

FIRST WEST CREDIT UNION 2016 ANNUAL REPORT

Risk Report

Management's Discussion & Analysis



Risk Report

ENTERPRISE RISK MANAGEMENT

First West continues to build a diversified financial operation. Management recognizes that taking risk is required in operating a successful financial organization. Our business activities expose us to a variety of risks throughout the organization and our ability to manage these risks is a key pillar in maintaining a strong credit union. In addition to our unique multi-brand model, we continue to add specialized subsidiary operations that require specific risk management. As well, regulatory reporting requirements continue to increase, which helps strengthen both First West and our industry.

GOVERNANCE OF RISK MANAGEMENT

At the highest level, oversight and awareness of significant risk is a key accountability of the board. The board of directors will:

- Define the credit union's risk appetite;
- Understand the material risks to which the credit union is exposed;
- Establish prudent risk management governance and policy;
- On an annual basis, review and approve the Enterprise Risk Governing Policy and other related risk policies;
- Gain assurance that First West Credit Union has an effective risk management process in place;
- Gain assurance that the risk management policies are being adhered to;
- Assess and monitor the level of risk and control over the risks through receipt of reports from management, the regulator and others (including internal and external auditors), and by making enquiries in order to determine if risk levels are appropriate; and
- Gain assurance that First West has established appropriate risk tolerance and appetite thresholds.

Management fulfills the board's direction to manage risk by employing a recognized enterprise risk management methodology. In principle, this requires management to take an explicit approach to the identification and aggregation of risk, to the measurement and stress testing of risks identified, and to respond to risk in order to reduce or optimize the risk to an acceptable level.

CORPORATE RISK MANAGEMENT

First West Credit Union maintains a risk services department that is led by the chief financial officer (CFO) and senior vice-president, risk. The SVP risk reports to the CFO and to the audit and risk management committee of the board of directors. The department is segregated from other business units and is responsible for reporting and aggregating risks at their residual levels and keeping management and the board informed. Risk services provides support to management in the area of enterprise risk management and is a resource to the board and senior management team in the development of policies and monitoring tools.

Risk services provides the following services:

- Identification of risks in conjunction with business owners and escalates where tolerance is exceeded;
- Development of measurement systems for risks;
- Coordination or reporting on stress and scenario testing;
- Establishing policies and procedures to manage risks in conjunction with the risk owner;
- Development of risk tolerance limits in accordance with the board-approved risk appetite;
- Monitoring of positions against approved risk tolerance limits;
- Reporting of results of risk monitoring and assessment to senior management and to the board through the audit and risk committee on a minimum quarterly basis; and
- Maintaining and testing the business continuity plan.

The primary objectives of our risk management program include:

- Maximizing earnings and return on capital within acceptable and controllable levels of the risks;
- Providing for growth that is sound, profitable and balanced without sacrificing the quality of service; and
- Managing and maintaining policies that are consistent with the short- and long-term strategic goals of the board.

RISK GOVERNANCE FRAMEWORK

The objective of First West's enterprise risk governance framework is to enhance value and preserve the long-term, sound business and financial operations of the credit union. First West's enterprise risk management is guided by the credit union's board of directors and administered by the risk services department of the credit union.

The eight categories of significant risks affecting First West are strategic, operational, credit, financial, market, liquidity, funding and counterparty, legal and regulatory, and information technology. We have established a risk profile to assess our risk levels and their related trends with actions being taken for identified risks reported to the board on a quarterly basis. This framework includes appropriate tolerances, risk reporting, and board and management risk policies to effectively manage and monitor risk.

Significant risks affecting the credit union are monitored, assessed and managed by management, with oversight provided by the executive risk committee and risk positions reported to the board on a quarterly basis. Areas of significant risk are subject to internal, external and regulatory audits.

Strategic Risk

Strategic risk includes risks related to business strategy execution, the credit union system, business continuity (or disruption) and the external environment in which the credit union operates. Strategic risk arises from an institution's inability to implement appropriate business strategies and/or the inability to adapt to changes in its business or economic environment.

Operational Risk

Operational risk includes people, process, reporting and outsourcing risks.

Operational risk is inherent in all business activities. It is the risk of loss or missed opportunity resulting from inadequate or failed activities with regard to internal processes, systems and projects, human error, or external partners or vendors. This risk may impact our earnings, reputation, competitive position, or result in regulatory penalties.

Fraud is an additional operational risk faced by all financial institutions. Fraud is an ever-evolving issue in the financial services industry and although it is impossible to prevent all fraud, we have rigorous controls, procedures and advanced security measures in place to safeguard the funds that our members entrust to us. To better protect our members from fraud, we have implemented a comprehensive cyber-security strategy and expanded our cyber-security team.

Strategies employed to manage operational risk include:

- Establishing standards of professional conduct;
- Implementing policies and procedural controls;
- Reviewing internal control effectiveness and strengthening areas where needed;
- Initiating employee training programs;
- Managing property, liability and financial bond insurance programs to provide additional protection from loss;
- Establishing a process for employees to confidentially report suspicious activities;
- Establishing a process to monitor, prevent and detect suspicious transactions, including a team of specialists dedicated to preventing fraud and managing compliance to legislative requirements;
- Maintaining regular audits for compliance and effectiveness of controls by independent internal and external audit teams, which provide senior management and the audit and risk management committee with recommendations to improve internal controls; and
- Issuing quarterly risk reports to the board.

Credit Risk

Credit risk is the risk that a financial loss will be incurred due to the failure of a party or counterparty to discharge its contractual commitment or obligation to the credit union. Credit risk arises principally in lending activities that result in loans to members but also from interest rate swaps (derivatives).

Please refer to Note 6b of the financial statements for more information on credit risk.

Financial Risk

Financial risk results from insufficient income to provide the necessary support to operations, strategic initiatives or unanticipated losses. Financial risk is continuously monitored. Specifically, financial statements showing actual results are analyzed by management against budgets and key performance metrics (KPIs). Each

quarter, forecasts are made to year end based on actual results year-to-date, and plans for the remainder of the year and variances to budget are analyzed by management and reported to the board.

Market Risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in interest rates. Interest rate risk arises when the values of assets and liabilities do not change by the same amount when interest rates change. Where portfolios are matched in terms of maturities, interest rate risk is reduced. This category also includes yield curve risk, basis risk and optionality risk. Market risk also incorporates price risk and foreign exchange risk.

Please refer to Note 6d of the financial statements for more information on market risk.

Liquidity, Funding & Counterparty Risk

Liquidity and funding risk is the risk that insufficient access to or inappropriate management of funds and capital threatens the credit union's capacity to grow. The exposure to loss as a result of the inability to satisfy cash flow obligations in a timely and cost-effective manner, or a poor investment, impacts our ability to achieve our business objectives. Counterparty risk is the risk of loss emanating from a counterparty failing to meet their obligation in accordance with contractual terms or a decrease in the value of the assets due to a decrease in the credit quality of the counterparty guarantor or the assets (collateral) supporting the counterparty exposure.

The liquidity and funding policy of the credit union addresses liquidity and funding risks on both an operational and strategic level. The desired liquidity level above the statutory requirement is determined by taking into account the balance between the cost of liquidity and the yield achieved. Contingency liquidity is managed by having a plan in place that can be invoked quickly and provides access to a diverse range of funding sources when needed.

The credit union at all times maintains statutory liquidity levels as required by regulations. Statutory liquidity deposits must be held with Central 1 Credit Union according to the credit union's deposit-loan agreement. The statutory liquidity ratio is 8.0% of deposits and borrowings as at the reporting date. Based on total deposits and borrowings as at December 31, 2016, our liquidity portfolio exceeded the minimum requirements by \$764.4 million.

First West Credit Union will only enter into derivative or credit facilities with Central 1 Credit Union or other counterparties that have a minimum DBRS rating of R-1 (middle) or the equivalent.

Legal and Regulatory Risk

Legal and regulatory risk is the risk of negative impact to our earnings or reputation as a result of failure to comply with or adapt to legal and regulatory requirements, industry practices or ethical standards. Our operations are governed by various acts and regulations, and we are expected to meet a high standard in business dealings and transactions.

Information Technology Risk

Information technology risk includes infrastructure, project, disaster recovery, information and operational risks. It includes the risk that confidentiality, integrity and availability of information is not maintained and is inclusive of both internal and external threats.

First West Credit Union takes seriously its responsibility to ensure our systems are secure, available, have high integrity and continue to meet members' needs. To ensure our systems remain current and robust, significant investments are made each year in infrastructure technologies and resources. First West employs rigorous testing procedures and plans for disaster recovery and business continuity with our technology systems and data.

PRIVACY POLICY

First West Credit Union is committed to ensuring the confidentiality, privacy and protection of the personal information of all members and other individuals whose personal information is held or controlled by the credit union.

The credit union has a designated chief privacy officer to oversee the protection of personal information in compliance with the BC Financial Institutions Act, the BC Personal Information Act, and the credit union's privacy policies and practices.

SUSPICIOUS TRANSACTION REPORTING AND TAX EVASION

First West Credit Union is committed to preventing the proceeds of crime being laundered through the credit union, including tax evasion or terrorist financing activities.

The credit union has a designated chief anti-money laundering officer (CAMLO) who oversees the organization's anti-money laundering and terrorist financing control framework. In addition, the CAMLO ensures compliance with:

- The federal Proceeds of Crime Money Laundering and Terrorist Financing Act; and
- The credit union's anti-money laundering policy

Suspicious transactions and potential tax evasion are reported to the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). This is a legislated requirement for all financial institutions in Canada.

WHISTLEBLOWER POLICY

The board of directors together with management is committed to maintaining a culture at First West Credit Union that empowers employees to report any suspected wrongdoing without fear of recrimination. Our whistleblower policy encourages and enables employees to raise concerns. First West is proud of its reputation and our whistleblower policy ensures that all reported incidents or suspected wrongdoings are investigated.