

# Role of On-site Examination

Presentation to STEP Bahamas

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# Agenda

- Background
- Context
  - Outcomes/Effects of Financial Crisis
  - Regulatory Response
- On-site Examination
  - Risk Convergence & Risk Appetite
  - Importance of Strong Supervision
  - Effective Examination
- Q & A

# Background

- My *personal* perspective & views
- Focus on a broader, global context: ‘the big picture’
- Not specific to any jurisdiction or financial institution
- Terminology: Regulation vs. Supervision (& *Examination*)

# Background: Regulation & Supervision

- Key components of a Regulatory infrastructure
  - A clear mandate for a national prudential regulator
  - Legislation, regulations, guidelines, reporting and information management
  - Supervisory framework including qualified resources, risk assessment criteria, supervisory policy tool-kit and a judicious balance of on-site examination & off-site supervision
- Characteristics of a Supervisory framework:
  - Risk-based approach to supervision: firms, products, geographies, processes
  - Balancing resources to prudential oversight requirements
  - Integrated off-site (desk-top) risk assessment, monitoring and intervention and on-site examination: processes, people, risk-view and follow-up
  - Reliance-based: use of audit findings (both internal/external), control functions (risk/compliance)
  - Co-operation with national & international supervisors
  - Not an auditing focus

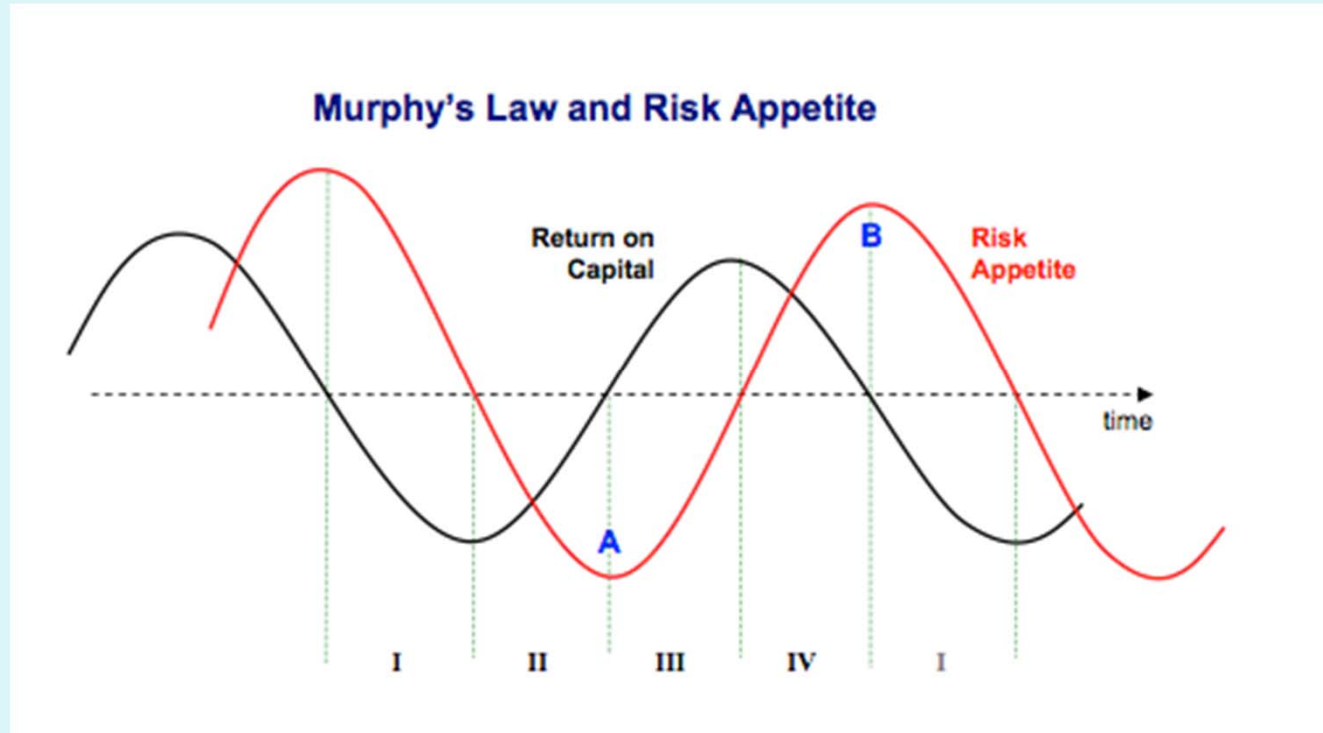
# Context

- Outcomes/Effects of Financial Crisis
- Where are we now? At a very high-level....
  - Not out of the woods yet, but things are looking brighter.
  - Regulators around the world are doing what they can to patch the leaks that contributed to the financial crisis.
  - Risks are converging: Credit/Market/Operational/Liquidity plus across banks; and across financial institutions: banks/insurers/other non-regulated entities
  - Risk appetite is possibly increasing & the seeds of the next crisis are probably already sown.

# Context

- Regulatory Response
- Has the pendulum swung?
  - Since the crisis a large number of studies have looked at what happened, and what should be done to prevent a recurrence.
  - We have seen reports from an alphabet soup of international bodies, the FSB, SSG, BCBS, IIF, FATF and the G-20 , to name a few, as well as work commissioned by national regulators. These reports all point to sizeable gaps in the risk management, and oversight, of financial institutions.
  - There is a lot of good work being done in the areas of liquidity, risk-based capital, compensation, disclosure, among others. The effect of which will be a global regulatory landscape that will be far more prescriptive than it has been, and certainly more restrictive.
  - A lot more weightage to rules, standards and prescribed directives as compared to supervisory intensity/effectiveness.

# Risk Return Cycle – a different view



- |                      |  |
|----------------------|--|
| <b>I – Fear:</b>     | <b>Returns in free fall; risk appetite falling</b>                 |
| <b>II – Shock:</b>   | <b>Returns are weak but improving; risk appetite still falling</b> |
| <b>III – Relief:</b> | <b>Returns stronger &amp; risk appetite begins to grow</b>         |
| <b>IV – Denial:</b>  | <b>Returns diminishing, risk appetite accelerating</b>             |

*Adapted from a speech "From Crisis to Recovery – the Regulatory Challenges Ahead" by Ted Price, Asst. Superintendent, Supervision, OSFI, to IIF Latin America Forum, March, 2011*

# Risk Convergence & Risk Appetite

- Increasing uncertainties: political, energy prices, extent of speculation in commodity market, inflation in emerging markets, potential asset price bubbles etc.
- Resurgence of shadow banking, the formation of emerging market asset bubbles and sovereign debt restructurings in developed markets (“Back to The Future” scenario put out by Oliver Wyman in “Financial Crisis of 2015”)
- More “innovative” & complex products; e.g. securitization of life insurance policies
- Destruction of economic facts & lack of transparency
- Pressures on seeking higher returns against the backdrop of higher capital – trading/capital markets focus but often without having the control infrastructure in place and dependence on “mercenary” resources!
- Compensation & incentive structures have not fundamentally changed
- Rightfully, financial institutions are in the business of making money by taking risk, and with risks come rewards. So to fully understand the risks, directors need to have a deep understanding of the products and the business of modern banking - not only how banks make money today, but also how they can lose it.



# Case for Supervision/Examination

- Historical focus has been on rules & less so, on supervisory oversight on examination
- Rules have a greater visibility, are easy(ier) to implement and trigger immediate response
- Rules are perceived as more concrete, comprehensible, consistent and transparent
- Tendency is to downplay supervisory oversight and underlying supervisory judgment
- Like in any traffic control – rules coupled with on-site monitoring & enforcement keep roads safer
- Supervisory oversight of financial institutions, including on-site examinations, is just as important
- A financial regime with strong rules but weak, ineffective supervisory oversight & examination is not safe or sound.

*Adapted from a speech “Developments in Bank Supervision, A Canadian Perspective” by Ted Price, Asst. Superintendent, Supervision, OSFI, May 2010.*

# So, what is Examination?

- Front-line interaction with firms, senior management and Board: asking specific questions!
- Examining characteristics & *effectiveness*
- Assessing risks & controls at a firm
- Reviewing policies, procedures, processes and adherence to leading practices
- Examining governance markers and indicators: Board meeting minutes, engagement of Directors – strategy, operations, risk management, audit outcomes
- Based on risk stripes and controls being assessed i.e. credit, market, operational and others – examine credit files, VaR reports, front/middle/back office operations, internal reports, risk dashboards, IT/operational platforms, DRP/BCP
- Assessing compliance to jurisdiction's laws & regulations
- Identify issues for discussions and mitigation required
- Seek concurrence to findings and mitigation plan proposed
- Monitor follow-up

# Examination: Characteristics

- No common measure of what's efficient & effective examination
- Frequency of examinations: permanent offices on-site vs. limited visits/relationship team interactions
- Scope: Compliance-focus (easy) to risk identification & mitigation (difficult)
- Role in corporate governance: attendance in board meetings; approval of directors & officials
- Extending reach/outourcing: in-house staff supplemented by consultants, external auditors
- Supervisory styles: autocratic, paternalistic, principles-based, laissez-faire

*Adapted from a speech "Developments in Bank Supervision, A Canadian Perspective" by Ted Price, Asst. Superintendent, Supervision, OSFI, May 2010.*

# Effective On-site Examination

- So let's focus on “Effective Examination” – what makes an effective on-site examiner?
- **Examine like you mean it**
  - It's not only about the rules.
  - Tough rules combined with ineffective supervision is not a safe and sound alternative. We need robust rules and effective examination
- **Remember Job 1**
  - Clarify your mandate. *Avoid conflicting objects: examiner does not own or run the firm; professionals do and work under Board oversight!*
  - Be focused
  - Be risk based
  - Know what the big issues are, and focus on them; the little issues will take care of themselves

# Effective On-site Examination *(cont'd.)*

- **It takes a strong team**
  - “Complicated”?; while not a rocket science, judgments required of examiners are complex, require experience and a variety of inputs.
  - Encourage constructive challenge
  - Be flexible. Plans are out of date as soon as the battle begins
  - This requires substantial external recruiting as well as internal development.
- **An ounce of prevention is worth a pound of cure**
  - Effective examiners must be forward looking, anticipate problems before they occur, and act effectively. Don't stand there, jump to a conclusion.
  - Examiners need to be able to extrapolate, based on scarce evidence, that improvements are needed in a firm. If they wait for irrefutable evidence, it will be too late.
  - Beware of icebergs. 80+% of problem are below the surface

# Effective On-site Examination *(cont'd.)*

- **Forget trying to make everyone happy**
  - This is not a popularity contest. If you have problems saying 'no', you are in the wrong business *but be reasonable, pragmatic & firm*
  - Firms, on being told they have a problem that needs fixing, go through the 5 stages of grief: denial, anger, bargaining, depression and acceptance
  - Credibility will help you to skip the first 4 stages, get on with fixing the problem
- **Examine how rewards are structured**
  - If you want to understand why people behave the way they do, ask how they are paid
  - *Corollary:* If you want to change their behavior, change the way they are paid; Supervisors need to focus on whether or not business line or individual's compensation is truly risk based
- **Take it to the top, before it's too late**
  - *If there is one thing supervisors can do to really change things, it is to put responsibility in the right place*

# Questions?



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