Risk-Focused Examination Process – an Overview

Federal Reserve System
Traditional Process

- Point-in-time
- Surprise entry
- Revalidation of the balance sheet and income statement
- Compliance with laws and regulations
- Significant transaction testing
Evolution of Examination Process

- Heavy reliance on bank’s internal controls/risk management systems
- Continuous supervision/risk assessment
- Customized examination plan
Risk-focused Examination Principles

- Encourage strong risk management practices in banks
- Tailor supervisory plan to individual bank risks
- Early warning system
- Don’t repeat what has already been performed by reliable sources
Risk-Focused Process

- **Community Bank Supervision**
  - Annual on-site examinations and quarterly meetings with bank management

- **Large Complex Bank Supervision**
  - Examiners assigned full time to institution with heavy emphasis on continuous monitoring plus a series of target examinations
Steps in the Process

- Develop an approach appropriate to the institution
- Develop a standard set of documents to describe the institution and document the examination approach
Examination Timeline

Off-Site
- Institutional Profile
- Scope Memo
- Supervisory Plan
- Risk Assessment
- Entry Letter

On-Site Review
- Analysis
- Transaction testing
- Discussions

Off-Site
- Follow up Monitor
THE RISK-FOCUSED EXAM PROCESS

- Understanding the Institution and Information Gathering
- Assessing Institutional Risk by Evaluating Risks and Risk Control Systems
- Determining Supervisory Work
- Defining Examination Activities
- Customizing Information Requests for the On-site Examination
- Institutional Profile
- Risk Matrix and Risk Assessment
- Supervisory Plan/Examination Program
- Scope Memorandum
- Entry Letter
THE RISK-FOCUSED EXAM PROCESS

- Performing On-site Examination
- Reporting Examination Findings
- Conducting Ongoing Off-Site Supervision
- Use of Examination Modules; Work paper Program
- Examination Report or Other Summary Documents; US Operations Letters; Meetings with Management and/or Board
- Updating Risk-Focused Documents; Surveillance and Monitoring; Management Meetings
Risk Categories

Inherent Risk

- Credit
- Market
- Liquidity
- Operational
- Legal
- Reputational
Inherent Risk

- The level of risk that is present in the business activities conducted by a bank
- The inherent risk involved in that activity should be described as
  - High
  - Moderate, or
  - Low
High Inherent Risk

High inherent risk exists where the activity is significant or positions are large in relation to the institution’s resources or to its peer group, where there are a substantial number of transactions, or where the nature of the activity is inherently more complex than normal. The activity potentially could result in a significant and harmful loss to the institution.
Moderate inherent risk exists where positions are average in relation to the institution’s resources or to its peer group, where the volume of transactions is average, and where the activity is more typical or traditional. While the activity potentially could result in a loss to the organization, the loss could be absorbed by the organization in the normal course of business.
Low Inherent Risk

Low inherent risk exists where the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the institution’s overall financial condition.
Effective risk management is the ability to adequately identify, measure, monitor and control the risks that are involved in its various products and lines of business in a safe and sound manner.
When assessing the adequacy of an institution’s risk management systems, primary consideration on the following key elements is essential:

- Active board and senior management oversight
- Adequate of policy and procedures
- Adequate risk management, monitoring, and management information systems, and
- Comprehensive internal controls and audit
Relative Strength of Risk Management Processes

- Relative strength should be characterized as
  - Strong
  - Acceptable
  - Weak
Relative Strength of Risk Management Processes

Strong risk management indicates that management effectively identifies and controls all major types of risk posed by the relevant activity. Board and management participate in managing risk and ensure proper policies exist. Policies and limits are supported by monitoring procedures, reports and management information systems that are accurate and timely. Internal controls and audit are appropriate for the activities of the institution. There are few exceptions to established policies and none of these exceptions would lead to a significant loss to the organization.
Relative Strength of Risk Management Processes

Acceptable Risk Management indicates that the institution’s risk management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution’s business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and addressed. Overall, the board and senior management oversight, policies and limits, risk monitoring and information systems are considered effective. Risks are generally controlled in a manner that does not require more than normal supervisory attention.
Relative Strength of Risk Management Processes

Weak Risk Management indicates risk management systems are lacking in important ways and therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important aspects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.
Board and Senior Management Oversight

The board of directors and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution’s activities and have made appropriate efforts to remain informed about these risks as financial markets, risk management practices, and the institution’s activities evolve.
Board and Senior Management Oversight

The board has reviewed and approved appropriate policies to limit risks inherent in the institution’s lending, investing, trading, trust, fiduciary and other significant activities or products.
The board and management are sufficiently familiar with and are using adequate record keeping and reporting systems to measure and monitor the major sources of risk to the organization.
Board and Senior Management Oversight

The board periodically reviews and approves risk exposure limits to conform with any changes in the institution’s strategies, addresses new products, and reacts to changes in market conditions.
Board and Senior Management Oversight

Management ensures that its lines of business are managed and staffed by personnel with knowledge, experience, and expertise consistent with the nature and scope of the banking organization’s activities.
Board and Senior Management Oversight

Management ensures that the depth of staff resources is sufficient to operate and manage soundly the institution’s activities and that its employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.
Management at all levels provides adequate supervision of the daily activities of officers and employees, including management of senior officers or heads of business lines.
Board and Senior Management Oversight

Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
Before embarking on new activities or introducing products new to the institution, management identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.
Adequate Policies, Procedures, and Limits
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The institution’s policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its activities.
Adequate Policies, Procedures, and Limits

The policies, procedures, and limits are consistent with management’s experience level, the institution’s stated goals and objectives, and the overall financial strength of the organization.
Adequate Policies, Procedures, and Limits

Policies clearly delineate accountability and lines of authority across the institution’s activities.
Adequate Policies, Procedures, and Limits

Policies provide for the review of activities new to the financial institution to ensure that the infrastructures necessary to identify, monitor, and control risks associated with an activity are in place before the activity is initiated.
Adequate Risk Monitoring and Management Information Systems
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- The bank’s risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources and procedures used in measuring risk are appropriate, documented, and tested for reliability.
Adequate Risk Monitoring and Management Information Systems

Reports and other forms of communication are consistent with the banking organization’s activities, are structured to monitor exposures and compliance with established limits, goals, or objectives, and as appropriate, compare actual versus expected performance.
Adequate Risk Monitoring and Management Information Systems

Reports to management or to the institution’s directors are accurate and timely and contain sufficient information for decision-makers to identify any adverse trends and to evaluate adequately the level of risk faced by the institution.
Adequate Internal Controls
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The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization’s activities.
Adequate Internal Controls

The institution’s organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures and limits.
Adequate Internal Controls

Reporting lines provide sufficient independence of the control areas from the business lines and adequate separation of duties throughout the organization’s activities.
Adequate Internal Controls

Official organizational structures reflect actual operating practices.
Adequate Internal Controls

Financial, operational, and regulatory reports are reliable, accurate, and timely; wherever applicable, exceptions are noted and promptly investigated.
Adequate Internal Controls

Adequate procedures exist for ensuring compliance with applicable laws and regulations.
Audit

Internal audit or other control review practices provide for independence and objectivity.
Audit

Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely high level attention; and management’s actions to address material weaknesses are objectively verified and reviewed.
Audit

The institution’s audit committee or board of directors reviews the effectiveness of internal audits and control review activities on a regular basis.
Net Residual Risk

High Quantity
Weak RM Process

High Exposure

Weak RM Process

Low Quantity
Weak RM Process

Low Exposure

Strong RM Process

Low Quantity
Strong RM Process
Trend

- Increasing
- Stable
- Declining
On-Site Review

From the off-site risk scoping process, the examiner needs to take the hypothesis of the bank’s condition and develop examination techniques for the on-site review to assess the level of risk.
On-Site Review

- Review transactions/processes
- Evaluate models
- Observe
- Discuss
- Finalize financial analysis
- Finalize analysis of risk management
Reporting Examination Findings

- Meetings with bank management or board of directors at conclusion of examination
- Written report of examination
Continuous Supervision

Begin the risk-focused process by following up on examination findings and continuously reviewing changes in the bank’s financial condition and risk management practices.
Questions
References