The Key Elements of Risk-focused Supervision and Assessing the Risk Profile of a Bank

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Agenda

- Regulatory Objectives and Principles of Good Regulation
- The need to risk-focus, its elements, and benefits
- The Supervisory Process
- Our approach in practice
- Comparing Supervisory Approaches

Regulatory Objectives and Principles of Good Regulation

Regulatory Objectives

1. The promotion and maintenance of efficiency, transparency and the integrity of the QFC;

2. The promotion and maintenance of confidence in the QFC of users and prospective users of the QFC;

3. The maintenance of the financial stability of the QFC, including the reduction of systemic risk relating to the QFC;

4. The prevention, detection and restraint of conduct which causes or may cause damage to the reputation of the QFC, through appropriate means including the imposition of fines and other sanctions;

Regulatory Objectives

5. The provision of appropriate protection to those licensed to carry on business at the QFC and their clients or customers;

   i. the financial integrity of Authorised Firms through appropriate financial resources requirements complemented by a robust system of internal controls;

   ii. the differing degrees of protection which may be appropriate for clients or customers of Authorised Firms as a result of their experience, expertise, business and means and the differing degree of information which it may be appropriate to give such clients or customers;

   iii. the differing degree of risk involved in different kinds of investment or transaction; and

   iv. the general principle that clients or customers of Authorised Firms should take responsibility for their own decisions;

Regulatory Objectives

6. The promotion of understanding of the objectives of the QFC amongst users and prospective users of the QFC and other interested Persons;

7. Ensuring the Regulatory Authority is run with a view to:
   i. it operating at all times in accordance with best international standards for financial and business centres of a similar kind; and
   ii. establishing and maintaining the QFC as a leading financial and business centre in the Middle East; and

8. Minimising the extent to which the business carried on by a Person carrying on Regulated Activities can be used for the purposes of or in connection with Financial Crime; have regard to the desirability of Authorised Firms having appropriate systems, controls and procedures to detect and prevent the incidence of Financial Crime.

Principles of Good Regulation

1. Use of resources in the most efficient and economic way;
2. Desirability of facilitating innovation and fostering the international competitiveness of the QFC;
3. Desirability of fostering competition between those who are subject to regulation by the Regulatory Authority;
4. Principle that the Regulatory Authority should exercise its powers and functions in a fair and transparent manner;
5. Need to comply with such generally accepted principles of good governance as it is reasonable to regard as applicable to it;
6. Balance the burdens and restrictions on firms with the benefit of regulation; and
7. Need to act in accordance with all laws and Regulations to which it is subject.

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The need to risk-focus, its elements, and benefits

Traditional Method of Supervision

Objectives

- Assess solvency of a financial institution.
- Examine conformity with the prescribed procedures.
- Assess the adequacy of internal controls

Weaknesses

- Backward looking.
- One size fits all approach.
- Highly resource intensive.
- Treating the symptoms rather than the underlying ailment

Addressing the shortcomings

"A supervisory approach designed to continuously monitor and evaluate the risk profile of supervised institutions and deploy resources to assess how the risks are being managed by the banks."

- Emphasis on understanding and assessing the risks that a financial institution is exposed to and evaluating the risk management system.
- Underlying unmanaged and unmitigated risks that could affect the future soundness.
- Assess the risks and the processes surrounding their measurement and management.

Why Risk focus?

- A Regulator cannot set out to eliminate all failures from the financial system.

- It is inevitable that:
  - we will see consumers suffer financial loss
  - there will be a certain level of financial crime
  - some regulated firms will suffer financial failure

- A regulator must therefore make conscious choices as to which risk(s) it seeks to mitigate.

- How it makes those choices, such as the factors it takes into account, is its risk-based approach.

Why Risk focus?

- Our regulatory approach
  - takes account of the principles of good regulation
  - is risk-based
  - aims to apply available resources to achieve the maximum possible net reduction of risks to our statutory objectives

- To do this we need to be able to:
  - have mechanisms to gather information related to firm risk rating
  - compare risks on a consistent basis
  - choose the most effective way to mitigate them

Key elements of Risk Focused Supervision

- Prioritisation of risks and corresponding allocation of resources
- Reliance on firms' management where possible
- "Horizontal" approach to tackling risk, where this is more efficient
- Outcome-focused assessments
- Not a zero-failure regime

Key elements of Risk Focused Supervision

In applying the risk based approach, the Regulatory Authority will....

- Maintain close relationships with each Authorised Firm and its senior management;
- Co-operate with other regulators to ensure that Authorised Firms which are branches or part of a group are effectively supervised but not overly burdened with regulatory requirements that duplicate those imposed by their home state regulator;
- Maintain a continuous cycle of risk management which ensures it regularly undertakes the risk assessment and classification of Authorised Firms using a standardised methodology; and
- Focus on achieving its objectives by making effective use of the supervisory tools available to it.

Benefits of a Risk-Based Approach

To the Firm

- Pro-active approach to managing risks. Not playing "gotcha" with punitive enforcement action after problems have occurred.
- Transparent explanation for the actions of the Regulatory Authority; actions should be proportionate to the risks, and consistent between firms in similar circumstances
- Incented for good behavior and management of their risks

To the Regulator

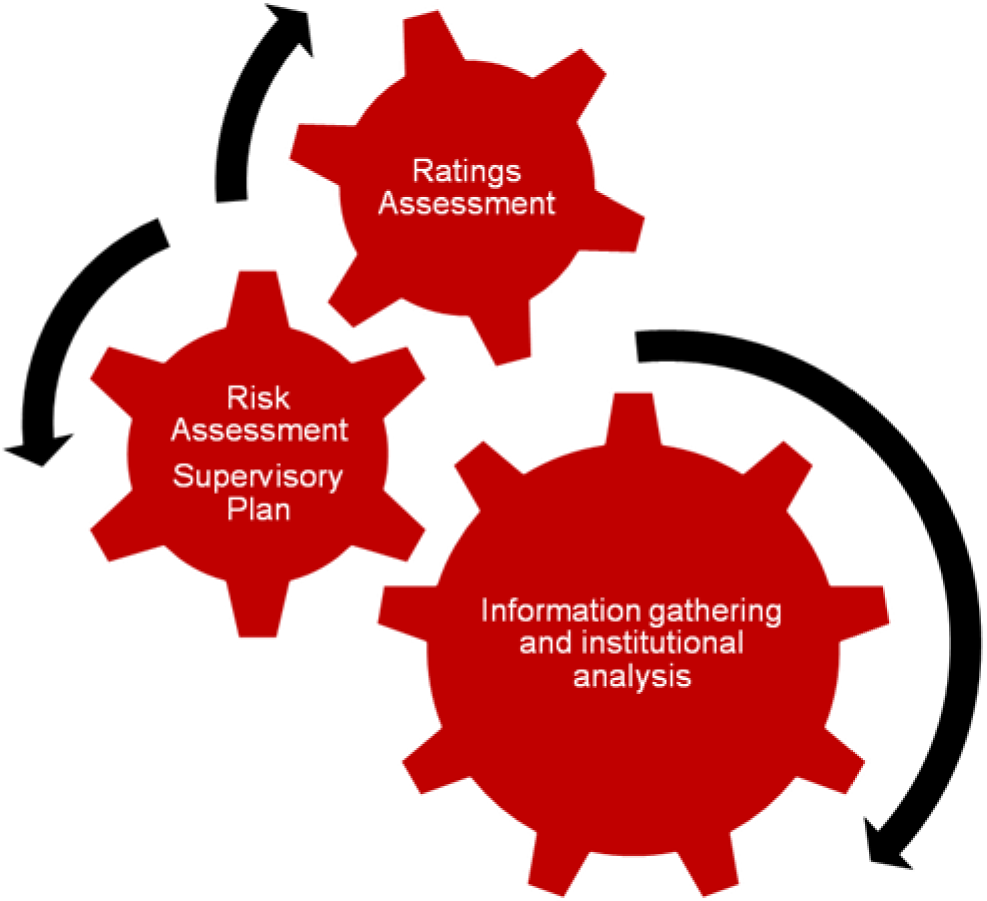
- Optimal use of resources: targeting greatest risks should lead to greatest overall benefit to our objectives
- Focus on risks to our objectives
- Sound, consistent basis for justifying our approach and actions; links senior management priorities and risk appetite with decisions and actions on the ground

General challenges

- The key constraints to a fully risk-based approach are:
  - fixed level of resources
  - incomplete information about the risks
  - different quality and skills of staff
  - lack of a common understanding of approach (internally and externally)
  - costs of applying the process itself

Supervisory Process – Our Approach

Supervisory Process



How the QFCRA measures risk

PRIORITIES for the QFCRA = **IMPACT of the problem if it occurs** × **PROBABILITY of the problem occurring**

Factors may include:

- Size of firm
- Perceived importance
- Home country jurisdiction

Factors may include:

- Business Risk
- Corp. Governance
- Control Measures

How the QFCRA measures risk

Scoring is subjective and high-level

Impact	**Probability**
High	High
Medium-high	Medium-high
Medium-low	Medium-low
Low	Low

A quantitative version of this model is in trialling phase.

The Risk Assessment Framework

Business Risks

- Financial Soundness
- Business Strategy
- Market and Operational
- Organisation and Regulation

Control Structure Risks

- Clients
- Conflicts Management
- Management and Control
- Financial Crime
- Human and Technical Resources

Business Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Financial Soundness	▪ Capital Adequacy	The risks arising from the nature of the Authorised Firm’s capital position. These include the firm’s: capital planning framework, the composition and quality of capital, the adequacy of capital to support the level of current and anticipated business activities, the adequacy of reserves and access to further capital.
	▪ Revenue / Profitability	The risks arising from the nature of earnings of the Authorised Firm. These include : the adequacy of profitability, volatility of revenues and profitability and track record of performance against budget.

Business Risks

Business Strategy	▪ Quality of Business Strategy and Plan	The risks arising from the overall strategy of the Authorised Firm. These include the quality of the strategic planning process, the achievability of the strategy, the implications of the strategy, particularly for risk appetite, and the track record of implementation.
	▪ Regulated Activities Offered	The risks arising from the characteristics of the business that the Authorised Firm is conducting including the extent and complexity of those activities.
	▪ Types of Clients	The risks arising from the characteristics of the Authorised Firm's client base including the types of clients (Market Counterparties, Business Customers, Commercial Customers and Retail Customers).
	▪ Types of Products	The risks arising from the characteristics of the current products or services provided by the Authorised Firm. These include complexity, tenor and performance of the products.
	▪ Markets Targeted	The risks arising from the markets targeted including the location of clients and the nature and jurisdiction of overseas investments offered.
	▪ Sources of Business and Distribution Channels	The risks arising from the nature of the current sources of business to and distribution mechanisms used by the Authorised Firm. These include introductions by existing clients and the use of intermediaries and sourcing of overseas customers.

Business Risks

Market and Operational	▪ Market Risk	The risks arising from the type and nature of market risk undertaken by the Authorised Firm. These include the risk appetite of the Authorised Firm, the nature of market risk exposures involved in the Authorised Firm's products and services.
	▪ Credit Risk	The risks arising from the type and nature of credit risk undertaken by the Authorised Firm. These include the risk appetite of the Authorised Firm, the nature of counterparty exposures involved in the Authorised Firm products and services, portfolio characteristics and the nature and extent of credit risk mitigation.
	▪ Operational Risk	The risks arising from the type and nature of operational risk involved in the Authorised Firm's activities. These include direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
	▪ Liquidity Risk	The risks arising from the type and nature of the Authorised Firm's liquidity or asset and liability mix. These include the liquidity management framework and the composition of liquidity to allow funding of the operational and financial obligations of the business both day to day and in crisis situations.
	▪ Insurance Underwriting	The risks arising from the type and nature of insurance underwriting risk undertaken by the Authorised Firm. These include the risk appetite of the firm, the nature of insurance underwriting exposures involved in the firm's products and services and the nature and extent of reinsurance cover.
	▪ Legal Risk	The risks arising from the type and nature of the Authorised Firm's contractual agreements. These include the risk that contracts may not be enforceable under applicable law.

Business Risks

Organisation and Regulation	▪ Clarity of Legal Ownership and Structure	The risks arising from the structure of the Authorised Firm or group. These include the nature of the legal and ownership structure and openness of the group structure to regulators.
	▪ Controllers and Group Entities	The risks arising from the characteristics of the controllers of the Authorised Firm. These include the jurisdiction and characteristics of shareholder controllers, directors, and nature of other group entities. The risks arising from the relationship between the Authorised Firm and the rest of the group. These include management arrangements, reliance on centralised functions, financial health and activities of the wider group and financial and other dependencies on other group entities.
	▪ Nature and extent of Laws, Regulation and Supervision	The risks arising from the content of applicable laws (such as statutory priority to local creditors), the level of regulation undertaken by another financial services regulator and the reliance that can be placed on the supervision of the firm by that regulator.
	▪ Political and Economic Environment in Home Jurisdiction	The risks arising from any instability in political or environmental factors in the Authorised Firm's home jurisdiction. This may include terrorism, political sanctions or likelihood of natural disasters.
	▪ Relationship with Regulators	The risks arising from the nature of the Authorised Firm's relationship with other regulators, including recent regulatory history.

Control Structure Risks

RISK GROUPS	RISK FACTORS	EXPLANATORY NOTES
Clients	• Communication with Clients and Financial Promotions	The risks arising from the nature of financial promotion and advertising practices employed by the Authorised Firm.
	• Client Assets	The risks arising from the firm holding or controlling of client’s or user's monies and assets.
	• Client Categorisation	The risks arising from customer classification and the documentation procedures.
	• Advice, Management and Dealing	The risks arising from dealing and managing customer assets and the quality of advice (e.g. suitability, customer understanding of risk and charges).
	• Disclosure and Reporting	The risks arising from the nature of product literature issued by the Authorised Firm and the terms of business, periodic statements and other documentation provided to clients.

Control Structure Risks

Conflicts Management	• Identification and Management	The risks arising from the identification of potential and actual conflicts of interest and the way that they are managed by the Authorised Firm.
	• Staff Remuneration	The risks arising from the recruitment quality and training procedures for the sales force. The risks arising from the nature of the remuneration scheme for employees.
	• Personal Account Dealing	The risks arising from potential insider dealing and the process for identifying and approving directors and employees trading for their personal accounts.

Control Structure Risks

Management and Control	▪ Allocation of Responsibilities	The risks arising from the nature of the allocation and definition of directors' and management responsibilities and the mechanism for ensuring that responsibilities are effectively delegated and carried out.
	▪ Quality of Management and Corporate Governance	The risks arising from the quality of Authorised Firm's management, the nature of the corporate governance of the firm and overall compliance culture. These include management's experience and integrity, fit with the business and operation of the executive body, non-executive directors and board committees.
	▪ Reporting Lines and Segregation	The risks arising from reporting lines between management and the board or other senior staff and the appropriate segregation of duties between functions of a risk taking nature and risk management nature.
	▪ Compliance Function and Arrangements	The risks arising from the nature and effectiveness of the compliance function. These include its mandate, structure, staffing, methodology, reporting lines and effectiveness.
	▪ Risk Management Systems	The risks arising from the nature and effectiveness of the systems and procedures in place to identify, measure, monitor and control the risk of the business in an appropriate and timely manner. These include credit risk, insurance underwriting risk, market risk, operational risk, legal risk and new product risk.
	▪ Complaints Arrangements	The risks arising from the procedures the Authorised Firm has in place to deal with the receipt of complaints and to consider the subject matters of complaints in order to rectify systemic issues.

Control Structure Risks

Management and Control	▪ Business Continuity	The risks arising from the nature and effectiveness of business continuity arrangements. These include the adequacy of the planning process, the quality of the business continuity plan and the testing process.
	▪ Outsourcing	The risks arising from the use of outsourcing to third party providers. These include the reliance on, and the controls over, the third party or outsourcer.
	▪ Monitoring and Audit	The risks arising from the nature and effectiveness of the internal audit function. These include its mandate, structure, staffing, methodology and effectiveness.
	▪ Employees and Training	The risks arising from human resources issues. These include recruitment, training, remuneration, disciplinary procedures and resources.
	▪ Provision of Information to Management	The risks arising from the nature of management information. These include its adequacy, accuracy, relevance and timeliness as well as the effectiveness and efficiency of its distribution.
	▪ Confidentiality and Data Protection	The risks arising from the use of personal information by Authorised Firm.

Control Structure Risks

Financial Crime	▪ Anti Money Laundering Procedures	The risks arising from the nature and effectiveness of the money laundering controls. These include effectiveness of the MLRO, training, identification of clients, know your business, internal and external reporting arrangements and record keeping arrangements.
	▪ Prevention of Market Abuse and Financial Crime	The risks arising from the Authorised Firm's susceptibility to having market abuse conducted through it. These include measures to prevent abusive, fraudulent or dishonest trading practices and co-operation in market enforcement matters.

Control Structure Risks

Human and Technical Resources	• Approved Individuals	The risks arising from the assessment of Approved Individuals fitness and propriety and those individuals ability to comply with the Principles of Conduct.
	• IT Systems and Technical Resources	The risks arising from the controls over the IT infrastructure. These include adequacy of resources, procedures for implementation and procurement, effectiveness of security framework, etc. and consideration as to whether the IT infrastructure is an adequate platform on which to run the business.

Risk Assessment Schedule

- Low impact firms:
  - Limited to High Level meetings, remote monitoring, with on-site work once every 2 years
- Medium-low impact firms:
  - Reduced scope assessment
  - Normally around 2-3 day on-site visit
- Medium-high impact firms:
  - Full scope risk assessment
- High impact firms:
  - "**Close & continuous**" approach – full scope risk assessment
  - On-site work conducted throughout the year

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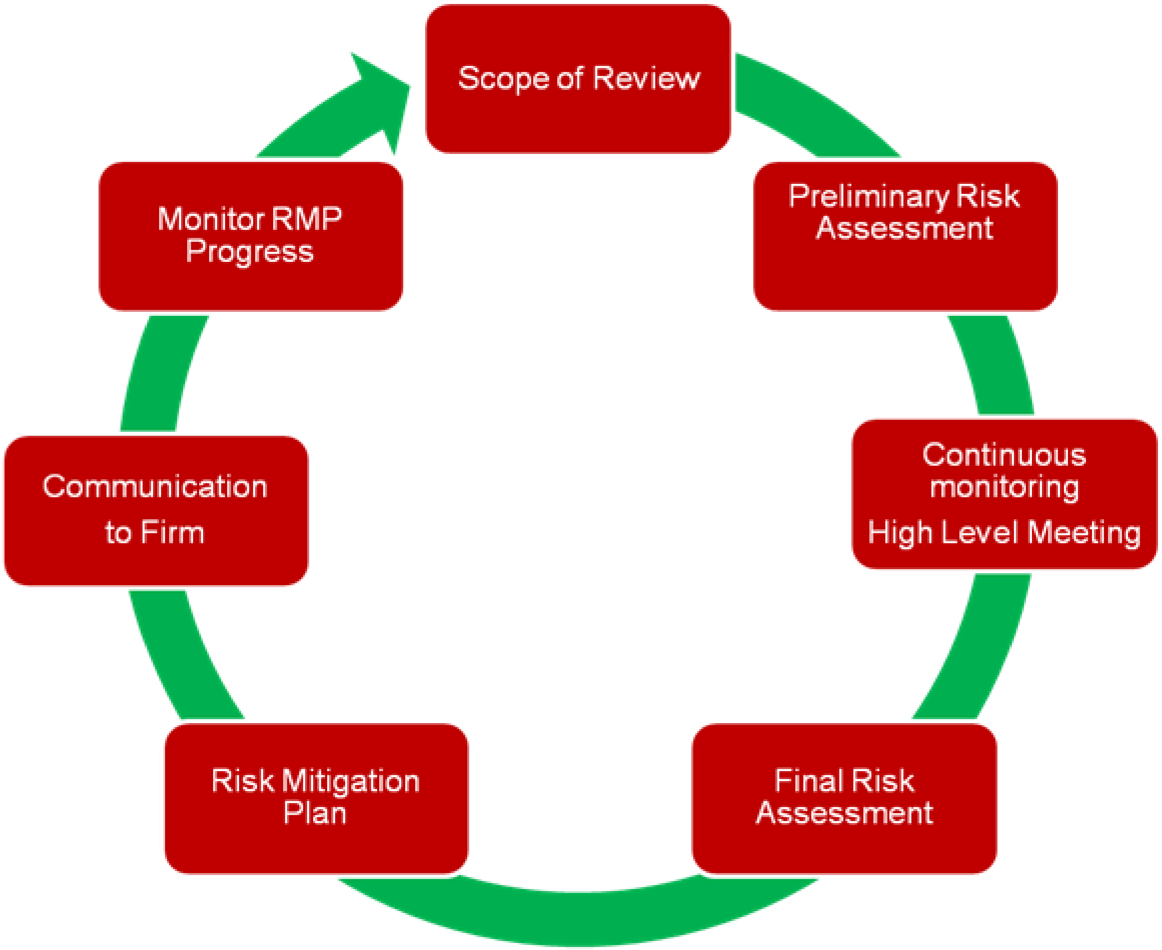
Risk Focused Supervision in Practice

Periodic Assessment of Individual Firm Risks



Scope and Preliminary Risk Assessment

- The supervisor starts with a generic, **sectoral view** of each risk group.
- Involves consultation with and input from the macro-prudential risk team:
  - default / benchmark **probability** scoring
  - trends (global, regional, domestic)
  - potential **issues** / topics to consider in assessment.
- **Sectoral view** is mapped against Supervisor's prior experience with and other knowledge of the firm to form a more focused view.
- Supervisory request for information from the firm, to inform planning e.g.:
  - compliance / internal audit reports
  - business / strategy documents
  - product range information

Scope and Preliminary Risk Assessment

- On the basis of the view of known and potential risks, the supervisor will generate a supervisory plan.

- The Supervisory plan addresses:

  – the risks and issues they want to investigate (and why);

  – the risks and issues they won't investigate (and why);

  – the volume and type of work they plan to carry out;

  – Subject matter expertise that will be need to carry out review;

  – How the work will be carried out.

The Supervisory plan will be discussed with the Director/Managing Director (Head of Supervision) and agreed upon before work commences.

On-site visit

- An on-site visit is conducted, to investigate the potential issues identified and fill remaining information gaps.

- Much of our on-site work involves interviewing senior management about the risks and the controls that the firm has in place. This typically includes discussions with:

  - Board members (including NEDs)

  - executive management (including business units)

  - control functions (internal audit, compliance, risk management)

- The performance of detailed testing (e.g. reviews of documentation) is proportional to our assessment of the effectiveness of high-level controls.

- At the end of the visit, the supervisory team will have a “close-out meeting” with the firm’s management to discuss the assessment and any issues raised.

Risk Mitigation Programme

- The supervisory team will write up their assessment of the firm and any issues they have identified. This will include finalising the probability scoring against the supervisory model.
- Where issues are sufficiently serious, the team will decide what actions should be taken to address the risks ("Risk Mitigation Programme").
- Once the assessment has been written up, further validation (including a comparison with other assessments of similar firms) is conducted to ensure:
  - **consistency** in scoring judgments
  - **proportionality** of actions proposed in response to issues
  - **supervisory "tone**" in communication.

Communication / follow-up

- Results are formally communicated to the firm via a supervisory letter. Details our assessment to the firm, and in particular what actions need to be taken to address any issues raised.

- This letter is sent in draft form to allow the firm to comment on matters of factual accuracy, and to ensure that when the final letter is issued (to the firm’s Board) there are no disagreements of fact.

- The firm is required to provide a formal response to the letter. We are open to any reasonable suggestions that the firm may have for alternative methods of addressing the issues raised.

- The letter is confidential, but is also typically sent to overseas regulators (for international firms).

Ongoing monitoring of firms

- Between assessments, we conduct activities designed to identify emerging risks.
- All firms are subject to “baseline monitoring”. Essentially, this is an analysis of the firm’s regulatory returns and other supplemental data.
- Irrespective of the effectiveness of their controls, the largest firms and those rated as high impact, are subject to “close and continuous” monitoring:
    - Monthly meetings with the firm’s senior management;
    - Enables us to remain fully apprised of developments
    - Emerging risks are promptly identified.

Thematic work

- In addition to supervising individual firms, the Regulatory Authority may engage in "thematic work".
- This is done in relation to issues that go beyond an individual firm, perhaps affecting an industry sector, or the markets as a whole, and where it is more efficient to analyse the issue centrally, and take action accordingly.
- This analysis often involves visits to a cross-section of firms, to gauge the size of the problem in the industry as a whole.
- As with firm-specific issues, the risk is measured in terms of impact on our objectives and the probability of harm occurring.
- Can result in thematic mitigation, via the issuance of:
  - Dear CEO letters
  - Rules changes

Implementing Risk-based Supervision

Risk-based supervision is only <u>one</u> element in achieving a sound regulatory system and ensuring financial stability

Other factors might include:

- adherence to the Core Principles for Effective Bank Supervision
- "quality" of supervisory staff/processes
- Understanding interactions among banks, banks and other financial sectors
- identification of regulatory gaps
- corporate governance, transparency, accounting standards, etc.
- Strength of legal environment
- Granularity of information captured

Rules of Engagement

- Principles of good regulation entrench primary responsibility on firms' senior management
- Management, Governance, and Attitude to risk are key focus areas in all assessments.
- Supervisory approach relies on adequacy and effectiveness of Firm's high-level controls.
- A principles-based approach, that allows firms to justify their own approach to risk; not prescriptive in its methods.
- Drives our approach to subsequent work
  - level of 'intrusion' and reliance placed on firm
  - likelihood of enforcement

In summary, Risk based supervision…

- Not a science; largely subjective
- Requires use of sound judgment, skilled resources, and the continuous development of skills
- Requires a sound understanding of the institution, industry and environment
- Requires an appreciation for local practices and nuances...not just a "lift and drop".
- Is not about closing out all risks.
- Objectives emanate from the central bank legislation as well.
- Needs to dovetail central bank objectives in risk assessment.
    - These include maintenance of the payment system, financial stability and balanced economic development.

Comparing Supervisory Approaches

Supervisory Approaches..

- There is no international consensus on a “perfect” risk-based supervision approach
  - each jurisdiction must tailor its model based on relevance and appropriateness to its jurisdiction
  - cannot simply “lift and drop” from another jurisdiction and expect it to work
- There are, however, some generic features
  - comprehensive/detailed assessment of the risk profile of the institution – overall assessment score/rating
  - assessment of the inherent risks of each business unit or significant activity
  - assessment of qualitative/quantitative risk factors and risk management oversight functions

Supervisory Approaches..

The spate of recent bank failures has raised the question whether it was a failure of *risk-based supervision?*

Was it the model or the implementation of the model that failed in some cases?

- The World Economic Forum rated the "soundness" of banking systems as follows

	'10	**'09**	**'08**
➢ Canada	1	1	1
➢ South Africa	6	6	15
➢ United States	111	108	40
➢ United Kingdom	133	126	44

- **ALL** supervise using a risk- based approach.

Supervisory Approaches..

Risk-based supervisors use different approaches

- "light touch" vs. intrusive
- rules vs. principles based
- transaction vs. process/policy testing

IS ONE REALLY BETTER THAN THE OTHER?

"It is noticeable..., that this distinction between supervisory styles is not clearly correlated with relative success. The US system of resource intensive bank examination has been no more successful than the UK's approach in preventing bank failure".

The Turner Review
Lord Adair Turner, FSA Chairman
March 2009