Risk-Based Supervisory Framework For Financial Institutions in Sierra Leone

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ACRONYMS AND ABBREVIATIONS

BSD	Banking Supervision Department
BSL	Bank of Sierra Leone
CRR	Composite Risk Rating
IO	Institutional Overview
RAR	Risk Assessment Report
RM	Relationship Manager

1. INTRODUCTION

The Bank of Sierra Leone (BSL) has adopted the Risk-based supervisory framework to enhance the effectiveness of its supervisory processes for commercial banks and other financial institutions (collectively referred to as financial institutions). The main objective of this initiative is to more appropriately focus supervisory attention on those areas that pose the greatest risk to the soundness of financial institutions through the assessment of management processes to identify, measure, monitor, and control risks.

This policy framework explains practical application of BSL's philosophy and methods for supervising financial institutions in a more risk-focused approach, taking into consideration a forward-looking view of the risk profile of supervised financial institutions. These supervisory concepts and methods are applicable to all financial institutions in Sierra Leone regardless of size.

1.1. Statutory Obligations

This supervisory framework is intended to support BSL's fulfillment of its statutory obligations contained in the Banking Act, 2011 and other governing legislations regarding the supervision of financial institutions.

1.2. Reliance on External Auditors

BSL, to some extent, relies upon the financial institutions' external auditors for the fairness of the financial statements. As such, BSL's assessment of a financial institution's overall financial performance depends upon the financial institution's audited financial statements.

1.3. Use of the Work of Others

To a reasonable extent, BSL will use the work of others to reduce the scope of its supervisory work and minimize duplication of efforts. This enhances both the BSL's efficiency and its effectiveness. For example, as supervisors do not perform audit work, they may use the detailed testing performed by a financial institution's external auditor and Internal Audit function to help them assess the effectiveness of controls. Similarly, they may use the detailed analysis performed by a financial institution's

Risk Management function to help them assess the effectiveness of the financial institution's models.

1.4. Coordination with Other Regulators

Effective supervisory planning for complex and diversified financial institutions requires adequate and timely communication among supervisory agencies. Based on the scope of a financial institution's operations, coordination includes communication with designated points of contact at all agencies and authorities supervising the financial institution (both domestic and foreign). These points of contact will assist examiners in the supervision of the entity on a consolidated basis, by facilitating the exchange of necessary information, the coordination of supervisory activities, and the communication of critical issues. In order to determine the overall risk profile of the financial institution, examiners consider the risks posed by external market forces and significant lines of businesses, including those subject to the primary supervision of other regulators. Examiners are required to obtain information to assess the quantity of risks from business lines and the risk management systems in place to address these risks at other institutions not supervised by BSL.

1.5. The Risk-Based Supervision (RBS) Process

The risk-based supervision process requires the application of sound judgment in identifying and assessing risks, as well as determining, from a wide variety of supervisory and regulatory options available, the most appropriate method to ensure that the risks facing financial institutions are adequately managed. This process includes an ongoing dialogue between BSL and financial institutions to help ensure that they have adequate capital, earnings and liquidity to cover all their risks, and also to encourage financial institutions to develop and use better risk management techniques.

1.6. Role of Relationship Manager

The BSL's risk-based supervision approach emphasizes the designation of a Relationship Manager (RM) for each financial institution. The RM is tasked with the responsibility of maintaining an up-to-date risk assessment of his/her assigned

institution, with support from specialists and other BSL staff. The RM serves as the central point of contact for the assigned institution or portfolios.

1.7. Institutional Overview (IO)

With the introduction of risk-based supervision, the BSL has employed some new supervisory processes such as the IO as a starting point in understanding a supervised financial institution. The IO, along with other new processes, is meant to sharpen the supervisory focus on those business activities of a financial institution that pose the greatest risk, and to assess the adequacy of the institution's risk management systems to identify, measure, monitor, and control the risks. As the banking environment changes, the IO should be revised periodically to reflect the current risk profile of a financial institution.

2. Benefits of Risk-Based Supervision

The key benefits of a risk based supervision framework for both supervisory agencies and financial institutions include but are not limited to:

- Directing resources more efficiently by compiling and assimilating relevant risk information that helps prioritize examination schedules, which in time should result in examination teams spending less time on site at individual financial institutions;
- A consistent framework for evaluating financial institutions through the separate assessment of inherent risks and risk management processes;
- Early identification of emerging risks in individual financial institutions and on a sectoral basis before they become serious problems;
- A better appreciation by supervisors of the characteristics of the financial institutions' business, the risks they face and the quality of their management;
- Encouraging frequent, open communication between BSL and financial institution management to resolve problems identified during on-site and off-site contacts, and reach agreeable solutions to reduce levels of unwarranted risk;
- Enhancing surveillance effort, in which the monitoring of new developments and strategic changes at a given financial institution are conducted throughout the examination cycle.

Below is a comparison of the supervisory compliance approach and the risk-based approach:

Compliance Approach vs. Risk-Based Supervision Approach

Compliance Approach	Risk-Based Approach
Transactions-based testing	Process-oriented
Point-in-time assessment	Continuous assessments
Standard procedures	Risk-profile driven procedures
Historical performance	Forward-looking indicators
Focuses on risk avoidance	Focuses on risk mitigation

3. Risk Assessment Process

3.1 General

The BSL's supervisory framework uses the under-mentioned elements to facilitate a holistic risk assessment of a financial institution by identifying the financial institution's primary risks. For this purpose, a risk matrix is used to indicate significant activities, the type and level of inherent risks in these activities, and the adequacy of risk management over these activities; as well as to determine net risk assessments for each of these activities and the overall risk of the financial institution. The risk assessment process includes the following stages:

- Identifying significant activities, such as business lines, entities or processes
- Assessing inherent risks for each significant activity
- Assessing the quality of risk management controls and mitigants
- Determining the net risks and direction
- Determining the importance of each net risk
- Determining the overall net risk
- Adjusting the overall net risk by taking into account the impact on capital, earnings and liquidity to determine the financial institution's composite risk rating.

3.2. Significant Activities

3.2.1. A significant activity can be a line of business, unit or process that is fundamental to the financial institution's business model and its ability to meet its overall business objectives (i.e. if the activity is not well managed, there is a significant risk to the financial institution as a whole in terms of meeting its goals).

3.2.2. There is no standardized categorization of financial institutions' operations or business lines. Examiners use judgment in identifying significant activities. Other sources for identifying significant activities may include but are not limited to the following:

- The financial institution's organizational chart
- Strategic business plan
- Planned growth
- Earnings contribution
- Capital allocations
- Internal and external reports
- Financial statements
- Internal management reports
- Potential for material loss from activities
- Correspondence and minutes of meetings between the financial institution and relationship manager, on-site and off-site examiners
- Any other report that is prepared for the financial institution's board of directors, senior management and any other stakeholder, to monitor performance.
- Financial institution's own classification of its different businesses, if deemed appropriate by the examiners.

3.2.3. Significant activities should be identified by the RM with the assistance of on-site and off-site examiners in the supervisory plan of a financial institution.

3.3. Inherent Risks in Significant Activities

3.3.1. Once the significant activities have been identified, the next step is to assess the key inherent risks for each significant activity or function. Inherent risk is intrinsic to a significant activity and defined as the probability of a material loss due to exposure to

uncertainty arising from, current and potential future events. This potential loss, or combination of losses, could negatively impact capital, earnings and liquidity of a financial institution and result in loss to depositors and shareholders. A good understanding of the nature and environment of the financial institution's activity is critical to proper identification and assessment of inherent risks.

The BSL employs six risk categories to assess inherent risk as follows (See Appendix A for inherent risk categories and ratings):

- Credit Risk
- Market Risk
- Operational Risk
- Legal Risk
- Strategic Risk
- Reputational Risk

3.3.2. The categories above represent a broad classification of the risks that are generally applicable to financial institutions. Most risks can be considered within one of these six categories. For example, settlement risk may be considered a subset of credit risk.

Important: Under the risk-based supervisory approach of the BSL, inherent risks are assessed independent of the controls that a financial institution may have in place to deal with each type of risk.

3.3.4. The level of an inherent risk, which is a judgment call by examiners, can be assessed as "low", "average", "above average" or "high". Qualitative as well as quantitative factors will be considered for each functional activity in arriving at the judgment. Examiners assess the inherent risks of the activity against the financial institution's own risk appetite: If examiners deem the risk appetite of a financial institution appropriate, it should represent the upper limit of its inherent risk such that exceeding the limit is taken to indicate a serious failing in the institution's risk management.

3.3.7. To derive inherent risks, examiners use a functional risk mapping chart prepared by relationship manager in a financial institution's supervisory plan. For example, a significant activity, say of a commercial financial institution, can be mapped out into

six inherent risks: credit risk, operational risk, market risk, legal risk, strategic risk and reputational risk in the financial institution's book. (See Appendix B)

3.4. Risk Management, Controls and Mitigants

3.4.1. General

3.4.1.1. The third step in a risk-based supervisory approach is to assess the quality of the financial institution's risk management and control processes against its inherent risks. When assessing the adequacy of a financial institution's risk management systems for each significant activity, examiners place primary consideration on findings related to the following key elements of a sound risk management system:

- o Operational management and controls on a day-to-day basis
- o Oversight functions, including Board of Directors' Oversight, Senior Management, Quality of Risk Management, Internal Audit, Financial Analysis and Compliance (See Appendix C for quality of risk management categories and ratings).

3.4.1.2. Operational management ensures there is a clear understanding by the financial institution's line staff of the risks facing the financial institution, and that appropriate policies, processes and staff are sufficient and effective in managing these risks. The BSL's main focus in assessing operational management is whether operational management has the capacity to identify the potential for material loss facing the activity and has in place adequate controls. Thus, the extent of examiners review of the effectiveness of operational management of a significant activity depends on the financial institution's oversight functions.

The responsibility of providing independent enterprise-wide oversight of operational management rests with the Oversight Functions. This role can be discharged through six or more functions such as Financial; Compliance; Risk Management; Internal Audit; Senior Management; and the Board. However, the presence and nature of these functions are expected to vary based on the nature, size and complexity of a financial institution's organization and its inherent risks. Notwithstanding, lack of some of the oversight functions can be an indication that the financial institution is not sufficiently independent, or does not have enterprise-wide responsibility. In such a situation

examiners would usually expect other functions, whether within or external, to step in and provide the independent oversight needed.

For each significant activity, BSL assesses operational management and the relevant oversight functions as **strong, acceptable, needs improvement or weak**. The appropriate rating is determined by comparing the nature and levels of the financial institution's controls and /or oversight against the risk.

3.5. Net Risk and Direction of Risk

3.5.1. The fourth step after assessing risk management and controls is assessing the net risk for each significant activity. The net risk is determined based on a judgmental aggregate of inherent risks offset by the aggregate elements of quality of risk management. For example, consider the case of the retail lending activity of a financial institution. It may be evaluated as having a high aggregate level of inherent risk arising from a high proportion of subprime borrowers (customers who do not meet the minimum lending requirements). However, net risk for the activity may be rated as average due to strong risk management/controls (for instance, strong underwriting standards, credit risk management, and senior management and board of directors' oversight). The supervisory expectation is that risk management controls in place are proportionate to the inherent risks to reduce the impact of net risk.

Net risk is rated **low, average, above average, or high**. Below is a sample of net risk for a significant activity.

Aggregate Quality of Risk Management for a Significant Activity	**Level of Inherent Risk for a Significant Activity**			
	Low	Average	Above Average	High
	Net Risk Assessment			
Strong	Low	Low	Average	Above Average
Acceptable	Low	Average	Above Average	High
Needs Improvement	Average	Above Average	High	High
Weak	Above Average	High	High	High

3.5.2. Net risk assessment should also include a determination of the direction of risk to reflect a forward-looking view of supervision. For this purpose, the direction of risk is determined as **increasing, stable or decreasing**. While on-site, examiners assess

the direction of risk. They should consider forward-looking features of risk factors used for the assessment of inherent risks. For example, if credit risk is the most significant risk for a particular activity conducted by a financial institution and one of its forward looking features of risk element like non-performing loans, is expected to increase in the following 12 months, then that may prompt on-site examiners to increase the net risk profile for the activity in question (i.e. from "average," to "high"). If, however, the direction of credit risk is either stable or declining, it may not alter the net risk profile for the activity concerned.

Since, however, the risk assessment process includes many judgmental considerations; it is also possible for the net risk profile for an activity to be lowered under the same scenario of a stable or declining credit risk environment after taking into account other relevant factors. Examiners can consider including, but not limited to, the following conditions while rating the direction of net risk:

- Country and world economic conditions
- Current and expected market prices on inherent risk
- The political stability of the country and its neighbors (for example, political instability can be expected to induce depositors to withdraw money from financial institutions, therefore, it increases the liquidity risk)
- Natural disaster
- Monetary policies of BSL (for example, if BSL follows a tight monetary policy to control inflation, this policy can bring about economic shrinkage. Economic shrinkage can induce the growth of non-performing loans of a financial institution)
- Financial institution's strategy (for example, whether it encourages risk-taking or risk-averse behavior)
- The possible impact of financial institution's new products and services on inherent risks
- The possible impact of new regulations on inherent risks
- Forward-looking feature of risk factors (such as expected increase in the rate of non-performing loans)

3.6. Importance and Overall Net Risk Assessment

The importance of the net risk of the significant activity is a judgment call and a function of its contribution to the overall risk profile of the financial institution. Importance is rated as **Low, Average or High**. The net risks of all significant activities are combined taking into consideration their relative importance to arrive at the Overall Net Risk of the financial institution. **Examiners exercise judgment to ensure that significant activities with high net risk but minimal impact on the financial institution's solvency do not unduly influence the composite risk rating**. The Overall Net Risk is an assessment of the potential adverse impact that the significant activities of the financial institution collectively could have on the capital adequacy, earnings performance and liquidity position. Overall Net Risk is rated as **Low, Average, Above Average or High** and the direction is assessed as **Decreasing, Stable or Increasing**.

3.7. Adjusting the Overall Net Risk

Capital

Capital adequacy is evaluated in relation to supervisory guidelines, the nature and extent of risks to the financial institution and the ability of management to address these risks. Consideration is given to the level and quality of capital and the overall financial condition of the financial institution; the nature, trend, and volume of problem assets and the adequacy of the provisions for loan and other valuation reserves; risk exposures presented by off-balance sheet activities; the quality and strength of earnings; balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and non-traditional activity risk; growth experiences, plans, and prospects; the reasonableness of dividends; access to capital markets and other appropriate sources of financial assistance; and the ability of management to address emerging needs for additional capital. The effectiveness of capital management processes for maintaining adequate capital relative to the risks across all of its significant activities is considered in the assessment.

Financial institutions with higher Overall Net Risk are expected to maintain a higher level and quality of capital and should have stronger capital management processes. Capital is rated as **Strong, Acceptable, Needs Improvement, or Weak**, and its direction is assessed as **Increasing, Stable, or Decreasing**.

Earnings

Earnings are an important contributor to a financial institution's ability to remain as a going concern. Quality and quantity of earnings are evaluated in relation to the ability to provide for adequate capital through retained earnings; level, trend, and stability of earnings; quality and sources of earnings; level of expenses in relation to operations; vulnerability of earnings to market-risk exposures; adequacy of provisions to the allowance for loan losses and other valuation reserves; reliance on unusual or non-recurring gains or losses; contribution of extraordinary items, securities transactions, and tax effects to net income; and adequacy of budgeting systems, forecasting processes, and management information systems. The assessment takes into consideration both historical trends and the future outlook under both normal and stressed conditions. Earnings are assessed in relation to the financial institution's Overall Net Risk.

Earnings are rated as **Strong, Acceptable, Needs Improvement, or Weak**, and their direction is assessed as **Increasing, Stable or Decreasing**.

Liquidity

Adequate balance sheet liquidity is critical for the overall safety and soundness of a financial institution. Liquidity management is evaluated in relation to the trend and stability of deposits, degree and reliance on short-term deposits, volatile sources of funds, including any undue reliance on borrowings or brokered deposits to fund long-term assets; availability of assets readily convertible to cash without undue loss; availability to securitize and sell certain pools of assets; access to money markets and other sources of funding; adequacy of liquidity sources and ability to meet liquidity needs; effectiveness of liquidity policies and practices, funds-management strategies, management information systems, and contingency-funding plans; capability of management to properly identify, measure, monitor, and control liquidity; and level of diversification of funding sources both on-and off-balance-sheet. Liquidity challenges may arise from a potential inability to purchase or otherwise obtain the necessary funds to meet its on- and off-balance sheet obligations as they become due. Financial institutions are required to maintain, both at present and prospectively, a level of

liquidity risk and liquidity management processes that are prudent, under both normal and stressed conditions.

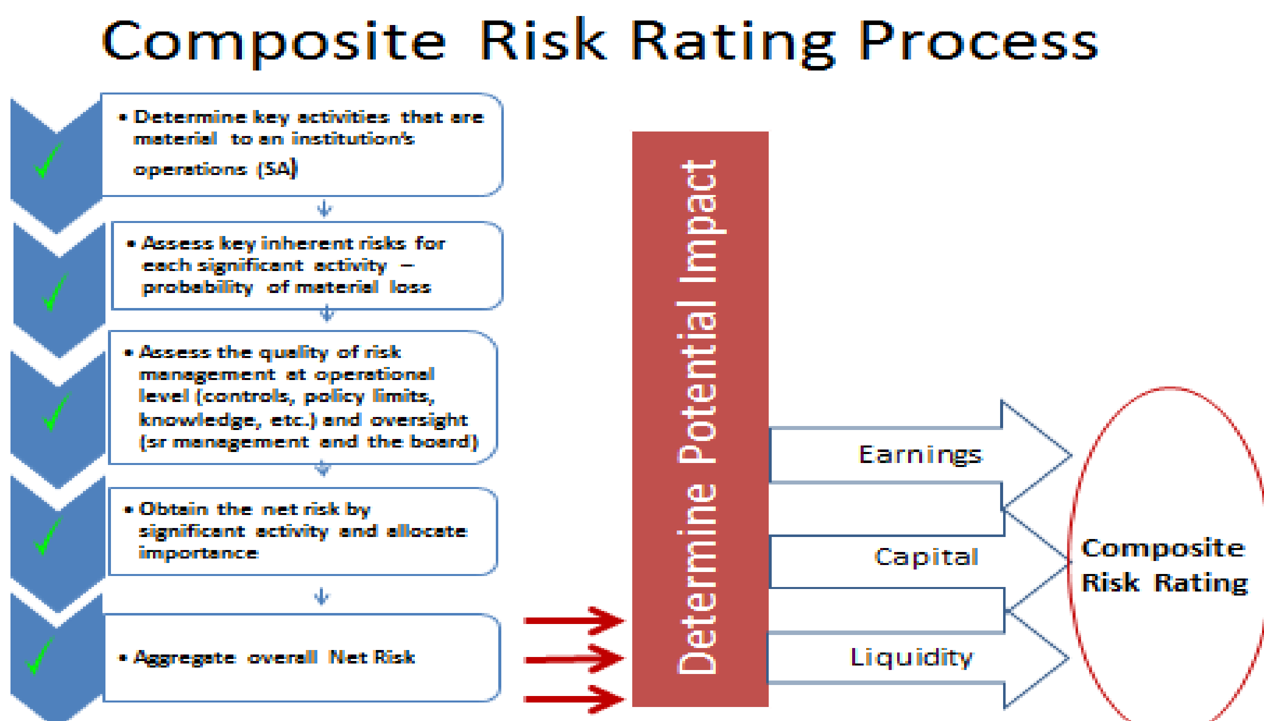
Liquidity is rated as **Strong, Acceptable, Needs Improvement, or Weak,** and the direction is assessed as **Increasing, Stable or Decreasing**.

3.8. Composite Risk Rating (CRR)

3.8.1. The CRR is an assessment of the financial institution's risk profile, after considering the impact of the Overall Net Risk on capital, earnings and liquidity. Composite Risk is rated **Low, Average, Above Average or High**.

The assessment is supplemented by an appropriate time frame for reviewing or updating the composite risk rating and the direction of Composite Risk, which is the examiner's assessment of the most likely direction in which the CRR may move. The direction of CRR is rated as **Decreasing, Stable, or Increasing**.

The BSL's approach to assessing CRR is summarized in the chart below:



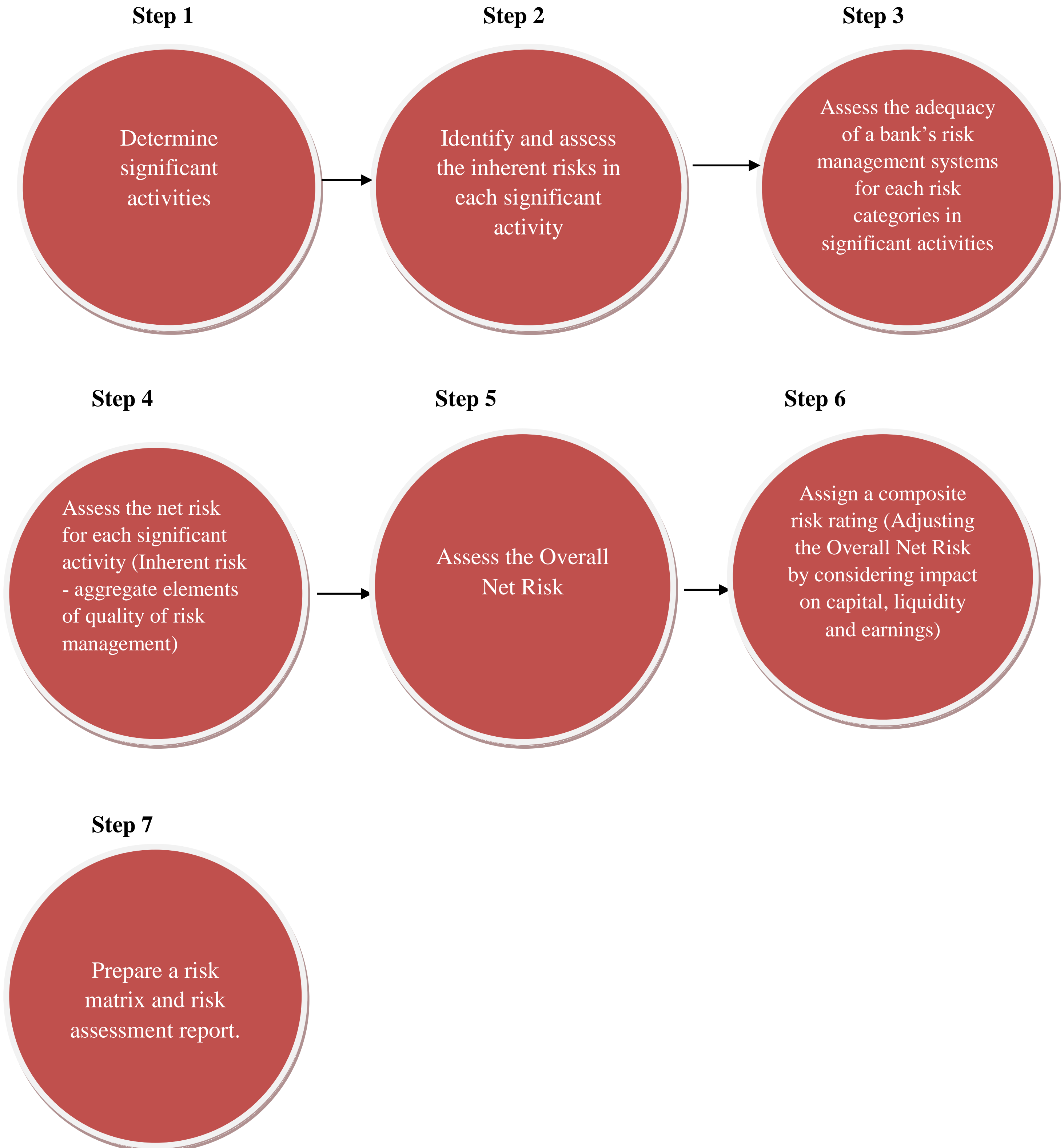
3.9. Risk Matrix and Risk Assessment Report

3.9.1. The next step is to develop a risk matrix which shows the composite rating and direction of risk. The risk matrix also reflects net risk of each identified significant activity, overall net risk and their direction. The Risk Matrix is a tool that summarizes the conclusions of the risk assessment **(S*ee Appendix D for a sample Risk Matrix*)**.

3.9.2. The Examiner prepares a risk assessment report (RAR) that shows the overall level of risk by inherent risk category and its direction. It analyses each of the risk categories within each of the significant business activities and evaluates qualitatively, management's effectiveness in managing and controlling the risk categories. The goal of the RAR is to develop a composite risk profile of a financial institution and provide the background to how the composite risk profile for the financial institution has been derived.

3.10. Risk Assessment Report Process

3.10.1. The following steps are tracked in the risk assessment process.



4. The Supervisory Process

Supervision is a process that begins with planning and continues throughout the examination and includes follow-up phases. BSL examiners prepare the appropriate supervisory products based on available resources and determine the frequency of financial institution examination and the order in which financial institutions' activities will be supervised. The examiners complete the risk profiling of financial institutions in accordance with risk-based supervision methodology before the beginning of the examination year. An effective supervision plan will save considerable time and effort during the on-site examination.

4.1. Institutional Overview (IO)

4.1.1 A critical aspect of risk-based supervision is developing an understanding of the financial institution. This step is important in tailoring the supervision program to meet the characteristics of the organization and adjusting that program on an ongoing basis as circumstances change. The IO emphasizes planning and monitoring, and directs supervisory focus on the significant risks of the institution and related supervisory concerns. Given the technological and market developments within the financial sector and the speed with which an institution's financial condition and risk profile can change, it is critical to keep abreast of events and changes in risk exposure and strategy. Accordingly, the RM for each financial institution should review certain information on an ongoing basis and prepare an IO that will communicate the RM's understanding of an institution. While an IO should communicate, concisely, information demonstrating an understanding of the institution's present condition and its current and prospective risk profiles, it should also include the following general types of information:

- A brief description of the organizational structure, with comments on the legal and business units, and changes through merger, acquisition, divestitures, consolidation, or charter conversion since the prior review

- A summary of the organization's business strategies, key business lines, product mix, marketing emphasis, growth areas, acquisition or divestiture plans, and new products introduced since the last review
- Key issues relating to the organization, either from external or internal factors (e.g., difficulties in keeping pace with competition, poorly performing business lines)
- An overview of management, commenting on the level of board oversight, leadership strengths or weaknesses, policy formulation, and the adequacy of management information systems. Comments should include anticipated changes in key management, unusual turnover in line management, and management succession plans. Key executives and the extent of their participation in strategic planning, policy formulation, and risk management may also be described
- A brief analysis of the consolidated financial condition and trends, including earnings, invested capital and return on investment by business line
- A description of the future prospects of the organization, expectations or strategic forecasts for key performance areas, and budget projections
- Descriptions of internal and external audit, including the nature of any special work performed by external auditors during the period under review
- A summary of supervisory activities performed since the last review, including: safety and soundness examinations, targeted or specialty examinations; supervisory actions and the institution's degree of compliance; and applications approved or in process
- Considerations for conducting future examinations, including the institution's preference for the coordination of specialty examinations and combined examination reports, as well as logistical and timing considerations, including conversion activities, space planning, and management availability

4.2. Supervisory Plan

4.2.1. General

4.2.1.1. During planning, examiners develop detailed strategies for providing effective and efficient supervision for each financial institution. Previous RAR shapes the supervisory plan. The supervisory plan brings out the unsatisfactory features in the operations of the financial institution that requires urgent and closer attention.

4.2.1.2. The supervisory plan summarizes the plan for monitoring and examining the financial institution
and its affiliates. The plan should generally address:

- The scope of supervisory activities
- Specific concerns regarding supervisory activities, if any
- Timetable of supervisory activities, participants, and expected resource requirements

4.2.1.3. The Supervisory plan should describe the priorities for BSL supervision activities in accordance with its risk assessment of the financial institution to assist in allocating and scheduling examiner resources. The Plan should be updated at least annually or at any time as a result of changes in the risk assessment of a financial institution. Relationship managers, in collaboration with on-site and off-site examiners, should develop the supervisory plan for each financial institution reviewed and this should be approved by the Director of BSL.

4.2.1.4. The planning horizon to be covered is generally 12 months. Financial institutions falling in the high and above average CRR categories should be examined at shorter intervals, and those falling in the average and low CRR categories at longer intervals. The plan should be finalized by the end of the year, for execution in the following year.

4.2.1.5. The plan is prepared by considering the risk-based supervisory methodology of BSL. The Risk-based supervisory methodology, which by design is circular and conducted on as current a basis as possible in a continuous cycle, can be complemented and strengthened by on-site visitations, prudential interviews, annual tripartite meetings and annual supervisory meetings with the board of directors of a financial institution.

4.2.2. Preparation of Supervisory Plan

4.2.2.1. The risk-based approach and preparation of the supervisory plan begins with on-site visitations to financial institutions during the process of updating the risk assessment prior to the start of, or subsequent to, the on-site examination. The purpose of the "pre-on-site" visitation is usually to obtain a current picture of recent developments, which may have an effect on the risk profile of the financial institution, such as the introduction of new products or any significant changes in the risk management systems. Also, during the pre-on-site visitation, examiners are required to perform a general assessment of the corporate governance and internal audit function of the financial institution. The corporate governance assessment should, at a minimum, include the financial institution's board and senior management's:

- Knowledge and experience in the financial institution's major business activities, and risk management systems
- Participation and involvement in developing the risk management processes, and
- Responsiveness to risk management and control issues raised by the BSL

The RM should also review the internal audit's independence and performance. The results of the assessment will be used to decide the scope for the risk-based on-site examination. If the corporate governance and internal audit function is acceptable and meets BSL's standards, the BSL will determine whether to place reliance on its work and reduce the scope of the on-site examination. In a pre-on-site visitation, the RM and examiner-in-charge should, at least, meet with:

- The audit committee and risk management committee of the financial institution
- Senior officers responsible for risk management and internal control functions
- The head of the internal audit function and external auditors of a financial institution.

The RM should prepare, with the assistance of the examiner-in-charge, pre on-site questionnaires to evaluate the financial institution's risk management, corporate governance and internal audit's independence and performance.

The pre on-site visitation may involve the following procedures:

- Discussions with board members and senior managers
- On-site observations
- Review of management reports and studies
- Flowcharting
- Functional walk through documenting key control activities

4.2.2.2. Once the draft supervisory plan is prepared, the RM discusses the draft plan, which typically

includes any issues arising out of the corporate governance, independence of internal audit and updating risk profile of a financial institution with the Director and Assistant Director of BSD.

In accordance with this discussion, the following issues are determined for supervisory plan:

- Significant activities and inherent risks related to those activities (the objectives and scope of supervisory activities)
- A schedule of activities, duration of time, and resource estimates, frequency of on-site examination for planned supervision (timetable of supervisory activities, participants, and expected resource requirements)
- The need for special examiner skills and the extent of participation by specialty disciplines

4.3. Examination

4.3.1. *General*

4.3.1.1. Supervisory activities are designed to determine the condition and risk profile of a financial institution, identify areas in need of corrective action, and monitor ongoing activities. During on-site activities, examiners focus on identifying the root cause of deficiencies and ensuring that management is taking appropriate and timely steps to address and correct all deficiencies. At the end of the examination, the examiners should prepare RAR.

4.3.1.2. Effective financial institution supervision should consist of both on-site and off-site supervision with forward-looking views. If a deterioration or potential deterioration in the financial institution's condition is detected in the off-site reviews, which typically involve analysis of information regularly submitted by the financial institution, on-site examination can be used to assess more precisely the nature, breadth and depth of the problem.

4.3.2. ***On-site Examination***

4.3.2.1. More specifically, on-site examiners should:

- Assess the financial institution's risk management system to identify, measure, monitor and control the various types of risks within its significant activities
- Assess the financial institution's policies, procedures, limits and controls to manage the appropriate types of inherent risk identified by the BSL in the financial institution's significant activities and any other risks, which have been identified by the financial institution itself
- Evaluate whether the financial institution's systems and procedures are in place to ensure compliance with guidelines related to the financial institution's significant activities, which have been issued by the BSL
- Perform sufficient testing to validate the integrity of risk management systems
- Identify unacceptable levels of risk, deficiencies in risk management systems, and the underlying causes of any deficiencies,
- Review the financial institution's prepared action plans to resolve each significant deficiency, including the appropriateness of the time frames for corrective action
- Verify that the financial institution is executing the action plans
- Evaluate whether the actions the financial institution has taken (or plans to take) adequately address the deficiencies

4.3.2.2. On-site examination begins with entry letter in which written responses and copies of specific documents or information are requested by the examiner-in-charge. The entry letter should be used as a starting point, or template, in preparing for an examination. The

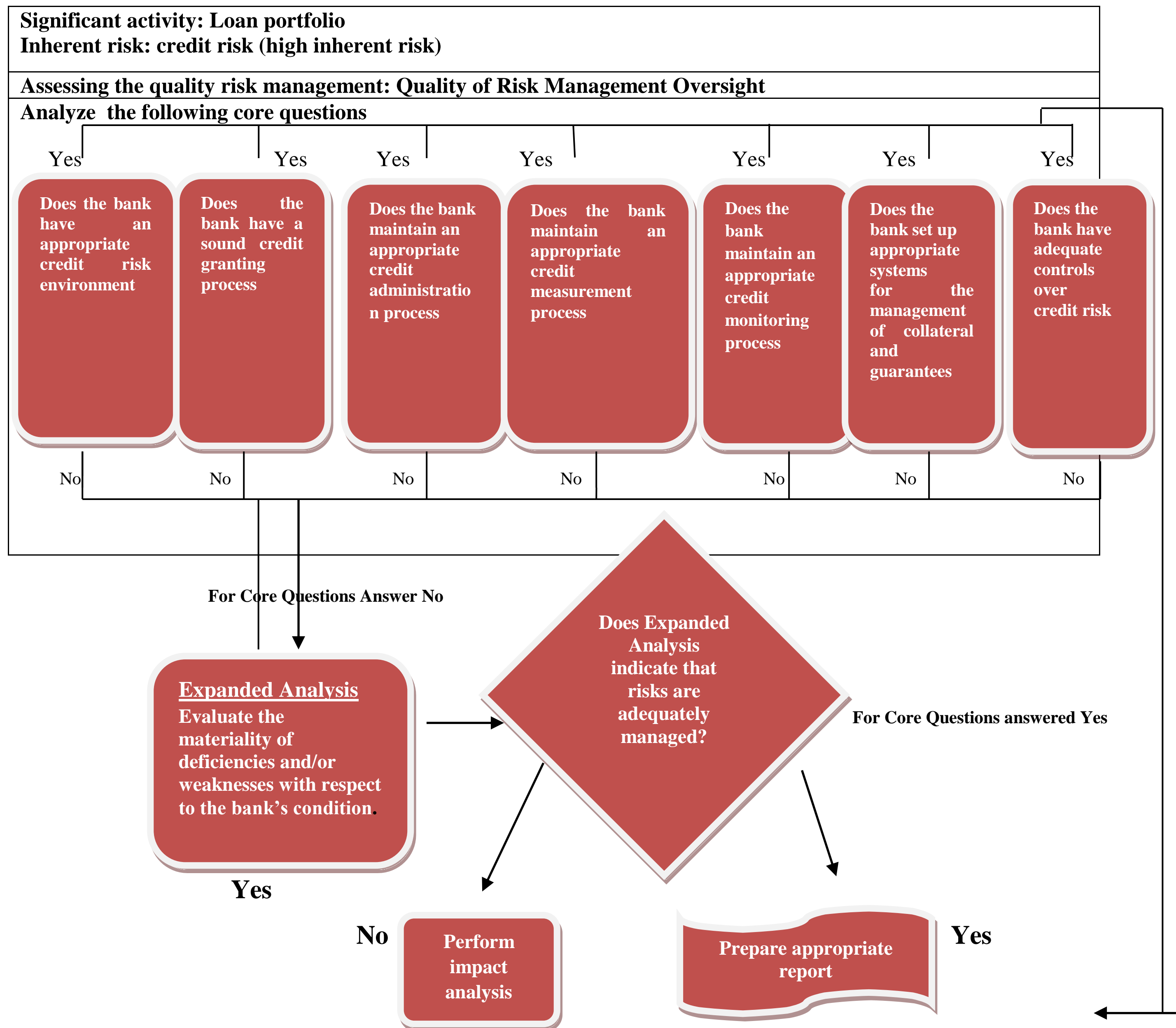
RM and examiner-in-charge jointly determine the information and documents that are used for supervision of financial institutions in accordance with the scope of the supervisory activity. There are no standard entry letters. The entry letters should be tailored in accordance with the supervisory plan to fit the proposed scope and profile of the financial institution to be examined. Care must be taken to ensure that items requested will facilitate efficiency in the examination process and lessen the burden on financial institutions and avoid duplication of requests for information already provided to off-site examiners. Additionally, management should be allowed sufficient lead time to prepare the requested information.

4.3.2.3. To assist the documentation of an examination, on-site examiners can use a tiered approach
for reviewing the financial institution's activities:

- Tier 1 –Evaluating the core risk elements for each significant activity
- Tier 2- Expanded analysis of deficiencies or weaknesses
- Tier 3- Impact analysis of the identified financial or non-financial deficiencies on the financial institution and possible supervisory actions.

Example:

Suppose the loan portfolio is identified as a significant activity and the quality of risk management is being assessed, the table below shows how the tiered approach works.



4.4. Exit Meeting with Management and the Board

4.4.1. Following the completion of the examination, a meeting is held with the relevant area line management and executive officers responsible for functions that are examined. Matters discussed typically include any issues arising out of the significant activities of

the financial institution such as weaknesses identified in the risk management system of the financial institution.

Prior to the exit meeting, the RM and on-site examiners should discuss significant findings including preliminary ratings with the Director and the Assistant Directors of the BSD. This discussion helps ensure that BSD policy is consistently applied and that BSD management supports the conclusions and any corrective action to be recommended. If examiners and directors have disagreement on discussion issues, the director's decision will prevail but those who have objection have the right to put an annotation on the RAR. The Governor or his Deputy can consider that annotation before the RAR is sent to the financial institution. The examiner-in-charge and the RM should attend the exit meeting. Depending on the severity of the findings, the Director, Deputy Director and Assistant Director will decide whether to attend such meetings.

At the exit meeting, the RM or directors will ask for management's commitment to correct weaknesses noted during the supervisory activity and will, when appropriate, offer examples of acceptable solutions to the identified problems. It is presumed that a Board of Directors meeting should be convened to present examination findings if deemed significant or of higher composite risk rating. The BSL is at liberty to invite Board members and/or senior management to discuss events subsequent to the examination. The examiners can have a meeting with external auditors to discuss their management letter and any other matters of prudential concern. After the exit meeting, BSL should finalize the draft report incorporating the financial institution's responses and the degree of supervisory intervention.

The degree of supervisory intervention should be consistent with the severity of the financial institution's risk profile, which is already captured in the assigned Composite Risk Rating. (See Appendix E for the alignment between Composite Risk Ratings and Intervention Ratings). Following the completion of the process, the financial institution's Risk Assessment Matrix should be updated on a continuous basis as necessary.

4.5. Off-Site Examination

4.5.1. The central objective of off-site surveillance is to monitor the condition of the individual institution, peer groups, and the banking system. Financial ratio analysis for individual institutions generates a warning if a ratio exceeds a predetermined critical level, or lies within a set interval, or is an outlier as far as the past performance of the institutions concerned. Peer group analysis is undertaken on the basis of financial ratios for a group of institutions. It is used to ascertain whether an individual institution is performing in a significantly different way from its peers and the reason for such significant difference, which may or may not imply supervisory concern. This process provides an early indication of an individual institution's problems as well as systemic problems.

The constitution of peer groups in systems under this approach is generally done on the basis of asset size (e.g. small versus large banks) or on the basis of specific segments of the banking industry (e.g. domestic commercial banks, foreign banks or community banks). Each institution's individual ratios are compared with the peer group to which it belongs. Within each peer group, either a simple identification of the worst performers as compared to the peer average is made or the financial ratios are sorted from best to worst, and percentile rankings are calculated. Individual institutions whose financial ratios have deteriorated relative to the averages of their respective peer group can then be identified.

Financial ratio analysis and peer group analysis should be used for the supervisory plan to prioritize the use of scarce supervisory resources.

APPENDICES

Appendix A: Inherent Risk Categories and Ratings

Risk Categories

Credit Risk

Credit risk arises from a counterparty's potential inability or unwillingness to fully meet its on- and/or off-balance sheet contractual obligations. Exposure to this risk occurs any time funds are extended, committed, or invested through actual or implied contractual agreements.

Components of credit risk include: loan loss/principal risk, pre-settlement/replacement risk and settlement risk.

Counterparties include: issuers, debtors, borrowers and guarantors.

Market Risk

Market risk arises from potential changes in market rates, prices or liquidity in various markets such as for interest rates, credit, foreign exchange, equities, and commodities. Exposure to this risk results from trading, investment, and other business activities which create on- and off-balance sheet positions.

Positions include: traded instruments, investments, net open (on- and off-) balance sheet positions, assets and liabilities, and can be either cash or derivative (linear or options-related).

Operational Risk

Operational risk arises from potential problems due to inadequate or failed internal processes, people and systems, or from external events. Exposure to operational risk results from either normal day-to-day operation (such as deficiencies or breakdowns in respect of transaction processing, fraud, physical security, money laundering and terrorist financing, data/information security, information technology systems, modeling, outsourcing, etc.) or a specific, unanticipated event (such as natural disasters, loss of a key person, etc.).

Legal Risk

Legal risk arises from a banking institution's potential non-conformance with laws, rules, regulations, litigation, court interpretations of a contract liability, prescribed practices, or ethical standards in any jurisdiction in which it operates.

Strategic Risk

Strategic risk arises from a banking institution's potential inability to implement appropriate business plans and strategies, make decisions, allocate resources, or adapt to rapid changes in its business environment.

Reputational Risk

Reputational risk arises from the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

Risk Assessment

A material loss is a loss or combination of losses that could impair the adequacy of the capital of a banking institution such that there is the potential for loss to depositors or other stakeholders.

Low

Low inherent risk exists when there is a lower than average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.

Average

Average inherent risk exists when there is an average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.

Above Average

Above average inherent risk exists when there is an above average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.

High

High inherent risk exists when there is a higher than above average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.

Appendix B: Functional Risk Mapping

Functional Areas						
Banking operations:	**Credit**	**Market**	**Operational**	**Strategic**	**Reputational**	**Legal**
-deposit liabilities other than banks		X	X	X	X	X
-special deposit accounts		X	X	X	X	X
-deposits from banks and financial institution			X		X	X
-bankers cheques and drafts issued		X	X	X	X	X
-payment orders/transfers payable			X		X	X
–trust and safe custody			X			
Cash management			X			
Clearing/Payment system:						
-cheques and items for clearing			X		X	X
-Interbranch float items			X		X	
-electronic payment system e.g. ATMs, internet			X		X	X

Appendix C: Quality of Risk Management Categories, Ratings and Overall Risk Ratings

Risk Categories

Oversight Functions

Financial

Financial is an independent function responsible for ensuring the timely and accurate reporting and in-depth analysis of the operational results of a banking institution in order to support decision-making by Senior Management and the Board. Its responsibilities include:

- providing financial analysis of the banking institution and business line/unit performance and the major business cases to senior management and the board, highlighting matters requiring their attention; and
- ensuring that principal risks are identified and appropriately managed.

Compliance

Compliance (including the Chief Anti-Money Laundering Officer) is an independent function with the following responsibilities:

- setting the policies and procedures for adherence to legal and regulatory requirements in all jurisdictions where the banking institution operates;
- monitoring the banking institution's compliance with these policies and procedures; and
- reporting on compliance matters to Senior Management and the Board.

Risk Management

Risk management is an independent function responsible for the identification, assessment, monitoring, and reporting of risks arising from the banking institution's operations. Its responsibilities typically include:

- identifying enterprise-wide risks;
- developing systems or models for measuring risk;
- establishing policies and procedures to manage risks;
- developing risk metrics (e.g., stress tests) and associated tolerance limits;
- monitoring positions against approved risk tolerance limits and capital levels; and

- reporting results of risk monitoring to senior management and the board.

Internal Audit

Internal audit is an independent function with responsibilities that include:

- assessing adherence to, and the effectiveness of, operational controls and oversight, including corporate governance processes; and
- reporting on the results of its work on a regular basis to Senior Management and directly to the Board or Audit Committee.

Senior Management

Senior Management is responsible for directing and overseeing the effective management of the general operations of the banking institution. Its key responsibilities include:

- developing, for Board approval, the business model and associated objectives, strategies, plans, organizational structure and controls, and policies;
- developing and promoting (in conjunction with the Board) sound corporate governance practices, culture and ethics, which includes aligning employee compensation with the longer-term interests of the banking institution;
- executing and monitoring the achievement of Board-approved business objectives, strategies, and plans and the effectiveness of organizational structure and controls; and
- ensuring that the Board is kept well informed.

Board

The Board is responsible for providing stewardship and oversight of management and operations of the entire banking institution. Its key responsibilities include:

- guiding, reviewing and approving the business model and associated objectives, strategies and plans
- reviewing and approving corporate risk policy including overall risk appetite and tolerance
- ensuring that Senior Management is qualified and competent
- reviewing and approving organizational and procedural controls

- ensuring that principal risks are identified and appropriately managed
- ensuring that compensation for employees, Senior Management and the Board is aligned with the longer term interests of the banking institution
- reviewing and approving policies for major activities
- providing for an independent assessment of management controls

Operational Management

Operational management is responsible for planning, directing and controlling the day-to-day operations of a significant activity of a banking institution.

Ratings

Strong

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function exceed what is considered necessary, given the nature, scope, complexity, and risk profile of the banking institution. The function has consistently demonstrated highly effective performance. The function's characteristics and performance are superior to sound industry practices.

Acceptable

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function meet what is considered necessary, given the nature, scope, complexity, and risk profile of the financial institution. The function's performance has been effective. The function's characteristics and performance meet sound industry practices.

Needs Improvement

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function generally meet what is considered necessary, given the nature, scope, complexity, and risk profile of the financial institution, but there are some significant areas that require improvement. The function's performance has generally been effective, but there are some significant areas where effectiveness needs to be improved. The areas needing

improvement are not serious enough to cause prudential concerns if addressed in a timely manner. The function's characteristics and/or performance do not consistently meet sound industry practices.

Weak

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function are not, in a material way, what is considered necessary, given the nature, scope, complexity, and risk profile of the financial institution. The function's performance has demonstrated serious instances where effectiveness needs to be improved through immediate action. The function's characteristics and/or performance often do not meet sound industry practices.

DEFINITION OF COMPOSITE RISK RATINGS (CRR):

The Composite Risk Rating is an assessment of the institutions overall risk profile, after considering the impact of the its Overall Net Risk on capital, earnings and liquidity. It reflects BSL's assessment of the safety and soundness of the institution.

An institution's Composite Risk Rating is assessed as **"Low"**, **"Average"**, **"Above Average"**, or **"High"**, with the direction of change assessed as **"Decreasing"**, **"Stable"** or **"Increasing"** for a specified time frame, depending on the institution's circumstances, and the business and economic environment.

Low Composite Risk Rating:

A strong, well-managed institution. The combination of its overall net risk and its capital, liquidity and earnings makes the institution resilient to most adverse business and economic conditions without materially affecting its risk profile. Its performance has been consistently good, with most key indicators in excess of industry norms, allowing it ready access to additional capital. Any supervisory concerns have a minor effect on its risk profile and can be addressed in a routine manner. Normally, an institution in this category would have a low overall net risk coupled with acceptable capital, earnings and liquidity, or average overall net risk coupled with

strong capital, earnings and liquidity. Other combinations may be possible depending on the circumstances of the institution.

Average Composite Risk Rating:

A sound, generally well-managed institution. The combination of its overall net risk and its capital, earnings and liquidity makes the institution resilient to normal adverse business and economic conditions without materially affecting its risk profile. The institution's performance is satisfactory, with key indicators generally comparable to industry norms, allowing it reasonable access to additional capital. Supervisory concerns are within the institution's ability to address.

Normally, an institution in this category would have average overall net risk coupled with acceptable capital, earnings and liquidity, or low overall net risk coupled with capital, earnings and liquidity that need improvement. Other combinations may be possible depending on the circumstances of the institution.

Above Average Composite Risk Rating:

The institution has issues that indicate an early warning or that could lead to a risk to its financial viability. One or more of the following conditions are present. The combination of its overall net risk and its capital, earnings and liquidity makes the institution vulnerable to adverse business and economic conditions. Its performance is unsatisfactory or deteriorating, with some key indicators at or marginally below industry norms, impairing its ability to raise additional capital. The institution has issues in its risk management that, although not serious enough to present an immediate threat to financial viability or solvency, could deteriorate into serious problems if not addressed promptly.

Normally, an institution in this category would have above average overall net risk, which is not sufficiently mitigated by capital, earnings and liquidity, or average overall net risk coupled with capital, earnings and liquidity that need improvement. Other combinations may be possible depending on the circumstances of the institution.

High Composite Risk Rating:

The institution has serious safety and soundness concerns. One or more of the following conditions are present. The combination of its overall net risk and its capital, earnings and liquidity is such that the institution is vulnerable to most adverse business and economic

conditions, posing a serious threat to its financial viability or solvency unless effective corrective action is implemented promptly. Its performance is poor, with most key indicators below industry norms, seriously impairing its ability to access additional capital from external sources.

Normally, an institution in this category would have high overall net risk, which is not sufficiently mitigated by capital, earnings and liquidity, or above average overall net risk coupled with capital, earnings and liquidity that need improvement. Other combinations may be possible depending on the circumstances of the institution

Appendix D: Sample of Risk Matrix

Significant Activities	Volume or Relative Weight	Inherent Risk						Quality of Risk Management						Net Risk	Direction	Importance
		Credit	Market	Operational	Legal	Strategic	Reputational	Board Oversight	Senior Management	Risk Management	Internal Audit	Fin Analysis	Compliance			
Lending Comm. RE Retail Personal Other OREO	60% TA Moderate 40% Mod 40% Low 10% Low 3% Low 2%	H	L	AA	H	L	H	Acc	Acc	Acc	Acc	Acc	Acc	A	Increasing	H
Treasury and Investment Concentration SWAP Funding Risk	Moderate 25% High Quality High NA Low	L	L	L	H	L	H	W	NI	NI	Acc	Acc	NI	A	Stable	H
Information System	High	N/A		AA	N/A	N/A	N/A	W	Acc	Acc	Acc	N/A	Acc	A	Stable	A
Mergers and Acquisition	High	N/A		AA	AA		AA	S	S	Acc	Acc	Acc	Acc	A	Decreasing	L
Human Resources	High	N/A		L	L			Acc	Acc	Acc	Acc	N/A	Acc	H	Stable	L
Overall Net Risk								Acc	Acc	Acc	Acc		Acc	A	Stable	

Key:

- H: High
- AA: Above
- A: Average
- L: Low
- Acc: Acceptable
- NI: Needs Improvement
- N/A: Not Applicable

	Rating	Direction	Time Frame
Capital	Acceptable	Stable	
Earnings	Needs Improvement	Increasing	
Liquidity	Strong	Stable	
Composite Risk	**Average**	**Stable**	**12 Months**

Appendix E: Aligning Composite Risk Ratings with Intervention Ratings

Composite Risk Rating	Intervention Rating
Low	0 Normal
Average	0 Normal 1 Early Warning
Above Average	1 Early Warning 2 Risk to financial viability or solvency
High	2 Risk to financial viability or solvency 3 Future financial viability in serious doubt 4 Non-viability/insolvency imminent