

Bulletin CU-02-1

TO: ALL TENNESSEE STATE CHARTERED CREDIT UNIONS
SUBJECT: INFORMATION ON THE RISK-FOCUSED EXAMINATION PROGRAM
DATE: September 23, 2002

The Tennessee Department of Financial Institutions is in the process of implementing the National Credit Union Administration's "Risk-Focused Examination Program." The purpose of this bulletin is to provide information regarding the new examination process that focuses on the seven risk factors that impact your CAMEL rating. The risk-focused process is designed to be forward-looking, with more focus on management's ability to identify and monitor current and potential areas of risk. Failure to properly manage these risk factors can reduce earnings and net worth.

The risk-focused program is based on examiners monitoring credit union risk profiles. The risk profile is made up of seven specific categories of risk. The first three categories of risk (credit, interest rate, and liquidity) are familiar terms. They can be assessed using objective financial data, combined with management's awareness and ability to control the risk.

- **Credit Risk** – the risk of non-repayment where the credit union invests or loans funds.
- **Interest Rate Risk** – the risk that changes in market rates will not be adequately managed to maintain an appropriate net interest margin.
- **Liquidity Risk** – the risk the credit union will not be able to liquidate assets quickly and with minimal loss in value to meet its obligations.

The last four categories of risk (transaction, compliance, strategic, and reputation) are more subjective and are difficult to measure using financial data. They must be evaluated in terms of the credit union's control structure and risk management systems.

- **Transaction Risk** – the risk that fraud or errors will cause a loss. This risk is a function of internal controls, information systems, employee integrity, and operating processes.
- **Compliance Risk** – the risk that failure to comply with laws and regulations, prudent ethical standards, and contractual obligations will harm the credit union.
- **Strategic Risk** – the risk that poor business decisions or improper implementation of strategic goals will reduce earnings and net worth.
- **Reputation Risk** – the risk that the credit union's public image will be tarnished due to improper actions on the part of officials, management, or staff.

Each of the seven categories will be assessed a risk level (High, Moderate, or Low) reflecting the current and anticipated risk to earnings and capital. Examiners focus the examination on only those risk areas determined pose the greatest risk to the credit union. Examination Overview comments

highlight areas that present more than a normal degree of risk. Additional comments related to these areas can be found in the pages following the overview. These pages may include Supplementary Facts, Examiner's Findings, Document of Resolution, and Loan Exceptions sections of the Report of Examination.

We believe you will find increased value in this new exam program, and we welcome your feedback as you have the opportunity to experience the risk-focused examination approach. We will continue to improve the program as it evolves into an even more effective approach for the Department and the credit unions we regulate.

If you have any questions, please feel free to contact our office at (615)741-5608.