RISK-BASED SUPERVISORY FRAMEWORK

This framework is applicable to all entities under the supervisory authority of the Turks and Caicos Islands Financial Services Commission.

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INTRODUCTION

Pursuant to section 4 of the Turks and Caicos Islands Financial Services Commission Ordinance (Chapter 16:01), the functions and powers of the Turks and Caicos Islands Financial Services Commission ("FSC" or "the Commission") provide for the supervision and regulation by the Commission of financial services businesses. In accordance with the Proceeds of Crime Ordinance Cap 3.15, the Commission is the designated supervisor of Designated Non-Financial Businesses and Professions, and Non-profit Organisations.

Regulation involves the development and enforcement of appropriate legislations, regulations and guidelines for institutions operating in and from the Turks and Caicos Islands.

Supervision involves the dynamic assessment of the operations of institutions to ensure they continue to operate in a safe and sound manner. It assesses compliance with governing statutes and supervisory requirements, in addition to intervening on a timely basis in cases where prudential issues or concerns are identified.

The supervisory framework is a principle and risk-based structured methodology designed to facilitate proactive and dynamic assessment of supervised institutions. It is outcome focused with sufficient flexibility to enable supervisors to identify and respond to new and emerging risks through an integration of macroeconomic and industry perspectives in the assessment of individual institutions.

The framework provides a structured approach for understanding and assessing key risks. It takes account of the different nature and regulatory mandate of the entities being supervised. For licensed entities, at varying degree, the risk based approach determines whether the risk management processes (i.e. identification, assessment, measurement, monitoring, controlling, mitigating and reporting of risks) at the institution are adequate in the context of the key risks, and whether earnings, capital and liquidity are sufficient to enable it to support its risk profile and withstand unexpected shocks.

For supervised entities, where the supervisory mandate is to assess compliance with the Proceeds of Crime legislation, this framework allows for the assessment of the risk management processes in determining whether money laundering and terrorist financing (ML/TF) risks are managed effectively. Hence, determining adequacy of capital, earnings and liquidity is not undertaken for these institutions, only the ML/TF and related risks are assessed.

This risk-based supervision methodology is being applied, where applicable, in the supervision of licensed institutions: banks, trust companies, money services businesses, insurance companies/brokers/ agents, investment dealers/ advisors, mutual funds administrators, company managers, credit unions; and supervised entities: Designated Non-Financial Businesses Professions and Non-Profit Organisations.

1. SUPERVISORY APPROACH

The following are the key principles of the supervisory approach:

i. It is risk and principle based, forward-looking and outcome focused.

ii. It recognises that Board of Directors and Senior Management of institutions are primarily responsible for their financial soundness and prudent management.

iii. It is intended to reduce, but cannot eliminate the risk of failure or inappropriate behaviour by institutions.

iv. Supervision is conducted on a consolidated basis, in coordination with other regulators and using information from them as appropriate. It includes an assessment of all significant entities, both national and international.

v. The exercise of sound judgment in identifying and evaluating risks is central to the effectiveness of the supervisory approach.

vi. Where appropriate, the Commission leverages on the work of the institution's corporate oversight and governance functions to minimise duplication of effort.

vii. Communication of assessments and recommendations to institutions are risk focused.

viii. The level and frequency of supervisory scrutiny and the degree of intervention depends on the risk profile of the institution. Entities that are well managed relative to their risks will require less supervision. Not all areas within an institution need to be reviewed with the same frequency.

ix. It enables the assessment of the risk profile of an institution to be maintained current and provides an objective basis for allocating supervisory resources across institutions and within an institution.

x. The Commission relies on external auditors for the fairness of the financial statements and uses their work to modify the scope of its reviews to minimise duplication of effort. Similarly, the Commission relies on actuaries for the adequacy of policy liabilities and uses their work to modify the scope of its work. Where appropriate, the Commission would rely on the work of other experts in its assessment of the entities.

xi. The intensity of the supervision is influenced by the nature, size, complexity and level of systematic importance of the entity being supervised.

2. BENEFITS

The key benefits of this supervisory approach are:

i. the integration of macro and micro prudential supervision, with focus on early identification of emerging risks to facilitate timely interventions;

ii. assessments are consistent with how an institution should be managed;

iii. better evaluation of risk through separate assessment of inherent risks and risk management processes resulting in a deeper understanding of an institution's operations, its risk appetite and the key drivers of its risk profile;

iv. early identification of institutions and/or areas within institutions with prudential issues and concerns;

v. cost effective utilisation of resources through prioritisation of supervision based on risks;

vi. provision of feedback to institutions on the supervisor's assessment of their risk;

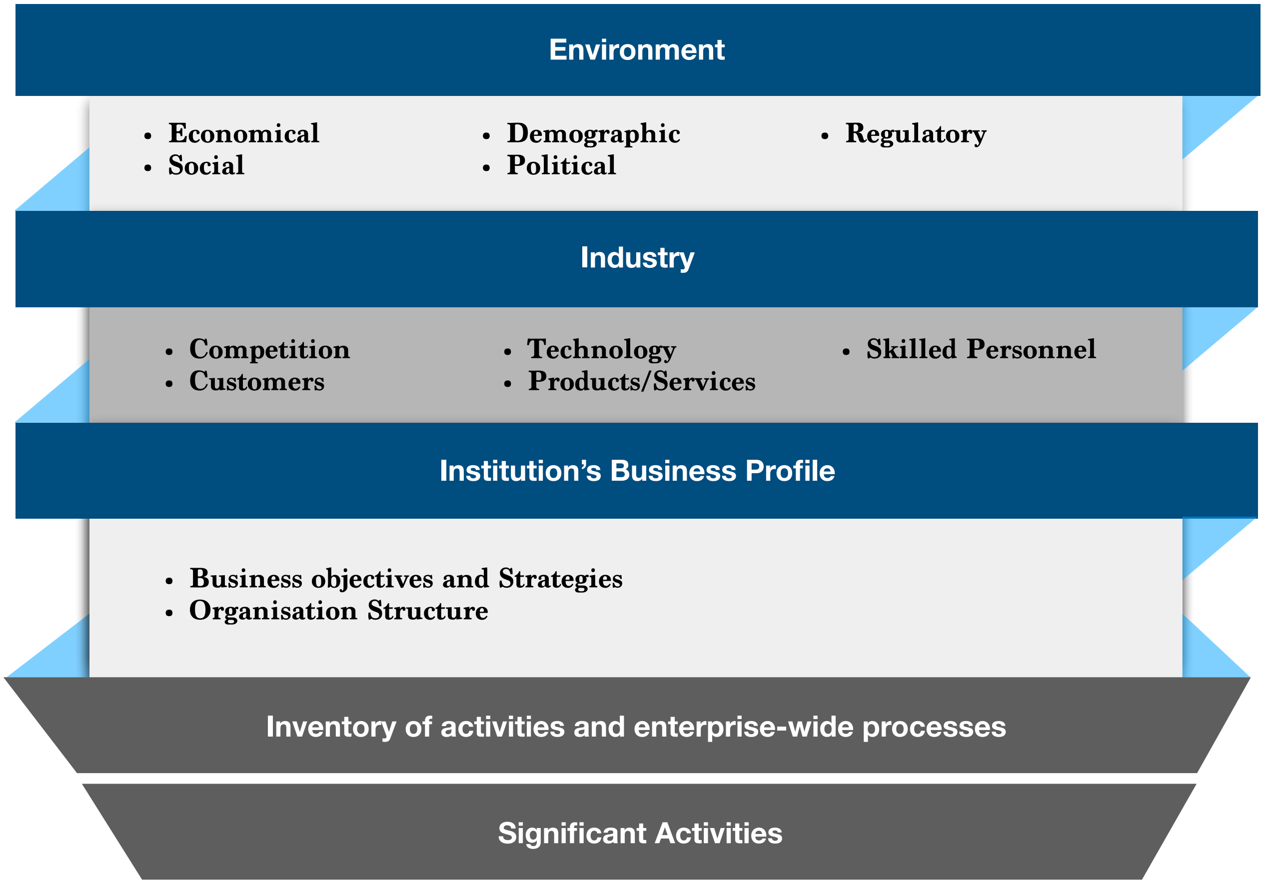
vii. reduced regulatory burden on well managed institutions;

viii. encouragement of a strong risk management culture in institutions; and

ix. allows flexibility for supervisors to use professional judgment within a structured approach.

3. INTEGRATING MACRO AND MICRO PRUDENTIAL SUPERVISION

Knowledge of Business and Identification of Significant Activities



The operations of institutions are increasingly more connected with each other and with other segments of the economy. Consequently, effective supervision of institutions requires an understanding and an assessment of the broader economic and industry environment in which they operate.

The supervisory methodology looks beyond individual institutions. It adopts a stronger macro prudential perspective with a focus on specific areas of risk and supervisory themes, without detracting from the supervision of individual institutions. This enables it to identify, monitor and analyse the market, financial and other material environmental factors that could impact an institution and the sector(s) being supervised. Methods of introducing macro prudential supervision factors include surveillance of the broader economic environment and the industry to identify emerging trends and vulnerabilities, as well as peer comparisons of individual institutions. It also includes regular exchange of information and assessments with other regulators as appropriate.

Through this process, supervisors also engage management of the institutions in a discussion of risks facing their institution as well as their views on risks in the industry and the broader operating environment.

The assessment aims at establishing a dynamic approach to identifying potential risks and vulnerabilities. It enables supervisors to link activities and risks of individual institutions to the industry and the wider system and vice versa. This assessment process is iterative.

3.1 Macro Prudential Risk Factors

Identifying and monitoring macro prudential risk factors in an institution's operating environment include monitoring factors such as: level of economic activity, gross domestic product, financial market indices, level of business failures, level of interest rates (current and projected), projected rates of inflation, health of the real estate sector, availability of investment products, introduction of new products, country risks, etc.

By monitoring relevant macro prudential factors, supervisors are able to assess their probable impact on the industry as well as on individual institutions.

3.2 Industry Risk Factors.

Industry analysis involves research and assessments of the state of the industry with a view to identifying issues or emerging risks. Industry analysis is based on periodic information filed by institutions with the Commission as well as on industry information available from other sources such as industry publications, rating agencies, etc. This information helps keep supervisors up-to-date on industry developments and emerging issues and trends.

3.3 Institution's Business Profile.

To understand the business profile of an institution, supervisors need to understand its business objectives, strategies to achieve its objectives, and organisation and accountability structures. The supervisor needs to understand how the institution plans to achieve its objectives, and the activities it engages in or plans to engage in. It is also important to understand its risk tolerance as well as its track record in executing its strategies. The institution's organisation and accountability structures need to be aligned with its strategies for successful execution.

4. ASSESSING RISK PROFILE OF AN INSTITUTION

An understanding and assessment of the broader economic, industry environments and the institution's business profile provide the supervisor with the necessary context for assessing the institution's risk profile.

Assessing the risk profile of an institution is a dynamic process comprising the following steps:

i. Identifying Significant Activities;

ii. Assessing key risks inherent in each Significant Activity;

iii. Assessing the quality of the Risk Management (Operational Management, Corporate Oversight and Governance) for each Significant Activity;

iv. Assessing Residual Risk in each Significant Activity;

v. Assessing Overall Residual Risk for all Significant Activities;

vi. Assessing Earnings, Capital and Liquidity; and

vii. Determining the Composite Risk Rating[1].

These steps are interrelated and operate in a dynamic manner. They represent building blocks for assessing the risks of an institution. The quality of assessment in each step can impact the quality of the assessments in the steps that follow, ultimately impacting the quality of the overall assessment. Hence, it is important that each step be carried out at an appropriate level of quality for a sound overall assessment of the institution's risk profile. The steps are discussed below in further details.

<u>It is important to note that steps vi. and vii. do not apply to supervised entities where the supervisors will not be assessing financial performance.</u>

4.1 Identifying Significant Activities

An institution's activities can include a line of business, business unit or an enterprise-wide process (such as information technology). Its activities can be identified from various sources of information, including its organisation structure, strategic and business plans, capital allocations, internal and external financial reporting, etc.

Once an institution's activities are identified, sound judgement is applied in determining the significance or materiality of the activities. Materiality for this purpose is a measure of the relative significance of the activities to the attainment of the institution's objectives. It is multi-dimensional, current and prospective, and considers both qualitative and quantitative factors.

The following are examples of criteria that may be used for determining materiality:

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[1]This step is applicable to financial institutions where the level of capital, earnings and liquidity are critical for the sustainability of the operation and protection of depositors, policy holders and other creditors. Therefore, risks are measured against the possible impact on capital, earnings and liquidity. However, the degree of importance of this step may vary from sector to sector.

a. assets generated by the activity in relation to total assets;

b. revenue generated by the activity in relation to total revenue;

c. net income for the activity in relation to total net income;

d. risk-weighted assets generated by the activity in relation to total risk-weighted assets;

e. internal allocation of capital to the activity in relation to total capital;

f. strategic importance;

g. risk level;

h. reputation;

i. criticality of an enterprise-wide process.

Activities identified as significant by the supervisors would generally parallel those considered significant by management. It may be appropriate to group or sub-divide activities for efficient and effective assessment. However, in doing so, supervisors need to ensure that key risks in the activities are not masked and would be assessed at an appropriate level.

Once activities considered significant are identified, risks inherent in those activities are assessed.

4.2 Assessing Risks Inherent in Significant Activities.

Inherent risk is a risk which cannot be segregated from the activity. It is intrinsic to an activity and arises from exposure to and uncertainty from potential future events. Inherent risks are evaluated by considering the degree of probability and the potential size of an adverse impact on a financial institution's capital, earnings and liquidity.

For institutions, where the capital, earnings and liquidity are not critical from a supervisory perspective, the inherent risks are assessed along with the strength of the risk mitigations (oversight functions) to determine the residual risk and possible impact if the risks were to materialise.

A thorough understanding of the environment in which an institution operates and its various business activities is essential to effectively identify and assess risks inherent in its activities.

An institution's Significant Activities are likely to have a number of risks. However, since the inherent risk assessments are in the context of assessing the risk profile (safety and soundness) of an institution, supervisory assessments are focused on risks that are likely to have a material impact on the institution's risk profile; i.e. key risks in its Significant Activities.

At this stage, key risks are assessed without regards to the size of the activity and without considering the impact of risk mitigation by the institution. That is, the first step in the process is to identify inherent risk, without considering materiality and the risk mitigations. The assessment is dynamic and forward-looking. Size of the activity is considered separately in assessing Overall Residual Risk in all of the institution's Significant Activities taken together.

The levels of key inherent risks are assessed as Low (L), Medium Low (ML), Moderate (M), Medium High (MH) or High (H). (Refer to Appendices A & B.)

The assessment of the level of key risks inherent in an institution's Significant Activities enables a supervisor to build expectations of the type and rigour of risk management and controls that would be required by the institution to effectively manage the key risks down to acceptable levels. This, in turn, equips the supervisor to assess the quality of the institution's risk management and controls in the context of the key risks inherent in its activities. The higher the level of inherent risks, the more rigorous the day-to-day management and oversight are expected to be.

4.3 Assessing the Quality of Risk Management Oversight

The quality of risk management and controls for each Significant Activity is assessed at two levels:

a. An assessment of the day to day management of the Significant Activity (Operational Management, also refer to as the first line of defence); and

b. an assessment of the Corporate Oversight and Governance (the second and third line of defence) for the Significant Activity.

4.3.1 Operational Management.

Operational Management is primarily responsible for the day-to-day management of a Significant Activity. This function ensures that policies, processes, control systems, staff levels and experience are sufficient and effective in managing and mitigating the key risks inherent in the Significant Activity. The organisation structure and controls must be effective in preventing and detecting material errors and irregularities in a timely manner.

The degree to which an institution's Operational Management for a Significant Activity needs to be assessed directly depends on the assessment of the effectiveness of its Corporate Oversight and Governance functions. In cases where Corporate Oversight and Governance functions are assessed as effective, supervisors would be able to use the results of the work carried out by these functions in respect of the activity as input into the assessment of the effectiveness of Operational Management for the activity. Where institutions lack some or all of the Corporate Oversight and Governance functions (e.g. in case of branches), supervisors look to other functions, within or external to the institution, that handle these responsibilities.

4.3.2 Corporate Oversight and Governance.

The presence and nature of Corporate Oversight and Governance functions vary based on the size, structure and complexity of an institution.

The Board of Directors is ultimately accountable for the management and oversight of an institution. The Board normally delegates management and oversight responsibilities to Senior Management. Depending on the size and complexity of an institution, Senior Management, in turn, may delegate some of its oversight responsibilities to other oversight functions. Oversight functions that may be set-up include Risk Management, Internal Audit, Compliance and Actuarial.

Senior Management retains the responsibilities not delegated to oversight functions. In smaller institutions, Senior Management sometimes performs responsibilities normally carried out by Operational Management. In these cases, the institution will need to demonstrate how independent oversight is provided over these responsibilities.

The quality of risk management (Operational Management, Corporate Oversight and Governance functions) is assessed as Strong (S), Satisfactory (SA), Needs Improvement (NI), Weak (W) or Critically Deficient (CD). (Refer to Appendix C.)

4.4 Assessing Residual Risk in each Significant Activity.

The assessment of the residual risk in each Significant Activity considers the extent to which the key risks inherent in the activity are effectively managed by Operational Management and independently overseen by Corporate Oversight and Governance functions.

For each Significant Activity, the effectiveness of oversight of each key inherent risk is considered separately and then compiled into an assessment of the residual risk for the activity. Hence, these assessments are multi-dimensional and are based on informed qualitative judgements. For example, a corporate lending activity may be assessed as having a high credit risk, and a moderate level of operational risk. However, the residual risk for the activity may be assessed as moderate due to an acceptable level of risk management by Operational Management and a strong oversight by Internal Audit and Senior Management and an acceptable level of oversight by the Board.

Net residual risk for an activity is assessed as **Low (L), Medium Low (ML), Moderate (M), Medium High (MH) or High (H).**

Table 1 on page 8 guides the residual risk assessments.

4.4.1 Direction of residual risk

The residual risk assessments include a determination of the direction of residual risk. Direction is assessed as **Decreasing (D), Stable (S), or Increasing (I)** over an appropriate time horizon for the institution; for example, the time horizon for a larger more complex institution may need to be longer than for a smaller institution.

4.5 Assessing Overall Residual Risk for all Significant Activities.

Overall Residual Risk of all Significant Activities considers the residual risk in each activity, relative to its materiality and the overall quality of each risk management category. The overall assessment is a qualitative assessment of the institution's susceptibility to adverse events.

Overall Residual Risk is rated as **Low (L), Medium Low (ML), Moderate (M), Medium High (MH) or High (H). The direction of Overall Residual Risk is assessed as Decreasing (D), Stable (S), or Increasing (I).**

4.6 Assessing Earnings, Capital and Liquidity.

After assessing the Overall Residual Risk in an institution's Significant Activities, for financial institutions, the supervisor then assesses Earnings,

Level of Inherent Risk						
		1	2	3	4	5
Quality of Risk Management		Low	Medium Low	Moderate	Medium High	High
1	Strong	Low	Low	Low	Medium-Low	Moderate
2	Satisfactory	Low	Low	Medium-Low	Moderate	Medium-High
3	Needs Improvement	Low	Medium-Low	Moderate	Medium-High	High
4	Deficient	Medium-Low	Moderate	Medium-High	High	High
5	Critically Dificient	Moderate	Medium-High	High	High	High

Table 1

Capital and Liquidity in the context of the Overall Residual Risk.

Under this methodology, Earnings, Capital and Liquidity are assessed separately to understand how they individually contribute to the safety and soundness of the institution, and then considered together to assess their adequacy in the context of the Overall Residual Risk in the institution's Significant Activities.

The adequacy of Earnings, Capital and Liquidity are assessed as **Strong (S), Satisfactory (SA), Needs Improvement (NI), Weak (W) or Critically Deficient (CD)**.

The criteria used to assess Earnings, Capital and Liquidity is summarised below:

4.6.1 Earnings

Earnings are intended to provide for an institution's expenses, expected losses, generate an adequate return for the shareholders and contribute to capital.

The assessment of earnings considers the quality, quantity, volatility, composition and sustainability in the context of the institution's business objectives and its Overall Residual Risk.

It also considers historical trends and future outlook, under normal and stress conditions, as well as reliability of its contribution to capital.

Consideration is also given to the institution's level of earnings in comparison with its peers.

4.6.2 Capital.

Capital represents resources of an institution to facilitate growth and expansion, and enable it to withstand unexpected losses and shocks (i.e. it is an institution's safety net).

The assessment of capital considers the adequacy of capital (quality and quantity) both at present and prospectively and under normal and stress conditions in the context of the institution's Overall Residual Risk. It also considers capital management processes, access to capital in the context of the institution's Overall Residual Risk and planned business activities.

It is not sufficient for an institution to merely meet minimum regulatory requirements.

Capital has to be sufficient to support the risk profile of the institution as well as its planned activities. Also, no matter how substantial an institution's capital is, it cannot be considered a substitute for appropriate risk management and oversight of the institution's activities.

Capital planning and management needs to be effectively overseen by Senior Management and the Board.

4.6.3 Liquidity.

Adequate level of liquidity is critical for the overall safety and soundness of an institution.

Assessment of liquidity considers the current level and prospective sources of liquidity compared to funding needs (under normal and stress conditions) as well as the adequacy of liquidity management practices in the context of the size, complexity, and risk profile of the institution. The assessment, for example, considers:

- The availability of assets readily convertible to cash without undue loss;
- Access to various sources of funding;
- The level of diversification of funding sources;
- The degree of reliance on short-term and volatile sources of funds;
- The trend and stability of deposits;
- The capabilities of management to identify, measure, monitor and control the institutions liquidity position, including the effectiveness of fund management strategies, liquidity policies, management information systems and contingency funding plans.

Liquidity management needs to be effectively overseen by Senior Management and the Board.

4.7 Determining the Composite Risk Rating of the Institution

The assessment of the risk profile (to determine the composite risk) is an overall assessment of a financial institution after considering the adequacy of its capital supported by earnings, and its liquidity in the context of the Overall Residual Risks in its Significant Activities. It is an assessment of the safety and soundness of the institution.

For non-financial institutions, the assessment of the risk profile will not take into account the level of capital, earnings and liquidity but emphasis is placed on the possible impact of a material risk materialising, taking into account the quality and strength of the risk management, governance and oversight functions.

The composite risk is assessed as **Low (L), Medium Low (ML), Moderate (M), Medium High (MH) or High (H).**

The assessment also includes a review of the direction of the institution's composite risk. Direction is assessed as **Decreasing (D), Stable (S) or Increasing (I)**.

The stability of the assessment is indicated in terms of a timeframe. For example, a shorter timeframe is assigned in cases where the risk profile is likely to be more volatile and a longer timeframe in cases where the risk profile is expected to be more stable.

The supervisory methodology provides for a baseline level of activity to assess the risk profile of each institution. It provides the basis from which to determine risk based priorities and the level of intervention considered necessary in individual cases.

Once an institution's risk profile has been assessed, it is refreshed through a dynamic assessment of the impact of any material changes for the institution. Accordingly, beyond this dynamic monitoring and updating of an institution's risk profile, most of the supervisory resources are invested in institutions that require attention based on their risk profile and the prudential issues that need to be addressed.

4.8 The Risk Matrix

A risk matrix (Appendix D) is used to summarise the assessments made through the supervisory process.

The risk matrix highlights the institution's Significant Activities, key risks inherent in those activities, how well the key risks are managed and overseen, residual risk for each Significant Activity, residual risk in all Significant Activities taken together, adequacy of its capital, earnings, and liquidity and the composite risk as well as direction and stability of the composite risk. The risk matrix provides a one-page window into the institution's operations and facilitates visualisation of the components that are the key drivers of the institution's risk profile. The risk matrix is tailored based on the relevant assessment requirement for the different sectors.

Assessments recorded in the risk matrix are supported by supervisory documentation.

5. OVERALL ASSESSMENT OF THE QUALITY OF RISK MANAGEMENT

The methodology facilitates the development of an overall assessment of the effectiveness of the Corporate Oversight and Governance functions.

The overall assessment combines an assessment of the characteristics of the functions (how they have been set-up to provide the oversight) and an assessment of their effectiveness (how well they carry out their oversight roles) across all Significant Activities of the institution.

Corporate Oversight and Governance functions are rated as **Strong (S), Satisfactory (ST), Needs Improvement (NI), Weak (W) or Critically Deficient (CT)**.
(Refer to Appendix C for further guidance.)

6. GUIDE TO INTERVENTIONS

The supervisory methodology includes an intervention system that triggers appropriate supervisory actions when prudential and regulatory concerns about an institution become elevated. The objective is to ensure the concerns are addressed on a timely basis.

7. CONSOLIDATED SUPERVISION

Consolidated supervision is an essential tool for supervising financial groups. It involves a comprehensive approach that seeks to evaluate the strength of an entire group, taking into account all the risks which may affect the group, regardless of whether the risks are carried by the institution or related entities.

In the case of financial groups, the methodology allows for the supervision at the level of the regulated entity in the group (either operating or non-operating) to ensure that all risks incurred by the group, no matter where they are located or booked, are evaluated and controlled across the group on an enterprise-wide basis. All assessments are made and documented on a consolidated basis. Various regulatory requirements (e.g. enterprise-wide risk management, concentration limits, large exposure limits, liquidity, capital, intra-group exposures, off-balance sheet exposures, etc.) are assessed on a consolidated and solo basis to ensure compliance.

The assessment considers the implications of, and relationship with, other regulated and non-regulated down-stream entities in the group, as well as potential impact of up-stream or other related entities outside the supervised group. The latter are assessed for any contagion risks likely to emanate from them for the supervised group.

Not all regulated entities in a group require a separate assessment beyond ensuring regulatory compliance. Separate or solo assessments may be necessary in the following circumstances:

a. Where the regulated subsidiary represents a significant part of the consolidated entity and is operated independently of the group.

b. Where a regulated subsidiary requires a more in-depth review to adequately assess the subsidiary's impact on the consolidated entity than would be possible at the consolidated level.

c. Where a regulated subsidiary's risk management and control practices are distinct from those of the group, and

d. Where regulated entity's risk profile is materially different from that of the group.

For groups operating across borders, supervisors will need to deal with home/host considerations. These would include establishing memorandum of understandings, regular and timely exchange of information, co-ordination of supervisory activities, co-ordination of supervisory intervention as appropriate, establishment of colleges of supervisors, etc.[2]

8. THE SUPERVISORY PROCESS

The Commission appoints an Analyst (Relationship Officer) for each institution.

The Analyst is the key contact for the institution at the Commission and is responsible for the on-going supervision of the institution and ensuring that supervisory processes are completed effectively and on a timely basis.

The main steps of the supervisory process are illustrated in Figure 2 on page 11. Although the steps are described sequentially, updating of the risk assessment is a dynamic, iterative and a continuous process requiring frequent reassessments at various stages.

[2]For further guidance refer to the Commission's Statement on Consolidated Supervision and the FSC's Role as a Host Supervisor.

8.1 Planning

Supervisory planning involves developing/updating a supervisory strategy for an institution and developing an annual supervisory plan.

A supervisory strategy is a multi-year plan for supervising an institution, taking into account the nature, size, complexity and risk profile of the institution. It outlines the supervisory work planned for three to four years, with an overall objective of reviewing all material areas of the institution at least once during the cycle. Supervisory work on significant activities is planned and prioritised after considering their residual risks, when they were last reviewed, the volatility of the activity, and the importance of the activity in the context of the risk profile of the institution. Not all activities of an institution need to be reviewed each year but higher risk or activities that are more volatile may need to be reviewed more frequently.

Similarly, supervisory work for each relevant oversight function is planned and prioritised based on the assessment of the quality of its oversight, timing of its last review and the level of changes in the function.

The supervisory strategy is the basis for a more detailed annual supervisory plan, which indicates work planned for the year and the required resources. In addition to institution specific supervisory planning, planning also includes comparing allocation of supervisory resources across institutions. Not all institutions need to be reviewed each year. Reviews of institutions are prioritised taking into account their systemic importance, their risk profiles, their volatility, material changes in strategies, any significant changes in management or corporate governance, etc. This is to ensure that available supervisory resources are allocated effectively across institutions based on risk.

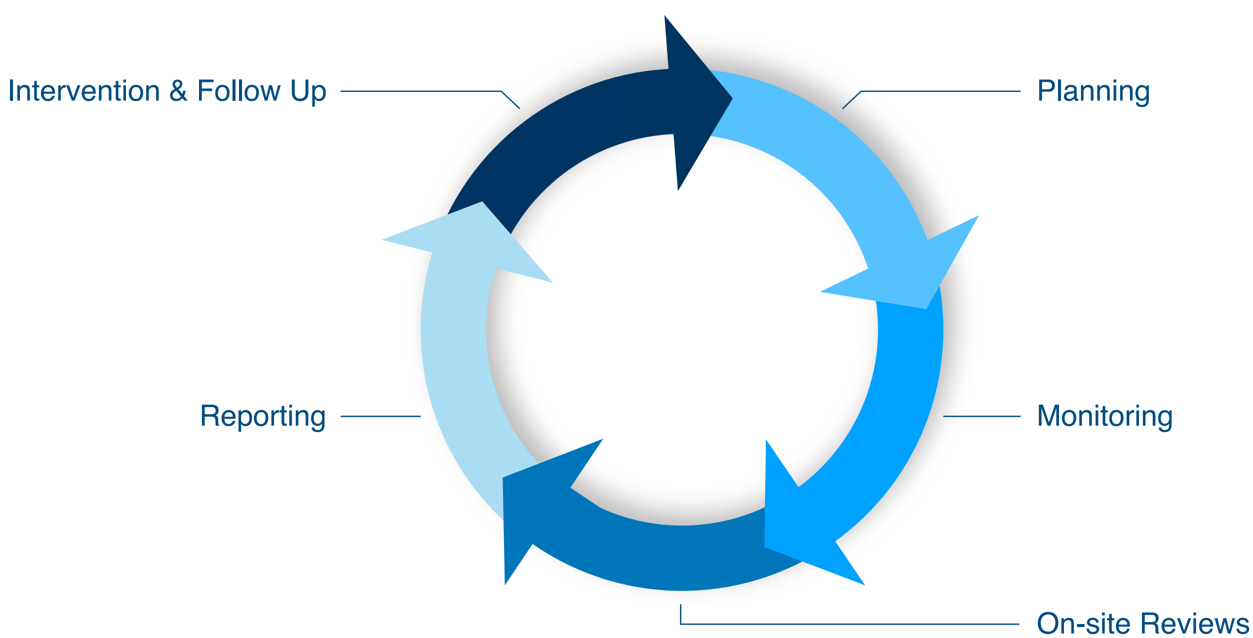
8.2 Monitoring

Institution specific monitoring includes a review of company information (including regulatory returns) and comparative analysis (both historical and against peers) of the results of early warning tests and ratios and the material changes in the industry and its operating environment that are likely to impact the institution in order to assess the probable impact of these changes on the institution's risk profile. Monitoring also includes meeting with key individuals at the institution to discuss trends and emerging issues.

The frequency and scope of monitoring depends on the size, complexity and risk profile of the institution but each institution should be monitored at least quarterly.

Higher risk institutions will require to be monitored more frequently. Results of monitoring are used to update the risk profile of the institution and provide the context for the on-site reviews. Where there are shifts in the risk assessment of the institution, supervisory strategy and plan are adjusted in the context of the changes. These adjustments are dynamic and help

Figure 2



ensure effective utilisation of resources across institutions as well as for an institution.

8.3 On-site Reviews/Examinations

On-site reviews are a critical part of the supervisory process. The scope of on-site reviews depends on the size, complexity and risk profile of the institution and the nature of prudential concerns, if any. These reviews and interactions with the institution's management and oversight functions are critical to effective supervision of an institution and deepen the supervisor's understanding of the institution and its risk profile.

8.4 Documentation.

Effective supervision requires a sufficiently deep understanding of an institution. This understanding is acquired over time through monitoring and on-site reviews, as well as through interactions with management and oversight functions of the institution. Hence, it is critical that knowledge acquired through the supervisory process be captured and built over time. Utilisation of this knowledge across the Commission will increase if it is captured using a standard structure.

Once the initial assessments of Significant Activities and Corporate Oversight and Governance functions are captured, future changes are incorporated by updating the original documents, which makes the process more efficient.

8.5 Reporting

Annually, supervisors prepare a Supervisory Letter to institutions to communicate the overall assessment of the institutions' risk profile, any prudential concerns identified and recommendations for addressing them. In addition, quarterly (or more or less frequently as may be deemed necessary) Risk Assessment Reports are completed by supervisors for internal use.

In the case of on-site reviews, the final stage of the process includes issuing an Onsite Examination Report or Letter. Assessments, findings and recommendations are first discussed with appropriate senior managers at the institution. This is followed by reporting to the Chief Executive Officer (CEO) and the Board as appropriate.

8.6 Follow-up

Prudential concerns identified are monitored by supervisors for timely resolution by the institution.

APPENDICES

CATEGORIES OF INHERENT RISKS

Following are descriptions of the nine inherent risk categories for assessment purposes. These descriptions should be read within the context of the definition of inherent risk contained in the Supervisory Framework.

Credit Risk

Credit risk arises from a counterparty's inability or unwillingness to fully meet its (on- and/or off-balance sheet) contractual obligations.

Market Risk

Market risk arises from changes in market rates or prices. Exposure to this risk can result from market-making, dealing, and position-taking activities in markets such as interest rate, foreign exchange, equity, commodity and real estate.

a. Interest Rate Risk

Interest rate risk arises from movements in interest rates. Exposure to this risk primarily results from timing differences in the repricing of assets and liabilities, both on- and off-balance sheet, as they either mature (fixed rate instruments) or are contractually repriced (floating rate instruments).

b. Foreign Exchange Risk

Foreign exchange risk arises from movements in foreign exchange rates. Exposure to this risk mainly occurs during a period in which the institution has an open position, both on and off balance sheet, and/or in spot and forward markets.

Insurance Risk

Insurance risk arises from claims and/or policy benefits exceeding the pure premiums charged for the products.

a. Product Design and Pricing Risk

Product design and pricing risk arises from the exposure to financial loss from transacting insurance and/or annuity business where costs and liabilities assumed in respect of a product line exceed the expectation in pricing the product line.

b. Underwriting and Liability Risk

Underwriting and liability risk is the exposure to financial loss resulting from the selection and approval of risks to be insured, the reduction, retention and transfer of risk, the reserving and adjudication of claims, and the management of contractual and non-contractual product options.

Operational Risk

Operational risk arises from problems in the performance of business functions or processes. Exposure to this risk can result from deficiencies or breakdowns in internal controls or processes, technology failures, human errors or dishonesty and natural catastrophes.

Legal and Regulatory Risk

Legal and regulatory risk arises from an institution's non-conformance with laws, rules, regulations, prescribed practices, or ethical standards in any jurisdiction in which the institution operates.

Money Laundering and Terrorist Financing Risks

Money laundering risk is the risk that an entity could be used to disguise the origins of illegally obtained money and/or the proceeds of criminal conduct; through the process of making such funds appear to have derived from a legitimate source.

Terrorist financing risk – addresses the risk where an entity is susceptible to be used as a conduit for financing or providing financial support to terrorists or terrorist groups.

Strategic Risk

Strategic risk arises from an institution's inability to implement appropriate business plans, strategies, decision-making, resource allocation and its inability to adapt to changes in its business environment.

Concentration Risk

Concentration risk can arise from uneven distribution of exposures to clients and/or third parties. Another type is sectoral concentration risk which can arise from uneven distribution of exposures to particular sectors, regions, industries or products.

Reputation Risk

The risk of potential losses arising from negative public opinion, whether based on facts or merely public perception, and the adverse impact this could have on an institution's revenues, liquidity, capital, operations or customer base.

RISK RATING CATEGORIES

DEFINITIONS OF RISK RATINGS[3]

Low
Low risk exists when there is a low probability of a material adverse impact, due to exposure and uncertainty from potential future events.

Medium Low
Medium Low risk exists when there is a lower than average probability of a material adverse impact due to exposure and uncertainty from potential future events.

Moderate Risk
Moderate risk exists when there is an average probability of a material adverse impact due to exposure and uncertainty from potential future events.

Medium High Risk
Medium High risk exists when there is a higher than average probability of a material adverse impact due to exposure and uncertainty from potential future events.

High Risk
High risk exists when there is a higher than above average probability of a material adverse impact due to exposure and uncertainty from potential future events.

[3]For financial institutions, the probability of an adverse impact on capital, earnings and liquidity is assessed in determining the rating.

QUALITY OF RISK MANAGEMENT CATEGORIES AND RATINGS

The quality of risk management is assessed in context of the nature, scope and complexity of the institution.

OPERATIONAL MANAGEMENT

Operational management is the first line of defence and is responsible for planning, directing, and controlling the day-to-day operations of a significant activity.

THE ACTUARIAL FUNCTION

The Actuarial Function is an independent function, applicable to insurance business, with responsibilities beyond the legal requirements of the appointed actuary that could include the following:

- Evaluating the design, pricing and valuation of the insurance products offered by the insurer;
- Assessing the reasonableness of provisions set for policy liabilities and the appropriateness of the process followed;
- Reviewing modes used to determine exposures and the adequacy of reinsurance programs to mitigate these exposure.
- Analysing the process used to establish the adequacy of capital and capital planning for the insurer under adverse conditions ("Stress Testing"); and
- Reporting on the results of its work to Senior Management and the Board.

THE COMPLIANCE FUNCTION

Compliance is an independent function within an institution that ensures that the institution meets the legal and regulatory obligations by 1) ensuring the institution has adequate policies and practices for adhering to the requirements; 2) monitoring adherence to those policies and practices and 3) reporting on compliance matters to Senior Management and the Board of Directors

RISK MANAGEMENT FUNCTION

Risk management is an independent function responsible for planning, directing and controlling the impact on the institution of the risks arising from its operations. The function may address the following:

- Identify current and emerging risks in the institution's operations,
- Develop measurement systems for risks,
- Establish policies and practices for managing risks,
- Develop risk tolerance limits and periodically stress test limits,
- Monitor positions against approved limits, and
- Report on risk monitoring to senior management and the Board.

CORPORATE GOVERNANCE

SENIOR MANAGEMENT

Senior Management is responsible for directing and overseeing the effective management of the institution's operations. Its key responsibilities include:

- Developing business objectives, strategies, policies (including policies for risk management and risk appetite), organisational structure and controls for Board approval;
- Effectively overseeing the operations of the institution to ensure day-to-day operations are carried out in accordance with Board approved business objectives, strategies and policies.
- Developing and promoting sound corporate governance practices; and
- Providing the Board with sufficient and timely information to enable it to carry out its responsibilities, including monitoring and reviewing performance and risk exposures of the institution.

BOARD OF DIRECTORS

The Board of Directors is responsible for establishing and implementing a corporate governance framework for a sound and prudent management of the institution. Its key responsibilities include:

- Reviewing and approving organisational structure, including clearly defining roles and responsibilities of its committees, management and heads of oversight functions.
- Regularly reviewing, approving and overseeing the implementation of the institution's business objectives, strategies to achieve the objectives and policies for major activities, including risk strategies and appetites.
- Ensuring that management and heads of oversight functions are qualified and competent.
- Providing oversight over the design and effective implementation of sound risk management and internal control systems.
- Providing for an independent assessment of, and reporting on, effectiveness of the institutions operations.
- Approving remuneration policies and practices.
- Monitoring performance against business objectives, strategies and plans and requiring timely corrective actions were warranted; and
- Providing effective oversight over management and oversight functions.

INTERNAL AUDIT FUNCTION

Internal audit is an independent function within an institution that assesses adherence to and effectiveness of operational and organisational controls and governance practices. In addition, internal audit may also assess adherence to and effectiveness of compliance and risk management policies and practices.

Characteristics:

- Independent enterprise-wide mandate to oversee the institution's operations.
- Appropriateness of the organisation structure and reporting, including seniority of the head of the function and direct reporting to the Board.
- Adequacy of resources to carry out its mandate, including the level of staffing and availability of required skills.
- Adequacy of its risk based audit methodologies and practices.
- Adequacy of its planning, coverage cycle and reporting and follow-up practices.
- Extent of Senior Management and Board oversight.

RATING CATEGORIES:

Strong
Characteristics of the function meet or exceed what is considered necessary for the nature, scope, complexity and risk profile of the institution, and the function has demonstrated highly effective performance on a consistent basis and shows superiority to industry practice.

Satisfactory
Characteristics of the function meet what is considered necessary and aligns with sound industry practice for the nature, scope, complexity and risk profile of the institution, and the function has demonstrated effective performance.

Needs Improvement
Characteristics of the function generally meet what is considered necessary for the nature, scope, complexity and risk profile of the institution; but, there are some significant areas that require improvement. Performance has generally been effective; but there are some significant areas where effectiveness needs to be improved. These areas are not likely to cause serious prudential concerns if addressed on a timely basis.

Deficient
Characteristics are not, in a material way, what is considered necessary given the nature, scope, complexity and risk profile of the institution. Performance has demonstrated serious instances where effectiveness needs to be improved through immediate action.

Critically Deficient
Characteristics of the function are critically deficient for the nature, scope, complexity and risk profile of the institution, and the function has demonstrated serious weakness in performance on a consistent basis.

These risk categories are also applied when evaluating the quality of risk management but at the significant

RISK MATRIX.

<table>
<tr><th colspan="7">RISK MATRIX</th></tr>
<tr><th>Significant Activities</th><th>Materiality</th><th>Inherent Risks</th><th colspan="2">Quality of Risk Management</th><th>Residual Risk</th><th>Direction of Risk</th></tr>
<tr><td>Activity 1

Activity 2

Etc...</td><td></td><td>§ Credit
§ Market
§ Insurance
§ Operational
§ Legal & Regulatory
§ Money Laundering& Terrorist Financing
§ Strategic
§ Reputation</td><td>Operational Management</td><td>Oversight
§ Actuarial
§ Compliance
§ Internal Audit
§ Risk Management
§ Senior Management
§ Board Oversight</td><td></td><td></td></tr>
<tr><td>Overall Rating</td><td colspan="3"></td><td>Overall Assessment</td><td></td><td></td></tr>
</table>

Capital	Earnings	Liquidity
Composite Risk	**Direction of Risk**	**Time Frame**