

Operational issues in the implementation of risk-based supervision framework

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Abstract

With the objective of the Bangko Sentral ng Pilipinas (BSP) to achieve and maintain a safe and sound banking system, the focus of regulators shifted from traditional supervision to risk-based supervision. This approach calls for changes in the supervisory environment such as enhanced supervisory tools, refocused on-site inspection process, reoriented human resource, and risk-focused prudential regulations. The BSP adopts risk-based supervision to compel banking institutions to be more risk-oriented through the evaluation of management practices, policies, and procedures in the context of managing potential risks. As a result, banking institutions can provide the best banking services and products with the highest return of investment at a minimal risk.

JEL classification: G28

Keywords: risk-based supervision, risk-focused supervision, risk-focused examination, risk-based examination

1. Introduction

The business of banking being largely driven by the earnings potential, is predicated mainly on risk-taking. The greater the risk taken, the higher the rate of return. Hence, as banking services become more sophisticated and financial products increasingly more complex, banking operations are increasingly exposed to a higher risk environment that points to the need for appropriate an risk management system by banks.

In response to this growing potential for risks, examination results have to be related to the risk exposures of banks. Accordingly, risk-based supervision was conceptualized by the US Office of the Comptroller of the Currency in the early 1980s. This developed into a framework that provides a consistent approach while allowing for flexibility. Eventually, this approach became the preferred approach to supervision as supervisory authorities of many economies, including the Philippines, shifted from traditional supervision to risk-based supervision.

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Risk-based supervision is an approach to supervision where the degree of supervisory attention is dependent on the risk profile of the institution and where the resources of the supervisors are focused on the institutions that present the greatest risk to the financial system. It is an approach to examination where the examiners concentrate their efforts on areas that pose the greatest risk to the institution.

Thus, it is important that supervisors understand (i) the economic and political environment in which banks and the banking systems operate; (ii) the risk profiles of individual institutions; and (iii) the risk profiles of the products, services and activities that make up the individual institutions. Aggregating these profiles will develop the overall risk profile of the institution.

The core of risk-based supervision is an assessment of how well institutions manage risk. Management of risks involves identification, measurement, monitoring and control of these risks. Hence, there arises the need for supervisors to identify the inherent risks that the institution is facing and to evaluate the quality of the risk management system in place to address these risks.

2. Operational issues

The shift to risk-based supervision necessitates certain changes in the supervisory environment to ensure the effective implementation of this approach.

2.1 Enhanced supervisory tools

The supervisor utilizes various tools that enable him to constantly monitor the operations of the institution and determine the level of supervisory attention needed. It may be a monitoring system that analyzes various financial data, discovers emerging weaknesses/problems, and signals a potential problem bank. It may be a rating system that (i) evaluates the performance of bank management and the condition of the institution based on defined criteria, and (ii) dictates the degree of supervisory attention required.

These various tools must be enhanced to facilitate risk assessment. Financial review must be modified to capture existing risk exposures and the direction of said exposures. The rating factors must be expanded to include the various risk implications. Assessment of management should emphasize the capability to manage risks.

2.2. Refocused on-site inspection process

The change in focus of the examination requires modifications in the entire examination process. Critical to the examination planning stage under a risk-focused approach is a preliminary risk assessment that must be undertaken to identify the areas of greatest risks to the institution. This will dictate the scope and objectives of the examination as well as the utilization of examination resources, and will

provide a foundation from which to determine the procedures to be conducted during the examination.

The traditional approach to examination is balance-sheet-driven and transaction-oriented. It places significant reliance on transaction-testing procedures. As stated earlier, the emphasis of a risk-focused examination is on the assessment of the risks and risk management practices, policies and procedures. This requires incorporating additional procedures while deleting those that no longer bear significantly on the assessment. It also incorporates forward-looking assessments on on-site examination work.

However, the risk-focused approach does not mean a total departure from the traditional approach. The quality of the risk management system will determine the degree of transaction-testing that needs to be undertaken. Transaction-testing will be reduced when risk management processes are determined to be adequate or risks are considered minimal. When these processes or internal controls are considered inadequate, more extensive transaction-testing is needed to fully assess the degree of risk exposure. In all instances, a higher level of transaction-testing will be required in areas that comprise the most significant portion of the institution's activities and thus, typically, represent high potential sources of risk.

One significant modification in the examination procedure is the use of transaction-testing to validate the competence of the management and the integrity of the various systems in use, and to test compliance with stated policies, procedures, practices and systems. It is not done merely to quantify each problem disclosed without regard for significance.

The results of the examination call for actions that will correct the causes of the problem, and not just the symptoms.

Communicating the results requires a report that has, as its core, the risk assessment and a thorough discussion of the findings from a risk perspective.

2.3 Reoriented human resource

An important transitional task towards risk-focused supervision is the reorientation of the supervisor. It is essential that supervisors recognize that external factors affecting not only individual institutions but the entire banking system as well are important considerations when assessing the institution's ability to deal with risks, both present and future. Supervisors must be able to translate economic information into potential risk factors for the system.

The primary objectives of the traditional examination are the accuracy of financial data and the adequacy of traditional internal controls designed mainly to prevent fraud. As such, examiners' efforts consist significantly of reviewing large numbers of individual transactions such as loans, and quantifying problems based on the aggregate of transactions reviewed.

In contrast, examiners under the risk-based supervision look at the examination process from a risk perspective. Thus, they must have a greater understanding of the institution and of the environment in which it operates. They must have an understanding of its risk profile, the nature of the risks, and of management's ability to handle both internal and external risks.

Examiners must, therefore, be equipped with the skills necessary to be able to assess the risk management capability of the institution. They must have the ability to evaluate management practices, policies and procedures in the context of managing risks. They must be able to recommend actions that are directed towards correcting the underlying causes of problems.

2.4 Risk-focused prudential regulations

The objective of supervision is to achieve and maintain a safe and sound financial system. In the face of a growing risk environment, it becomes imperative that safeguards are in place to ensure that risks are properly managed. The institutions supervised must, therefore, not only have an understanding of risk assessment and risk management, but must also set up the appropriate system.

The supervisor may, in the exercise of his authority, issue regulations that address capital adequacy, liquidity and internal control, among others.

However, it is to be noted that risk-based supervision does not encourage risk-avoidance for to do so would tend to limit the scope of products and services that the bank can offer, thereby limiting also the bank's ability to serve the economic needs of the community. Risk-based supervision recognizes risk mitigation and risk offsetting as valid approaches to risk management, and allows banks that can manage risk to take greater risks.

3. Adoption of the risk-based supervision by the Bangko Sentral

In keeping with its mandate, the supervisory processes at the Supervision and Examination Sector (SES) of the Bangko Sentral continue to evolve in response to the changing financial environment. The shift to risk-based supervision is one giant step in this direction.

The SES has recognized the emerging potentials for greater risk exposure in the system brought about by derivatives activities when a regulation prescribing the minimum standards for risk management of derivatives¹ was issued in December 1995. This regulation defined the basic risks inherent in derivatives and the basic elements of a sound risk management system.

Implementation of the risk-based approach formally commenced with a series of seminar-workshops conducted in 1997. Using materials of the Federal Reserve Bank, the Office of the Comptroller of Currency, and the Bank for International Settlement, the training introduced the examiners to the different kinds of risks,

¹BSP Circular No. 102 dated 29 December 1995.

the inherent risks in the different banking activities, the elements of a sound risk management system, and the procedures in assessing risks and in evaluating the quality of risk management practices. Accordingly, the SES has adopted the policy of requiring examiners to undergo training on the key aspects of risk-based supervision as conducted by regulatory authorities from multilateral agencies as well as by experts from the local banking industry.

Gradually, the thrust of the on-site inspection focused on the risk exposures and assessment of how banks manage their risks. The scope memorandum that is prepared before the examination included, as its integral part, the risk assessment process.

The format of the examination report was revised to highlight the risk assessment. Sections discussing the levels of risk and effectiveness of the risk management system were added. Thus, from a purely financial analysis and compliance review, the report now presents an evaluation of the risk profile of the bank.

The CAMEL rating system was modified into CAMELS² to capture the institution's sensitivity to market risk and the risk implications in its various activities as they impact on capital, asset quality, profitability, and liquidity. Evaluation of the quality of management was expanded to include its risk management capability.

A Risk Assessment System was designed to provide a uniform framework for risk assessment in terms of quantity of risk, quality of risk management, and aggregate risk.

The off-site surveillance process that supplements on-site examinations was enhanced with the introduction of the Bank Performance Report and the Forecast of Non-Performing Loan Levels, among others.

Numerous regulations requiring banks to observe certain standards on risk management were issued. As mentioned earlier, a circular prescribing the risk management guidelines for derivatives transactions was issued. Most notable among the later issuances are the regulations requiring the board of directors of banks, as part of their duties and responsibilities, to adopt and maintain adequate risk management policy³ and to attend a seminar on corporate governance⁴. Other issuances include the setting up of a compliance system and the appointment of a Compliance Officer⁵, and enhanced disclosure requirements⁶.

In March 2001, the Bangko Sentral issued a regulation⁷ requiring banks to comply effective July 2001 with the credit risk-based capital requirement consistent with the recommendation of the Basel Committee on Banking Supervision⁸. This

²Under the CAMELS rating system, each bank is assigned a composite rating that represents an overall assessment of six (6) key component areas; namely the adequacy of capital; the quality of assets; the capability of management; the quality and level of earnings; the strength of liquidity; and the sensitivity to market risk.

³BSP Circular Nos. 130 dated 6 June 1997 and 283 dated 17 May 2001.

⁴BSP Circular No. 296 dated 17 September 2001.

⁵BSP Circular No. 145 dated 2 October 1997.

⁶BSP Circular Nos. 208 dated 17 August 1999 and 212 dated 30 October 1999.

⁷BSP Circular No. 280 dated 29 March 2001.

was further enhanced with the issuance in December 2002 of another regulation⁹ that incorporates market risk in the capital requirement effective July 2003.

The adoption of the risk-based capital compels banks to be more risk-oriented and to continuously strengthen their risk management systems. To address the non-performing assets which weigh heavily on capital, the Bangko Sentral contributed to the enactment of R.A. No. 9182, the Special Purpose Vehicle Act, which encourages the transfer of these assets to other individuals/entities under certain guidelines. On the other hand, the Bangko Sentral allows the use of unsecured subordinated debts as Tier 2 capital to boost capital base, subject to the guidelines on risk-based capital.

To ensure the competence and independence of external auditors engaged by commercial banks for regular or special audit, the Bangko Sentral has issued guidelines¹⁰ that govern the selection and appointment of external auditors and that require the reporting to the Bangko Sentral of material findings noted during the audit.

4. Actions of the banking industry

As in their counterparts in other economies, local banks have extensively utilized technological innovations and have enhanced their capability to offer products and services that meet the financial needs of their clients. However, these developments posed greater risks to their institutions.

To address this concern, systems for identifying, measuring, monitoring and controlling risks have been put in place. However, the level of sophistication of these systems depends largely on the size, complexity of activities, and risk profile of the institution. Thus, a rural bank that engages in purely lending operations would have less elaborate systems than a universal bank that actively engages in derivatives activities. Different risk management tools have been developed and continue to be improved to enable banks to measure risk more quickly and accurately. Information systems have been redesigned to provide up-to-date information and analysis essential to quick and sound decision-making for risk mitigation.

Consistent with Bangko Sentral regulations, the Board of Directors of all banks and non-bank financial institutions are required to formulate and maintain written policies and procedures relating to the management of risks throughout their institution. Along this line, some institutions have seen the importance of having a Risk Manager and a separate unit whose task is devoted solely to risk management. Currently, there are 14 universal banks, 11 commercial banks, 14 foreign bank branches, and 4 foreign bank subsidiaries in the country which have already set up risk management systems in varying degrees of sophistication.

⁸The Basel Committee on Banking Supervision is a committee of banking supervisory authorities established in 1975 by the central bank governors of the Group of Ten countries. It usually meets at the Bank for International Settlement located in Basel, Switzerland.

⁹BSP Circular 360 dated 3 December 2002.

¹⁰BSP Circular 410 dated 29 October 2003

5. The challenges ahead

Banks and supervisors should welcome their transformation as they surge towards an uncertain and increasingly risky future.

Banks should relentlessly improve their capability to manage risks. As financial transactions become more complex, banks should have the appropriate infrastructure to ensure that they are not exposed to unwarranted risks. Risk management policies, practices and procedures should be constantly reviewed so as to be aligned with the international best practices. Staff members involved in risk-taking functions should possess the required skills and expertise and should be trained continuously to enhance their abilities. The scope for independent audit should be widened to include the application and effectiveness of risk management procedures and risk assessment methodologies, in addition to a critical evaluation of the adequacy and effectiveness of the internal control systems.

For their part, supervisors should keep pace with the dynamism in the banking environment. To underscore the importance of a sound risk management system, the designation of a full-time Risk Officer and the creation of a risk management committee at the board level, as well as the adoption of a risk-focused internal audit, may likewise be considered mandatory.

Examiners should be provided with continuous extensive training to hone their skills in risk assessment. They should have the capability to interpret information on the economic environment as it impacts on the risk profiles of banks. The development of specialists may be considered. There should also be continuing efforts to streamline the structure and processes towards more effective and efficient supervision.

The growth of banking groups and conglomerates engaging in highly diverse and risky activities points to the need for a consolidated assessment and management of risks by banks and supervisors alike. In this regard, further enhancements of the supervisory tools and examination procedures, as well as of the risk management practices, are essential.

6. Conclusion

While the Bangko Sentral has the mandate to ensure a safe and sound banking system, banks have the responsibility towards their stakeholders to ensure that their institutions engage in safe and sound practices.

However, it must always be remembered that dealing with risks should not necessarily constrain access to credit. Risk-taking, when properly managed, should provide financial services that contribute to economic growth.