.00				4.20	
Institutional Planning Process	3	5			2	7.00				0.00	
Savings Mobilization Process	3	5			1	7.00				0.00	
Liquidity Management Process	3	5			0	7.00				0.00	
Credit Administration Process	4	6			0	7.00				0.00	
Internal Control Process	3	5			0	7.00				0.00	
IT Systems Control Process	3	5			4	7.00				5.60	
Governance	Positive (Yes) Answers										
Use of Power	8	13			9	17.00				9.00	
Use of Financial Resources	3	5			4	14.00				8.00	
Use of Products and Services	2	3			1	14.00				0.00	
Legislation and Supervision	Positive (Yes) Answers										
Legislation and Supervision	1	2			0	6.00				0.00	
Total Indicators			82								
TOTAL QUALIFICATION						F	100.00	0.00	0.00	31.83	