The macro environment plays a major role in financial intermediation as there have been developments in the financial sector across the globe and banking activities and products which include sophisticated financial instruments in the recent years. The sector has experienced quickening pace of technological innovation; falling barriers between different financial markets; banks exposed to complex risks; consolidation in the financial industry; development of financial frauds and scams; massive eruption of event risks; evolving accounting standards; and hence the changing regulatory environment. All these factors combined inspired the need to document this paper on RBS as it is eminent that supervisory agencies need to re-visit their supervision strategies in order to heighten financial sector oversight.
Preface

A brief background on the Central Bank of Lesotho (the Bank) is essential at this point so as to spot how RBS comes in. The Bank is charged with the regulation and supervision of banks in Lesotho according to the Central Bank Act 2000, section 6(e) and (i) which stipulate that the Bank shall license and supervise the banks and also promote the safe and sound development of the financial system. In compliance with this, the Bank established Supervision Department which is tasked with ensuring the stability and soundness of the banking sector. The supervision of banks started as far back as 1973. However, a major regulatory and supervision overhaul took place in the late 1990s when the banking sector faced closure of two State-owned banks namely Lesotho Bank and Lesotho Agricultural Development Bank. It was at this time that through concerted efforts the new banking law was passed in 1999. It became possible therefore to review the supervision structure and the name changed from Supervisory and Development Services to Supervision Department. One of its Divisions was the Financial Institutions Supervision Division (FISD) which was charged with bank supervision and other non-bank financial institutions including insurance and micro-credit providers.

The Division in its present form supervises only banks as the non-banks have been deployed under a separate Division since 2003. The FISD has two sections named after the supervision tools namely Off-site surveillance and On-site examinations which are responsible for supervising the banks’ overall condition and risk management systems. The Off-site is a continuous assessment which is performed continuously based on the incoming returns from banks. The compliance of banks with the statutory and regulatory requirements is also determined. These returns are submitted weekly, monthly, quarterly, and bi-annually. The analysis usually focuses on the individual banks and then consolidation to illustrate the banking industry. These are tabled before the Financial Institutions Supervision Technical Committee (FISTC) and any supervisory concerns and directives are communicated to the relevant bank. The off-site surveillance has the reporting guidelines concerning all the regulatory returns.
The on-site examinations section is responsible for the examination of banks. The examinations are conducted applying the CAMELS approach, assessment of internal controls including the physical security and adherence to regulatory requirements. There is a detailed manual covering examination procedures for all activities and operations of the bank. The examinations unlike the off-site assess the overall condition and future prospects of the financial institutions. This means that the examiners have direct access to the books, records, files, audit reports and any third party review. The reports generated from the examination normally depict the institution’s whole picture.

With regard to banks, it is also critical to include them in the situational analysis and this is achieved through a survey and present knowledge about the bank. The banks in Lesotho already have risk management structures although they are at different levels depending on the character and nature of that bank. One of our banks introduced risk management gradually since 2003 and has at present a fully fledged risk management unit. The banks have always been managing their risk so the emphasis is in ensuring that they do have an enterprise wide risk management mechanism so as to judge the interdependence of their risks and the overall risk. It works as a checkpoint to ensure that the financial institution recognises all its risks. The banks still have to align their risk management structures in line with the Risk Management Guidelines that the CBL will issue.
IMPLEMENTATION OF RISK BASED SUPERVISION

THE CASE OF LESOTHO

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Abbreviations

APRA     Australian Prudential Regulation Authority
BIS      Bank for International Settlements
BNR      National Bank of Rwanda
BOM      Bank of Malawi
BOT      Bank of Tanzania
BOU      Bank of Uganda
BCPS     Basel Core Principles of Effective Supervision
CBK      Central Bank of Kenya
CBL      Central Bank of Lesotho
East AFRITAC  East Africa Regional Technical Assistance Centre
FSA      Financial Services Authority
FSI      Financial Stability Institute
MEMFI    Macroeconomic and Financial Management Institute of
         Eastern and Southern Africa
NBE      National Bank of Ethiopia
RBZ      Reserve Bank of Zimbabwe
RBS      Risk Based Supervision
The FED  Federal Reserve System
USA      United States of America
UK  The United Kingdom
CHAPTER 1   INTRODUCTION

1.1 Background

Since 1973, the Central Bank of Lesotho (CBL) has constantly endeavoured to enhance efficiency level of its supervisory process. Recently the growing diversities and complexities of the banking business, necessitated by advanced technologies, innovative products and services as well as volatility and general growth of risks facing the banking industry have provided reasons enough for the CBL to upgrade its supervision approach. The international banking scene has in recent years witnessed strong trends towards globalisation and consolidation of the financial system. Stability of the financial system has become the central challenge to bank regulators and supervisors throughout the world. The regulators in response have changed their supervisory methods and since the introduction of risk based supervision some supervisory methods have reviewed the method twice.

It is important to note that regulators in the region were keen in keeping pace with the developments in supervision processes in order to maintain soundness and stability in the ever evolving financial sector. This is seen by the champions in the region such as Bank of Uganda (BOU) and Reserve Bank of Zimbabwe (RBZ), which took lead by implementing RBS right after Australian Prudential Regulation Authority (APRA), one of the international pioneers of risk based approach to supervision, rolled over the framework in 2002. Uganda led the implementation in 2003, followed by Central Bank of Kenya (CBK), RBZ, Bank of Tanzania (BOT) in 2006, National Bank of Rwanda (BNR) 2007 as well as Reserve Bank of Malawi (RBM) and National Bank of Ethiopia (CBE) in 2008.

For many years since the inception of the Basel I in 1988, the supervisors in the MEFMI region have been applying the traditional supervisory approach. Regrettably the traditional approach has
merit for determining the point in time condition of a financial institution and quantifies current problems but provides little insight into the future. Traditional approach has merit for determining the current condition of a financial institution and quantifying current problems. It provides little insight into the financial institution’s future performance and does not put the onus of accurate record keeping, problem identification and corrective measures on the Board of Directors. The weakness of this approach is that it usually addresses only the symptoms of the problem without addressing the causes of the problem. Therefore, even after problems seem to have been resolved, the probability remains high that they will recur.

The traditional approach to supervision is rules-based or compliance-based, and primarily focuses on assessing banks’ compliance with the legislative and regulatory requirements to minimise the risk of failure. The approach also focuses on the accuracy of the balance sheet, including loan loss reserves, the income statement and the adequacy of the internal controls that are primarily designed to prevent fraud. It is a one size fits all approach regardless of the size and nature of the institution.

Although the traditional approach requires a great deal of technical knowledge and skill, it is still deemed inadequate in assessing risks. It usually does not differentiate among high – medium - and low - risk activities. Also, it is labour intensive and strains the resources of most regulatory institutions that employ it. Risk focused approach, on the other hand, focuses on the inherent risks for each institution, assesses the risk management systems and adjusts the supervisory resources in carrying out the assessments based on the strength of the risk management systems.

Risk based supervision has several benefits to stakeholders, such as supervisors, banks and the general public. Central Bank of Kenya in its RBS policy in 2005 conferred that it is a cost effective way of using supervisory resources. There is emphasis to focus and dedicate supervisory resources to identify activities and practices of greater risk to the soundness of banks, and also to identify high-risk institutions. Once these activities and institutions have been identified, supervisory attention is focused on assessing and measuring those risks,
including examining how the risks are mitigated. The Basel Committee has indicated that the following benefits accrue from risk based supervision to the supervisor and banks respectively:

**Supervisor**

a) Cost-effective use of supervisory resources through a greater focus on risk, which in turn results in better allocation of supervisory resources;

b) Early identification of emerging risks at individual banks and on an industry basis;

c) A better appreciation by supervisors of the characteristics of the banks' business, of the risks they face and of the quality of their management;

d) RBS provides consistent definitions of risk, a structure for assessing these risks and a more integrated use of risk assessment in the supervisory process;

e) It uses a common framework and terminology developed specifically to assess risks and evaluate management practices, policies and procedures in the context of managing risks.

**Banks:**

a) RBS emphasises the need for banks to understand and adequately manage risk associated with their operations. Thus, leads to better risk management.

b) It ensures that the Board (top – bottom approach) is no longer a peripheral figure in managing the bank by raising the need to put in place policies that address exposures from all business activities;

c) It leads to correct decision making including pricing, and attendant revenue leading to profitability;

e) It provides a transparent explanation and rationale for the actions taken by the Supervisor;

f) It leads to less intensive supervision of well managed institutions;
It incorporates an assessment of management ability to deal with risks beyond their control such as systemic risks in the economic environment in which the institution operates.

Risk based supervision also benefits the government and public in that it ensures banks are run in a sound and safe manner thereby promoting financial stability and then enhancing a sustainable economic development.

RBS is one of the supervisory approaches for conducting ongoing supervision with many positive attributes as opposed to the traditional approach. It is described as dynamic, structured, forward looking process, designed to identify key risk factors, to evaluate the level of risk management and direction of risk to which individual banks and the entire industry are exposed. The word ‘structured’ is emphasised as it implies that all key activities of an institution are systematically considered and within each key functional area, the level and quantity of risk, the quality of risk management and direction or risk are evaluated. Reserve Bank of Zimbabwe (2006). 

The Bank of Spain referred to RBS as a comprehensive process which uses the current information to focus on identifying and controlling the key risk areas currently and into the future as well as providing foresight to the supervisors to detect potential triggers and early preventative measures. One would wonder what this new practice is and what makes it so special from the way supervisors in the MEFMI region have been operating. This methodology focuses on identifying the risk profile, that is, the type and level of inherent risk, assessing the quality of risk management, identifying inadequate management practices that cause both current and potential problems. It encourages financial institutions to build risk management culture within their organisations and explore various risk mitigation techniques to support the nature and scope of their banking operations and business lines. The risk is taken not only as a guiding principle for the institutions but also highlights issues of concern and provides enhancement in planning and managing supervisory procedures and resources accordingly. RBZ says that it means the supervisory resources are based on or guided by the risk characteristics of the financial institutions.
As much as RBS is a commendable framework, its implementation can be challenging. It has been realised that in the process of implementation and application of RBS, there have been hurdles caused by, among other reasons, lack of proper documentation on the guidelines to follow to successfully implement RBS. Some of the regulators such as RBZ had to relaunch the implementation process as it did not take off successfully the first time. However, in the absence of a formal implementation guide in the region at that time, RBS was still a success and proved to be very useful as compared to the traditional approach. For example, its success was eminent in capacity building and skilled professionals in supervision. It has been reported that the National Bank of Ethiopia and CBK lost their staff to the commercial banks due to the extensive knowledge they had on risk management in banking which they gained in the framework.

During the implementation in the region, the available document was the policy framework of which most countries customised into their own jurisdictions and they are almost similar in all the countries that have adopted the methodology. This implies that the region needs more than one formal guide in the implementation of this methodology to emphasise the importance of enhancement of the supervisory process. Moreover, it has been evident, through taking stock in the region, that RBS implementation process is a “paradigm shift” which does not only affect the supervisory process but the how the supervisory resources are used, the calibre of supervision staff and the banking industry operations, too. Consequently, it is necessary to formalise the implementation steps, and define the methodology in order for the supervisor as well as the supervised institutions to internalise the framework. Therefore, the main aim of this paper is to define the RBS methodology, share experiences of other countries and show the implementation steps for the CBL.

1.2 Scope and objectives
Many writings have been produced by various regulators in various jurisdictions about RBS. The paper seeks to define RBS, outline its benefits vis-a-vis the traditional approach, explain the stages for implementation of RBS and supply the CBL with a customised roadmap to follow in implementation. The scope also covers the main pointers in the development of a risk based policy framework. Therefore to achieve the scope the following objectives will be undertaken:

a) To underscore the various lessons learned from other regulatory authorities regarding the importance and challenges of risk based supervision as well as its implementation;

b) To compile a step by step process of RBS implementation;

c) To outline the basic elements of a risk based supervision methodology framework for CBL and provide improvements where necessary on the existing policy framework that has been developed and adopted by countries in the region; and

d) To draw a road-map towards a successful implementation of RBS for the CBL.

1.3 Justification

This paper comes at the backdrop of intense financial sector challenges especially the recent global financial crises which recorded huge financial institutions failures of all time. The main reason was the short-sightedness of some financial institutions by allowing maximisation of profit in short-term as against risk versus return in the long term only to the detriment of the global economy. The financial markets allowed sophisticated instruments or instruments that lacked real value such as the sub-prime mortgages, derivatives and shady equity instruments and this led to the built-up of the crises.

The financial crisis was a real systemic occurrence which hit the global financial system and the world economy at large and the region tasted the second round effects as some of the international financial institutions such as the Citi Group had a rough experience. Citi Group was only bailed out in November 2008 by the United States of America (USA) government.
In Lesotho, the export market was also hit very badly as the country’s two large commodities, textiles and diamonds could not be sold abroad. This occurrence came like a dawn with a message that regulators should really be alert, proactive and observant with not just the financial sector activities but the linkage between those activities and the macro-environment at large. This occurrence has invited so many comments regarding regulation to the extent that some of the leading Economists like Borio of the Banking of International Settlements, in one of his columns stated that “Looking ahead, the challenges involved in implementing a macro-prudential approach to regulation and supervision should not be underestimated” ((Borio and Drehmann, 2008)).

It comes at a time when the supervisory agencies in the region were eager to enhance the supervision framework as many have already implemented RBS and indeed the crises effects re-emphasised the need for implementation to those regulators which were still lagging behind. Therefore this paper seeks to reinforce the need for heightened supervision and encourages the need to implement RBS effectively in the MEFMI region. Some countries as already stated have fully implemented RBS such as Uganda and Zimbabwe whereas some are still lagging behind such as Lesotho and Botswana.

Furthermore, the macro environment plays a major role in financial intermediation as there have been developments in the financial sector across the globe and banking activities and products which include sophisticated financial instruments in the recent years. The sector has experienced quickening pace of technological innovation; falling barriers between different financial markets; banks exposed to complex risks; consolidation in the financial industry; development of financial frauds and scams; massive eruption of event risks; evolving accounting standards; and hence the changing regulatory environment. All these factors combined inspired the need to document this paper on RBS as it is eminent that supervisory agencies need to re-visit their supervision strategies in order to heighten financial sector oversight.
The traditional supervisory practice has since reflected shortfalls among the developed countries such as the USA and the United Kingdom (UK) in the early 1990’s. Since then a number of regulatory authorities such as the Federal System of the USA and the Financial Stability of the United Kingdom UK adopted an advanced approach to supervision namely ‘risk focused’ or ‘risk based’ supervision. The traditional approach as compared to RBS is outdated as it is transaction based and tends to duplicate the internal audit function. It is considered largely reactive, narrow in scope and uniformly applied to all supervised institutions. By being reactive, it lacks the forward looking perspective and overlooks majority of potential problems and early signals or triggers as the assessment is made for one point in time. It also falls short to consider the complexity and size of operations, as well as the risk profile hence it is referred to as a one size fits all approach whereby it applies the same scope to all financial institutions. In this regard, it is also costly as there is no perspective as to the economic allocation of resources. It is labour intensive, time consuming on-site and strains the supervisory resources. This approach often addresses the symptoms of problems instead of causes; it frequently leads to remedies that promote reducing risks as opposed to employing techniques that effectively manage risks.

Indeed the traditional supervisory practice falls short to address these rising challenges as it uses the transaction testing approach which ignores the level of risks embedded in individual banks, functional activities and products and fails to allocate the scarce supervisory resources effectively. On the contrary, RBS methodology as expressed by Nestor A. Espenilla\(^1\), allows the institutions to take risks as long as they demonstrate the ability to manage and price those risks. Then each institution could be supervised depending on its ability to manage the risks the institution is exposed to. That means RBS is tailor-made towards every institution and the supervisory processes are well defined as the first step will be to assess the institution profile then, undertake the risk assessment which would include the assessment of the internal controls and risk management strategies and if an institution poses less risk then the supervisor applies less effort and likewise if there is a high risk. Therefore, these processes demonstrate that RBS is cost sensitive as there is an economic allocation of resources.

\(^1\) Espenilla Nestor A, Jr, (Assistant Governor of Bangko Sentral ng Pilipinas), San Pedro Teodora I, & Prenio Jermy Y. 2005 Basel II & Risk Based Supervision Presentation to the Officers of Supervision Department
The Basel committee\(^2\) in its efforts to strengthen the prudential supervision has seen the need to move to common supervisory and reporting framework and therefore have developed the core principles for effective banking supervision in 1996 and many other working documents with regard to various issues such as banking risks, capital and corporate governance. Banking supervision core principles 6 to 18 \(^3\) clearly state that supervisors should ensure that banks have in place risk management and internal controls systems to identity, measure, monitor and control risk and to hold adequate capital commensurate to these risks. Hence in the 1990’s when inadequacies were evident in the supervisory framework, many countries in the G10 \(^4\) modified their supervisory process moving towards a more risk based approach Sahajwala R & Van de Bergh (2000)\(^5\). The approach is defined by The Financial Stability Institute (FSI)\(^6\) as “an efficient and effective process which seeks to achieve a reasonable assessment of individual banks’ financial condition and managerial strength, on an on-going basis, in order to facilitate a prompt and timely response to emerging problems.”

This goes to show that RBS does not only benefit supervision but also the financial institutions themselves as they are encouraged to cultivate an appropriate control environment and put in place adequate risk management systems. However supervisors still need to verify that the banks have systems in place that, provide adequate control measures, mitigate the risks and indeed produce expected triggers to foretell future risks and provide adequate control measures. According to APRA “this approach recognises that management and boards of supervised institutions are primarily responsible for financial soundness” APRA (2002).

\(^2\) Basel Committee is a standard setter for supervision across the world. it is fairly represented by the G10 supervisors and all other regional supervisory bodies.


\(^4\) G10 countries include United States of America, United Kingdom, The Netherlands, Italy, France, Germany


The banks’ capital adequacy is also regulated hence in 1988, the Basel Committee came up with Basel I accord, a capital measurement based on the assets in particular the loans and ignored to measure risks emanating from other activities. With the banking developments it was realised that capital measurement has to be extended to other risks such as market and operational hence the remodelling of capital in 2004 to Basel II, (the revised capital accord). Basel II considers all the key functional business lines and their risks and requires capital charge to all the identified risks. In the same manner, RBS focuses on risk assessment of all functions and Basel II complements this process by focusing on the capital charge. As a result relationship between the two has been established which makes RBS a prerequisite to Basel II implementation, The Basel Committee has even encouraged that all supervisors should adopt Basel regardless of whether they would adopt Basel II or not. This is because RBS has the fundamental elements of effective supervision in particular serving as a tool for maintaining financial stability, providing an early warning system and setting a platform for prompt corrective action. Therefore RBS again sets a platform for Basel II implementation as it is a comprehensive risk oriented assessment of banks.

It is worth mentioning that it also prepares supervisory agencies for Financial Sector Assessment Program (FSAP), an assessment undertaken by International Monetary Fund (IMF) which includes compliance with the bank supervision core principles. With RBS a supervisory agency is able to develop its supervisory processes to the international best practice and standards and when the FSAP is undertaken, such an agency is likely to be largely compliant.

In addition, to the supervisory approach developments, the new approach itself poses challenges with regard to its implementation, therefore requires clear implementation criteria, which allows paced introduction and room for modifications. In this regard, for those supervisory authorities that have adopted and implemented the methodology, there were difficulties along the way as

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7 BASEL II – the Revised Capital Measurement framework, which is the recent capital convergence introduced in 1999 and published in 2004 as a supplement to the deficiencies noted in Basel I, which was the initial capital accord published in 1988.

8 FSAP is IMF/World Bank program that assesses the financial sector in line with the core principles among other things
some countries in the region experienced smooth transition while some did not. Similarly, it seems one of the pioneers of RBS, APRA experienced similar challenges in its implementation. It has been mentioned that it took 18 months or so for appreciation and three years for full implementation (IOPS, 2007). Another example is the implementation by Reserve Bank of Zimbabwe which had to be repeated in 2006 as it did not go well the first time. Therefore this factor emphasises and calls for clear step by step guide for effective implementation of this methodology.

The characteristics and benefits of RBS are distinctive and obviously the answer to the ever evolving financial sector supervision such that as the financial sector progresses, the supervisory process responds accordingly. RBS seems to have the capacity to stand the times since it genetically focuses on the risk, therefore as the risks of financial institution changes, the process follows. This is an approach that will go a long way in filling the supervisory gaps as the financial sector develops because activities produces the risk and those activities will always be assessed in order to evaluate the level of risk. The use of RBS will contribute to strengthening the supervisory process in Lesotho and seen in all other jurisdictions where RBS has been implemented.

It was the dream of MEFMI region to have implemented RBS in the region by 2010 and indeed most of the countries in the region have implemented the methodology. This paper will serve as as footage and a reference for the region to the fact that RBS has been a success. Furthermore, chapter 3, relates to the policy framework, in particular, which is intended to uphold transparency and a specific standard of accountability for supervisors with regard to the risk focused supervision. It is the view and submission of the writer to appreciate and augment

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9 IOPS 2007, Experiences and Challenges in Introducing Risk Based Supervision for Pension Funds
10 Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) is the regional capacity building institute composed of 13 countries in the Southern and Eastern Region apart from South Africa (Angola, Botswana, Kenya, Lesotho, Malawi, Mozambique, Namibia, Rwanda, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe).
the efforts that have already been taken in implementation of RBS such as the policy\textsuperscript{11} framework that is available in all countries that have implemented RBS and the recently produced guidebook in the East African Community\textsuperscript{12}.

Therefore, the writer submits that reinforcement of RBS working papers is essential for the region and each supervisory agency should uphold the risk based supervision standards amidst all financial sector challenges which seem to be insurmountable as mentioned in the above paragraphs.

1.4 Methodology

In order to gather relevant and specific information concerning this paper, the writer will apply the qualitative method in the collection of data. This will be done through the use of secondary sources in the form of desk research such as speeches and writings by supervisors in various jurisdictions, financial and economic journals, finance and banking books, reference to internet sources and citation of policy documents from other regulatory authorities. Some of this information will be applied in the section of literature review to engage the reader in intellectual and practical discourse and also to capture the work of other supervisory agencies as the intention of the writer is not to reinvent the wheel but to emphasise the need for implementation of RBS.

The second form of information gathering will be in observation where the writer will take study tours by being attached to specific central banks, internationally and regionally, which have implemented RBS. This will enable the writer to get exposure of the practical RBS process and

\textsuperscript{11} An example is the Reserve Bank of Zimbabwe Bank Licensing, Supervision & Surveillance, 2006, Risk Based Supervision Policy Framework, guideline no 2- 2006/BSD

\textsuperscript{12} East Africa Technical Assistance Centre (East AFRICAC), 2009, Guidebook on the implementation of Risk Based Supervision Field Manual \#2, DarEs Salaam: Bank of Tanzania
appreciate all the steps entailed in RBS as this is needed especially for the writing of the section related to the policy framework.

1.5 Limitations

RBS is a new study in Lesotho therefore there is limited technical information from the literature. However, this is a generally work specific subject and most of the materials will be sourced from various supervisory agencies, related academics and professionals.

1.6 Sequence of Chapters

The outline of the rest of the paper will be as follows: Chapter 2 will be on literature review so as to engage the reader in professional discourse whether theoretical or practical on the elements of risk based supervision and the implementation implications. Chapter 3 will focus on the actual steps of implementation and provide a full documented policy framework for the supervisory process. In conclusion, chapter 4 will offer a roadmap of implementation for the Central Bank of Lesotho (CBL)\textsuperscript{13}.

1.7 Conclusion

This chapter addressed the background, the scope and objectives of this paper. It also highlighted the justification of this paper and the method to be used in the collection of data.

In conclusion, it is evident that the financial sector in the MEFMI region is faced with the most challenging times which require proper supervisory techniques and adequate risk management.

\textsuperscript{13} Central Bank of Lesotho is the mega regulator as it regulates not only banking institutions but also supervises all licensed financial institutions namely, insurance companies and non-banks financial institutions including the micro lenders.
systems bearing in mind that the banking industry is the hallmark for financial intermediation and financial sector stability. The recent global financial crisis has illustrated this relationship between banks and financial sector stability in so many ways. As stated in the leading paragraphs, the main objective of this paper is to develop a comprehensive strategy for implementation of risk based supervision for banking institutions with the assurance that there will be a clear standard of supervisory processes after implementation.

The next chapter discusses the literature review which is meant to cover the evolution and principles of RBS and the experiences of the regulatory authorities in the implementation of RBS.
CHAPTER 2  LITERATURE REVIEW

2.1 Introduction

In the early 1990’s the financial sector experienced deregulation, innovation and increased globalisation and this contributed to making banking business more complex, competitive and more risky. The financial market became more open and due to stiff competition banks started to develop sophisticated products to attract customers and also to keep afloat huge profits remain profitable.

In this respect, although there was deregulation, this opened way for prudential regulation. Consequently, supervisors faced challenges in terms of maintaining on-going and effective supervision systems. It became apparent that it was necessary for supervisors to be able to predict bank failures through use of early warning signs and be able to take pro-active prompt corrective action. There was a need to develop new methods and processes for monitoring and assessment of banks on an on-going basis. This would mean supervisors and banks alike should be able to also have systems that can assist in identifying changes particularly the deterioration in a bank’s financial condition in a timely manner.

It also became apparent that there was a general notion to move to more formal and distinctive risk focused framework as the risks have always been analysed but using the ineffective traditional methods. This risk featured framework happens to be in sync with the Basel Core Principles which require banks to have risk management systems based on their risk profiles and the ability of those systems to generate early warning signs and any potential changes in the banking activities and the environment. The World Bank under the Introduction to the Topic for Supervisors (2001) describes risk focused approach to supervision as a “structured process aimed at identifying the most critical risks that face each company and through a focused review by the supervisor to assess the company’s management of those risks and the company’s financial vulnerability to potential adverse experience.”
Therefore in this chapter, emphasis is to discuss the theoretical and practical aspects of shifting from the traditional supervisory approach to a risk based supervisory approach. The emphasis is on the benefits of risk based supervision (hereafter referred to as RBS) by linking RBS to the core principles of bank supervision and by indicating the experiences of other countries both internationally and regionally.

2.2 Risk Based Supervision Vs. Traditional Approach

2.2.1 Background

As already mentioned the financial sector liberalisation and globalisation in many countries including the MEFMI region posed many challenges to regulation and supervision of financial institutions in particular banks. Such trends have material implications for financial sector regulation and maintenance of financial sector stability as there are complex and inherent risks embedded in the nature of activities undertaken. The reason for regulation of banks is that banks play a critical role of financial intermediation in the economy and are highly geared institutions such that in case of a bank failure, the investing public stands to loose more than shareholders of the bank.

In the region there is also a strong presence of foreign owned banks resulting in stiff competition. Domestic banks may be tempted to venture into high risk areas in an attempt to maintain their market share. There is also increased conglomeration in areas such as insurance and banking as well as high product innovation. This leads to increased risk exposures and for this reason proper and strict regulation is required. RBS provides a common risk language and framework which it is possible to make comparisons across various sectors of the economy that are regulated. Therefore it enables supervisors to understand which banks pose the greater risk and where best can the supervisory resources be devoted Financial Services Authority (2007)

2.2.2 The Definition
In order to keep pace with the trends supervisors response was to improve the supervisory methods by introduction of new processes of improving efficiency, for example the inclusion of market risk analysis in the uniform approach in 1996 and the revised set of Core Principles of Effective Supervision in 1997. The highlight of the improvements was dedicating the supervisory resources in identifying high risk areas, high risk institutions and banking groups by measuring those risks and examining mitigation techniques applied against those risks (FSI). This method was called risk based supervision, in some countries risk focused supervision.

Risk-based supervision is a structured, forward-looking process designed to determine key risks to which individual financial institutions and the entire industry are exposed. It involves assessing the risk management policies and practices that are used to mitigate risk, focussing supervisory resources (including examination time) based on the risk characteristics of the institutions.

The process is “structured” because it systematically considers all key functional activities (business lines or operational areas) of a financial institution and, within each key functional area, evaluates the level of inherent risk, then assesses the risk management function, the (composite) residual risk, the level and direction of risk.

Risk-based supervision is a departure from 'one-size-fits-all' approach as it puts emphasis on the preparation of a supervisory programme that is tailored to fit the institution’s risk profile and organisational structure.

A risk-based supervision approach focuses on evaluating banks’ risk management practices and internal controls including adequate Board oversight, management and staff expertise, sound policies and procedures, prudent risk limits and effective management information systems (MIS).
A risk-based supervisory process provides flexible and responsive supervision to foster consistency, coordination and communication among supervisors. It also involves an ongoing analysis of bank data and frequent communication with key bank personnel. It provides examiners with the discretion to communicate examination findings and conclusions to bank management in several ways, in addition to the formal examination report.

The risk assessment process highlights both the strengths and vulnerabilities of an institution, and provides a foundation from which to determine the level and extent of supervisory attention, including the scope of on-site examinations and off-site monitoring. Instead of conducting checklist type examinations, examiners have greater discretion in identifying areas that require attention and allocate time accordingly. Activities posing the highest risk receive most supervisory attention.

Consequently RBS has been defined as an approach where supervisors place strong emphasis on understanding and assessing the adequacy of risk management systems to identify measure and monitor risk in an appropriate and timely manner. The key is to identify risks, the level of its significance and therefore giving the supervisors an opportunity to deploy to appropriate supervisory techniques. Risk based supervision provides systematic assessment with a formalised framework both at the time of an on-site examination and in between the examinations. In other words the traditional approach does not provide any standardised approach, however, risk analysis is performed unceremoniously as it is embedded under the CAMELS\textsuperscript{14} approach and all the distinctive characteristics of risk sensitivity are not formalised. This leads to certain areas or problems being missed when undertaking the on-site and off-site examinations as the resources allocated for all operations and banks are equal. Risk focused approach assesses the condition of the bank regarding its risk profile and determines the

\textsuperscript{14} This is the uniform supervisory framework adopted internationally representing assessment of Capital Adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risks
probability of failure and also takes into consideration the impact to that failure to the financial sector (FSI Connect Tutorial).

The risk based assessment covers all the steps taken in relation to risk identification, risk management systems, and risk measurement techniques then paying more attention to high risk areas and high risk institutions hence directing supervisory time, efforts and skills where they are needed most thus making RBS a focused and results driven assessment. This is achieved by identifying institutions and areas within institutions where risk exposures are high through the risk assessment system (see chapter 3). Therefore RBS is taken to be the preferred method since it assists supervisors to assess the safety and soundness of the bank or a banking group and its significance to the stability of the financial system. It is an approach of effective and efficient processes for monitoring and assessing the institutions on an on-going basis, to accurately assess its financial condition, material strength in order to facilitate a prompt and timely response to emerging problems (FSI Connect Tutorial).

2.2.3 Cost – Effectiveness (Effective Use of Supervisory Resources)

In the past, bank inspectors relied extensively on transaction testing in many cases this exercise has done little more than duplicate the audit processes which therefore rendered it very intensive, expensive and ineffective. On the other hand risk focused supervision method is formal assessment of risk management systems in banks. Financial institutions are encouraged to have their own risk management systems which are effective have the right skills to make sure that business is run smoothly and risks are mitigated against rather than to wait for supervisors. In this way RBS this contributes to cost-effectiveness of supervision of banking institutions, supervisors assess bank’s risk management systems to determine areas of high risk exposures and focus supervisory efforts on these areas.

RBS is very cost effective as emphasis is on high risk areas and institutions. It facilitates supervisors to direct more resources on high risk areas whenever necessary according to (FSI).
They only concentrate on areas that need attention and on problems banks and reduce their time with stable banks. This gives the supervisor the benefit also of allowing good banks to be more effective. Supervisors can now rely on the control and risk management systems hence engage fewer resources on the banks and actually let the banks be in full control of risks inherent in their operations. In other words, it facilitates the effective deployment of limited resources thereby promoting cost effectiveness.

On-site examinations take place at irregular intervals and are aligned to the risk profile of the financial institution. (Alan Greenspan, 2009), has agreed that a combination of improved risk management and the utilisation of financial derivatives to manage the risk portfolio has enabled banks to calculate risks more efficiently in business, which in turn has resulted to a reduction of the burden of the banking system on its regulators.

2.2.4 Proactive Indicators (Early Warning Indicators)

The traditional approach assessed the current and past information about the bank in order to determine the current condition of the bank without taking cognizance of the future especially adverse issues that may affect the bank. Bank inspectors primarily focused on compliance, finding contraventions to banking law, rules and regulation and the deficiencies in the internal controls and financial accounting regardless of materiality. The mishaps and scandals in the banking sectors however proved that this method is ineffective and therefore banks were forced by circumstances to reinforce their risk management systems and the supervisor sought ways to enforce accountability and responsibility to the board and senior management of banks. In response RBS is found to close those gaps as a continuous system in that whether work is performed through off-site surveillance or on-site examination, the Institutional Profile is updated with the latest information and corrective action taken accordingly and timely. It encourages application of risk management systems by banks and for supervisors to assess whether such systems are adequate.
Through continuous assessment, foresight is applied as not only the current condition is analysed but any potential threats and vulnerabilities in the financial sector are detected and corrective action is applied timely. This also facilitates way to variety of corrective actions; there is no one way as with the traditional supervision where on-site examinations were the norm. Egan (2003) articulates that supervisors should seek to intervene at an early stage if there is a risk of a bank’s capital falling below the regulatory minimum. There are also various alternative measures that are influenced by the factors from the risk profile from which; prudential meetings and special audits can be conducted as necessary. Therefore, supervisors are able to focus on determination of early warning signs from which prompt corrective action can be recommended to the supervised entities.

2.2.5 Continuous Assessments

The uniform rating system commonly referred to as CAMELS was applied for both on-site examinations and off-site analysis as a one point in time exercise and with no link between the two supervisory tools and with different reporting formats for both on –site and off –site analysis. Since there was no link between those two supervision tools, various reports were produced off-site which were prepared in a different format from on-site examination. The two reports could not feed into each other hence there was no consistency nor continuity, for example, CAMELS rating was only developed from the on-site examinations and there were no updates from the off-site analysis.

On the contrary RBS has regular updates of CAMELS rating and risk ratings every time new information is received and there is a uniform reporting format including of such updates. With RBS the institutions risks are identified on a continuous basis and attention could be placed where it is necessary. The reporting formats for the off-site analysis and on-site examinations have similar formats therefore allowing comparison and update of information. The ratings do not only provide current indicators as the traditional approach but forward looking indicators as well.
2.2.6 Comparability

Banks were never compared to determine those likely to survive or fail. And they received same treatment whether bad or good except in extreme cases where a bank would be facing insolvency or show signs of weakness. With RBS there are more frequent visits on relatively weak banks and frequent supervision on risky and unmanaged areas even in stable banks. There is formalisation of risks hence there is a better understanding of risks and risk management functions. Bank risk management systems are expected to follow the basic risk management standards and this allows supervisors to compare the banks in sync with the nature, size and complexity of the bank making RBS a more effective approach. Therefore Risk Assessment System (RAS) compliments CAMELS as it puts the banks in the same footing and make ease the banking sector analysis in relying on more than one system to determine the banks’ condition. Sehajwala and Van den Gergh (2000) pronounced that the use of more than one system for supervisory risk assessment is essential, with the intention that problem institutions maybe identified by at least one of systems.

2.2.7 Process-oriented

The traditional approach focused more on a narrow based approach where revalidation of financial statements, and transaction testing was done. The supervisor used to have a one-size fits all scope of the activities to be covered in individual institutions and determined the bank’s overall condition. This was normally done by transaction reviews which tend to quantify problems as opposed to qualifying them. In such cases where problems are quantified, the supervisory response is usually to take actions that are directed towards reducing the size of the problem. The trouble with this approach is that it usually addresses symptoms without addressing the root causes. RBS therefore is considered a more advanced and efficient way in identification, measurement, monitoring and controlling of risk on an on-going basis. The institution’s problems are qualified by identifying the flaws in the risk management and internal control systems as well as management practices that cause either current or potential threats. RBS has similarities with CAMELS (capital adequacy, asset quality, management, earnings,
liquidity, and sensitivity to market risk) in that there is planning, on-going surveillance, on-site examinations, feedback only that with the former there is a formal structure and processes to calculate the risk and to measure the quality of risk management processes and internal control systems.

The banks by themselves have their own policies, procedures and external and internal assessments of adherence to these principles. With RBS reliance in placed on the work performed by auditors and depending on the scope and the quality of the work done allowing the supervisor to develop an appropriate supervisory plan and the depth of tasks to be performed at the time of examination. This makes RBS a consistent framework for evaluating banks through separate assessment of inherent risks and risk management processes.

In instances where the audit has significant shortfalls or where problems are deemed significant, the supervisor has the liberty to employ detailed examination procedures, or call the auditor to perform relevant tasks in order to address the weaknesses identified and determine more precisely to what extent capital, earnings, and liquidity are at risk and prescribe appropriate remedies.

2.2.8 Risk focused

Since the banking sector is highly regulated, the analysis of the banks operations traditionally is largely compliance based and some of the components of the business which are not covered by law could be easily overlooked. In this regard, RBS allows for the formalised assessment of significant activities, their inherent risks, relevant risk management and control systems in the light of an existing shadow of the bank’s own assessment of risks and what methods they have employed in detection, monitoring and controlling of those risks. It provides a better appreciation by supervisors of the characteristics of the banks’ business, the risks they face and the quality of the risk management systems.

Therefore all significant activities and their risks should be identified and appropriate risk management programs deployed by banks to mitigate such risks and to ensure that all licensed
institutions deploy appropriate systems. To this effect, regulators have developed risk management guidelines for banks, outlining minimum standards to ensure key principles of risk management, become a way of doing business – not just a compliance exercise. The higher the bank’s appetite for risk, the greater the risk management techniques it should have.

In consideration of minimisation of transaction based supervision and focusing on areas that need attention, Office of the Superintendent of Financial Institutions (OSFI) uses the work of internal auditors (and other controls) in making risk assessments, and relies on the work of external auditors regarding financial statements – allowing regulators to focus on key risk issues. Given limited resources, a reliance-based framework built on principles has been very effective (Canadian Experience). It focuses on an institution’s material risks and the quality of its risk management, rather than applying a rules-based approach. Where a bank’s risk management and governance is effective, the OSFI relies on such internal processes. Where it is not, correcting this deficiency is a priority.

Another important aspect of risk focused supervision is the ability to link the impact of risk to failure of the whole financial sector not only to the institution. FSI mentions that “it is evident that the failure of a larger institution that is systematically important is liked to have a greater impact on the financial system than the smaller bank” However smaller banks also might pose a reputational risk which might cause contagion and pose systemic risk. An example of systemic risk is the Northern Rock experience which caused bank run in Europe in 2007. Systemic risk occurrences by nature are time consuming, costly, strain supervisory resources and sometimes cause government intervention such the recent bail-outs that the U.S had to provide during the financial crises in 2008 and 2009. Hence it is essential for the supervisor never to ignore the early warning signals, to assess the quality of risk management systems and to take prompt corrective action.

2.2.9 Basic aspects of RBS
Having discussed the RBS in brief, it is necessary to highlight some of basic aspects that qualifies it to be an effective tool as follows:

Supervision Structure

The risk-based supervision structure contains the following key elements:

a) Designation of a central point of contact known as **Portfolio Analyst** - a "central point of contact" has to be designated for each bank to facilitate coordination and ensure continuous supervision of banks.


c) Focus on bank’s risk management processes – emphasis on each institution’s responsibility to identify measure, monitor and control or mitigate all material risks.

d) Customised supervisory program - tailored supervisory activities to the risk profile of an institution

e) Continuous monitoring: Continued supervision through follow-ups on supervisory actions and off-site monitoring.

The **Portfolio Analyst** who acts as the central point of contact should:

a) Be knowledgeable, on an ongoing basis, about the institution’s financial condition, management structure, strategic plan and direction, and overall operations.

b) Remain up-to-date on the condition of the assigned institution and be knowledgeable regarding all supervisory activities, monitoring and surveillance information, meetings with management, and enforcement issues, if applicable.

c) Ensure that the objective of risk-based supervision is achieved for each institution and that the supervisory tools (i.e. an institutional profile, risk matrix, risk assessment, supervisory plan, examination procedures, scope memorandum, and report of examination) are prepared in a timely manner.
d) Ensure appropriate follow-up and tracking of supervisory concerns, corrective actions, or other matters which come to light through ongoing communication and or surveillance.

e) Participate in the examination process, as needed, to ensure consistency with the institution’s supervisory plan and effective allocation of resources.

2.2.8 Improved Communication

“The risk-based approach, which by design is circular and conducted on as current basis as possible in a continuing cycle, is complemented and strengthened by on-site visitations, prudential interviews, annual tripartite meetings and annual supervisory meetings with the board of directors.” Hong Kong Monetary Authority (HKMA) (2001). Indeed the diagram below confirms that the this process facilitates a continuous and effective communication throughout as there is constant contact with the supervised entities. The improved communication demonstrated in RBS is essential. Before a supervisory activity begins, the examiners in charge or a designated team meets with the appropriate members of the bank’s management. At this meeting the examiners will discuss the purpose and scope of the review. Open discussions between the supervisor and the management facilitates a more efficient and less burdensome supervisory process USA Handbook (2002).

Open communication is also in line with principle 16 which states that banking supervisors must have regular contact with bank management and a thorough understanding of the institution’s operations. Prudential meetings as indicated in the figure below uphold this principle as well. APRA (2001) in its self assessment report related that the program of regular meetings with senior and middle management to discuss operational matters, such as strategy, group structure, corporate governance, performance, risk management systems and etc., is essential.

The following figure depicts the proposed communication phases under the risk based approach.

Figure Supervisory Framework
2.3 COMPONENTS OF RISK MANAGEMENT PROGRAMS

2.3.1 Risk Categories and Definitions

Risk based supervision assesses the appropriateness, adequacy, and effectiveness of a bank’s risk management systems. All supervisory plans and examinations activities are based on a bank’s risk profile. The responsibility for effective risk management still lies with the board and management as a bank’s first line of defence.

a) Definition of Risk
From a prudential supervision perspective, risk can be defined as a potential that events expected or unexpected may have adverse effects on a bank’s net worth, earnings, set goals and objectives. Banking risks are defined as adverse impacts on profitability of several distinct sources of uncertainty. Therefore, risk measurement requires capturing the source of the uncertainty and the magnitude of its potential adverse effect on profitability Joel Bessis (2003). Hence, these types of risks defined below implicate the sources of each risk to enable identification and measurement of risk in institutions.

b) Types of Risk

Banking business by nature involves risk taking. For the purpose of risk based supervision the supervisor should has identify the risk categories and define them. Nine categories of risk are identified and described hereunder, strategic risk, credit risk, foreign exchange risk, interest rate risk, price risk, liquidity risk, operational risk, compliance risk and reputational risk. These should be clearly defined in the risk management guidelines that the banks have

i) Strategic risk is the risk associated with the financial institution’s future business plans and strategies. It arises from an institution’s inability to implement appropriate business plans, strategies, decision making, resource allocation and inability to adapt to changes in the business environment. This risk category includes plans for entering new business lines, expanding existing services through mergers and acquisitions, and enhancing infrastructure (e.g. physical plant and equipment, information technology, and networking).

ii) Credit risk is the potential that a borrower, financial instrument issuer or counterparty will fail to meet its obligations in accordance with agreed terms resulting in economic loss to the financial institution. Losses stem from outright default due to inability or unwillingness of a borrower or counterparty to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively, losses may result from reduction in portfolio value due to actual or perceived deterioration in credit quality.
iii) Liquidity risk is the potential that an institution will not be able to meet its obligations when they fall due without incurring unacceptable costs or inability to transform its assets into cash or cash equivalent in a timely manner at a reasonable price. Liquidity risk is considered a major risk for financial institutions. It arises when the cushion provided by the liquid assets is not sufficient to meet obligations.

iv) Interest rate risk is the exposure of a financial institution's financial condition to adverse movements in interest rates. This risk is a normal part of banking and can be an important source of profitability and shareholders’ value. However, excessive interest rate risk can pose a significant threat to a financial institution's earnings and capital base.

v) Foreign exchange risk is the current or probable risk to earnings and capital arising from adverse movements in currency exchange rates. It refers to the impact of adverse movement in currency exchange rates on the value of open foreign currency position of the financial institution.

vi) Price risk is the exposure of a financial institution’s earnings and capital to adverse movement in market prices. This is the risk to an institution's financial condition resulting from the volatility of positions taken in the four fundamental economic markets namely, interest-sensitive debt securities, equities, currencies, and commodities. The volatility of each of these markets exposes financial institutions to fluctuations in the price or value of marketable financial instruments.

vii) Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Central Bank of Lesotho recognises that operational risk has a variety of meanings within the financial institution industry; therefore financial institutions may choose to adopt their own definitions of operational risk. The adopted definitions should take into account a full range of material operational
risk facing the financial institution and should capture the most significant cause of severe operational losses.

viii) Compliance Risk is the risk arising from a financial institution’s failure to comply with laws, regulations, rules, or failure to comply with code of conduct applicable to its activities or to comply with its own policies and procedures. Non-compliance with laws and regulations may expose a financial institution to fines and penalties. Compliance risk can also lead to reduced expansion potential and limited business opportunities.

ix) Legal risk is the risk that financial institution will conduct activities or carry out transactions in which they are inadequately covered or are left exposed to potential litigation. The legal risk management framework should provide an outline of the important issues that directors may need to consider in ensuring due diligence in the operation of the financial institution.

x) Reputation risk is the potential that negative perception, past or present, regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions. Such damage may result from a breakdown of trust, confidence or business relationships. This risk may also result from an institution’s failure to effectively manage any or all of the other risk types.

2.3.2 Risk Management Framework

The board and senior management of each financial institution have the overall responsibility to establish an effective risk management system with clearly articulated objectives and goals. Supervisors should require each bank to develop an appropriate risk management system, tailored to its needs and circumstances. All sound risk management systems/programs regardless of their design, have several common
fundamentals with the four key processes namely risk identification, risk measurement, risk control and risk monitoring.

a) **Key Processes of Risk Management Framework**

i) **Risk Identification**

In order to properly manage risks, financial institutions must recognise and understand risks that may arise from both existing and new business initiatives. Risk identification should be a continuing process, and should be understood at both transaction and portfolio levels. This is to enable new risks and changes affecting existing risks to be identified quickly and dealt with appropriately before they can cause unacceptable losses.

ii) **Risk Measurement**

Once risks have been identified, they should be measured in order to determine their impact on the financial institution’s earnings and capital as well as the likelihood of occurrence. This can be done using various techniques ranging from simple to sophisticated models. Accurate and timely measurement of risk is essential to effective risk management systems, in order to enable risks to be controlled or monitored. Financial institutions should periodically test their risk measurement tools to ensure that they are accurate and relevant. Good risk measurement systems assess the risks of both individual transactions and portfolios.

iii) **Risk Monitoring**

Financial institutions should have effective management information systems to monitor risk levels as well as facilitate accurate and timely review of risk positions and exceptions. Monitoring reports should be frequent, timely, accurate, and informative and should be distributed to appropriate individuals to ensure action is taken, when needed.

iv) **Risk Control**
Financial institutions should establish and communicate risk limits through policies, standards and procedures that define responsibility and authority. These limits should serve as a means to control exposure to various risks associated with the financial institutions’ activities. Financial institutions may also apply various mitigating tools in minimising exposure to various risks.

b) **Key Elements of Risk Management Systems**

The banks are also expected to have these key elements of risk management systems: board and senior management oversight, adequate policies, procedures and limits, adequate risk monitoring and management information systems and adequate internal control systems and audit.

i) **Board and Senior Management Oversight**

Effective risk management calls for active board and senior management oversight. The board has ultimate responsibility for the level of risk taken by a bank. In fulfilling this responsibility, the board should take steps to develop appropriate risk management systems. The board should approve the overall business strategies, significant policies of the bank and ensure that competent management is in place to run the affairs of the bank.

Senior management should be fully involved in the activities of the financial institutions and should possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated.

ii) **Policies, Procedures and Limits**

A financial institution should have effective policies, procedures and limits. They should provide for adequate identification, measurement, monitoring and control of risks posed by significant activities of the financial institution. They should also be consistent with management’s experience, the financial institution’s stated goals and objectives and the
overall financial condition. Policies and procedures should clearly delineate accountability and lines of authority across a bank’s activities.

iii) Management Information Systems

Financial institutions should have an effective risk monitoring to identify and measure all material risk exposures. These risk monitoring activities must be supported by information systems that provide senior management and the Board with timely reports on the financial condition, operating performance, and risk exposure of the financial institution, as well as with regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the institution's activities. The sophistication of MIS should be consistent with the complexity and diversity of a bank’s operations.

iv) Internal Controls and Audit

The internal control structure is critical to the safe and sound functioning of the financial institution generally and to the risk management system, in particular. Establishing and maintaining an effective system of controls such as the enforcement of official lines of authority and appropriately segregating duties is a fundamental and essential element of a sound risk management and internal control system.

Internal controls should be tested by an independent internal audit function which reports directly either to the board or its designated committee (Board Audit Committee). Given the importance of appropriate internal controls, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to them.

2.3.3 Other Vital Risk Management Factors

a) Enterprise wide risk management
Financial institutions are also compelled to derive an enterprise wide risk management which covers the entire spectrum of risks and how they will be managed. A separate unit responsible for risk management oversight should be established in banks. However it has been found that some banks still manage risk from relevant business operations, for example, Treasury Division manages interest rate risk which stems from investments in various financial instruments. The importance of the risk management function is demonstrated by its roles which include identification and measurement of risk, monitoring of overlaps and gaps.

b) Contingency Planning

Another vital aspect of risk management system is the reinforcement of the liquidity contingency planning. A contingency is a set of policies and procedures that serve as a blueprint for a financial institution to meet its funding needs in a timely manner and at a reasonable cost. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are also important products of such qualitative analyses. The contingencies should focus on both short-term and long-term funding crises. They help to ensure that a financial institution can manage routine and extraordinary fluctuations in liquidity efficiently. The contingency also includes an analysis of what could potentially go wrong with the credit portfolio and the results of this analysis should be factored into the assessment of the adequacy of provisioning as well as capital of the financial institution.

c) Stress Tests

Stress testing involves identifying possible events or future changes in economic conditions that could have unfavorable effects on a financial institution’s exposures and assessing the financial institution’s ability to withstand such changes. Risk measurement systems should support meaningful evaluation of the effect of stressful market and environmental conditions on the financial institution. Stress testing should provide information on the kinds of conditions under which the financial institution’s strategies
and/or positions would be most vulnerable, and thus be tailored to the risk characteristics of the financial institution. Stress tests should not be limited to quantitative exercises that compute potential losses or gains. Stress tests should also include more qualitative analysis of the actions management should take under particular scenarios, such as the evaluation of the financial institution’s capacity to absorb potentially large losses and identification of measures that the financial institution can take to reduce risk and conserve capital.

2.4 General Banking Supervision Fundamentals and Basel Committee Banking Principles (BCPS)

2.4.1 Fundamentals of Regulation

It has been discussed that risk assessment process plays a major role in identifying the early warning signs. In that regard, it would be necessary to briefly touch on the importance of regulation for the banking sector in-sync with the new approach. There have been conflicting discussion brought about by free banking and regulated banking theories and risk focused supervision seem to knit the two together as it is a mediator between the two theories. The market participants or financial institutions do take the risk and should bear the costs. On the other hand, the supervisor’s primary objective is to promote financial sector stability therefore should establish effective supervisory processes and adequate arrangements for problems bank resolutions as they are responsible for maintaining a sound and stable financial sector.

Ngaujake (2009) highlighted that priority should be given to preservation of the financial system to avoid costs associated with weak financial system. There is a need for constant upgrading of the regulation the reason being that “supervised institutions are constantly introducing innovative products and methods with the aim of circumventing legislation” (Board 1998). Therefore indirectly risk focused supervision, plays an important role in bridging the gaps brought in by innovation and outdated legislation, as it leaves the market players to constantly take responsibility of their own risk. As they become innovative, they are also held responsible for
their risk exposure. The Basel Committee explicitly also stated that when supervisors recognise the triggers and recommend prompt corrective action, that does not mean supervisors prevent banks from failing.

As a convention, RBS emphasises the value of board and senior management to take responsibility in establishing sound risk management and control systems that are consistent with the business risks and not shift the blame or responsibility to the supervisor. Therefore in a way risk focused supervision, plays an important role in bridging the gaps brought in by innovation and outdated legislation, as it leaves the market players to constantly take responsibility of their own risk by being innovative but also being responsible. In that case even if the banking law will not cover all bank activities and embedded risks, the fact is, this methodology ensures that the banks adopt the risk management environment that will identify, measure, monitor and control risks taken.

(Polizatto 2009) indicated that establishment of an “effective” regulatory infrastructure is critical because many crises have occurred and will continue to occur because of procyclicality, a pattern of increased economic activity leading to increased banking activities, high capital levels, high interest rates hence possibility of defaults followed by consciousness. In this cycle it can be deduced that the economic system is inherently unstable because of the over optimistic behaviour of the economy. The recent crises and all other failures in the past speak for the mere fact that much as the banks are measuring and controlling the risks, supervisors should detect potential problems and take prompt corrective action. Banking requires extensive regulation and should ensure smooth exit for weak banking institutions. Regulation therefore, is a formal way of not letting the market administer itself because it is imperfect and unstable. The regulator balances the act in that way by preserving stability. (Selgin 2009) refers to regulation as a balancing act between the regulation and deregulation by terming it “soothing and beneficial placebo”.

In agreement with Ngaujake, it is inconceivable for a return to a free banking era. Therefore the task to try to harness formal regulatory setting by incorporating the good features of the market driven arrangements are prominent in the risk based supervision. Ojo (2009) also touches on risk
focused supervision by rendering it as good practice in that supervisors monitor and evaluate banks’ awareness of created risks, risk management systems as well as internal controls in place in order to determine and enforce banking stability. In addition, Ojo shed more light when saying that risk based supervision can be described as having fundamentals of regulation of self regulation. Indeed RBS presents the fundamentals of self regulation The regulator only provides minimum pointers and the bank being the risk taker, sets appropriate risk appetite, and establishes accurate measures of risk to protect capital and earnings. This complex phenomenon of self regulation is referred to as Meta regulation which indeed allows the regulator to oversee the activities of banks without being too restrictive.

In comprehension of the two conflicting theories RBS calls for market participation as financial institutions should identify risk in order to eliminate failures and minimise crisis occurrences. It supports indirectly free banking system by encouraging the banks to take the risk as long as they will mitigate it and allow the banks to take the corrective steps rather than to allow automatic correction which has been proven not to work in an imperfect and unstable market. Regulation in this case portrays an oversight function to the effect that banks do maintain a risk management environment by applying risk mitigation techniques, adequate risk management systems and effective internal controls.

Why risk based regulation? Regulators made this development a major priority for the banking industry, because they focus on system risk, the risk of the entire banking industry made up of financial institutions whose fates are intertwined by the density of relationships within the financial system. The risk environment has changed drastically. Banking failures have been numerous in the past, the great depression in 1930’s, the crises of 1990’s including the Asian crises, the recent global financial crises and the 2010 Nigerian banking crises. It seems crises rapidity cannot be measured as global crises indicated contrary to Bessis (2003) who stated that in recent periods the number of misadventures has tended to decrease in most, although not all, of the OECD countries, but they became spectacular.

However, he captures clearly the calamity of financial sector, which on a daily is faced by a possibility of failure due to interconnectedness of this system. He articulated that banking
failures make risks material and convey the impression that the banking industry is never far away from major problems. Mutual lending and trading create strong interdependencies between banks. An individual failure of a large bank might trigger the contagion effect through which other banks suffer unsustainable losses and eventually fail. From an industry perspective, system risk, the risk of a collapse of the entire industry because of dense mutual relations, is always in the background. Regulators have been very active in promoting pre-emptive policies for avoiding individual bank failures and for helping the industry absorb shock of failures when they happen. To achieve these results, regulators have totally renovated the regulatory framework. They promoted and enforced new guidelines for measuring and controlling the risks of individual players. Egan (2003) reinforced on system risk and said that a company that poorly manages risk will suffer the consequence, but in most industries there will be little contagion.

Banking however, is different. Banks play a crucial role in the financial system such that problems in one can be quickly transmitted to other institutions and changes in banks’ capacity to lend leading to broader macroeconomic effects. Regulators, on the other hand, seek to protect the financial sector. Nonetheless, regulation cannot and should not seek to guarantee a zero failure rate of prudentially regulated institutions or provide absolute protection for market participants APRA.

2.4.2 Accuracy of reports

Another critical factor established in the risk focused process is timeliness in risk assessment. BCPS are clear that risk management standards are essential as they play an important role especially when bank products, financial instruments and measurement techniques become more complex. Timeliness and correct information become key in reporting as the information is useful in tracking the risks, hedging the risks and making decisions hence standard guidelines that come through a formalised process promote and enforce sound policies and procedures in banks as well. To ensure that the principle of information accuracy is adhered to, a supervisor should monitor the way in which the bank controls risks starting from the top of the institution’s hierarchy to promote effective board and senior management oversight, comprehensive controls,
adequate risk management policies and procedures as well as proper risk measurement and monitoring systems.

2.4.3 Compliance with Regulation

Strengthening the supervisory process by focusing on risk management does not render compliance with laws and regulations irrelevant. Compliance is still essential and mandatory as it provides sound minimum standards for the running of the bank. Under the risk based approach, compliance falls under legal and reputation risks and if the banks comply, legal and reputation risks are reduced. As already stated, a regulator sets pointers or thresholds. This means when an institution complies with the minimum standards, there is a positive indication that the risks are being managed. If the institution maintains capital above the regulatory threshold, then it is an indication that all risks relating to credit risk may be covered at a minimum. However if the bank cannot comply with these standards, it is an indication that the controls and risk management techniques are inadequate to identify, measure and control the risk. In any case, if the bank fails to adequately cover the credit risk by appropriate loan loss provisions and a loss occurs, there will not be enough capital cushion to cover for the loss.

2.4.4 Accuracy of reports

BCPS are clear that risk management standards are essential as they play an important role especially when bank products, financial instruments and measurement techniques become more complex. As the banks become innovative they need an updated MIS that can capture information accurately. Timeliness and accuracy have been identified as critical components of an effective risk management system and risk assessment process. They become key in recording and dissemination as the information is useful in tracking the risks, hedging the risks and making decisions. Hence standard guidelines are set by regulators to ensure that a formalised process that promotes and enforces sound management information policies and procedures is established by banks as well. To ensure that the principle of information accuracy is adhered to, a supervisor should monitor the way in which the bank controls its information starting from the top of the institution. This is done by ensuring that there is effective board and senior
management oversight, comprehensive controls, adequate risk management policies and procedures as well as adequate management information systems.

**Basel Core Principles**

2.4.5. Consolidated supervision

**Principle 20:** An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Risks do not only emanate from within an institution but from its affiliates as well. Banking has become an international or global activity with stiffening competitive and conglomeration which has birthed cross-border and cross sector activities. Therefore supervisors cannot ignore the effects thereof but should regulate institutions on a consolidated basis. Principles 18, 20, 23, 24 and 25 discuss consolidated supervision in length. However, it should be mentioned that RBS provides and facilitates a formal analysis of the bank’s background to include domestic, international and regional affiliations to cover cross border, cross-sector and group or inter-group activities. This is because risk does not emanate only from own business but also from group activities which give rise to high contagion risk. Any adverse occurrences in any of the group companies will have multiple effects. This will also impact supervision or regulation in various jurisdictions and for this reason it is essential to have arrangements for sharing information with other supervisors. There is specific legislation for every jurisdiction and sharing information will facilitate common understanding of supervisory processes entailed in cross-border and cross-sector supervision. The Reserve Bank of India is one of the first supervisory agencies to implement risk based supervision and consolidated supervision and vouch for its positive benefits.

In cognizance of the challenges in terms of compilation, storage and accessibility of information, the Basel Concordat provides the fundamentals for cross border supervision. The Basel Committee makes it clear that there must be arrangements for host and home supervisors to have memorandum of understanding in order to establish a clear picture of activities to be undertaken
by either host or home supervisor. RBS prepares a good foundation towards consolidated supervision as all risks, the bank is susceptible to, will be monitored from the conglomerate and or group institutional overview. For cross sector regulation, the single regulators like the CBL and FSA seem to possess the strength needed in consolidated supervision as information is available under one umbrella. However that information should be easily accessible in order to perform timely risk assessment with the goal to detect errors on time and take corrective action.

It is worth mentioning that there are other elements of supervision such as financial soundness indicators and macro-prudential regulation that will require a risk based functional supervisory agency vis-à-vis a traditional-based one. Therefore RBS lays a good foundation for any other components of supervision as it is comprehensive enough to cover risks emanating from micro and macro environment of the financial system.

2.4.6 Risk Management standards

Core Principles on Banking Supervision 6-15

Principle 6: Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.
Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

These principles set the pace for the supervisor and also indicate to what extent the supervisor can set the standards for the banks. RBS encourages adoption of all these standards and also assists in the assessment of financial sector soundness and supervision which is undertaken by Financial Sector Assessment Program (FSAP). FSAP actually determines the level of compliance by the banking supervisor to the core principles. When these principles are institutionalised they leave less room for banks to slacken their risk management systems. The board of directors is expected to set the risk profile, formulate all major policies and risk limits, establish a clear chain of command and segregation of duties as well as ensure that these policies will be adhered to by delegating daily running of the bank to a competent senior management. In a way this speaks for adoption of sound corporate governance standards by the
supervised entities. The issue of adequate internal controls is critical to good corporate governance.

The principles articulate the need for a vigilant regulator with full knowledge of the market, the risks involved and the appropriate risk management as well as internal control systems for each institution. The regulator should deploy the right calibre of staff and highly skilled to undertake this responsibility. Supervisors should indeed be skilled enough to identify the risks, assess whether the quantitative measurement techniques applied by banks are appropriate, detect the early warning signals and take the corrective action where necessary. This type of responsibility also requires a certain level of judgement therefore supervisors should be objective and independent in character.

The Financial Stability Institute has indicated the need for a strong supervisor, for where the bank internal oversight such as the risk management systems and internal audit function fail or are weak, the supervisor should be able to detect the problems facing the banks and establish corrective action. Problem detection should be done as early as possible to minimise failures such as the Australian Central Bank which had weak internal controls ranging from internal processes to oversight. In such a situation the regulator is expected to be effective and APRA played a very major role by identifying the weaknesses and designing a corrective program.

2.4.7 Basel II

It is also vital to link RBS to Basel II capital standards as capital is the core component in the sound operations of any financial institution and closely linked to risk as it is a cushion against any possible losses that arise out of risk exposures. The BCPS advocate not only for the need for risk management systems but also for the need for banks to align risks with capital. Why because risks threaten the earnings and capital of the banks, if risks are not managed they can actually expose the banks to losses that can erode capital and earnings. Therefore the regulatory scheme of risk based capital is a central concept Bessies (2003). Its philosophy is that capital
should be capable of sustaining the future losses arising from current risks. This provides a simple solution to the difficult issue of setting up pre-emptive ex ante regulatory policy.

In 1988 when the capital standards were first drawn by the Basel Committee, they focused on the elements of credit risk but later they were adjusted as it appeared that not only credit risk that requires capital allocation. In 1996, the market risk was included in capital adequacy determination and with the revision of the capital accord in 2004 the operational risk was also included. That is the capital standards as they stand currently extend beyond the capital charge for credit risk and market risk as they cover operational risk as well. Furthermore, it endorses strengthening supervisory process by ensuring that the supervisors can be able to determine that capital is consistent with the institution’s overall risk profile.

Capital provides a cushion to ensure banks’ safety and soundness and it provides a benchmark by which the financial condition of banks can be measured. Egan (2003) highlighted that Basel II by providing a spectrum of approaches, seeks to provide approaches that are both more comprehensive and more sensitive to risks. That is, it aligns with RBS by being risk sensitive as against one fits all approach. Basel II aims to match the level of capital to the amount of risk, while ensuring that all the components of the risk are provided against.

The strengthening of supervision facilitates compliance with BCPs in particular relating to risk management and encourages risk based supervision as a prudent way to regulate risk and also as an underlying framework for Basel II which ensures capital is relative to risk exposure. The BCP 11 states clearly that supervisors must ensure that banks have in place adequate risk management systems and enough capital to support its activities. In addition Basel Committee in its efforts to harmonise regulation has detailed papers relating to various risks.

The foregoing discussions imply that there is no need to continue with the traditional approach alone but to move to a more advanced and risk sensitive supervisory method. Much work has been done already towards a risk based supervision approach. This advanced and comprehensive
approach has been adopted as far back as 1998 in realisation of the shortfalls of the traditional supervisory methods which were reactive and not proactive. Some international supervisory agencies adopted the risk focused approach back then in the late 1990’s. An important factor that contributed was the pressure to comply with international best practice since the emphasis on risk management concept to the supervision framework was made plain in 1997 through the revised BCPS.

RBS became the best alternative methodology to effective supervisory process as there were various financial failures in the 1990’s. In 2003 it was first adopted in some countries in the MEFMI region. Although this region has never seen what can be termed financial crisis, there have been material bank failures and various reforms to address any deficiencies noted in the regulatory structures.

Basel II and RBS have ‘risk’ as the common factor. By ensuring that banks allocate risk weighted capital and put in place a measure of controlling and mitigating those risks, the two would have been satisfied. Without RBS it would be difficult to implement Basel II as the risk management framework in banks lays a good foundation for the allocation of capital. Subsequently, RBS is a prerequisite for Basel II adoption since under Basel II bank’s own internal risk management measurement models are to be sanctioned by regulator under the advanced measurement approaches.

2.5 Relating Risk Management to Bank’s Performance

Risk based supervision can only be implemented and work smoothly where the risk management are deployed. In essence, risk based supervision is an advocate for the deployment of sound risk management. Therefore it is necessary to discuss whether risk management is the key to a well managed institution and whether positive results have been received by companies who have adopted it so that it can be proven to be a working concept.
There is a need for a robust framework to effectively identify, assess and manage risk. Risk is embedded in companies’ activities and wrong approach in taking those risks could create a severe impact to companies e.g. Malaysian Airline system and Tenaga National Berhad suffered huge losses during the financial crisis in 1997 as they did not well manage their foreign currency exposure / risk Yazid and Daud (2009). Pyle (1997) pointed that the manager of Orange County Investment Pool took less that three years to increase one month loss to a disastrous 5% of its investors claims. It has been proven that those who have adopted a risk management has increased boards and senior management’s ability to oversee the portfolio of risks facing an organisation.

Pyle (1997) indicates that financial misadventures are hardly a new phenomenon, but the rapidity with which economic entities can get into trouble is. This was evident in all the above examples.

Committee of Sponsoring Organisation of the Treadway Commission (COSO) defines is as a process affected by an entity’s board of directors, management and other personnel applied in a strategy setting and across the enterprises. It is designed to identify potential events that may affect the entity and manages risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity goals.

Banks do seem to have risk management systems, which managed well assist institutions assess and manage the risk so as to maximise profitability. Wharton School, University of Pennsylvania has produced papers regarding risk management practices in banking and insurance. Risk can be segmented into three types by (Oldfield & Santomero 1997) which are can be eliminated, can be transferred and can be actively managed at business level. Within the third category banks has standards and reports, limits, guideline and incentives contracts and compensation. The also had risk categories in financial risk- credit, liquidity, interest rate and market risk. Yet, there are still other risks, somewhat more amorphous, but no less important.
Yet you may find that they are generally not addressed in any formal, structured way, yet they are not ignored Santomero (1997). It has been evident in study made in Germany on internal controls by Deunes and Knechel (2008) firms do disclose their risk types accordingly in these three types. Typically, firms mentioned activities to transfer risk (e.g., through derivatives or insurance), activities to share risk (e.g., via alliances or pricing), policies and procedures to mitigate risk (e.g., credit checks or centralized approvals), and activities to avoid risk (e.g., avoiding interest rate risk by borrowing in local currencies).

Improvement have been seen in the banking industry where risk management has been centralised to evaluate overall firm level risk and determine the best interest of the bank as a whole. At the same time line officers are still accountable for risks under their control.

Although Deunes and Knechel were interested in the disclosure requirements and voluntary disclosure of internal controls, their study revealed that investors are interested in information about such activities is likely to be very relevant as it reveals whether management understands the risks in the business and is managing them effectively. It is likely that high inherent risk it may be difficult to report where there are weaknesses but this paper highlights on the importance of banks to measure, monitor risk having management information system that will ensure that all risk is reported accordingly.

Pyle although he was confined his study to market risk and credit risk provided a general notion on risk and regulation. He stated that regulators want to be sure a bank’s potential for catastrophic net worth loss is accurately measured and that the bank’s capital is sufficient to survive such a loss.
As an example under market risk “the need for total risk measure implies that risk measurement cannot be decentralised.” This is a costly and consuming process. Bank managers compromise between measurement precision on the one hand and the cost and timeliness of reporting on the other (Pritsker 1996). This has been supported by Pyle in that since regulators are to rely on risk measurement of banks in particular with the cost of accurate risk measurement, bank relation have chosen to monitor and stress test bank risk measurement system as opposed to undertaking their own risk measurements.

Bank regulators are concerned about whether the bank will not fail in case of worst case scenario and this has been supported by Pyle, “They can set the bank’s required capital to be greater than the estimated maximum loss and be almost sure that the bank will not fail over a certain horizon.

Success of risk management should be supported by an enterprise risk management which is bank-wide, lies on the support of a risk deciated unit, the board of directors as well as the internal audit, the management information systems. To a large extent but only hypothetically and practically strong enterprise risk management has been linked to the support of a board of directors, internal audit and risk management unit Daud and Yazida explained. As the consequence, those firms which adopted ERM experience a reduction in stock price volatility, increased asset opacity, a decreased market to book ration and decreased earnings volatility besides increased board and senior management ability to oversee the portfolio of risks facing the institution (Beasly et al, 2006 and Pagach and Warr, 2008). This has been emphasised by (Shenkir& Walker 2006) in that executives should be eager to make a commitment to ERM because they are ultimately responsible for protecting, creating and enhancing shareholder value.

Many conceptual papers were consulted in search of a empirical one and it seems there is limited empirical studies on risk management and performance. Nonetheless, Tandelilin, Kaaro et al., (2007) used a Triangle Gap Model of three variables including risk management and performance to determine causal relationship. The study found that there is significant negative
inter-relationship between risk management and bank performance. Risk management however heavily relies on enterprise risk management and good corporate governance. This goes to show that the importance of the role of the board of directors and senior management in risk management cannot be overemphasised. The risk management function should start from the top of the organisation where the board of directors develop structures that are conducive for independent risk function. They should provide direction and set risk appetite in line with the size and nature of the institution. “Both bank performance and risk management are dependent on implementing good corporate governance hence the correlation between risk and return. Better risk management indicates that banks operate their activities at lower relative risk and at lower conflict of interest between parties.” Tandelilin, Kaaro et al.,(2007) This lead to exceptional bank performance leading to good reputation, lower cost of funds hence increase in assets therefore profitability. On the notion of risk versus return, 

This TGM study confirmed Bessis (2003), who wrote that those banking institutions that actively manage their risk have a competitive advantage. They take the risks more consciously, they anticipate adverse changes, they protect themselves from unexpected events and they gain the expertise to price risks. The competitors who lack such abilities may gain business in the short term. Nevertheless, they will also lose ground with time, when those risk materialise into losses.

Kablan (2010) wanted to assess the efficiency of banking in Sub-Sahara that is he was looking at costs or challenges to determine what it takes for banks to perform well. He related that for a bank to gain competitive edge over others, it must have a good strategy to ensure that deposits will be invested so as to maximise profitability. He continued by clarifying that it is at this strategic level where the risk appetite is set hence it is in effect the choice of financial risks the institution plans to manage.

In conclusion, it can be said that for regulators to apply RBS is not wasteful exercise, there are benefits however more studies are essential to determine even the link between RBS and banks performance in particular after the global financial crises of 2007/8.
2.6 Examples – International Supervisory Authorities

2.6.1 Background

There have been many pressures in the financial sector arising from the scandals, crises and other failures such as Barings Bank, WorldCom, Asian Crises in the 90’s, and the recent financial crises of 2007. Somehow they indicated that institutions, in particular, banks, should have an organised culture of control and that the supervisory process has to be in sync with the developments in the financial sector. It also became apparent that resources should be prioritised towards high risks and banks themselves should have risk monitoring systems. It seems the financial and non-financial crises also in government agencies in the US pointed the need for various forms of risk management David Hyle (1997). He continues to say that the financial misadventures are not a new thing, but brought attention to the haste in which economic entities can get into trouble, as the main concern. The unfortunate aspect is that the direction and the damage that the crises or failures can take is not known therefore it is essential to have risk management techniques in place so that at least forecasting can be done and early warning signs can be detected and corrective action taken on time. This also means that taking corrective action should go beyond just the banks being responsible but the supervisor being vigilant enough to calculate the impact of a loss derived out of an unwarranted risk.

It became perceptible even in those days that the problem in many failures was not necessarily with the risk taken but the lack of risk management techniques to identify risk timely and accurately. These failures happened amid of regulatory requirements which banks ought to have complied with. Therefore the big question had to be answered, what went wrong? Most of the failures such as the Barings Bank, the World Com and the recent crises unmistakably indicated greed, lack of control culture, and ineffective governance. It certainly indicates that no amount of regulation can regulate spontaneity and lavishness. Hence it has become really necessary to think beyond compliance, and tighten rules not in so much arbitrage but with regard to letting the players take the lead in being the goal keepers for their own teams.
For a long time the regulator played the goal keeper but time has shown that establishment of sound risk management including good corporate governance and control environment is essential. Risk management allows banks to be responsible and take risks only if they are warranted. This is by ensuring that banks can internally have reliable risk measures and direct their capital to the high risk with relevant sustainable rewards not just short-term. In addition banks should have the ability to measure the potential threats embedded in the taken risks and be able to make sure that their losses will in no way interfere with set limits to meet daily obligations and derail the banks from being a going concern. Banks must also be able to monitor their set limits against their positions and create incentives for prudent risk taking. For these reasons advanced, RBS comes forth as a suitable supervisory process as it facilitates for banks to set own risk management techniques and controls of which the supervisor can rely on.

It would be necessary therefore to show experiences of other supervisory agencies in terms of how the supervisory methods have been redefined, what the implications were and the benefits thereof. The different experiences were drawn from the three pioneers of RBS and outlined hereunder to appreciate different dimensions of risk based supervision as follows: Implementation challenges from Australia; The reason for shifting to a new method from U.S.A; and the benefits of the redefined methods from the FSA. The important lesson learned was that the regulator should fit supervision principles to match with the core objective of regulation which is maintenance of financial safety and soundness henceforth making sure that supervision is focused. The most interesting aspect also highlighted in these experiences is the uniqueness of each supervisory process in every jurisdiction and how the supervisory process needs to align with the regulator’s objectives and clearly outline what the agency cannot do.

2.6.2 Australia

The APRA adopted RBS in 1998, one year after the Basel Committee has reviewed the banking supervision principles which clearly pushed the regulator to adopt a risk focused supervision by encouraging banks to formulate own risk management policies and procedures. It was quite a journey for APRA which took more two years as against the initial thought that it can be
implemented swiftly. The roll-over took time and allowed all parties involved to understand the process hence an effective implementation. APRA had the first RBS in the names of Supervisory Oversight and Response System (SOARS) and later changed to Probability and Impact Rating System (PAIRS). This indicated the need to appreciate RBS implementation as a process rather than as a once off exercise.

The interesting features in the Australian framework was the fact that the banks’ risks were identified, then risk management system assessed, any residual risk and the impact of risk to the institution were measured. APRA uses SOARS as a guide in taking corrective action or determining the supervisory scope or plan. APRA has four supervisory stances namely normal, oversight, mandated improvement and restructure. This is equivalent to rating them by strong to weak risk management systems. The supervisory process, PAIRS, follows a five step, which is to identify inherent risk, to manage and control risk by type, to assess the capital support, to determine the net risk and finally allocate the weighting.

2.6.3. United States of America

The U.S has long been using the traditional approach before they introduced a more advanced approach. As already stated the financial complexities forced the regulators to strengthen the supervisory process. Munich (2009) stated that the regulator adopted risk focused approach due to its nature of continuity versus the one- point in time examination. The Fed has been using the Uniform Financial Institutions Rating System (UFIRS) commonly referred to as CAMELS since 1979 and they only updated the system in 1997. The U.S system has an element of risk focused supervision which maintains the compliance, safety and soundness of the banks’ operations, assessment of the risk management system while focusing resources on highest risks FFDIC (1997).

The resources are focused on bank’s management to identify measure, monitor and control risks. Banks normally have their own risk management systems hence risk focused supervision insists on ‘‘testing rather than duplicating’’ FFDIC (1997). The former Fed chairman, Alan Greenspan
made it clear that if banks manage their own risks, the regulatory burden is reduced. This framework is also referred to as supervision by risk which facilitates for the supervisor to be able to determine whether the bank systems and processes permit management to manage and control existing and prospective levels of risk USA Handbook (2001). The supervisor’s mind is shifted from refusing the banks to take risks but to letting the banks to take risk but risk that is warranted. If there are any excessive risks above the risk management systems in place, the bank should have means to improve on those systems or reduce the risk exposure. For example if there is excessive credit risk, the capital should increase to cover the excess or the credit exposure should be decreased.

The U.S system also highlights the importance of segregation of risk taking activities from risk management activities and the need to have systems that are compatible with the risks taken. Furthermore a bank should communicate its risk tolerance throughout the institution with clear set policies, procedures and limits. There should also be timely and accurate information systems for ease of reporting and most importantly for monitoring risk. According to Sehajwala , the new method is meant to assist supervisors to identity change particularly deterioration in bank’s financial condition as early as possible.

The supervisor also compiles the risk profile through the risk assessment process and this profile gives direction to supervisory strategy, facilitates discussions with banks’ management and ensures more sufficient and efficient examinations. The supervisor’s judgment to determine the depth of each functional area is crucial to the success of risk focused supervisory process (FFDIC). That is, the supervisor is on the outlook of any activities that require specific attention. The U.S system has the core assessment which is the analysis the bank’s condition and the Risk Assessment System (RAS) which is the process that depend on supervisor’s own judgement on the risk management systems.
Here the supervisor determines the residual or aggregate risk and direction of risk. According to Central Bank of Cyprus, they conduct supervision in such a way that they adequately supervise the most significant risks. Under this risk based approach, the supervisor reviews all operations of a bank, recognises inherent risk and assesses materiality of the risks associated with each function, applying RAS they have developed. The level of intensity of supervision depends on the nature and complexity of the banks’ activities.

The FDDIC has an eight step supervisory process as in identifying the significant activities in the bank, assessing the inherent risks in the significant activities and developing matrix, examining the quality of the risk management in the bank, planning and scheduling supervisory activities, defining examination activities, performing examination activities, performing examination procedure and writing the report.

2.6.4 United Kingdom

The FSA has also implemented the risk focused approach to supervision in 1998. Their approach was first called Risk Assessment Tools of Supervision and Evaluation (RATE) and they later changed to Advanced Risk Response Operating Framework (ARROW). In this approach the FSA sets the risk appetite for the institutions according to its own objectives. This is an interesting dimension that the FSA took, qualified as extremely important aspect, in which supervision is based on the magnitude of the risk’ impact to the FSA objectives and not on the shareholder’s value (FSA Framework 1998). This sets a clear line of supervision responsibility as the objectives are specific namely confidence, public awareness, consumer protection and the reduction of financial crime. Therefore the supervision of banks is cautiously undertaken to suit the objectives of the regulator so as to ensure that supervision focus is not derailed into pursuing the objective of bank which is primarily profit maximisation. What matters is how is the risk taken going to affect the reputation of the financial system, how will the customers be exposed and if the bank’s operations are safe enough not to detect and safeguard against financial crime. Why because the regulator has to maintain financial stability, therefore if the risk is there and if negatively affects the bank but not the financial stability, the regulator is not bothered.
After the appetite is set, the risks are identified to assess the impact on capital, reputation, earnings and brands (FSA Handbook 1998). FSA follows a guiding principle of non-zero failure approach’. This principle emphases the fact that if a bank has inadequate risk management systems in proportionate to its risk, it will eventually fail and the regulator cannot prevent it. Therefore this highlights the vital RBS aspect, which is that management should take responsibility to mitigate the institution’s risks. The regulator is clear that, its responsibility is to influence the limited resource allocation in such a way that they can be applied effectively and to ensure that appropriate regulatory tools assess the banks’ risks.

Not only the FSA practices this firmness but the Bank of Poland through the Barents Group (2000) Report on Strengthening Bank Supervision, explained that when looking at the role of a regulator of maintaining financial stability, to close a bank that fails seems contradictory but it is a positive step as regulation allows orderly exit from the financial sector. He qualifies this statement by adding that, in the short-term it may seem that stability is hampered but in the long-term stability remains intact as better manages banks continue to operate.

The FSA has the six step supervisory process as preparing for the risk assessment, probability assessment, development of a risk mitigation programme, internal validation, communicating the results of the assessments to the financial institution, and on-going assessment and response to risk escalation.

Both the Advanced Risk Responsive Operating framework (ARROW) and PAIRS assessment have a common factor, which is the impact of the risk on the financial stability and the probability of occurrence of such risk. The risk is measured against the size of damage it can cause to the institution and the economy as a whole (impact) meaning that if an institution’s impact is rated high, it should be closely supervised, for if anything goes wrong, the institution can fail or have a contagion effect in the banking system. If the institution fails, its failure affects the financial sector regulation objectives hence the need for regulation. Under the probability
assessment, every risk is assessed to determine its occurrence likelihood. This is done to identify the frequency of a risk in relation to the impact on the financial sector. However the level of thoroughness of assessment is not the same for every institution or activity, it depends on the level of impact.

Risk based approach to supervision is necessary but its implementation is a process that takes time as well as it has to be understood very by the regulator. Bank of Poland took time to come up with a comprehensive framework and all its document, the FSA in the UK also took time and came up with some documents such as the ARROW framework in 2002. The U.S also had its handbook in 2002. *The guide normally outlines the types of intervention can expect from the regulator, If issues are unresolved, this can lead to a bank restructuring, sale or winding up. This flexible, clear and well understood intervention framework by both parties contributes to financial stability (Canadian experience). Focusing on risk based capital adequacy ensures that banks with greater risks entered the turmoil with greater cushion against unexpected losses. In addition to risk based capital adequacy, Canadian banks must meet a leverage test (assets to capital multiple), that typically ensures a ratio of total assets to total capital of no more than 20 times.

Although many companies and industries use different risk assessment methods, the fundamentals of the risk assessment process are common namely to identify hazards, assess risk, reduce risk, and document the results. Bruce Main (2004)

2.9 Examples – Regional Countries

It has been made explicit that risk must be managed well to minimise catastrophes as it has been pointed out, as an example, that poor operational risk has been the underlying cause of every major financial services loss over past two decades Investopedia (2010). In this regard until all investors and stakeholders including regulators understand this risk and how to measure and manage it, there is no way to guarantee that the financial sector will not face future financial
melt-down as big as or bigger than the most recent one (Ali Samad –Khan 2009). It is imperative that regulators take an active role in formalising the establishment of risk management systems. All risk must be measured to avoid obscuring the underlying causes of financial losses in a bank.

In response to the ever evolving banking environment and to align with international best practice unreservedly stated in the BCP’s, the central banks in the MEFMI region adopted the commended risk focused approach to supervision. The journey started in the early 2003, at the time when most developed countries had tried, tested and recommended this methodology. It started at the Reserve Bank of Zimbabwe in 2004 where RBS was adopted in principle and also by the Bank of Uganda in 2003. It was in 2006 when the risk based was fully implemented and a risk based policy framework finally published by RBZ whereas Uganda revised its approach in 2009. All the countries in the region have adopted this methodology and their policy framework is more or less the same except in the organisation of the framework where it has been customised to suit the local environment. Some countries like Malawi, Rwanda have gone all the way to include the risk focused examination procedures in the customisation of the framework.

The RBZ in its annual report of 2004 defined RBS as a methodology that is aimed at assuring a qualitative and quantitative assessment or risk profile of an institution. Further it has been related to promote interaction among supervisors, and banks and provides a solid foundation for implementation of Basel II. The Risk Assessment process has been considered to complement the CAMELS system. The RAS system has three ratings of risk from low, medium to high and risk management systems from weak, moderate and strong. These two systems have been deployed by all regulators in the region.

RBZ has since enhanced the RAS ratings tiers from three to five as follows:

- Green- (very low);
- Lime- (low);
- Orange-(medium);
- Yellow-(high); and
- Red (extremely high).

The five tier rating system is termed GLOYR. This new measure is an improvement which was necessary due to the fact that the original RAS ratings had only three tiers Green-low, Moderate-orange and High-red leaving subjective gaps in correlating RAS with CAMELS which is five tier rating. Hence with GLOYR there is harmonisation of RAS tiers with CAMELS ratings which are 1 to 5 indicating unsatisfactory, fair, satisfactory, strong in any of the components or composite components.

According to (Sehajwala and), there is no theoretically optimal system or standard textbook blueprint for the structure and process of regulating and supervising banks. In agreement with this statement, it is apparent that supervisors should consistently strive to strengthen supervisory processes by being proactive in order to improve their accuracy and predictive power. The RBZ has developed financial stability indicators, stress testing and back testing approaches to predict the early warning signs (Annual Report, Reserve Bank of Zimbabwe, 2004).

The Reserve Bank of Malawi officially launched the risk focused approach to supervision in January 2009. The decision to adopt RBS was made in 2007. The East AFRITAC became innovative by providing a guidebook on the implementation of RBS and was published in March 2009 in Dar Es Salaam, Tanzania and provides detailed implementation experiences of the Eastern African countries.
It has been testified that RBS has a long way in terms of promoting sound risks management practices in banks which in turn will contribute to healthy and stable financial system. (2009, EA guidebook)

The following table shows the status of implementation in the MEFMI region February 2011

Table Regulator Status of Implementation

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Adoption</th>
<th>Implementation</th>
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<tbody>
<tr>
<td>Uganda- Bank of Uganda</td>
<td>2003</td>
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<tr>
<td>Tanzania- Bank of Tanzania</td>
<td>2006</td>
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<td>Rwanda- National Bank of Rwanda</td>
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<td>Zimbabwe- Reserve Bank of Zimbabwe</td>
<td>2002, re-launch 2006</td>
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<td>Zambia- Bank of Zambia</td>
<td>2008</td>
<td>Work in progress 2009</td>
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<tr>
<td>Swaziland – Central Bank of Swaziland</td>
<td>2009</td>
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<td>2009</td>
<td>Work in progress 2009</td>
</tr>
</tbody>
</table>

As the table depicts the MEFMI region has really made progress. The region has made an undertaking to foster international best practice, and to them it is indeed overdue to implement RBS as Basel II also requires a high level of mind shift and there have been other developments since it has been introduced in 2004 and after the recent global financial crises there is more emphasis on macro-prudential supervision. The gear has shifted to a macro-prudential supervision which includes all non-bank financial institutions, non-financial institutions and individuals’ assessment and reporting which are intended to indicate the indirect and direct forces that affect the financial sector soundness in advance. RBS serves as the best methodology.
especially when it provides benefits such as good risk taking principles within financial institutions, allows for consolidated supervision and facilitates effective integration of financial sector indicators of which the traditional approach could not do.

2.8 Conclusion

RBS is essential as an advanced supervisory process. Recently after the crises it has been topical that macro prudential analysis of the financial sector is essential for financial sector soundness. A system-wide perspective which incorporates all significant financial activities, including banks, markets, their interactions with the real economy, is necessary to evaluate the risks faced by financial institutions and the potential for the propagation of adverse shocks in the system, as well as the potential for macroeconomic factors to adversely affect financial institutions and markets. It is critical that regulators aim to avoid damage to the financial systems as a whole. This emphases the need for RBS as it is an overlay to all supervisory processes. Talks are going on after the crises regarding the reforms and it is critical to implement RBS so as to align and link in new methods and advancements on regulation very effectively.

It is critical at this stage to point out that RBS has serious implementation implications on the way supervision used to be undertaken therefore it requires a paradigm shift from the traditional supervision to a risk focused approach. It requires management appreciation and support so that there of RBS to make this happen. There is a need to train and retain staff, to enhance the supervisory tools, and overhaul the format is of current working documents. This issue will however be tackled in more detail in the next two chapters.
CHAPTER 3 STEPS TOWARDS IMPLEMENTATION OF RBS
CHAPTER 3 STEPS TOWARDS IMPLEMENTING RBS

3.1 INTRODUCTION

Having defined risk based supervision and identified its benefits and experience in other supervisory jurisdictions across the globe, it is imperative to provide the critical steps towards implementation of risk based supervision in this chapter. The sections below discuss the preparatory steps, the steps for developing a framework, the components or risk management programs for the banks, developing the methodology, testing the methodology, developing the risk based examination manuals and the working papers, the review of off-site manuals and training of staff.

3.2 STEPS OF RBS IMPLEMENTATION IN LESOTHO

For RBS to be implemented effectively the framework should be developed so that supervisors should appreciate.

The risk-based supervision framework consists of six key steps outlined in the tabled below:

Table 1: Risk Based Supervision Framework\(^\text{15}\)

<table>
<thead>
<tr>
<th>STEPS</th>
<th>OUTPUT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Understanding the institution</td>
<td>• Institutional Profile</td>
</tr>
<tr>
<td>2. Assessing the institution’s risks</td>
<td>• Risk Matrix</td>
</tr>
<tr>
<td></td>
<td>• Risk Assessment Summary</td>
</tr>
<tr>
<td></td>
<td>• Risk Rating Indicators</td>
</tr>
</tbody>
</table>

\(^{15}\) The risk based supervision methodology has been drawn from U.S. Federal Reserve model of risk based supervision and customised to the region with modifications from other jurisdictions such as Hong Kong and Singapore and the local environment.
### UNDERSTANDING THE INSTITUTION

The initial step in risk-based supervision is to develop an understanding of the specific characteristics or risk profile of a bank. This is achieved by means of compiling an institutional profile. An institutional profile is a comprehensive but concise document that demonstrates the institution’s current condition and provides a description of among others, the bank’s ownership structure, functional lines, activities, management, nature and level of risk. It also highlights outstanding past supervisory findings and future prospects.

#### Institutional Profile

a) An institutional profile is prepared to demonstrate the institution’s current condition. It is a dynamic document that supports the risk focused supervisory process and facilitates ongoing monitoring of a specific institution.
b) The institutional profile should be updated on a continuous basis to capture material changes in the bank that may result from, among others, new products development, expansion into new markets or technological changes aimed at enhancing efficiency. Supervisors should be aware that changes in the condition and risk profile of an institution could occur within a short time due to both internal and external factors.

c) A comprehensive up-to-date institutional profile should be maintained for every supervised institution. Portfolio Analysts responsible for each institution should review and update the institutional profile, on an ongoing basis. It is necessary for Section Head or the Head of division to subject Institutional Profiles to random checks to ensure that it is consistent and complete.

3.2.1.2 Sources of Information for Compiling an Institutional Profile

a) Information for compiling and updating an institutional profile should be collected from reliable sources, which the portfolio analyst has access. Formal sources of information include: previous on-site examination reports, regular prudential and statutory returns, published financial results, meetings with the institution’s Board or senior management, external and internal auditors, reports of or meetings with other supervisors or regulators.

b) Banks should be required to notify the Central Bank of any significant changes in their activities or any material adverse developments, including breach of legal and prudential requirements.

c) Portfolio analysts should hold regular meetings with the respective institution’s management, board members, and heads of individual units to discuss operational matters among others: strategies, corporate governance, performance, capital adequacy, asset quality, liquidity, risk management systems, and results of recent internal and external audits.
d) Less formal and informal sources can provide additional insight into an institution’s condition and such information can be obtained from media reports, informal meetings with bank management, complaints filed against the institution and information from other authorities (e.g. Lesotho Revenue Authority, Anti-Corruption Unit and any other law enforcement agencies).

3.2.1.3 Contents of an Institutional Profile

The Institutional Profile should provide all important information and supervisory concerns about a bank. General types of information included in the institutional profile are as follows:

a) **Overall Condition** indicates the institution’s current condition based on the level of supervisory concerns and risk assessment. Key issues or concerns relating to strategies employed are also highlighted.

b) **Risk Assessment Summary** outlines the level of inherent risk, adequacy of risk management, overall composite risk and direction of overall composite risk as per risk matrix below:

<table>
<thead>
<tr>
<th>Type of Inherent Risk</th>
<th>Level of Inherent Risk</th>
<th>Adequacy of Risk Management System</th>
<th>Composite Risk</th>
<th>Direction of Composite Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>High</td>
<td>Strong</td>
<td>Medium</td>
<td>Stable</td>
</tr>
<tr>
<td>Liquidity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>----------------------</td>
<td>---------------</td>
<td>---------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Exchange</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operational</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal &amp; Compliance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reputation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Level of Inherent Risk: Low, Medium High;
Adequacy of Risk Management: Weak, Acceptable, Strong;
Level of Composite Risk: Low, Medium, High;
Direction of Risk: Decreasing, Stable, Increasing.

c) Corporate Profile

i. **Background** captures a brief history of the bank, covering among others: date of establishment, changes in name, mergers and acquisitions, conversions of banking license.

ii. **Shareholding Structure** indicates the names of shareholders, number of shares held and the percentage shareholding over the past two years. The holding or parent structure should also be shown if the bank is owned by a holding or parent company.

iii. **Capital Structure** presents capital components of the bank, over the past two years.
iv. **Related Organisations** shows the institution’s subsidiaries, associates and any related organisations including the respective percentage shareholdings.

v. **Vision/Mission/Strategies** states the vision, mission and strategic goals of the bank.

vi. **Key Functional Lines** identify significant activities, business lines as well as major products and services of the bank. Major support services such as Information Technology (IT) should also be included.

vii. **Risk Management Framework** provides an overview of the risk management structures, systems and procedures that are used to manage the various risks inherent in the bank’s operations. The roles and responsibilities of the individuals involved in risk management processes should be clearly stated. Board and senior management reports, limits and IT capabilities should also be covered.

viii. **Branch Network** indicates the number of branches, agencies and other points of representation, including their respective physical addresses.

ix. **Staff Complement** states the total number of employees distinguished between managerial and non-managerial staff of the bank. Include comments on the adequacy of the human capital particularly in key functional areas in respect of number, qualification and skills.

x. **External Auditors and Lawyers** indicate the names and contact details of the bank’s auditors and lawyers.

xi. **Board of Directors and Committees** provide the names, age, qualifications, experience and other directorships of the members of the Board. Includes the composition of various committees of the Board and their terms of reference.

xii. **Senior Management and Committees** stipulate the names, age, qualifications and experience of all senior managers. Takes into account, the composition of various committees of management including their terms of reference.

xiii. **Top Twenty Depositors and Borrowers** indicate among others the names, amounts, sector, and the type of facilities with the bank.
d) **Examinations Results and Audit findings** present the results of the recent two on-site examinations showing respective CAMELS components, overall CAMELS ratings and overall risk ratings. It also summarises significant findings of the latest on-site examination and internal and external audits. Highlights of the prudential meetings with the auditors should also be included.

e) **Off-site Analysis** provides a summary of the overall condition of the bank based on the latest off-site review and comments on CAMELS components ratings.

f) **Non-Compliance with regulatory and supervisory requirements** provides information on the bank’s compliance with the banking law, regulations, guidelines and directives issued by the Central Bank of Lesotho. Major compliance violations should be stated.

g) **Environmental considerations** identify and state any external environmental issues that may have an impact on the operations and condition of the bank.

h) **Financial stability and stress testing assessment**

   i. **Stress Testing results** state assumptions and results of stress tests conducted by supervisory agency and the bank.

   ii. **Financial Stability Considerations** provide information on the institution’s financial performance, strength, chances of failure and the contagion effect on the financial system, in the event of failure.

   iii. **Future Prospects** indicate the bank’s strategic forecasts or projections of key performance areas, budgets, products and markets.

3.2.2 **ASSESSING THE INSTITUTION’S RISKS**

The second step in the risk based supervision framework is assessing the institution’s risk. The purpose of the risk assessment exercise is to identify the type, level, management and direction of all significant risks affecting a bank or inherent in the bank’s activities. This step is designed to develop a comprehensive risk profile of the institution and the supervisors are expected to
draw risk rating indicators, factors that serve as a guideline for examiners to judge whether there is high risk or not. For example, to determine the level of risk for interest rate risk:

Table 3: Risk Rating Indicator

<table>
<thead>
<tr>
<th>Low</th>
<th>Medium</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Little repricing risk and minimal exposure to basis and yield curve risk</td>
<td>Repricing, basis and yield curve risks are collectively maintained at manageable levels</td>
<td>Significant levels or repricing, basis and yield curve risks exist</td>
</tr>
</tbody>
</table>

The risk assessment results in the development of a Risk Matrix and a Risk Assessment Narrative. The main objective of a risk matrix is to present, in a tabular format, the type, level, management, and direction of risk inherent in a banking institution. On the other hand, a risk assessment narrative is an interpretation of the risk matrix and provides a brief description of the type and level of risks inherent in the banking institution’s activities, the adequacy of risk management systems in place, and the direction of the risk and the impact of the external risk factors.

The risk assessment process highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted during an examination. The Portfolio Analyst should perform quarterly risk assessment and update the institutional profile accordingly. This will ensure that supervisory resources are always focused on the areas of greatest risk to an institution.

**RISK ASSESSMENT SYSTEM**
The risk assessment system will be termed Assessment of Risk, Risk Management, Aggregate Risk and Direction – ARRMAD. ARRMAD is divided into four phases namely Risk Assessment Process, Risk Matrix and Risk Assessment Narrative and Impact assessment to the institution and the financial system.

3.3.1 Phase 1- Risk Assessment Process

The risk assessment has six distinct stages

Stage 1 Identify key Functional Lines/Activities

Sufficient information must be gathered to understand the institution’s business activities and risk management systems. The key functional lines of a bank (such as credit, treasury etc) and their significance are largely identified by reviewing the institution’s financial statements, senior management reports and any other reports that are prepared for the financial institution.

Stage 2 Identify Type and Level of Inherent Risk of Significant Activities

After significant activities are identified, the type and level of risk inherent in these activities should be determined. An assessment of the level inherent risk in each functional area takes into account several factors including the frequency of occurrence, probability of occurrence and or severity of impact. The level of inherent risk is rated as high, moderate, or low.

It is important to remember that the assessment of inherent risk is made without considering risk management systems.

Stage 3 Assess Adequacy of Risk Management Systems

Assessing the adequacy of an institution’s risk management systems, place primary consideration on key elements of a sound risk management system:
a) Active board and senior management oversight;

b) Adequate policies, procedures, and limits;

c) Adequate of management information systems; and

d) Adequate internal controls and audit.

Taking these key elements into account, the supervisor should assess the relative strength of the risk management processes and controls for each identified function or activity. Relative strength should be characterised as strong, acceptable, or weak.

a) **Strong risk management** indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function.

- The Board and senior management participate in managing risk and ensure that appropriate policies and limits exist, which the Board understands, reviews, and approves;

- Policies and limits are effectively supported by risk measuring, monitoring and control procedures and MIS which are timely, accurate, complete and reliable;

- Internal controls and audit procedures are appropriate and drawn in line with the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the institution.

b) **Acceptable risk management** indicates that the institution’s risk management systems, although largely effective, may be lacking to some modest degree. It reflects ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution’s business plan. While the institution may have some minor risk management weaknesses, these problems have been recognised and are being addressed.

- Overall, board and senior management oversight is considered effective
• Management information systems are considered effective in maintaining a safe and sound institution.

• Risks are generally being controlled in a manner that does not require more than normal supervisory attention.

c) Weak risk management indicates risk management systems that are lacking in material respects and, therefore, are a cause for more than normal supervisory attention.

• Overall, the board and senior management oversight is considered ineffective

• MIS at various levels exhibit significant weaknesses and may not consolidate total exposures.

• The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures.

Stage 4 Assess Composite Risk

The composite risk for each risk is determined by balancing the overall level of inherent risk with the overall strength of risk management systems. High risk areas need strong risk management practices. For example, loans and advances will usually be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with loans and advances may be moderate.

The following table provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related risk management systems.
a) A **high composite risk** would generally be assigned to an activities or risk where the risk management system does not significantly mitigate the high inherent risk. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the institution’s overall condition, even in some cases where the systems are considered strong. For an activity with moderate inherent risk, a risk management system that has significant weaknesses could result in a high composite risk assessment because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.

b) A **moderate composite risk** generally would be assigned to an activity with moderate inherent risk where the risk management systems appropriately mitigate the risk. For an activity with a low inherent risk, significant weaknesses in the risk management system may result in a moderate composite risk assessment. On the other hand, a strong risk management system may reduce the risks of an inherently high risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the bank.

c) A **low composite risk** generally would be assigned to activity(ies) with low inherent risks. An activity with moderate inherent risk may be assigned a low composite risk where internal controls and risk management systems are strong and effectively mitigate much of the risk.

**Stage 5  Determine Direction of Aggregate Composite Risk**

After assessing the aggregate composite risk, the direction of aggregate composite risk for each category of risk is determined. Direction of aggregate composite risk is the probable change of the aggregate risk profile per category or risk over the next examination cycle and is characterised as **decreasing, stable, or increasing**.
(a) **Decreasing** direction indicates that the supervisor anticipates that, based on current information, the aggregate composite risk will decline over the next examination cycle. Such a scenario reflects decreasing aggregate inherent risks and/or improving risk management systems.

(b) **Increasing** direction denotes anticipation of higher risk over the next examination cycle. This indicates that inherent risks may be increasing and/or risk management systems are getting weaker.

(c) **Stable** direction indicates that inherent risks are stable and/or risk management systems are unchanged.

**Stage 6 Institution’s Overall Risk**

The final step in ARRMAD is the assessment of the institution’s overall risk profile by determining the overall inherent risk, overall risk management systems, overall composite risk, and direction of overall composite risk.

Overall inherent risk takes into account aggregate inherent risks across all risk categories, Overall risk management systems consider all the aggregate risk management systems across the institution. Overall composite risk rating is determined by balancing the overall inherent risk and overall risk management systems. Direction of overall composite risk will be assigned to complete the process.

**3.3.2 Phase 2 - Preparation of the Risk Matrix**

The risk matrix is a very important and flexible tool that documents the risk assessment process followed to assess the overall risk. It also serves as a basis for preparation of the risk assessment narrative and forms basis on which supervisory plan is developed and on-site examination activities are determined. It should also be updated whenever changes occur.
It presents in a tabular format, the type and level of inherent risks, the adequacy of risk management systems, level of composite risk and the direction of inherent risk. A full functional risk matrix should be drawn as it represents the functional lines where the aggregated risk is derived from.

3.3.3 Phase 3 - Preparation of the Risk Assessment Narrative

The risk assessment narrative describes the type and level of inherent risk in bank’s activities, the adequacy of risk management controls in place and direction of the risk. It is a document that presents a comprehensive, risk-focused view of the institution, identifies the areas of supervisory concern and serves as a platform for developing the supervisory plan.

It is important that the risk assessment reflect a thorough analysis leading to conclusions regarding the institution’s risk profile rather than a reiteration of the facts. For example, it is not sufficient to merely report a high loan-to-deposit ratio as a liquidity concern but should carefully analyse the liability structure to form a judgment about the seriousness of the concern. The significance of a relatively high loan-to-deposit ratio in an institution whose liabilities are virtually all highly stable core deposits is possibly less of a concern than the same ratio in an institution with a highly volatile liability structure. Liquidity risk might be high in the latter and moderate or low in the former, even though the ratio is the same.

3.3.4 Phase 4 – Impact Assessment

Consider the relationship between the likelihood of an adverse event and the potential impact on an institution as well as the financial system. As a matter of urgency the regulator’s main objective is not to micro manage the banks but to assess the financial safety and soundness of the institutions so as to determine stability to the financial system. Therefore risk assessment of banks is a leg in risk management which should be complemented by assessing the impact of that risk to the institution as well as to the financial system will not be assesses. In this case impact of
the risks to the institution and financial institution should be measured. This will guide the banks to draw prompt corrective knowing the level of impact of the occurrence and also guide the supervisors to assess the level of systemic risk.

In rating the impact of an institution, MAS considers the financial services sector that the institution operates in as well as the nature and scale of the activities that are carried out. For example, the market share of retail deposits will be an important factor for assessing the impact of banks because a financially-distressed bank with a large retail depositor base could have grave direct consequences on confidence in the banking system and on the wider economy. Another example would be the role played by a bank in the payment system, given the potential impact for such bank to trigger payment system problems and gridlock if it fails to settle its payments.

As banks have inherent risk so does the financial system in general. Therefore adverse impact to the institutions and the financial system should be determined so that prompt corrective action can be taken accordingly.

Measurement of impact to the institution

The rating of impact can be Insignificant, Minor, Moderate, Major, Catastrophic – This helps the banks to know what the risk can do and what action may be appropriate to remedy the effects timely and cautiously. Although it was in the field of engineering, more or less the same risk assessment matrix has been developed by the Texas State LBT Student Centre by Jacob Engineering and U.S. Marine Corps and others.

Measurement of impact to the financial system

Impact to the financial sector -measures systematic important institutions and caters for systemic risk which comes through the link in financial services and the contagion effect of any one banking institution can bring. The criteria comprise
• Market share - Systemic importance of an institution to its financial sector

• Contribution to GDP - the contribution of the institution to the GDP

• Loss as a percentage to capital – Capital is a buffet for unforseen losses and if losses go beyond a certain point of capital, then there is cause for concern.

That is a systematic important bank will have more harm in the system than the small bank however systemic risk is inherent in all banks. As indicated from the Arrow model the impact of the risk is assessed and how likely it is to occur since some risks are more probable to occur than others. For example event risks are very rare but if they occur like Haiti and Iceland natural disaster, their impact could be highly material. The recent crises emanated from the sub-prime mortgages whereby the borrowers could not afford to repay their loans when the interest rates were increasing thus leading to the credit crunch and lack of trust amongst the institutions and liquidity dried up. Therefore it is critical to have the ability to foresee the future through the early warning signs.

Taking capital measurement as one of the proven items to help predict the future, Estrella, Park, and Peristiani examined the relationship between different capital ratios and bank failure, and found that the simple capital to assets ratio (leverage ratio) predicts bank failure as well as more complex risk weighted capital ratios over one-year or two-year horizons. In addition, Estrella et al. recommended using the simple capital ratio as a tool to provide a timely signal of the need for supervisory action. Thus, a choice of a 5.5 percent primary capital to asset ratio is a suitable proxy for an early stage of financial distress as proven. Jagitiani, Kolari et al (2000)

The impact shows how catastrophic or insignificant an occurrence can be whereas the probability indicates how probable is that occurrence and using a combination of the two management can use this tools to address their problems and supervisors as well. The diagrams below illustrate the impact and the likelihood.

Table 4: Impact and Likelihood of Risk
### Impact

<table>
<thead>
<tr>
<th>Rating</th>
<th>Impact</th>
<th>Measure of impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Insignificant</td>
<td>Little or no cost to capital</td>
</tr>
<tr>
<td>2</td>
<td>Minor</td>
<td>Minor losses below 1- 3% capital to assets</td>
</tr>
<tr>
<td>3</td>
<td>Moderate</td>
<td>Average losses between 3- 5% capital to assets</td>
</tr>
<tr>
<td>4</td>
<td>Major</td>
<td>Major losses above 5- 8%</td>
</tr>
<tr>
<td>5</td>
<td>Catastrophic</td>
<td>Huge potential financial losses above 8% capital to total assets</td>
</tr>
</tbody>
</table>

### Likelihood

<table>
<thead>
<tr>
<th>Rating</th>
<th>Probability</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Rare</td>
<td>Only under the most exceptional circumstances</td>
</tr>
<tr>
<td>2</td>
<td>Unlikely</td>
<td>Unlikely to occur</td>
</tr>
<tr>
<td>3</td>
<td>Moderate</td>
<td>May occur under certain circumstances</td>
</tr>
<tr>
<td>4</td>
<td>Likely</td>
<td>Will probably occur</td>
</tr>
<tr>
<td>5</td>
<td>Highly Certain</td>
<td>Will most probably occur</td>
</tr>
</tbody>
</table>

These two can be combined to determine the level of management attention required and the supervisory attention as depicted by the following diagram:

Table 5: Attention Required
3.2.3. PLANNING AND SCHEDULING SUPERVISORY ACTIVITIES

The third step of risk based supervision framework is to develop and maintain a supervisory plan, which details activities to be conducted prior to or during an examination of a bank. The supervisory plan is a bridge between the supervisory concerns identified through risk assessment and supervisory activities to be conducted. A supervisory plan will be developed for each institution yearly and will be reviewed as appropriate as circumstances demand.

Source: Santos Carmecinta RBS workshop 2009 Unpublished
Each supervisory plan provides a detail of supervisory techniques that will be applied during the examination period, and it also demonstrates how supervisory concerns identified through the risk assessment and deficiencies noted in the previous examination or any other concerns are being, or will be addressed. The plan should be institution specific based on the analysis of factors such as the bank’s current condition, results of operations and the economic environment as a whole.

The plan should generally address at a minimum the following:

- Time table of all supervisory activities to be conducted, and resource requirements;
- The objectives of supervisory activities, scope of activities (full or limited) and any specific concerns regarding those activities; and
- The extent to which internal and external audit and other risk management systems will be tested and relied on.

### 3.2.3.1 Pre-examination

The pre-examination planning is accomplished using both the on-site and-off-site information. It is essential that the pre-examination planning begin far enough in advance of the examination to allow sufficient time to request and review the information necessary to develop the scope of the examination.

The time table below will be followed as a pre-examination time line, however there maybe exceptions especially with regard to problem institutions:

Table
<table>
<thead>
<tr>
<th>DATE</th>
<th>Required Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 1 (30-45 days before the actual examination)</td>
<td>Write letter (entry letter) requesting information from the bank and also indicating the intended start date of the examination.</td>
</tr>
<tr>
<td>Day 15 (two weeks after the dispatch of the entry letter)</td>
<td>All requested information should have been submitted two weeks from the date of dispatch of the entry letter.</td>
</tr>
<tr>
<td>Day 16</td>
<td>Dispatch letter requesting prudential meeting to be held (one week after date of issue) with bank management. Director of Supervision will be the chair of this meeting.</td>
</tr>
<tr>
<td>Day 17 to Day 23 (within one week of receipt of the requested information)</td>
<td>Prepare an examination plan, preliminary risk assessment and scope memorandum of the bank and submit to the Head of FISD for review and approval. It is also at this stage that the institutional profile should be updated, if there are any changes.</td>
</tr>
<tr>
<td>Day 25</td>
<td>Conduct pre-examination prudential meeting with financial institution management.</td>
</tr>
<tr>
<td>Day 27 to Day 31</td>
<td>Conduct on-site review of sensitive information</td>
</tr>
<tr>
<td>Day 32</td>
<td>Update the examination plan and the scope memorandum with any change or new information from the prudential meeting and or the on-site review of sensitive information.</td>
</tr>
</tbody>
</table>
Day 33

| Hold entry meeting and conduct on-site examination of the financial institution. |

3.2.2.2 Sources of Information for On-site Examination Planning

The following are various sources of information which could be used to collect information necessary for planning and scheduling an on-site examination:

- **Institutional Profile** – this should be used as a starting point in formulating a supervisory plan. The institutional profile contains information about the institution’s current condition, ownership structure, functional lines, nature and level of risk, etc.

- **Off-site surveillance** – this involves off-site monitoring of the institution on the performance and condition together with progress on implementation of various directives and/or recommendations from the supervisor.

- **Prudential Meetings** – these are meetings with management of the institution to discuss its financial performance, risk profile, strategies, the market in which it operates, and/or any other supervisory concerns.

- **Meetings with external/internal auditors of the institution** – these meetings shall be arranged to discuss supervisory issues that need the attention of both the auditors and the supervisor.

- **Liaison with home/host supervisors** – correspondence or visits to the home/host supervisors may be necessary to obtain further information on the institution.

3.2.2.3 Frequency of Examination
Examination should be scheduled in accordance with approved FISD annual programme, however some incidences at the bank will warrant examinations of those institutions outside the approved annual programme.

Nonetheless, on-site examinations should be scheduled as per the following guidance:

- Financial institutions rated “1” should have on-site examination within one and a half year interval
- Financial institutions rated “2” and “3” should have on-site examination on a one year interval
- Financial institutions rated “4” and “5” should have on-site examination on a six month interval, or more regularly.

### 3.2.2.4 Supervisory Plan

The table below provides a template of the Supervisory Plan, while Appendix 3 provides a completed example of the same.

<table>
<thead>
<tr>
<th>Bank</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reporting Date</td>
<td></td>
</tr>
<tr>
<td>A. Supervisory Concerns:</td>
<td></td>
</tr>
<tr>
<td>Identify supervisory concerns by reviewing the following:</td>
<td></td>
</tr>
</tbody>
</table>
• Risk Assessment
• CAMELS assessment
• Any other available information (e.g. previous examination findings, internal and external audit reports etc)
• Any significant events (e.g. mergers, acquisitions, etc.)

B. Supervisory Strategies and Activities to be Conducted:

1. Off-site Monitoring

*Provide information on proposed off-site activities, taking into consideration the objectives, scope and relevant supervisory concerns.*

<table>
<thead>
<tr>
<th>Activity</th>
<th>Objective/Scope</th>
<th>Period</th>
<th>Resources and Comments</th>
</tr>
</thead>
</table>

2. On-site Examination

*Provide information on proposed on-site activities, taking into consideration the objectives, scope and relevant supervisory concerns.*
3.2.5. **DEFINING (SCHEDULING) EXAMINATION ACTIVITIES**

After the supervisory plan has been drawn, the next step shall entail examination activities that must be performed during the planned examination. In defining the examination activities, the supervisors should draw scope memorandum and task list which shall be followed by an entry
letter. The Examiner in Charge (EIC) for each of the supervised institutions shall take responsibility for preparation of the scope memorandum which helps identify the key objectives and activities of the examination. The entry letter shall inform the bank’s management about the planned examination and request for information necessary for the successful execution of the on-site examination.

The focus of on-site examination activities, identified in the scope memorandum, should be oriented to a top-down approach that includes a review of the institution’s internal risk management systems and an appropriate level of transaction testing. The risk-focused methodology (risk assessment system) provides flexibility in the amount of on-site transaction testing.

Although the focus of the examination is on the institution’s processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal control systems. If internal control systems are considered reliable, then transaction testing should be targeted to a level sufficient to validate that the systems are effective and accurate. Conversely, if internal management systems are deemed unreliable or ineffective, transaction testing must be adjusted to increase the extent of coverage.

4.1 Scope Memorandum

After the areas to be reviewed have been identified in the supervisory plan, a scope memorandum should be prepared that details out specific objectives for the projected examinations. A sample scope memorandum is presented in Appendix 4.1. This document is of key importance, as the scope of the examination will likely vary from year to year and from institution to institution depending on the institution’s risk profile. Thus, it is necessary to identify the specific areas chosen for review and the extent of those reviews.
4.1.1 Contents of the scope memorandum

The scope memorandum should be documented and tailored to the size, complexity, and current rating of the institution. The scope memorandum should include:

a) Objectives, proposed scope and focus of the examination, i.e. summary of issues to be investigated or areas to be targeted, and reasons why;

b) Overview of the activities and risks to be evaluated;

c) Summary of financial condition and risk profile of the institution derived from CAMELS Rating and RAS/Preliminary Risk Matrix;

d) Summary of pre-examination (prudential) meetings and any liaison with other supervisors and inputs from divisions within CBL;

e) Level of reliance on internal risk management systems and internal or external audit work;

f) Summary of the examination procedures that are to be performed, indicating sampling process to be used and the level of transaction testing, where appropriate;

g) Identification of the procedures that are expected to be performed off-site;

h) Identification of examination resource needs i.e. examination team, duties/task list and timeframes.

4.1.2 Objectives, scope and focus of the examination…

The examination scope memorandum should clearly state the objectives of the planned examination. The examination may serve as

- a follow up on matters of supervisory concerns raised in the previous examination
- a normal examination within the supervisory cycle
- planned examination to cover specific areas such as new products introduced since the last examination
• examination prompted by a suspicious changes such as termination of external or internal auditors contract.

An examination should ideally be designed to cover areas of supervisory concerns that arose from previous examinations to ensure an effective risk based supervision.

The examination scope can be expanded or narrowed depending on the adequacy of management oversight, policies and procedures, effectiveness of internal controls and management information systems.

4.1.3 Summary of the institution’s risk profile….

The scope memorandum should incorporate a brief preliminary risk assessment of the institution’s financial condition and major risk areas associated with business activities.

4.1.4 Summary of pre-examination meetings…

a) Meetings with Board and senior management:

The pre-examination meeting with the bank’s board and/ or senior management should be undertaken. The pre-examination meetings enable examiners to obtain the management’s understanding and perspective of the institution’s risks, financial condition, internal audit and external audit programs, and risk management programme. The meetings should be held closer to planned examination to ensure relevance and usefulness of the information for the proper execution of examination.

The discussions with management should at least cover changes in management policies and procedures, business strategy, products and services, management information systems, board and senior management oversight, key functional areas and risks thereto and any other significant changes that occurred since the last examination.
b) Meetings with external/internal auditors, other supervisors and regulatory bodies:

The pre-examination meeting should also cover a summary of matters that arose from meetings with the institution’s external/internal auditors and other regulatory bodies. The summary should include key control issues raised by the auditors as well as the management responses thereto.

4.1.5 Determining the scope of examination…..

The examination scope memorandum is a tentative document that varies from time to time depending on the purpose and risk profile of an institution. The scope memorandum should clearly state the key issues to be reviewed in an on-site examination. This should take into consideration the issues raised during the pre-examination meetings and also from prior examinations in order to monitor progress and assess remedial measures taken to address them. The institution’s financial performance and condition since previous examination should be provided in summary form for incorporation into the scope memorandum.

In designing the scope memorandum, the supervisors should draw a risk matrix to identify areas to be covered. The sample matrix for determining the scope memorandum is provided below;

<table>
<thead>
<tr>
<th>Table 3.1 Scope of the Examination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent Risks</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Risk Level</th>
<th>Aggregate Risk</th>
<th>Review Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Moderate to High</td>
<td>Limited Review</td>
<td>Moderate to High Aggregate Risk Minimum or a limited review, broader testing on target areas.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>High Aggregate Risk Full Scope Review</td>
</tr>
<tr>
<td>Moderate</td>
<td>Moderate Aggregate Risk</td>
<td>No Review</td>
<td>Moderate to High Aggregate Risk Limited Review at a minimum</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Moderate to High Aggregate Risk Full Scope Review</td>
</tr>
<tr>
<td>Low</td>
<td>Low Aggregate Risk</td>
<td>No Review</td>
<td>Low Aggregate Risk No Review</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Low to Moderate Aggregate Risk Limited Review</td>
</tr>
</tbody>
</table>

Source:

As a result of additional information obtained in the course of on-site examination from discussions with management, review of policies and procedures, internal control reports and any other documents, the scope may be adjusted, expanded, contracted or otherwise refined.

5. PERFORMING AN ON-SITE EXAMINATION
The actual on-site examination takes place once a scope memorandum has been completed. However if any thing occurs during the examination that affects the contents of the scope memorandum, adjustments should be done accordingly.

The examination should start with an Entry Meeting which formally commissions the exercise, indicates the scope and highlights any supervisory concerns in particular those raised in previous examinations (both off-site and on-site). The examination procedures that will be applied should be consistent with the risk assessment done, supervisory plan and the scope memorandum (refer to table).

The major results of the examination shall be communicated to the institution after completion of the examination in the Exit Meeting and in the final Examination Report. This shall be done in clear and concise manner that will ensure mutual understanding between the institution and the supervisor. The findings will be presented to the functional heads, senior management in the Exit Meeting and the bank’s board of directors.

The bank would be given two weeks in which to acknowledge receipt study and review the final report.

**Layout of Examination Report**

The report of examination should be presented in a standardised format. Based on the condition of the institution and its risk profile, examiners may alter the structure of the report to better reflect the weaknesses unveiled during the examination. The report consists of five major sections which are briefly discussed below:

a) Executive Summary
This section generally outlines the objectives and scope of examination, overall ratings (CAMELS and Risk Assessment) and major issues of concern requiring attention.

b) Core Assessment
This section covers the areas inspected applying the core examination procedures, the risk management review and the CAMELS assessment.

c) Findings and Recommendations
All significant findings and the relevant recommendations are tabled in this section in this format:

Relevant local codes or best practice guideline
Description of Finding
Impact
Recommendation

This will be attached as an appendix to show the importance of aligning the findings with recommendations in order to avoid situation whereby the bank cannot be sure of what to do. In some jurisdictions such as the banking law in Lesotho, the recommendations actually become directives and the bank has to comply. The good thing with this method is that the implications of the deficiencies are shown, and the impact to the institution can be ascertained. It also provides the institution as well as the regulator with a clear outline of issues and makes follow-up an attainable task. This section can also be attached as an appendix where findings are many to cut the length of the report. HKMA also has adopted this format of the report where findings are exclusively put in the report.

d) Auxiliary Section
This section provides all the supporting documents such as the financial statements, ratios, concentrations, loan classification summary, functional risk matrix and any other relevant information. It acts as a supplementary part since it explains the bank’s position in
summary form. The bank’s position can be fully understood by reading/interpreting the tables.

d) Receipt of Acknowledgement Form signed by the Board of Directors

This section relates to that part of the final examination report on which the Board of Directors of the examined bank sign off the report to acknowledge receipt thereof. The signatures shall not mean that they agree but shall serve as evidence of the fact that they have gained knowledge of the findings and conclusions.

3.2.6. CONDUCTING OFF-SITE SURVEILLANCE

The Off-site is a critical and continuous leg of risk based supervision. It follows the risk assessment done and the supervisory plan. However due to its nature of providing current information of the institution, it also serves as a monitoring and follow-up process. Follow-up on recommendations and directives to the institution shall be made to ensure that the examination findings are addressed to avoid repeat findings.

Various analysis and reports are generated on a periodic basis using qualitative and quantitative information submitted through regular statutory returns and other reliable sources of information. However the main report is the Quarterly off-site analysis which will provide a lucid picture of the institution status. It is imperative that the Portfolio Analyst and senior personnel in Supervision formally and informally gather and share information about the condition of the bank.

Layout of Off-Site Analysis Report

1. OVERALL CONDITION
2. MARKET SHARE, RANKING &SIGNIFICANT DEVELOPMENTS
3. SUPERVISORY ACTIONS IN PLACE OR PENDING

4. CURRENT SUPERVISORY STRATEGY

5. ASSESSMENT OF CAMELS FACTORS & STRESS TESTING

5.1 Capital Adequacy
5.2 Asset Quality
5.3 Management
5.4 Earnings
5.5 Liquidity and Funds Management
5.6 Sensitivity to Market Risk

6. COMPLIANCE TO SUPERVISORY ACTIONS

7. MATTERS REQUIRING ATTENTION

8. RECOMMENDATIONS FOR FOLLOW-UP

6.3 Off-site Monitoring

The objective of this step is to follow up on implementation of the supervisory directives and recommendations made to the institution. The Portfolio Analyst should maintain an on-going list of issues to be followed up with the institution within a specified timeframe.

The Portfolio Analyst should update the Institutional Profile, Risk Assessment Summary, Risk Matrix, and Supervisory Plan to reflect significant information arising from Off-Site analysis and on-site examinations. These updates are generated on a periodic basis using quantitative and qualitative information submitted through regular prudential returns and other sources of reliable information.
It is imperative that the Portfolio Analyst maintains continuous contact, formally and informally, with the institution(s) and the market in general, to gather information about the condition of the institution(s).

6.4 Quality Assurance

The objective of Quality Assurance process within supervision unit is to ensure consistent, high quality work, and conformity to international best practice. The Quality Assurance programs cover both off-site and on-site quality control processes, to ensure that supervision tasks undertaken are in compliance with established policies and procedures. All key off-site reports should be reviewed by Section Head, Division Head and Director. Similarly, on-site reports should be subject to review process as follows:

a) All working papers relating to examined areas are reviewed by the Examiner in Charge;
b) All working papers and reports are reviewed by the Section Head;
c) A meeting should be held to discuss the draft examination report by entire on-site team;
d) The draft examination report should be reviewed by the Division Head; and
e) Review by the Reports Review Committee or the Director responsible.

3.3 TESTING THE METHODOLOGY

Once the policy framework has been designed, the supervisor tests the new method by conducting a pilot examination. The pilot examination is performed so to experiment with the advanced framework in order to assess the level of response from banks and understanding of supervisors. The results for the test come in a form of feedback from the banks regarding the new approach and also the examiners experience. Having the feedback assists in making proper adjustments to the framework. However it is critical to change the framework to customise it the local environment.
3.4 DEVELOPMENT OF EXAMINATION MANUALS AND WORKING PAPERS

The on-site examinations normally outline the procedures to be performed in undertaking an examination. They normally cover all operations and activities of the bank. With the development of the risk–based procedures, the focus is more on risks rather than on the operations and functions and the extent of the examination is driven by either high risk-intensive procedures or low risk-standard procedures.

The manual should follow the six step which is consistent with the framework. The procedures should cover the overview of the institution, the risk assessment process which entails understanding and profiling the risk characteristics of a bank from its inherent risk to the residual and direction of risk. They also should cover each specific risk. However the challenge in applying the procedures should be noted in where the risk is derived from many functions, for example, the credit risk which is derived from the credit and treasury transactions. The examiners have to take care of the overlaps. There is also an overlap of issues with CAMELS and Risk Assessment System, for example, asset quality and credit risk which should be tread with caution.

The completion of a risk matrix should come as a result of proper guidance to the risk assessment. Since the examiner’s judgment plays role in determining the bank’s position and how risk is handled, there should be guidance as well to ensure consistency and transparency on examiner’s opinion.

Since the level of risk dictates the kind of examination that will be taken, it is imperative also to have clear indicators of what is low risk and which procedures will be applied and vice versa. Another vital aspect is to have procedures on consolidated supervision since the examination extends beyond that supervised entity. It may mean a financial institution is a part of the group and or which may have business across other jurisdictions. In this case, the regulator has an option to view consolidated supervision as a separate and time-worth project to the betterment of supervision.
Another important aspect of the manual is to present the treatment of problem banks and corrective action. The regulator should state indicators of a problem bank and the appropriate action. The Basel Committee has general guidelines for supervision of weak banks. Apart from consolidated supervision, this is also a project that needs full attention and its framework and manuals should be developed separately.

3.5 REVIEW OF OFF – SITE SURVEILLANCE

The off-site surveillance method is a core component in the implementation of risk based approach because it provides a continuous assessment of supervised financial institutions’ financial performance. The off-site surveillance entails analysis and monitoring and the results are incorporated into preliminary risk assessments for the on-site examinations, the risk assessment summary, the CAELS rating and the update of the institutional profile.

The most critical part of off-site surveillance is that it is meant to be used an early warning tool hence reports should be forwarded to the financial institutions for action. The banks are already furnishing the regulator with the timely returns which the analysis is derived from. The review that comes with risk based supervision is that the off-site reports were not consistent with the on-site examination reports. Traditionally, the off-site had various reports based on the returns such as liquidity, capital adequacy and exposure to large borrowers and so forth. Therefore apart from these piece-meal reports, the main shift is having the key report for off-site surveillance as the quarterly report which is formatted the same way as the on-site examinations’ although its style is brief. It clearly demonstrates the CAMELS and the risk ratings and the main supervisory concerns and conclusion.

Another issue is the aspect of holding trilateral meetings with the external auditors and the bank to discuss key issues arising out of the external audits including the weaknesses identified in
internal controls, adequacy of provisions and compliance with the international financial reporting standards and the compliance with the requirements of the banking act. These meetings add value since traditionally few institutions relied on the audit work, they tend to repeat the work that is already done, hence by so holding these meetings redundancy ceases. The examiner has the comfort to rely or not to rely on the work done.

3.8 TRAINING

It has been said in so many ways that risk based supervision requires a mind-shift as it is proactive rather than reactive. It requires sound judgment of the examiners. It also requires banks to have internal risk management systems and these systems have proven to include sophisticated models and techniques in terms of risk recognition and measurement. This requires the examiner to have a full and sober appreciation of the individual risks, the risk management systems and most importantly how to assess these risks and the adequacy of these systems. That means the examiner should have extraordinary skills so as to understand the bank’s business and to supervise it. There exists variety of training platforms for smooth implementation and enforcement of the new approach.

The skill-set required by supervisors has changed radically over the past few years. With the introduction of technology and new products and the move towards risk-based supervision, the demands on supervision have also increased. Reserve Bank of India (2000)

It has been indicated that the core team can play the trainer of other staff hence they could be handpicked and trained specifically to train other and transfer the skills. However as already stated earlier this approach is suitable for a large number of staff; where the number of staff is minimal, all examiners can be trained. This training ensures that all relevant staff is taken on-board. There should also be training for management and supervisory roles to ensure that the fundamental concepts of and any changes that the framework bring are imparted to all so as to maintain the so required quality assurance of supervision work.
The staff can also be taken on study tours or attached to other jurisdictions in order to learn practically from other regulators. It has been proven to be an effective method by the East AFRITAC. The intention is to transfer skills and the incumbents should not necessarily copy but should grasp the principles of examination and analysis and develop the same for the home supervisor.

In dealing with banks, the implementation roll-out should be done step by step from inception whereby the banks are sensitized of the modernisation to the supervision approach. This should be followed by a survey to assess the level of appreciation of risk management in banks. This is critical since in some countries the banks belong to international group of companies or a foreign parent which may be well ahead in terms of risk management or even lagging in host supervisor jurisdiction due to lack of risk management guidelines. For example in Lesotho, three of her banks are subsidiaries of banks in South Africa. Thereafter the guidelines (refer to risk management programs above) should be formulated which of course should be forwarded to the banks for comments. Once they are formalised, these become the blue-print for banks to align their risk management structures even if they already had them. The risk based approach involves consistent and frequent communication which was not common with the traditional approach therefore the banks should be made aware of such changes. A special seminar after the pilot examination should be held for the high level bank management in order to gain their invaluable experience and comments on the whole new approach.

3.7 CONCLUSION

Risk based supervision implementation is of course a challenging turn of events and comes at the backdrop of so many failures. It is indeed a holistic project since it is an upgrade to the existing method and should not be taken to replace the traditional approach. Therefore the link between the two systems, the CAMELS and the RAS should be identified clearly in order to do away with overlaps and gaps that may be brought by the advancement.
Therefore the steps of implementation facilitate ease task and clear documentation of the approach. The banks risk management systems should clearly indicate the identification, measurement, monitoring and control of the risks. The guidelines also should provide each specific risk and how it is managed from the top management to the general personnel of the bank in order to be consistent with the bank’s risk profile.

Any change requires step-by step implementation for the sake of understanding the concepts and bringing everybody on board. This means that the timed roll-out and the training play an important role. The process should not be too slow lest the progress is lost and not too fast lest the concepts are raped. A balance is vital hence the theoretical aspect should be balanced with the practical side of the project. The examiners and management should all be trained accordingly.
CHAPTER 4  RECOMMENDATIONS FOR IMPLEMENTATION OF RISK BASED SUPERVISION IN LESOTHO

4.1 Introduction

The step by step implementation of risk based supervision evidently is effective as the supervisory agencies that have deployed the method already states. However, the situational analysis is vital since there is need to determine the level of knowledge of the examiners, the current structure of banking supervision, the current manuals for the off-site surveillance and on-site examinations so as to ensure smooth transition and also to avoid redundancy between the traditional approach and the enhancement. There are chances of overlaps in the assessments and one has to be careful not to repeat what is already available to minimise repetition and redundancy. There are areas where the supervisor’s focus in applying CAMELS and risk assessment ( ARRMAD) is on the same issues for example, credit risk versus asset quality, market risk versus sensitivity to market risk, strategic risk and compliance risk versus management. Caution should also be taken as some terminology or words may mean the same thing but to bring emphasis on risk are given a different term under risk –based supervision.

Therefore what has been noted is that risk focused supervision has been practiced in Lesotho only that there was no formal framework hence as explained earlier, Lesotho supervisors could be currently conducting some aspects of RBS but not as structured as in RBS, for example, the conducting of prudential meetings. Due to lack of a policy framework some critical steps of effective supervision were skipped, for example, the meetings were held during the examination and as prudential meetings to asses the bank’s operations and risk profile. Communication is also emphasised in the Basel core principles. In RBS they are called prudential meetings and follow a formal structure which is not present currently, however the discussion points may not differ since the subject matter is the institution to which they relate to.
In addition, it is worth reiterating that the majority of banks in Lesotho are subsidiaries of South African banks therefore already have risk management function and certain risk management systems which may not necessarily follow the same pattern as the recently drafted guidelines but the subject coverage is the same. Therefore implementation of RBS is a tedious task since similarities and differences to the current approach should be clearly distinguished and captured.

The main advantage or RBS is that it provides a formal set-up of performing the supervision process which brings consistency to the conclusions made by examiners and preserve continuity on assessments hence promoting reliable and informative reports. The same assessment may be common to both traditional and RBS but RBS has formalised all the steps with the focus on risks and impact. Therefore the formalised method in the form of the policy framework provides a clear blue-print to supervision areas, issues of concern, the lagging risk indicators and the rating of each indicator so as to know whether the risk is low or high and add value to supervision.

4.2 Key factors for consideration

4.2.1 Paradigm shift
Risk based supervision is seen as an advancement of the supervisory method and like any other change requires supervisors to have an open mind to accept the changes it brings. Paradigm shift simply means “moving from one thought system to the other” This is highly critical for supervisors which were already applying risk focused supervision in their supervision and yet not having that explicit structure. Most of the exercises and methods in RBS were practised by supervisors around the MEFMI region and but lacking some of the formal structures within the RBS which also comes with enhancements such as the risk matrix and the risk ratings.

4.2.2 Coordination between Off-site Surveillance and On-site Examinations Section
As already indicated the FISD has two separate functions as stated above. These two sections presently struggle to feed information into each other due to lack of common reporting format. As already indicated the off-site has various reports emanating from the returns and has no single report that captures the overall bank condition whereas, on-site has a single report although divided into two supervisory and bank report that capture the overall condition of the bank including any deficiencies noted and any policy issues or implication that the Central bank may need to take up.

In this instance RBS comes in handy as it provides a common ground for reporting both on-site and off-site assessments. Both reports are expected to cover the main conclusion of the analysis, the CAMELS and Risk ratings, and any supervisory concerns and corrective actions. However an off-site report is expected to be epigrammatic contrary to the on-site one which is meticulous. Therefore the reports of the Central Bank both on-site and off-site will have to be streamlined accordingly. A continuous quarterly report will be introduced for Off-site.

Another issued relating to Off-site reporting was that it is utilised internally by the central bank management to discuss supervisory concerns and with relevant supervisory action and it was never furnished to the relevant supervised entity. So for the first time the banks are going to receive this report and the banks are expected to act accordingly.

The main issue related also to the FISD structure which has two separate sections. There is an option to combine the two in order to maximise coordination. Since 2008, On-site examinations section currently runs a portfolio management of banks therefore, an examiner is responsible for a particular bank and during the examination that portfolio manager is the examiner-in charge however this is meant to run on a rotational basis. The benefits are such that an examiner becomes familiar with banking operations by dealing with one bank and also provides the examiner with the benefits to sharpen the skills. Rotation assists in that banks differ so examiners get exposed to different challenges and also that in itself allows the bank to be
managed by different skills and compliments any skills gaps that might have been there previously. When these two sections are combined, this style of portfolio management should be continued with, and during off-site surveillance the portfolio analyst /examiner will still run the show for a specific bank on a rotational basis, preferably two years.

This would facilitate continuous monitoring of the banks and knowledge about the banking operations for the examiners. This will also enhance communication between the bank and the supervisor as there will be that responsibility tied to individuals and it will be easy to get information on any bank in particular updates and follow-ups.

4.2.3 Staffing Arrangements

The subject of combining these On-site and Off-site sections is critical as it expands further to the staffing levels, recruitment of varied skills and retention programmes. The Bank has a daunting task to undertake as it is currently staffed with the same set of skills which is accounting. RBS has indicated that being risk sensitive supervisor, there will be a need to deploy a range of skills from statistics, economics and law. There will be a need to validate models, to contextualise banking into the economy and interpret the sector against its environment and to be legally conversant so as to ensure that all legal implication associated with innovative banking operations and supervision are well captured. With the latter, the Basel core principles advocate for a flexible legislative framework and indeed banking has become so dynamic and the regulator cannot afford to be stagnant.

Risk management is topical in the financial sector and is a critical skill and the Bank should develop such a skill as it will contribute to immensely the efficiency of financial sector in Lesotho. This issue however gives birth to a sensitive issue of retention of staff which means remuneration should commensurate the level of responsibility expected out of Supervision staff. Otherwise the Bank might face the staff leaving due to risk management skill demand in the private sector. Some supervisors such as National Bank of Ethiopia, Central Bank of Kenya
have lost most of their staff, who were top gurus in risk management, to the commercial banks. The East Africtac also raised retention of staff as an issue of concern and emphasised the importance of competitive pay for examiners lest they flee to greener pastures. This implies that the banks’ compliance will elevate leading to minimum supervision from the regulator, and certainly, in the short term the regulator might seem to be losing but in the long term the financial sector gains skill and stability meaning the main regulatory goal would have been achieved.

4.2.4 Training needs

Training is a common phenomenon which only means to capacitate staff with basic and exceptional knowledge about their job and the necessary skills to deliver the job expeditiously. Its importance is demonstrated by the price tag that it has and sometimes companies perceive it as a trajectory to be avoided at all cost but not training staff actually is even more costly because it means people deliver using their own means without having a common understanding about the same concepts. So training of staff enhances knowledge and also levels the playing field amongst staff and any additional personal developments represent bonus to the organisation and the individual.

Examples of relevant training for examiners range from attachments, in-house training and workshops. Attachments are very useful as the person is allowed to learn by observation and experience from those who are already in that field. Consequently it covers the practical aspects of a subject in particular on introduction of a new system in this case RBS. The relevant workshops also assist with the head knowledge as there is an intellectual discourse, academic premise and hypothetical examples that the incumbents will learn from. Examiners have to understand each specific risk, for example, credit risk, how is it measured and what indicators are there to assist the examiner in making the precise judgement. It has been said that the
examiner’s greatest tool and asset is judgment. In house training is more beneficial as it addresses specific subjects of concern to the relevant staff. Therefore the Bank should train its staff accordingly and the three types of training combined enhance the individual’s skills and the corporate or team skills.

To put emphasis, Lesotho’s jurisdiction has some SA subsidiaries which have already deployed risk management systems including the risk measurement techniques such as models that need thorough understanding from the examiner’s point of view. The examiner is expected to validate the models to ensure that they are realistic and interpretable. These banks have already implemented the Basel II measurement techniques and report to their parent company using Basel II requirements as their parent supervisor the Reserve Bank of South Africa requires so. This brings into perspective the issue of consolidated supervision which in all honesty is another worthy project and great challenge that still has to be pressed since SARB’s supervisory methods and regulatory requirements have an impact on CBL’s jurisdiction.

The need for training is emphasised indirectly in the Basel core principles by mention of the fact that “each such agency should possess operational independence and adequate resources (including staffing, funding and technology) to meet the objectives set, provided on terms that do not undermine the autonomy, integrity and independence of the supervisory agency”. The writer believes instilling knowledge and appropriate skills goes a long way in supporting integrity since supervision will be done with diligence and objectivity so required and financial stability will certainly be achieved.

In conclusion, with right skills the bank will perform to the utmost ability and with necessary caution therefore minimise chances of any unnecessary litigation. This will result in minimisation of provision of legal protection from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties. However, the writer has a resolute ideology that a central bank may look at the staff move to the
commercial banks as positive with the comfort that the market will be served by personnel from the regulatory point of view.

4.2.5 Budget

The implementation of any systems requires the financial backing to be a success. Therefore it is highly necessary for the bank to set aside funds for this project as this means technical assistance will be sought in terms of in-house trainings, attachments and workshops. This means that examiners will have to travel to explore other supervisors’ knowledge not only in the region but internationally to have diverse knowledge which will be complementary to the regional skills. There should be workshops that staff go to in order to have the general idea of this methodology.

Another important financial implication is that in cognizance of that new staffing arrangement should be made including the recruitment of varied skilled persons and all the necessary resources.

4.3 Implementation Roadmap

The road map followed should be guided by the experience of other jurisdictions in the region. Most of the countries in the region conducted surveys which were focused on risk management and control environment of banks. The study also justifies that not only the financial crises in other countries played part or that this is just an international best practice as said but indeed it is relevant to our society, economy and jurisdiction. Some of the concepts have been good and recommended and practiced but financial scandals and failures still appear.

Therefore it is advisable also to have a full report on the banking sector and the supervisory outlook at the time of implementation. This helps a great deal to those who were not aware of the status quo and what the change in methodology brings. It also provides a full history of the banking sector and its regulation at that time. Publishing all policy documents and surveys made to the public necessary and ensure transparency and accountability. This will facilitate appreciation of the banking sector and the regulatory framework by the public and any potential investors.
<table>
<thead>
<tr>
<th>Activity</th>
<th>Timelines</th>
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<tbody>
<tr>
<td>a. Testing the supervisory framework through pilot examinations to as an experiment</td>
<td>September 2010</td>
</tr>
<tr>
<td>b. Approval by CBL management of risk based supervision policy framework for the supervisor</td>
<td>June 2011</td>
</tr>
<tr>
<td>c. Workshop stakeholders( CBL, banks) about the risk management in banks and the need for a revised methodology in banking supervision</td>
<td>July 2011</td>
</tr>
<tr>
<td>d. Publishing the risk management survey results to ensure transparency to the market and public</td>
<td>July 2011</td>
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<tr>
<td>e. Finalise the Risk Management Guidelines for Banks</td>
<td>July 2011</td>
</tr>
<tr>
<td>f. Allowing the banks to align their risk management systems with the draft guidelines</td>
<td>March 2012</td>
</tr>
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<td>g.</td>
<td>November 2010</td>
</tr>
<tr>
<td>h. Issuance of Risk Management Guidelines</td>
<td>March 2011</td>
</tr>
<tr>
<td>i. Approval of the risk based policy framework , issuing to the public and banks</td>
<td>December 2010</td>
</tr>
<tr>
<td>j. Testing the supervisory framework</td>
<td>From October 2010</td>
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<td>through pilot examinations to as an experiment</td>
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<tr>
<td>k. Making adjustments where necessary on the supervisory framework (After one more on-site examination)</td>
<td>April 2011</td>
</tr>
<tr>
<td>l. Making an addendum of a risk based manual to the current manual to capture risk focused procedures</td>
<td>December 2011</td>
</tr>
<tr>
<td>m. Draft and promulgation of new set of regulations such as corporate governance, consolidated supervision</td>
<td>June 2012</td>
</tr>
<tr>
<td>n. A study of the full banking sector and the regulatory framework and publishing it to the public</td>
<td>December 2012</td>
</tr>
<tr>
<td>o. Training of relevant staff</td>
<td>On-going</td>
</tr>
</tbody>
</table>
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