Risk Management Guidelines
For
Co-operative Financial Institutions
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1 PREAMBLE

1.1. CFIs, like any other banking institutions, are exposed to a variety of risks including credit, interest rate, liquidity and operational risk. Failure to adequately manage these risks exposes CFIs not only to the possibility that they may suffer losses, but, more importantly, to the possibility that they may not achieve their strategic business objectives. In the worst case, inadequate attention to risk management may result in circumstances so catastrophic that the CFIs cannot remain in business resulting in depositors losing their savings.

1.2. The focus of CFIs has been traditionally on operational aspects, with attention to risk mainly directed towards credit risk. It is clear, however, that attention to all types of risk is critical, moreso as the CFIs adopt innovative technological products and related financial innovation. Inadequate risk management can expose a CFI to litigation, financial loss or damage to its reputation. Therefore, it is imperative that CFIs take the responsibility to carefully evaluate all types and levels of risk in their business operations and activities.

1.3. To facilitate a consistent approach to risk management, the adoption of international best practice (Basel Core Principles for Effective Supervision of Microfinance Institutions), and the risk based supervision approach adopted by the Supervisors of CFIs, the Supervisors have prepared this set of guidelines which provides minimum requirements for sound risk management practices. These guidelines encompass the management of credit, interest rate, liquidity, operational, legal & compliance, strategic and reputational risks; and include guidelines on sound internal controls. The Supervisors expect CFIs to have in place appropriate mechanisms to manage risk that adequately identifies, measures, monitors and controls risk.

1.4. These guidelines emphasize four key pillars of a sound risk management framework, namely, adequate board and management oversight, sound risk management policies and operating procedures, adequate management information systems, strong risk measurement, monitoring and control capabilities and adequate internal controls.
1.5. The principles recommended in these guidelines, which are based on best practices, are not intended to be exhaustive or to prescribe a uniform set of risk management requirements for all CFIs. CFIs shall be cognizant that the sophistication of the process, and internal controls used to manage risks, depends on the nature, scale and complexity of their activities.

1.6. The nature of CFI business requires sound internal controls. It is against this background that the first part of the guidelines is on internal controls, which transcend all the risk types. The rest of the guideline is organized by risk type namely credit, interest rate, liquidity, operational, legal and compliance, strategic and reputational risks.

2 INTERNAL CONTROL ENVIRONMENT WITHIN A CFI

2.1 Introduction
a) A system of effective internal controls is a critical component of a CFI's risk management framework.
b) Internal controls are the policies, procedures and processes established by the board and management to provide reasonable assurance on the safety, effectiveness and efficiency of the institution's operations, the reliability of financial and managerial reporting, and compliance with regulatory requirements.
c) An effective internal control system is a fundamental mechanism for reducing the scope of risks faced by the CFI.

2.2 Internal Control Environment
a) The following elements constitute a sound internal control environment:

2.2.1 Constitution
a) The constitution of a CFI is the document which contains all the rules for how a CFI shall be structured and managed. The constitution must include regulations about general matters, membership, meetings, management and finances.
b) The Board of Directors of a CFI are required to follow all the rules and procedures laid down in the constitution and ensure that the general membership are conversant with the requirements of the constitution.

c) Each CFI must have in place a detailed constitution that complies with the Co-operatives Act of 2005, in particular section 14 and 15. Secondary and tertiary co-operatives must adopt a constitution that complies with sections 14 and 16 of the same Act. In addition to the requirements of the Co-operatives Act, the CFI's constitution must also be aligned with the requirements of Section 13 of the Co-operative Banks Act No 40 of 2007.

2.2.2 Annual General Meeting (AGM)

a) Every year, a CFI shall hold an Annual General Meeting (AGM) of the membership. As a co-operative, CFIs are legally obligated to do so. In addition, it gives the members an opportunity to hear about how institution is doing and allows members a chance to provide management and the board with feedback on the operations of the co-operative.

b) During such meetings, the Board of Directors and Managers present reports to the membership on the performance of the CFI. It also allows the general membership to participate in the risk management processes of the CFI by being elected into the board committees.

2.2.3 Board and Management Oversight

a) The board of directors has the ultimate responsibility for ensuring that an adequate and effective system of internal controls is established and maintained. In this regard, the board’s mandate in relation to internal controls shall include:

   i. Ensuring that management has developed and implemented a properly structured internal control system;
   ii. Periodic discussions with management concerning the effectiveness of the internal control system;
iii. Timely reviews of evaluations of internal controls performed by management, internal auditors, and external auditors;

iv. Periodic checks to ensure that management has promptly followed up on recommendations and concerns expressed by auditors and supervisory authorities on internal control weaknesses; and

v. Periodic reviews of the appropriateness of the CFI’s strategy and risk limits.

b) On the other hand, management shall implement the strategies and policies approved by the board; develop processes that adequately identify, measure, monitor and control risks faced by the CFI.

c) Further, management shall maintain an organisational structure that clearly assigns responsibility, authority and reporting relationships and ensure that delegated responsibilities are effectively carried out.

2.2.4 Policies and procedures

a) Every CFI shall have comprehensive and sound policies, approved by the Board, for prudent management of significant risks arising from its business activities. The approved policies shall be consistent with the nature, complexity and scale of the CFI’s activities. The institution shall have a clear delineation of roles, responsibilities and accountability for the implementation of consistent policies across the institution.

b) The CFI shall establish appropriate procedures and processes to implement its policies. These shall be documented in procedure manuals. The manuals shall be periodically reviewed to ensure that they reflect current practices.

c) There shall also be adequate systems to monitor compliance with established policies and procedures. Deviations from such policies and procedures shall be independently investigated, reported and addressed by the relevant parties.

2.2.5 Code of conduct

a) Co-operative principles require ethical behavior. Thus CFIs shall conduct its activities with prudence and integrity at all times. In this regard, the CFI shall
establish a code of conduct that is commensurate with its structure and complexity of operations as well as paying due attention to the co-operative principles.

b) The code of conduct shall state the ethical values of the institution and prescribe guidelines for employees to observe when discharging their duties. The code shall cover areas such as acceptance of gifts and entertainment, conflicts of interest, and safeguarding confidentiality of information.

c) An institution shall ensure that all personnel understand and adhere to the code of conduct. The code shall come under the purview of a senior staff member or an appropriate committee. Employees shall be required to acknowledge in writing that they have read, understood and would observe the code. Disciplinary actions shall be taken against those who breach the requirements.

d) The board or management shall periodically review the code of conduct to incorporate changes in the internal and external environment.

2.2.6 Delegation of Authority

a) CFIs shall clearly define the responsibilities and levels of authority required in relation to various types of activities and exposures for accountability purposes. Approval limits assigned to personnel shall be commensurate with their seniority and responsibilities.

b) The delegation of authority needs to be clearly documented and shall specify, among others, the specific authority being delegated, the authority of recipients to further delegate authority, and restrictions placed on the exercise of delegated authority.

2.2.7 Segregation of Duties

a) Institutions shall ensure adequate segregation of duties to mitigate the risk of unauthorised transactions or fraudulent activities. Management is responsible for ensuring that staff is not assigned incompatible duties which may allow a CFI’s data to be manipulated for personal gain, or for irregularities or financial losses to be concealed.
b) Wherever possible, CFIs shall conduct periodic reviews of the responsibilities of key personnel to minimise areas of potential conflict of interest and ensure independent checks are in place.

2.2.8 Audits

a) Every CFI shall be subject to an independent audit by external auditors at least annually. The Supervisory Committee shall review the risk management process and internal controls periodically, and scale the audit frequency according to the level of risk.

b) Results of audits and reviews by the supervisory committee or other persons and management responses or comments shall be adequately documented.

2.2.9 Compliance

a) CFIs shall take a proactive view of their compliance responsibilities by ensuring sufficient oversight of their compliance issues.

b) Anomalies detected or instances of staff’s failure to address compliance issues in a responsible manner shall be promptly escalated to management or the Supervisory committee for action.

2.2.10 Other elements of the control environment

a) Succession planning processes that are linked with strategic plans shall be developed to ensure business continuity.

b) Personnel policies requiring staff in key areas to be rotated regularly to facilitate timely detection of unauthorised transactions and other irregularities, shall be developed and approved by the board.

c) A CFI shall have adequate procedures for centralising, recording, investigating and monitoring complaints from customers which could be symptomatic of inadequate controls or non-compliance with existing procedures.

d) Personnel shall be provided with relevant and adequate training at regular intervals to equip them with knowledge of new products, new or amendments to
laws, rules and regulations, as well as to enhance their efficiency and effectiveness.

2.3 Business Process Controls

2.3.1 Legal Documentation

a) CFI shall have written agreements with counterparties, where appropriate and in line with market practice, specifying the duties and responsibilities of each party, as well as the necessary legal protection. For the institution’s own protection, it shall have clear guidelines and policies to ensure that the counterparty has the legal and necessary regulatory authority to enter into a transaction, prior to engaging in the transaction.

2.3.2 Management Information Systems

a) CFI shall have adequate management information systems (MIS) to facilitate effective risk management and control of all aspects of their operations. The sophistication of the MIS shall be consistent with the nature and size of the institution’s operations. CFI shall consider key elements such as timeliness, accuracy, consistency, completeness and relevance when developing their MIS.

b) The management information systems shall also be sufficiently flexible to cope with various contingencies and have the capability to monitor compliance with the institution’s established policies, procedures and limits.

c) Relevant levels of management shall receive reports with adequate information to facilitate effective oversight of the institutions’ activities.

2.3.3 New Products/Services/Activities

a) A CFI shall have a new product policy to ensure that the risks inherent in new business lines or activities are properly assessed. Proposals on new products, business lines or activities shall be accompanied, where appropriate, by a product program document that includes:

i. A review of legal and regulatory requirements;
ii. A description of the relevant financial product and markets, and the underlying objectives of the transactions (e.g. customer service, or risk management);

iii. An analysis of the risks that may arise from these activities, and details of any risk management procedures and systems established, for identifying, measuring, monitoring and controlling risks;

iv. An evaluation of the impact of the proposed activities on the CFI’s overall financial condition and capital level, where applicable.

3 CREDIT RISK

3.1 Introduction

a) Credit risk is the current and prospective risk to earnings or capital arising from a borrower or counterparty’s failure to meet the terms of any contract with the CFI or otherwise fail to perform as agreed. A CFI is exposed to credit risk mainly from financial instruments such as loans and acceptances. Credit risk often does not occur in isolation, hence the CFI shall ensure that adequate capital resources are available to cover the risk assumed.

b) The effective management of credit risk is underpinned by effective board and management oversight, well-defined policies and procedures, strong management information systems and adequate internal control systems.

3.2 Board and Management Oversight

3.2.1 Board of directors

a) The board of directors shall be ultimately responsible for providing overall strategic direction to the CFI through approving and reviewing the credit risk policies (credit policy). The credit risk policies shall clearly set the acceptable risk appetite and tolerance of the institution covering all the activities of the CFI in which credit exposure is a significant risk. The board shall ensure that:

   i. An appropriate committee is in place to oversee the credit risk policy;

   ii. The credit risk policies are reviewed, approved and effectively communicated throughout the institution;
iii. Management shall be fully capable of managing the credit activities conducted by the CFI and that such activities are done within the strategy, policies and procedures approved by the board;

iv. There is an internal audit function capable of assessing compliance with the credit policies and management of the entire credit portfolio;

v. The delegation of authority and approval levels are clearly defined; and

vi. Management provides periodic reports on insider loans, provisioning and write-offs on credit loan losses and audit findings on the credit granting and monitoring processes.

3.2.2 Management

a) Management shall implement the credit strategy and policies approved by the board of directors and develop procedures for effective management of credit risk. Management shall ensure that:

i. The credit granting activities conform to the laid down procedures;

ii. written policies and procedures are developed, implemented and responsibilities of the various functions are clearly defined;

iii. The credit policies are communicated throughout the institution, implemented, monitored and reviewed periodically to address any changes;

iv. Compliance with internal exposure limits, prudential limits and regulatory requirements is enforced;

v. The development and implementation of appropriate reporting systems with respect to the content, format and frequency of information concerning the credit portfolio;

vi. Internal audit reviews of the credit risk management system and credit portfolio are undertaken regularly; and

vii. Adequate research is undertaken for any new products or activities to ensure risks are appropriately identified and managed. These products must receive prior board approval.
3.2.3 Policies, Procedures and Limits
a) The Board shall approve credit policies, including concentration limits and lending to related parties. It shall also be the approving authority for changes and exceptions to such policies. Management shall set out operational processes and procedures to implement the credit policies.
b) Credit policies shall set out the conditions and guidelines for the granting, maintenance, monitoring and management of credit, at both the individual transaction and portfolio levels. Such policies shall be documented, well-defined, consistent with prudent practices and regulatory requirements, and adequate for the size and nature of the institution’s activities.
c) Every CFI shall be very clear about its credit risk tolerance, including the nature and level of risk it is prepared to undertake. Risk tolerance shall be compatible with the institution’s strategic objectives.

3.2.4 Credit Granting
a) Every CFI shall have a clearly established process for approving credit facilities. This includes amending, renewing and refinancing of existing credit facilities. At a minimum, the policy shall document the following:
   i. Roles and responsibilities of staff involved in the granting, administration and monitoring of credit facilities;
   ii. Delegation of credit authority to various levels of board committees, management and staff (including authority to approve deviations and exceptions);
   iii. Credit risk acceptance criteria;
   iv. General terms and conditions of the facility structure, such as pricing, tenure and limit;
   v. Acceptable types of collateral and security documents;
   vi. Standards for credit review and monitoring; and
b) Credit approvals shall be made in accordance with the CFI’s written guidelines and granted by the appropriate level of management. There shall be an audit
trail documenting the approval process and identifying the individuals and committees providing input and making the credit decision.

c) Credit analysis requires that management shall have a clear understanding of the borrower or counter-party and obtain adequate information to enable a comprehensive assessment of the risk profile of the customer. This will include the purpose of the loan, repayment sources, financial statements, integrity and reputation of the borrower or counter-party. The policies shall articulate the principle of Know Your Customer/FICA even for existing members.

d) Lending authority delegated to staff with clearly established limits shall be documented. It is important to include the functions and reporting procedures of the various committees and individual lending officers.

e) In addition, CFIs shall establish checks and balances that ensure all credit facilities are granted at arms’ length in all respects. Extension of credit to directors, management and other influential members, for example Supervisory Committee members, shall not override the established credit granting and monitoring processes.

3.2.5 Credit Limits

a) A CFI shall have sound and well-defined policies and procedures incorporating credit concentrations, limits and level of credit risk it is willing to assume. These limits shall ensure that credit activities are adequately diversified.

b) The policy on large exposures shall be well documented to enable CFIs to take adequate measures to ensure that concentration risk is limited. The policy shall stipulate the percentage of the CFI’s capital that the institution can lend to any individual or related entities.

c) Credit limits shall be reviewed on a periodic basis to take into account changes in the counterparty’s credit strength and environmental conditions. All requests to increase credit limits shall be substantiated.

3.2.6 Credit Products
a) Every CFI shall maintain adequate documentation relating to various types of loan products and credit instruments.

b) Prior approval for all new products shall be obtained from the board as well as clearance from independent control functions such as Audit and Supervisory Committees.

c) All material risks arising from new products shall be assessed before introduction to customers. Such policies shall stipulate the credit risk analysis procedures and the administration of these credit instruments.

### 3.2.7 Credit risk mitigation

a) In controlling credit risk, a CFI can use a variety of mitigating techniques which include collateral, guarantees and netting off of loans against deposits of the same counter-party. While the use of these techniques will reduce or transfer credit risk, other risks may arise which include legal, operational, liquidity and market risks.

b) Therefore, a CFI shall have comprehensive procedures and processes to control these risks and have them well documented in the policies. Security held by the institution to mitigate against credit risk shall satisfy the following conditions:

i. There must be legal certainty. All documentation used for collateralized lending must be binding to all parties and be legally enforceable;

ii. The legal environment must provide for right of liquidation or right of possession in a timely manner in the event of default;

iii. Necessary steps must be taken for obtaining and maintaining an enforceable security, for example registration, right of set-off or transfer of title must meet all the legal requirements;

iv. Procedures for timely liquidation of collateral shall be in place;

v. on-going valuations of the collateral shall be undertaken to confirm that it remains realizable; and

vi. Guidance on the various acceptable forms of collateral shall be documented.
c) The institution’s decision to lend shall be based on the borrowers’ capacity to repay and not on the adequacy of collateral.

3.2.8 Management of problem credits
a) A CFI’s credit policy shall establish the procedures for dealing with problem credit facilities. Early recognition of weaknesses in the credit portfolio is important and allows for effective determination of loan loss potential.
b) An institution must have clearly articulated and documented policies in respect of past due credit facilities, and shall at a minimum have approval levels and reporting requirements in respect of granting extensions, deferrals, renewals and additional credit facilities to existing accounts.
c) The policy shall define a follow-up procedure for all loans and identify the reports to be submitted both to management and board of directors.

3.2.9 Provisioning policy
a) The credit policy must clearly outline the provisioning procedures for all credit facilities and the capital charge to be held. This shall comply at a minimum with the International Financial Reporting Standards, regulatory and statutory requirements.

3.3 Measuring and Monitoring Credit Risk
3.3.1 Measuring credit risk
a) Every CFI shall have procedures for measuring its overall exposure to credit risk including exposure to related parties, products, customers, market segments and industries for appropriate risk management decisions to be made.
b) Credit risk measurement tools and techniques shall take into account the nature of the credit, maturity, exposure profile, existence of collateral or guarantees and potential for default and environmental circumstances.

3.3.2 Monitoring credit risk
a) An effective monitoring system shall ensure that the CFI:
   i. Understands the current financial condition of the borrower;
   ii. Monitors compliance with the existing terms and conditions;
   iii. Assesses collateral in relation to the borrower's current condition; and
   iv. Identifies non-performing accounts and enforces proper classification and loan loss provisioning.

3.3.3 Credit administration
a) Every institution shall have a system for the on-going administration of its various loans accounts. Management shall set-up a credit administration team to ensure that loan portfolios are properly maintained and administered. This will include record keeping, preparation of the terms and conditions as well as perfection and safe custody of the securities. Credit files shall at a minimum contain the following information:
   i. Credit application;
   ii. Evidence of approval;
   iii. Latest financial information;
   iv. Record and date of all credit reviews;
   v. Record of all guarantees and securities;
   vi. Record of terms and conditions of facility; and
   vii. Evidence of securities validation function that shall include legal validity, existence, valuation, registration of charge and safekeeping.

3.3.4 Credit exposure and risk reporting
a) Credit risk information shall be provided to board and management with sufficient frequency, currency and, shall be reliable with appropriate disaggregation.

3.3.5 Internal controls and audit
a) CFI investments may suffer a loss if there is a fall in the market value of an investment. This is called ‘market risk’ or sometimes ‘price risk’. There are three major types of market risk:
  i. *Equity risk*: If the price of equities listed and traded on the major stock exchanges changes, then the CFI balance sheet may be affected by a fall in the value of its equities or bonds. Even if equity investment assets carry a capital guarantee, there is still a risk. This is because if they don’t increase in value as much as had been expected the overall financial performance of the CFI will be less than expected.
ii. *Currency risk*: Changes in the exchange rate of currencies can lead to a loss in the value of investments denominated in foreign currencies.

iii. *Interest-rate risk*: If interest rates rise the value of assets that promise a return at a fixed rate will fall. Typically, the interest rate used for reference is the market benchmark interest rate for the appropriate maturity. Prime lending rate is the commonly used benchmark for the Rand. CFIs that have investments in the CFI retail bond, might be affected by increasing or decreasing returns on their investments. The changes in interest rates affect a CFI’s earnings by altering interest sensitive income and expenses. Interest rate changes also affect the underlying value of an institution’s assets, liabilities through changes in the present value of future cash flows.

b) CFIs are not expected to have significant equity and currency risk on their balance sheets without prior approval by the Supervisor. Consequently, the rest of this guideline places more emphasis on the interest rate risk component of market risk as it is the predominant factor.

### 4.2 Board Oversight of Interest Rate Risk

a) The responsibilities of the board of directors include the following:

i. Reviewing the overall objectives of the CFI with respect to interest rate risk and ensuring the provision of clear guidance regarding the level of interest rate risk acceptable to the CFI;

ii. Approving broad business strategies of the CFI with respect to interest rate risk and ensuring that management takes the steps necessary to identify, measure, monitor, and control interest rate risk;

iii. Approving policies that identify lines of authority and responsibility for managing interest rate risk exposures; and

iv. Delegating responsibility for establishing interest rate risk policies to the relevant board committee.

### 4.3 Management Oversight
a) It is the responsibility of management to maintain:
   i. Appropriate limits on risk taking;
   ii. Adequate management information systems and standards for measuring interest rate risk;
   iii. Standards for valuing positions and measuring performance;
   iv. A comprehensive interest rate risk reporting and management review process; and
   v. Effective internal controls.

b) In order to fulfill the above responsibilities management shall periodically review the co-operative’s interest rate risk management policies and procedures to ensure that they remain appropriate and sound. It shall also periodically update the board of directors regarding interest rate risk measurement, reporting and management procedures.

5 LIQUIDITY RISK

5.1 Introduction

a) Liquidity risk arises from the CFI’s inability to pay depositors and other liabilities when they fall due without incurring unacceptable cost or losses. CFI balance sheets are such that long-term assets (loans and advances) are funded by short-term liabilities such as regular and fixed savings.

b) Inadequate liquidity risk management can have a negative impact on earnings and capital and, in a worst case scenario, cause the collapse of an otherwise solvent CFI.

c) Liquidity risk and other inherent risks such as credit, market, interest rate, operational, reputation and strategic faced by CFIs are not mutually exclusive and shall not be considered in isolation. In fact, liquidity risk often arises as a consequence of these other risks.
5.2 Sources of liquidity risk

5.2.1 Asset liquidity

a) The asset portfolio of a CFI provides liquidity through the maturity of an asset, sale of an asset and the use of an asset as collateral for borrowing or repurchase agreements (repos).

b) A CFI shall maintain a portfolio of liquid assets (e.g. CFI Retail Bonds) to supplement its funding sources. In addition, significant concentrations within the asset portfolio increase the level of liquidity risk.

c) In managing asset liquidity, CFI shall establish a clear strategy for holding liquid assets, develop procedures for assessing the value, marketability and liquidity of the asset holdings under different market conditions, and determine the appropriate volume and mix of such holdings to avoid potential concentrations.

5.2.2 Liability liquidity

a) Every CFI shall employ liability funding strategies which are appropriate to the nature and scale of its activities, including the proper mix of liabilities to avoid potential concentrations.

b) In managing liability liquidity, a CFI shall be able to distinguish the behavior and characteristics of different funding sources and monitor their trends separately.

5.3 Board and Management Oversight

5.3.1 Board Oversight ...

a) The board of directors shall have ultimate responsibility for liquidity risk management and establish the level of tolerance for liquidity risk. The board of directors’ responsibilities in relation to liquidity risk management shall include:

i. Approving significant policies that govern or influence the institution’s liquidity risk;

ii. Establishing an appropriate structure for the management of liquidity risk and identifying lines of authority and responsibility for managing liquidity risk exposures;
iii. Approving reviews of the liquidity risk management strategy and policies;
iv. Monitoring the institution’s overall current and prospective liquidity risk profile on a regular basis;
v. Taking steps to ensure that liquidity risk is adequately identified, measured, monitored and controlled; and
vi. Reviewing adequacy of the contingency plans of the CFI

5.3.2 Management Oversight …
a) A CFI shall have an appropriate management structure to oversee the day-to-day and long-term management of liquidity risk in line with the board approved strategy, policies and procedures. The management structure shall ensure that the liquidity strategy approved by the board can be effectively implemented, including:
i. Establishing a schedule of liquidity reviews with appropriate frequency and depth;
ii. Translate the board’s approved strategy, objectives and risk tolerances into operational standards;
iii. Implement management information systems that facilitate effective liquidity management through adequate identification, measurement, monitoring and control of liquidity risk;
iv. Institute effective internal controls over the liquidity risk management process; and promptly communicate any material changes in the institution’s current or prospective liquidity position to the board of directors.

5.4 Liquidity Strategy, Policies, and Limits
5.4.1 Strategy
a) The liquidity strategy shall set out the general approach to liquidity management (including goals and objectives) and specific aspects of liquidity risk management, such as:
i. Composition of assets and liabilities;
ii. Managing access to the central finance facility; and

iii. Diversification and stability of liabilities.

5.4.2 Policies

a) While specific details vary across CFIs according to the nature of their business, the key elements of any liquidity policy include:

i. Management’s responsibilities - outline of responsibilities of the liquidity risk management functions, including structural balance sheet management, pricing, marketing, contingency planning, management reporting, lines of authority and responsibility for liquidity decisions;

ii. Liquidity risk management structure - systems for monitoring, reporting and reviewing liquidity;

iii. Liquidity risk management tools - approach for identifying, measuring, monitoring and controlling liquidity risk (including the types of liquidity limits and ratios in place and rationale for establishing limits and liquidity ratios); and

iv. Contingency plan - strategy for handling liquidity crises.

b) The policy must be reviewed at the board and management at least annually or more frequently when there are material changes in the institution’s current and prospective liquidity risk profile.

c) Ratios and limits that CFIs shall use to monitor liquidity risk may be categorized as follows:

i. **Cashflow Ratios and Limits** - liquidity risk may arise from a CFI’s failure to roll-over maturing liabilities or realize anticipated cash flows from assets. Cash flow ratios and limits attempt to measure and control the volume of liabilities maturing during a specified period of time.

ii. **Liability Concentration Ratios and Limits** - these ratios and limits help to prevent a CFI from relying on few funding sources. Limits shall be expressed as either a percentage of liquid assets or an absolute amount.

iii. **Other Balance Sheet Ratios** CFIs shall use the following ratios: total loans/total deposits, total loans/total member share capital, total external
funds/total assets, deposits held with the CBDA or higher tier CFI among other ratios to monitor current and potential funding levels.

5.5 Liquidity Risk Measurement and Monitoring

a) Every CFI shall establish a risk measurement system to ensure that liquidity requirements are identified and managed on an on-going basis. The measurement system and associated procedures shall be applicable under both normal and stressed liquidity conditions. Techniques such as simple gap analysis can be used for measuring liquidity risk.

b) An institution shall track and evaluate its current and anticipated liquidity position and capacity to fund potential gaps. A monitoring system shall consist of limits, guidelines and trend development that enable management to monitor compliance with approved risk tolerances and to track variances.

5.6 Funding Capacity

a) Every CFI shall estimate its “normal” funding capacity in both retail and wholesale markets (centralized finance facility). Deterioration in the institutions’ funding capacity can result from the following, among other circumstances:
   i. Difficulty in accessing the central finance facility;
   ii. Concentration in funding sources;
   iii. Deterioration in asset quality; and
   iv. Worsening of earnings performance

5.7 Contingency Plan

a) Every CFI shall have a contingency plan for handling liquidity crisis situations. A contingency liquidity plan is a projection of future cash flows and funding sources of a CFI under stressed market scenarios including aggressive asset growth or rapid liability erosion.

b) The plan shall be updated and reviewed on a periodic basis (at least annually) by management to ensure that it remains robust over time and reflects the
institution’s changing operating circumstances. At a minimum, the contingency plan shall:

i. Designate the personnel responsible for the identification of crisis and for contingency management. This shall include provisions for prompt notification of problems to the Supervisors and the Agency.

ii. Specify the early warning indicators that are used to signal an approaching crisis event. There shall be mechanisms to facilitate constant monitoring and reporting of these indicators;

iii. Contain reporting procedures to ensure that all necessary information is available for management to make quick decisions;

iv. Set out procedures for making up cashflow shortfalls in crisis situations. These shall clearly spell out sources of funds, their expected reliability and the priority ranking of the sources;

v. Outline courses of action for altering asset and liability structure and assess the likely impact of these on the member’s perception of the institution, including details for handling member management.

5.8 Internal Controls

a) Each CFI shall have an adequate system of internal controls over its liquidity risk management process. The internal controls shall promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations and institutional policies. An effective system of internal controls for liquidity risk management includes:

i. An adequate process for identifying and evaluating liquidity risk;

ii. The establishment of control measures such as policies and procedures;

iii. Adequate management information systems; and

iv. Continual review of adherence to established policies and procedures.
6 OPERATIONAL RISK

6.1 Introduction

a) Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

b) Failure to implement proper processes and procedures to control operational risks can result in a misstatement of the CFI’s risk/return profile and expose the CFI to significant losses.

6.2 Board and Management Oversight

6.2.1 Board of directors

a) The ultimate responsibility for operational risk management rests with the board of directors. To discharge this responsibility, the board or its delegated committee shall:

i. Understand the major aspects of the institution’s operational risk as a distinct category of risk that shall be managed;

ii. Define the operational risk strategy and ensure that the strategy is aligned with the co-operative’s overall business objectives;

iii. Approve the operational risk policies developed by management;

iv. Review periodic high-level reports on the institution’s overall operational risk profile, which identify material risks and strategic implications for the institution;

v. Establish a management structure with clear lines of accountability and reporting; and

vi. Ensure compliance with regulatory disclosure requirements on operational risk.

6.2.2 Management responsibilities

a) management shall:
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i. Define the institution’s organisational structure and clearly assign authority, responsibility and reporting relationships to encourage accountability;

ii. Implement the board approved operational risk management policy;

iii. Ensure that the institution’s activities are conducted by competent staff with the necessary experience and technical capabilities

iv. Ensure that the policies have been clearly communicated to staff at all levels;

v. Pay particular attention to the quality of documentation controls and to transaction-handling practices; and

vi. Put in place clear reporting systems of operational risk failures and provide for their subsequent resolution.

6.2.3 Policies and Procedures

a) A CFI shall have well-documented policies and procedures for managing operational risk. The policies shall clearly set out the strategy, objectives and the major elements of the operational risk management framework, including identifying, measuring, monitoring, and controlling operational risk.

b) Operational risk management policies, processes, and procedures shall be documented and communicated to staff at all levels.

c) Policies and procedures shall contain processes, among others, to identify and assess operational risk such as:

- **Self-Risk Assessment**: Every business unit of a CFI shall assess its operations and activities against a menu of potential operational risk vulnerabilities. The process shall incorporate checklists and/or workshops to identify the strengths and weaknesses of the operational risk environment.

- **Key Risk Indicators**: Key risk indicators are early warning statistics and/or metrics, often financial, which may include staff turnover rates and the frequency and/or severity of errors and omissions.
• **Thresholds/limits**: The CFI’s operational risk framework must stipulate limits to be adhered to. Threshold levels in key risk indicators shall be used to alert management on areas of potential problems when exceeded.

**6.3 Monitoring and Reporting**

a) To facilitate monitoring of operational risk, results from the measurement system shall be summarized in reports that can be used to understand, manage, and control operational risk and losses.

b) These reports shall serve as a basis for assessing operational risk and related mitigation strategies and creating incentives to improve operational risk management throughout the institution.

c) A CFI shall have relevant policies and procedures to control/mitigate their exposures arising from the following operational risk drivers, among others:

i. New products and activities;
ii. Change of IT systems, facilities and equipment;
iii. E-banking services;
iv. Outsourcing arrangements;
v. Money laundering;
vi. Suitability of members, and
vii. External documentation e.g. contracts and transaction statements.

**6.4 Contingency and Business Continuity Plans**

a) A CFI shall have documented contingency and business continuity plans to ensure its ability to operate as a going concern and minimise losses in the event of severe business disruption.

b) The business resumption and contingency plans shall take into account different types of scenarios to which the CFI may be vulnerable and shall be commensurate with the size and complexity of its operations.

**7 LEGAL AND COMPLIANCE RISK**
7.1 Introduction

a) Legal and compliance risk is the risk of legal or regulatory sanctions, material financial loss or damage to reputation that an institution may suffer as a result of failure to comply with laws, regulations, rules, self-regulatory organization standards and constitutions applicable to its activities.

7.2 Board Oversight

a) Effective board oversight is the cornerstone of an effective legal & compliance risk management process. The board shall understand the nature and level of legal & compliance risk to which the CFI is exposed and how its risk profile fits within the overall business strategy.

b) Board committees, such as the Governance Committee may take the lead in the review of the constitution, assist the board in discharging its responsibilities for the democratic process, including the annual general meeting, review the representational responsibilities and terms of the board annually and review and develop board policies, including aspects of board succession planning.

7.3 Management oversight

a) Management is responsible for the effective management of a CFI's legal and compliance risk. As such, the CFI's management is responsible for establishing a written compliance policy the contains the basic principles to be followed by management and staff and explains the main processes by which compliance risks are to be identified and managed at all levels of the co-operative.

7.4 Policies and Procedures

a) In general the policies and procedures shall provide for the following among other considerations:

   i. A framework for dealing with legal matters of varying complexity;
   ii. maintenance of a central inventory of key documents such as contracts, licenses, policy statements and others;
iii. Regular review and assessment of legal risk in the co-operative’s activities including new products;
iv. Adequate documentation on all significant transactions including security administration;
v. Record maintenance in line with relevant statutory requirements; and
vi. Maintenance of confidentiality provisions.

8 STRATEGIC RISK
8.1 Introduction
a) Strategic risk refers to the current and/or prospective impact on a CFI’s earnings, capital or business viability arising from adverse business decisions and implementation of strategies which are inconsistent with internal factors and the external environment.
b) At a minimum every co-operative shall have strategic plans which shall be supported by appropriate organisational and functional structures, skilled and experienced personnel, an adequate budget, management information systems, as well as risk monitoring and controlling systems.
c) In this guideline, a strategic plan is defined as a roadmap indicating the vision, mission and the business direction of a CFI, generally for a period of at least one year. A good strategic plan must be consistent with the organisational goals and shall be adjustable to changing environmental factors.

8.2 Strategic planning process
a) Setting future business direction is the ultimate responsibility of the board of directors or a delegated committee. If the strategic planning process is not appropriate or if the assumptions are not realistic, the strategic plan will be flawed thereby exposing the institution to strategic risk.
b) The board shall formulate the overall strategic plans and set an appropriate budget, while management shall develop operational plans for each function by month, quarter or year. The operational plans shall be consistent with the overall organizational strategy.
c) A CFI’s strategic plans shall complement and be integrated with other important issues such as capital adequacy, liquidity, source and use of funds, level and quality of earnings and management efficiency.

### 8.3 Risk Mitigation Factors

a) CFIs shall adopt and implement robust strategic risk mitigation measures and techniques to enhance the achievement of strategic objectives. These include engaging qualified board and management, formulation of strategic and operational plans, high quality of personnel and proper training, comprehensive risk management systems and adequate access to information.

### 8.4 Managing Strategic Risk

a) To be effective, the risk management system needs to be aligned with a co-operative’s overall objectives, corporate focus, strategic direction, operating practices and internal culture.

b) The institution shall integrate risk management within existing governance and decision-making structures both at the operational and strategic levels in a manner that is appropriate for its size, complexity and scope of business.

c) A system to report detailed progress of implementation of the plans and objectives shall be implemented including comparison of actual performance against the operational plan and budget, and the business continuity plan for unusual circumstances to facilitate coping with unexpected changes in the environment.

d) A CFI shall control strategic risk through the following approaches, among others:

i. Adaptive risk management structure;

ii. Policies, procedures, and risk limits;

iii. New product reviews;

iv. Comparisons of the actual performance with projections;

v. Quality and effective independent reviews and internal control systems;

vi. Management succession plan and training; and
9 REPUTATIONAL RISK

9.1 Introduction
a) Reputational risk arises when a situation, occurrence, business practice or event has the potential to materially influence the public and stakeholder’s perceived trust and confidence in a CFI.
b) Reputational risk may arise from a variety of sources, such as fraud and noncompliance with statutory or regulatory requirements. Other sources of reputational risk may arise from failing to safeguard non-public customer information through outsourcing relationships, a high volume of customer complaints, or public regulatory sanctions.
c) Reputational risks may arise where occurrences in other categories of risk also threaten co-operative’s image and stakeholder regard. As such, the task of managing reputation risk represents a critical aspect of risk management.
d) As with the other risks, the board is overall responsible for reputation risk.

9.2 Categories of Reputational Risk
a) CFIs shall pay special attention to three general categories of events or circumstances which give rise to reputational risk. The risk methodologies employed must be broad enough to reach all risks in each category.
   • Inherent Risk: These are risks that arise from, or are an intrinsic feature of products and services (or their delivery) and which negatively impact member satisfaction. Thus, inherent risk mainly derives from challenges in operational risk, quality assurance and member satisfaction.
   • Environmental Risk: These are risks which arise from the manner in which business is conducted (e.g. geographic, industrial, political, societal etc.) which while unrelated to the quality of the products or services can negatively impact member brand acceptance.
9.2.1 Governance and Control Risk

a) A CFI shall protect itself against these risks which arise from losses as a result of inadequate or failed internal processes, people and systems as well as from losses caused by an organisation’s failure to adhere to applicable laws, regulations, industry standards or practices which negatively impact the members’ perception of institutional integrity.

9.3 Policies and Procedures

a) CFIs shall have policies and procedures under which they will:
   i. Adopt sound risk management practices that include the practice of building reputational capital, and earning the goodwill of key stakeholders;
   ii. Manage reputational risk through a process of anticipation, risk analysis and planning, and then attempting to manage both internal and external expectations;
   iii. Measure trends in a CFI’s reputation as a precursor to remedial action; and
   iv. Identify risk events as being either specific or systemic as this will determine the course of corrective action.

9.4 Risk management and monitoring

a) Management shall ensure that opportunities to exploit CFI's reputation capital are taken advantage of. Positive information about a CFI shall also be communicated appropriately to the members and the market place.

b) Management shall be fully aware of an event that has the potential to impact a CFI's reputation and shall ensure that it establishes a crisis management procedure to manage the potential impact of reputational events.

c) CFIs shall also ensure that there is no general release of information to the public or press without approval from management and/or the board.
9.4.1 Reputation Risk Analysis Methodology and Process

a) Every CFI shall conduct a risk diagnostic review to identify potential reputational risk issues. The board’s responsibilities shall include requiring management to use proven analysis methodologies as well as independent and objective reviews designed to bring out and analyse both quantitative and qualitative risk factors and to review critical control points within the CFI.

b) All aspects of reputational risk management shall be subject to internal audit review.