



**Federal Deposit Insurance Corporation**

# **Risk Management Examinations and Supervisory Response**

**Regional Seminar on Risk Management and Risk-Focused Supervision  
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# Discussion

- Risk management and risk focused supervision
- Risk management examinations
  - Examination cycle and analysis
  - Uniform financial institutions rating system
- Supervisory response
  - Enforcement actions and monitoring

# Risk Management Programs



- Effective risk management is critical to safe and sound banking activities
- Essential elements of risk management
  - Identify and understand existing and potential risk
  - Accurate and timely measures of risk
  - Frequent, timely and accurate monitoring of risk
  - Limits, responsibilities and authorities to control risk
- Internal controls, internal/external audit, loan review and other bank control activities play especially important roles

# Risk Focused Supervision



- Objective
  - Evaluate the safety and soundness of a bank, including risk management systems, financial conditions, and compliance with laws and regulations, while focusing examination resources on the highest risks of the bank
- Emphasis
  - Examination resources are focused on validating the ability of bank management to identify, measure, monitor and control risks, maximizing the effectiveness and efficiency of the supervisory process

# Risk Matrix



Quality of Risk Management	Quantity of Risk		
	Low	Moderate	High
Weak	Low to Moderate	Moderate to High	High
Satisfactory	Low	Moderate	Moderate to High
Strong	Low	Low to Moderate	Moderate

# Risk Focused Supervision Benefits



- Effective and efficient use of supervisory resources required to complete examinations
- Lower levels of transactions testing, evaluation and review where internal systems and controls are satisfactory
- Reduced supervisory demands on banks and management with effective risk management programs
- Minimization of time spent on site and disruptions to the business of banking

# Risk Management Examinations



- Risk focused supervision is carried out through the risk management examination program
- Purposes of risk management examinations
  - Determine bank adherence to laws and regulations
  - Understand and correct individual bank problems
  - Protect the financial integrity of deposit insurance funds
  - Maintain public confidence in the banking system

# Examination Cycle

- Examination cycle
  - Phase 1 – Continuous off site monitoring
  - Phase 2 – Pre-examination planning
  - Phase 3 – On site examination
  - Phase 4 – Supervisory response
- Important elements
  - Pre-examination risk scoping process
  - On-site risk-focused examination documentation modules



# Off Site Monitoring (Phase 1)



- Ongoing process of review and assessment
  - Follow up unusual information with bank management
  - Carry out short term visits on site when warranted
  
- Sources of information
  - Reports of Condition and Income filed by banks
    - Automated monitoring via multiple early warning systems
    - Supervisory analysis of bank reporting (UBPR)
  
  - Other leading sources
    - External audit report and annual financial report
    - Bank correspondence, authorization requests, etc.
    - Progress reporting for banks subject to enforcement actions

# Pre-Exam Planning (Phase 2)



- Pre-exam planning helps define the initial focus of attention, allocation of resources, and approach to examining the bank
- Basic procedures
  - Determine examination requirements
  - Request selected information from the bank
  - Conduct pre-examination meeting with management
  - Complete risk-scoping activities module

# Risk Scoping Activities



- The risk scoping process is essential to pre-exam planning and includes the following steps
  - Identify significant and higher-risk activities of the bank and any indications of red flags
  - Conduct pre-exam meeting at the bank to discuss material changes in conditions and operations
  - Review internal and external audit findings and reported control risks and management response
  - Determine initial allocation of examination resources and prepare a memorandum of scope

# On Site Examination (Phase 3)



- Examination team
  - Examiner In Charge, Asset Manager, Operations Manager and Examination Specialists (CM, IT, fraud, etc.)
  - Loan review and operations analysis groups
- Concurrent/subsidiary examinations
  - Trust department, information technology, AML/CTF, etc.
- Procedural guidance for examiners
  - Risk-focused examination documentation modules

# Exam Documentation Modules



- Examiner guidance focusing on risk management strategies and systems for each major business activity
- Examiners consider areas of potential risk and associated risk control procedures, while taking into account industry norms/standards
- Procedures are separated into three tiers for increasingly detailed evaluations as needed
  - Examiner expertise, judgment and discretion remain key to using the procedures effectively

# Types of Modules

- Primary modules
  - Exam procedures designed to address CAMELS
  - Analysis completed for all examinations
- Supplemental modules
  - Exam procedures designed for specialized banking activities
  - May or may not be applicable or needed
- Loan and other references modules
  - Exam procedures designed for individual types of lending and other specialized considerations as needed

# Tiers of Risk Analysis



- Core analysis
  - Baseline level of evaluation of risk
- Expanded analysis
  - Additional review and assessment of risk
  - Usage depending on the core analysis findings
- Impact analysis
  - Effect on the overall condition of the bank
  - Consideration of possible supervisory options and response

# Expanded Analysis



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	Low	Moderate	High
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Strong	Low	Low to Moderate	Moderate



# Report of Examination



- Structure of the report
  - Open and confidential report sections
  - Mandatory and supplemental report pages
- Bank of Anytown
  - Sample report included with ROE instructions
- Risk Management Manual of Examination Policies (pdf)
  - Primary examiner guidance (688 pages)
  - Including ROE instructions and Bank of Anytown

# Uniform Rating System



- Uniform Financial Institutions Rating System (UFIRS) consists of several elements
  - Composite rating
  - Six component ratings (CAMELS)
- Ratings also take into consideration three key aspects
  - Financial institution size and sophistication
  - Nature and complexity of activities
  - Aggregate risk profile
- Composite and component ratings range from 1 (strongest) to 5 (weakest)

# Component Ratings

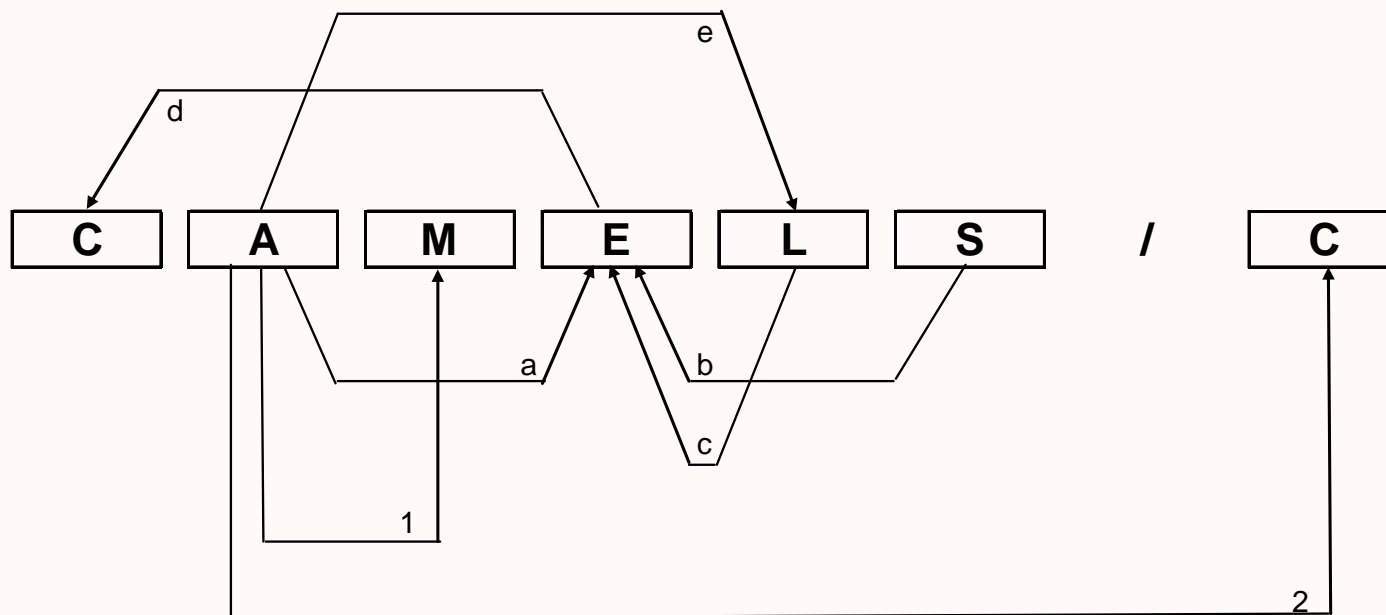
- Essential component ratings (CAMELS)
  - Adequacy of capital
  - Quality of assets
  - Capability of management
  - Quality and level of earnings
  - Adequacy of liquidity
  - Sensitivity to market risk
- Component ratings are based in part on specific evaluation factors for each of the six areas (pdf)

# Composite Rating Scale



- 1 – Strong Sound in every respect, with no cause for supervisory concern
- 2 – Satisfactory Fundamentally sound and stable, with only moderate weaknesses
- 3 – Weak Weaknesses ranging from moderate to severe, with some degree of supervisory concern
- 4 – Deficient Unsafe or unsound practices or conditions, with close supervisory attention required
- 5 – Critical Extremely unsafe or unsound practices or conditions, with immediate outside assistance required

# Interrelationships



- Types of interrelationships
  - Financial effects (a-e) and ratings effects (1-2)
- Asset quality
  - Poor asset quality directly affects earnings, capital and liquidity (a, d, e)
  - Poor asset quality ratings usually affect management and composite ratings (1-2)

# Ratings Functions – Part I



In terms of bank supervision programs,

- Evaluate the safety and soundness of financial institutions in a comprehensive and uniform manner
- Compare and categorize financial institutions and their risk profiles based on component and composite ratings
- Identify and segregate financial institutions requiring special supervisory attention or concern

# Ratings Functions – Part II



In terms of risk management examinations,

- Risk-focus examination resources on institutions and areas with financial and operational weaknesses or adverse trends
- Determine level of supervisory response to bring about corrective actions in problem financial institutions
- Determine level and nature of continuous off site monitoring and analysis and interim bank reporting

# Examination Results



- Findings, conclusions and discussions with management
  - Summary conditions, existing supervisory actions, etc.
- Disclosure of composite and component ratings
  - Discuss basis, derivation and implications
  - Management rating
- Management commitments
  - Specific corrective actions and time frames
  - Responsiveness to supervisory concerns
- Meeting with board of directors



# Supervisory Response (Phase 4)



- Composite 1 or 2
  - Minor to moderate weaknesses handled in a routine manner or correctible in the normal course of business
  - No material supervisory concerns and supervisory response is informal and limited
- Composite 3
  - Moderate to severe weaknesses requiring more than the normal level of supervision
  - Some degree of supervisory concern requiring informal and sometimes formal action
- Composite 4 or 5
  - Severe to critical unsafe-and-unsound practices or conditions requiring close supervisory attention
  - Distinct threat of failure requiring formal action and often outside assistance

# Enforcement Actions



- Purposes of enforcement actions
  - Correct deficiencies in safety and soundness
  - Ensure compliance with laws, regulations and guidelines
  - Address problems with management and contractors
  - Assess civil money penalties
  
- Informal enforcement actions
  - Voluntary bank commitments and agreements
  - Not legally enforceable and not publicly disclosed
  
- Formal enforcement actions
  - Legal supervisory orders and notices
  - Enforceable in court and publicly disclosed

# Types of Enforcement Actions



- Informal actions
  - Letter of commitment
  - Board of director resolutions
  - Memorandum of understanding
  
- Formal actions
  - Order to cease and desist
  - Suspension, removal or prohibition of participation
  - Civil money penalties
  - Termination of deposit insurance

# Basis for Enforcement Actions



- Examples of management issues
  - Poor underwriting and credit administration
  - Insufficient corporate planning (strategic, budget, etc.)
  - Inadequate internal controls
  
- Examples of financial issues
  - Inadequate capital or loan loss reserves
  - Large volume of problem loans or assets
  - Failure to recognize loan losses
  - Undue concentration of loans
  - Excessive asset growth
  - Poor earnings and unwarranted dividends
  - Inadequate liquidity

# Memorandum of Understanding



- Most common form of informal action
  - Typically used for banks rated composite 3
  - Detailed bilateral agreement with specific corrective actions and time frames for completion
- Informal version of order to cease and desist
  - Expectation that management will act in good faith
  - Failure to act and to correct deficiencies may facilitate subsequent formal enforcement action
- Termination requires
  - Significant improvement in overall bank conditions and substantial compliance with terms of the agreement

# Order to Cease and Desist



- Most common form of formal action
  - Used for banks rated composite 4 and 5
  - Legally binding order issued unilaterally by supervisor
- Banks commonly stipulate and consent to orders
  - Temporary orders can be issued for immediate action
- Orders usually prohibit and require actions at the same time
  - Cease and desist from unsafe and unsound practices
  - Take affirmative actions within specific time frames
- Termination requires sufficient improvement in conditions and material compliance with the order

# Suspension, Removal and Prohibition



- Enforceable against directors, officers, employees, controlling shareholders, and contracted parties (institution affiliated parties)
- Removal from the bank and prohibition of participation in the conduct of bank affairs are subject to hearings
  - Emergency suspension (removal) or prohibition is available with immediate effect if needed
- Prohibition may be extended to a blanket lifetime ban on participation in the banking industry in any capacity

# Civil Money Penalties



- Imposed for violations of laws, regulations, orders, etc.
  - Institutions and individuals are subject to penalties
  - Penalties are publicly disclosed
- Variety of factors taken into account, such as
  - Intent, duration, frequency, concealment, personal gain, institutional harm, cooperation, restitution, etc.
- Penalties can range up to \$1.25 million per day
  - Three tiers of penalties depending on nature of offense



# Capital Restoration



- Capital directive
  - Legally binding order issued to correct a capital deficiency
  - Sometimes used with a memorandum of understanding
- Written agreements may be used to correct deficient capital in lieu of terminating insurance
  - Triggered by tier 1 leverage capital ratios below 2 percent
- Prompt corrective action
  - Supervisory actions framework for deteriorating capital
  - Triggers increasingly severe restrictions on bank
  - Requirement for capital restoration plan

# Monitoring Enforcement Actions



- Supervisors monitor ongoing compliance with both informal and formal enforcement provisions
- Monthly or quarterly progress reports are submitted by bank management according to specific deadlines
- Visitations and targeted or full-scope examinations are used to document and determine compliance with actions
- Failure to comply with the provisions of formal actions are subject to civil money penalties

# Future Inquiries



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