3. Fundamentals of Risk-Based Supervision

Asia Pacific Economic Cooperation Forum –
Financial Regulators Training Initiative –
Bank Analysis and Supervision Seminar

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RBS: Definitions and Contrasts with Other Approaches (1/2)

"Effective prudential supervision of financial institutions is about risks, rather than rules."

-- David Lewis, General Manager
Australian Prudential Regulatory Authority (APRA)

Definition 1 (Basel Committee): "A forward-looking approach where the supervisor assesses the various business areas of the [bank], and the associated quality of management and internal controls to identify the areas of greatest risk and concern...[and] directs supervisory focus to these areas."

Definition 2 (14th Int'l Conference of Banking Supervisors): "The essence of risk-based supervision, and its key distinguishing feature, is that supervisory resources are allocated where they are needed most, based on the supervisor's explicit assessment of risk."

RBS: Definitions and Contrasts with Other Approaches (2/2)

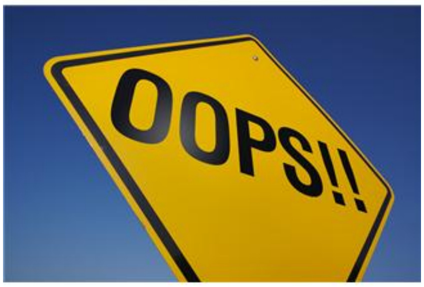
Supervisors following a risk-based approach will aim to:

- ***Identify systemic risks (affecting all banks)***
- ***Identify idiosyncratic risks (affecting only specific banks)***
- ***Identify those banks in which risks are greatest***
- ***Identify within each bank those areas in which risks are greatest***
- ***Apply scarce supervisory resources in order to minimize overall risk in the system***
- ***Engage in a constant dialogue with bank management to judge their effectiveness***

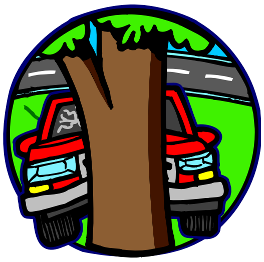
RBS: Contrasts with Other Approaches – the financial crisis

Investigations into the financial crisis in the US and UK criticized regulatory authorities for:

- *Failure to read the warning signs*
- *Failure to make adequate use of the regulatory powers to stop the build-up of risk in the system*
- *Failure to stop the risky practices themselves*
- *Devoting too much attention to policy changes needed to support Basel II and not enough attention to the substantive risks that these reforms sought to avert.*



RBS: Contrasts with Other Approaches – compliance, baseline



Baseline supervision: Routine off-site financial analysis and monitoring of data to identify level, trend, and stability of key indicators; routine on-site inspections to validate data (such as classifications and provisions, correct identification of large loans, insider loans)

Compliance-based supervision: Routine monitoring, off-site and on-site, to ensure compliance with laws, regulations, best banking practices (as stated in regulatory policies and guidelines); enforcement action when violations are noted.

Most traditional supervision activities are a combination of baseline and compliance-based.

RBS: What does it add to baseline and compliance-based? (1/3)

For the various categories of risk, an opinion is formed, stated, and discussed with the bank that the QUANTITY of risk is:

– **High**	-- ***High***
– **Moderate**	-- ***Above Average***
– **Low**	-- ***Moderate***
	-- ***Low***

And the QUALITY of risk management is:

– **Strong**	-- ***Strong***
– **Satisfactory**	-- ***Acceptable***
– **Weak**	-- ***Needs Improvement***
	-- ***Weak***
3 categories used in USA	***4 categories used in Canada***

***Note**: All regulatory authorities, probably perform some aspects of RBS already, along with baseline and compliance.*

RBS: What does it add to baseline and compliance-based? (2/3)

And an AGGREGATE level of risk is determined, summing up the various risks and characterized as:

– High	-- High
– Moderate	-- Above Average
– Low	-- Moderate
	-- Low

And the DIRECTION of aggregate risk is:

-- Increasing
-- Stable
-- Decreasing

This opinion, called a "Risk Assessment," is *in addition to*, and not a substitute for, the evaluation of condition and performance that is summarized in the periodic CAMELS (or other) rating process and its components.

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RBS: What does it add to baseline and compliance-based? (3/3)

Once the risk assessment is completed, it is used in the following ways:

- ***Discussed with bank management.*** Management needs to understand the regulator's evaluation of aggregate and individual risks and the direction of risk**.** *A formal response from the Board is required, including their commitment to reduce risks or implement better risk management, if required.*
- ***Used in allocating supervisory resources***
    - Frequency of on-site examinations
    - Scoping of on-site examinations (incl. targeted)
    - Frequency of meetings with bank management

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Risk Assessment as a Building Block in a Complete RBS System

Step 1: Risk identification and risk assessment.
(already discussed)

Step 2: Risk rating. Estimating the likelihood and potential impact of the bank's failure.

Step 3: Risk response. Preparation of a "Supervisory Action Plan" (SAP) on each bank, to be updated at least annually.

Step 4: Risk re-assessment and risk re-evaluation. Periodic review of accuracy and completeness of risk assessments and ratings, including incorporation of new and growing risks.

Typical Categories of Risk in RBS

Credit Risk

Market Risk

- ***Interest Rate Risk.***
- ***Foreign Exchange Risk***
- ***Equity or Commodity/Price Risk***

Liquidity Risk

Operational Risk

Compliance Risk

Reputation Risk

Strategic Risk

Relationship between RBS and Bank Risk Management

Risk-based supervision and bank risk management are related, but they are not the same thing.

Bank risk management is evaluated as an important part of RBS.

In RBS, the regulatory authority evaluates the ability and success of bank management to:

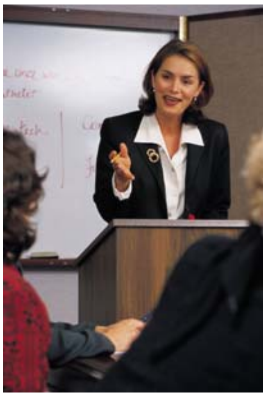
- **Identify**
- **Measure**
- **Monitor**
- **Control**

for all of the previously mentioned risks.

Steps to Proper Risk Management in Banks (1/2)

Identify risk **–** banks must understand existing risks as well as risks that arise from new banking initiatives

–Must identify risk at the transaction level and at the portfolio level.



Measure risk **–** banks must develop "metrics" to quantify risk.

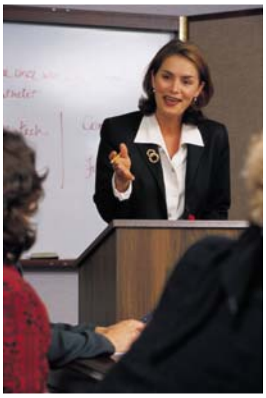
–Examples of metrics are the Liquidity Coverage Ratio to measure liquidity risk, and "Post Shock Core Income" to measure interest-rate risk.

–Some metrics are required regulatory ratios; others are only internal or external monitoring indicators.

Steps to Proper Risk Management in Banks (2/2)

Monitor risk **–** banks must carefully watch over the metrics and keep close watch over risks that cannot be quantified.

- *Requires timely and accurate MIS*



Control risk **–** banks must establish limits for all risks and communicate them through policies, standards, and procedures that define responsibility and authority.

- *Limits should be enforced, and policies should exist to allow exceptions under certain, rare conditions.*

"Frequently asked questions" about RBS (1/5)

Q. Does RBS replace CAMELS?

A. RBS does not replace CAMELS (or other rating system). CAMELS is still required to develop a comprehensive opinion about the condition and performance of a bank *at this point in time.* The risk assessment goes further, by aggregating the level of risk and showing the direction of risk. To that extent, it is more forward-looking than CAMELS.

Q. What if the Asset Quality component of CAMELS is "satisfactory", yet the risk assessment shows "high credit risk with an increasing trend" ?

A. The reference (or internal) CAMELS rating should be lowered.

“Frequently asked questions” about RBS (2/5)

Q. What kind of a shift in thought is required to adopt RBS?

A. We need to start by identifying the risks – new, emerging, and familiar – and structure our processes to deal with these risks, rather than starting with the processes and hoping that they catch all the risks.

Q. How can we identify new and emerging risks?

A. Macroprudential supervision, stress testing, brainstorming, attentiveness to media reports and security analysis, industry analysis (performance of large conglomerates, key sectors in that particular economy), etc.

“Frequently asked questions” about RBS (3/5)

Q. How does corporate governance at the banks fit into RBS?

A. We evaluate corporate governance as part of the Management component of CAMELS. Risk management, internal audit, internal controls, and compliance are key. But we also need to:

- Gain a deep understanding of the bank’s business model and appetite for risk
- Have frequent interaction with Board and senior management
- Have the capacity to assess the effectiveness of the bank’s risk management function
- Be able to identify incentives that may be pushing senior management or staff to take excessive risk
- Be willing to apply enforcement action when deficiencies are identified, including removal of management

“Frequently asked questions” about RBS (4/5)

Q. How does capital management fit into RBS?

A. We need to accept that compliance with Basel II or Basel III capital standards may not be enough. Banks must also perform an Internal Capital Adequacy Assessment Process (ICAAP), which may result in higher levels of required capital, depending on the risks identified.

Q. How does the ICAAP work, and how does it involve the supervisory authority?

A. The ICAAP attempts to place a value on “unexpected losses” over the next 12 months (expected losses are to be covered by provisions), and requires capital to be adjusted. The regulatory authority checks the bank’s ICAAP through a supervisory review and evaluation process.

“Frequently asked questions” about RBS (5/5)

Q. Are we concerned about risk, wherever we find it?

A. Taking risk is part of the basic business of banking. The presence of risk is not necessarily reason for supervisory concern. We determine if the risk is effectively managed, when it is identified, understood, measured, monitored, and controlled as part of a deliberate risk/reward strategy.

Q. What do we do if we determine that a risk is unwarranted (i.e., not managed or not supported by adequate capital)?

A. We must communicate to the Board and senior management the need to mitigate or eliminate the excessive risk.

Every risk must have an owner!

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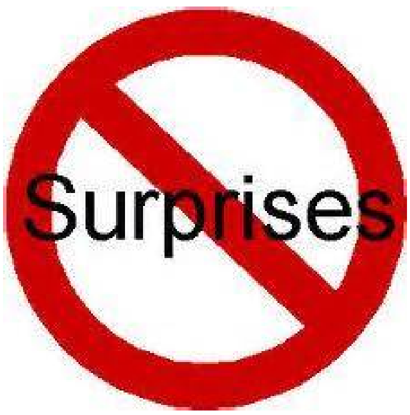
RBS helps to avoid surprises!



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