Risk Offset

Assessment Criteria

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INTRODUCTION

Credit Union Deposit Guarantee Corporation's (the Corporation) Supervisory Framework and processes serve as an early identification and warning system that is designed to protect the interests of all stakeholders. Risk-based supervisory approaches are focused on evaluating a credit union's and SaskCentral's risks and the management of those risks, either through mitigation or through increased risk offset, to ensure that there are no undue or excessive exposures that could jeopardize the safety and soundness of a provincially regulated institution. This system furnishes the Corporation and institutions with information that supports proactive identification and resolution of issues before they escalate into a costly or unmanageable crisis.

This document represents the assessment criteria to be used in evaluating the adequacy of a provincially regulated institution's Capital, Earnings and Liquidity Risk Offsets. These three components, taken together, encompass the total risk offset and are used to determine an institution's overall risk profile, or Composite Risk Rating.

The primary objective of the assessment criteria is to ensure that institutions have an appropriate cushion available to support operations, risks and growth. Assessment criteria for Capital, Earnings and Liquidity reflect both a qualitative and quantitative approach to arriving at a rating for risk offset. The qualitative components include an organization's management of capital, earnings and liquidity and the appropriateness of current and prospective levels of risk offset. The Corporation will assess whether Capital, Earnings and Liquidity are, and will continue to be, adequate to maintain the safety and stability of the institution.

Capital is very important, but cannot be considered a substitute for weak oversight functions or risk management. High levels of capital cannot compensate for material flaws in risk management practices. However, it may be undesirable to fully mitigate risk and it is expected that institutions will hold additional capital, beyond regulatory minimums, to minimize any future negative impact of the residual or unmitigated risks.

The following are key points that are helpful to understanding the assessment criteria and how the Corporation applies them, based on an institution's unique circumstances.

1. Assessment criteria should be read in conjunction with the Corporation's Supervisory Framework, Standards of Sound Business Practice (the Standards), directives and guidance or the prudential standards. Credit unions and SaskCentral are expected to comply with all applicable legislation and regulatory requirements. Assessment criteria are designed to objectively assess the degree to which an organization is being managed and operated within prudential legislation, and in accordance with regulatory requirements. Assessment criteria are not a replacement, or a substitute, for legislation or regulatory requirements.

2. Assessment criteria represent a high-level overview of "what" the Corporation will be evaluating. It does not provide the details of "how" the Corporation will go about measuring the specifics within the components of risk offset.

3. Capital, earnings and liquidity evaluations are made within the context of the nature, scope, complexity and risk profile of the institution. Assessment criteria and ratings are deliberately framed to provide a flexible and scalable framework that is able to reflect the unique circumstances of each organization. To support this, they include terms such

as “adequacy of”, “appropriateness of” and “extent to which”. This allows the rating to be scaled taking into account the nature, scope, complexity and risk profile of each provincially regulated institution. Sound judgment is essential in applying criteria to the unique circumstances of each organization.

4. Capital, earnings and liquidity are assessed in relation to the institution’s overall net risk. Institutions with higher overall net risk are expected to maintain a higher level and quality of capital and liquidity, stronger capital and liquidity management processes, and generate a higher quality, quantity and consistency of earnings. Larger institutions generally have the capacity to implement processes, practices and controls to effectively mitigate risk. Smaller institutions may not have the same capacity and, as a result, may have higher overall net risk.

5. Assessment criteria presented do not serve as a checklist to which a credit union or SaskCentral is expected to comply. They serve as an internal tool that guides the Corporation’s analytical processes necessary to objectively assess the degree to which an institution is being prudently governed, managed and operated. Ratings assigned are based on actual findings and observations from supervisory activities.

6. Not all assessment criteria will be applicable to all institutions. When an institution believes one does not apply, the Corporation may challenge the institution’s reasoning by seeking responses to the following types of questions:
   - Why does the organization believe the criterion is not applicable?
   - What rationale was used to arrive at that conclusion?
   - Was due consideration given to the risks?
   - Through its analysis, did the organization arrive at a more appropriate way to manage the same types of risks?
   - How has the approach worked?

7. Assessment criteria and ratings are driven by generally accepted industry practices. The term “generally accepted practices” is not a reference to codified standards, but to practices observed by the Corporation to be in general use within the industry, and which the Corporation considers acceptable, including meeting all legal and regulatory requirements and expectations. It is important to note that generally accepted practices often evolve to incorporate new and emerging practices.

8. Assessment criteria that speak to “policies” refer to the guiding principles by which an institution conducts its activities. An institution’s regular or usual practices are derived from these principles, whether written or unwritten.

For more information related to regulatory requirements and expectations for risk offset, credit unions should refer to section sections 2.1 (Financial Management), 3.1 (Capital and Profitability Management) and 3.2 (Liquidity) of the Standards of Sound Business Practice, as well as regulatory directives and guidance. SaskCentral should refer to the prudential standards.

CAPITAL

ROLE OF CAPITAL

The role of capital is to provide financial support to protect an institution against unexpected losses. Capital management is the on-going process of building and maintaining capital at levels sufficient to support planned operations and unexpected events. It also involves the allocation of capital to recognize the level of risk in various activities.

Capital adequacy is assessed based on the appropriateness of its level and quality, both at present and prospectively. Capital management is assessed based on the effectiveness of the institution's processes for maintaining adequate capital to support planned operations and growth, as well as offset risks across all significant activities.

CAPITAL ASSESSMENT CRITERIA

1. **Capital Adequacy**
   a) adequacy of the level of capital in relation to regulatory minimums and targets
   b) adequacy of the level of capital in relation to the organization's risk profile and internal targets, under both normal and stressed conditions
   c) adequacy of the level of capital to support planned business activities and unexpected events
   d) appropriateness of the types and mix of capital components, and the level of high-quality capital

2. **Capital Management Policies and Practices**
   a) extent to which capital management policies and practices are enterprise-wide and supported by sufficient authority and resources
   b) appropriateness of the process for developing capital management policies and practices
   c) appropriateness of capital management policies and practices
   d) extent to which the capital management process provides for an appropriate level of stress testing under different scenarios, including possible events or changes in environmental conditions that could adversely impact the organization
   e) adequacy of the capital plan
   f) extent to which the capital planning process is integrated with the organization's strategic and business plans and provides for regular monitoring to ensure that it continues to meet regulatory minimum capital requirements and internal targets
   g) adequacy of the Internal Capital Adequacy Assessment Process (ICAAP)

QUALITY RATINGS

Strong

Capital adequacy is strong for the nature, scope, complexity and risk profile of the institution, and meets regulatory expectations. The trend in capital adequacy is expected to remain positive. Capital management policies and practices are superior to generally accepted industry practices.

Acceptable
Capital adequacy is appropriate for the nature, scope, complexity and risk profile of the institution, and meets regulatory expectations. The trend in capital adequacy is expected to remain positive. Capital management policies and practices meet generally accepted industry practices.

Needs Improvement
Capital adequacy may not be appropriate for the nature, scope, complexity and risk profile of the institution and, although meeting regulatory minimum requirements, may not meet, or is trending below, regulatory expectations. The trend in capital adequacy is expected to remain uncertain. Capital management policies and practices may not meet generally accepted industry practices.

Weak
Capital adequacy is inappropriate for the nature, scope, complexity and risk profile of the institution, and does not meet, or marginally meets regulatory minimum requirements. The trend in capital adequacy is expected to remain negative. Capital management policies and practices do not meet generally accepted industry practices.

EARNINGS

ROLE OF EARNINGS

The role of earnings is to absorb normal and expected losses in a given period and provide a source of financial support by contributing to the institution's internal generation of capital. Adequate earnings are vital to an institution's long-term viability.

Earnings are assessed based on their quantity and consistency and their ability to ensure the institution's long-term viability. The assessment takes into consideration both historical trends and the future outlook, under both normal and stressed conditions.

EARNINGS ASSESSMENT CRITERIA
1. Historical Trends, Level and Composition a) adequacy of the level of earnings in relation to the organization's risk profile and internal targets b) trend and volatility of earnings c) level of, and reasons for, earnings variances to plan d) extent to which sources of income are diversified e) extent to which earnings are from non-recurring sources of income f) profitability and earnings trends compared to peers **2. Future Outlook** a) vulnerability of earnings to competition b) extent to which the organization's earnings may be affected by an economic downturn or market event c) extent to which the organization's earnings ensure its long-term viability

QUALITY RATINGS

The following statements describe the rating categories used in assessing the components of earnings risk offset. The components assessed include the quantity, consistency and outlook of earnings.

Strong
Earnings performance is consistent, producing returns that significantly contribute to the institution's long-term viability, and there is no undue reliance on non-recurring sources of income to enhance earnings. The earnings outlook is expected to remain positive.

Acceptable
Earnings performance is satisfactory, producing returns needed to ensure the institution's long-term viability, and there is no undue reliance on non-recurring sources of income to enhance earnings. Although there is some exposure to earnings volatility, the earnings outlook is expected to remain positive.

Needs Improvement
Earnings performance is inconsistent, with returns that, at times, may be inadequate to ensure the institution's long-term viability. The earnings outlook is uncertain.

Weak
Earnings performance is consistently negative, producing operating losses or earnings that are insufficient to ensure the institution's long-term viability. The earnings outlook is expected to remain negative.

LIQUIDITY

ROLE OF LIQUIDITY

The role of liquidity is to ensure an institution's ability to meet its on- and off-balance sheet commitments. Liquidity management is the on-going process of building and maintaining liquidity at levels sufficient to support planned operations and unexpected events.

The assessment is made based on the quality, quantity and consistency of current and potential liquidity sources, both at present and prospectively. Liquidity management is assessed based on the effectiveness of the institution's processes for obtaining funds to meet its on- and off-balance sheet obligations, under both normal and stressed conditions.

LIQUIDITY ASSESSMENT CRITERIA

1. **Liquidity Adequacy**
    a) level of liquidity risk in relation to industry standards and regulatory expectations
    b) level of liquidity risk in relation to the organization's internal targets
    c) adequacy of the level of liquidity to support planned business activities and unexpected events
    d) appropriateness and volatility of funding sources

2. **Liquidity Risk Management Policies and Practices**
    a) extent to which liquidity risk management policies and practices are enterprise-wide and supported by sufficient authority and resources
    b) appropriateness of the process for developing liquidity risk management policies and practices
    c) appropriateness of liquidity risk management policies and practices
    d) extent to which the liquidity risk management process provides for an appropriate level of stress testing under different scenarios, including possible events or changes in environmental conditions that could adversely impact the organization
    e) adequacy of the liquidity plan
    f) extent to which the liquidity planning process is integrated with the organization's strategic and business plans and provides for regular monitoring to ensure that it continues to meet regulatory expectations and internal targets

QUALITY RATINGS

The following statements describe the rating categories used in assessing the components of liquidity risk offset. The components assessed include the quality, quantity and consistency of liquidity sources and liquidity management.

Strong
The level of liquidity risk is low for the nature, scope, complexity and risk profile of the institution, and meets regulatory expectations. Funding sources are appropriate and expected to remain stable. Liquidity management policies and practices are superior to generally accepted industry practices.

Acceptable
The level of liquidity risk is appropriate for the nature, scope, complexity and risk profile of the institution, and meets regulatory expectations. Funding sources are appropriate and expected to remain stable. Liquidity management policies and practices meet generally accepted industry practices.

Needs Improvement
The level of liquidity risk may not be appropriate for the nature, scope, complexity and risk profile of the institution, and is trending below regulatory expectations. Funding sources may not be appropriate or expected to remain volatile. Liquidity management policies and practices may not meet generally accepted industry practices.

Weak
The level of liquidity risk is inappropriate for the nature, scope, complexity and risk profile of the institution, and does not meet regulatory expectations. Funding sources are not appropriate. Liquidity management policies and practices do not meet generally accepted industry practices.