SUPERVISION GUIDELINE NO. 9

ISSUED UNDER THE AUTHORITY
OF THE FINANCIAL INSTITUTIONS ACT 1995
(NO. 1 OF 1995)

RISK MANAGEMENT

Bank of Guyana
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TABLE OF CONTENTS

1.0 Introduction

The Bank of Guyana (BOG) considers issues in risk management to be of sufficient significance to warrant a separate Supervision Guideline. This Guideline sets out the minimum standards that shall be expected of a risk management framework in a licensed financial institution.

2.0 Management of Risk

Risk-taking is inherent in the business of any enterprise, none more so than financial institutions. A financial institution's decisions on business objectives and strategies must be made in the light of decisions taken regarding the nature and degree of risks the institution is prepared to assume and the measures it will use to manage and control those risks.

For the purpose of this guideline, risk in a financial institution refers to the possibility that the outcome of an action or event could create adverse impacts on the institution's capital, earnings or its viability. Sound risk management systems enable managers of the institution to take risks knowingly, reduce risks where appropriate and strive to prepare for a future, which by its nature cannot be predicted with reasonable certainty.

Risk management systems and practices will differ, depending on the scope and size of the institution, the nature of its risk exposures and its risk tolerance or appetite. But whatever the particular approach, every institution should have integrated policies that, taken together, apply to the organization's significant activities regarding the corporate philosophy on risk management, the institution's permissible exposure to risk, objectives of risk management, delegation of authorities and responsibilities, and processes for identifying, monitoring and controlling/managing risk. The approach should be tailored to the particular nature of the institution and can, for example, have different degrees of centralization or decentralization and be organized in various ways. It should enable the board of directors and senior management to meet their organization-wide responsibilities. Comprehensiveness is a key attribute of effective risk management.

Risks may arise from direct exposure or through exposures taken by subsidiaries or affiliates. In either case, the licensed financial institution should be in a position to identify all the significant risks it faces, assess their potential impact and have policies in place to manage them effectively. The licensed financial Institution should review its policies and practices regularly to ensure that they remain appropriate in light of changing circumstances and in light of how policies and practices have performed. Along with senior management, the board of directors is responsible for overseeing the performance of such reviews.

Effective risk management increases the prospect of business objectives being achieved, whereas neglect of this responsibility can have consequences for the board of directors and senior management and fair treatment of customers, with resulting damage to the business. The BOG places significant emphasis on the board of directors and senior management taking responsibility for the licensed financial institution's systems and controls and, in particular, assessing and managing risks. This is evident by Supervision Guideline No. 8 – Corporate Governance.

A licensed financial institution which can manage its business well and demonstrate effective risk management procedures and processes is likely to receive less supervisory attention. Good risk management should not be thought of primarily as necessary to comply with BOG's guidelines, but rather as a route to improved business effectiveness and performance. Risk should become a factor in strategic and business planning and in performance reviews. Multi-year business plans ought to include reference to the key business risks of the licensed financial institution in terms of macro-economic risks, business environmental risks, processes and systems risks and people risks, among others, coupled with a focus on the controls related to those risks.

In some licensed financial institutions, complex risk management systems may not be necessary as there is no prescribed risk management system that works for all. However, individual directors and senior managers ought to maintain a reasonable level of understanding of all of the key issues and processes within the business and tailor its risk management system to its needs and circumstances. The board of directors has ultimate responsibility for the level of risk taken by its institution. Accordingly, the board of directors should approve the overall business strategy and significant policies of its organization, including those related to managing the activities that the institution conducts.

2.1 Risk Tolerance

Risk tolerance defines the level and nature of risks to which the board of directors of the licensed financial institution considers it is acceptable to expose the institution.

Risk tolerance may be defined differently for different categories of risk. In financial institutions, risk tolerance is commonly applied to activities such as lending and investments. Often the tolerance levels are derived from, or lead to, the authority limits established for the institution. Tolerance may also be defined in terms of the "damage" that the licensed financial institution is prepared to accept in its key business areas. For example, "damage" may be measured by the potential impact on

- Capital and its replenishment and cost
- Profits and returns to shareholders and other stakeholders
- Achievement of objectives
- Reputation
- Relationships with authorities

Clear definition of risk tolerance and its regular review in the light of operational experience will ensure that the respective tolerance levels remain relevant and are contributing to the decision-making process.

3.0 Risk Categories

While the risks to be managed by a licensed financial institution will reflect an institution's business and strategic plans, the following risks will be common to virtually all:

3.1 Credit Risk (Assets)

Credit risk arises from a counterparty's inability or unwillingness to fully meet its on and/or off-balance sheet obligations as they fall due. A counterparty may be a borrower, issuer of debt instruments, broker, dealer or guarantor.

3.2 Market Risk

Market risk arises from exposure to changes in market rates or prices. Exposure can result from dealing and position-taking activities in securities, currencies, commodities and other investment instruments.

3.2.1 Interest rate risk

Interest rate risk arises from exposure to movements in interest rates and usually results from differences in the timing of repricing of the assets and liabilities of an institution as they either mature (fixed rate instruments) or are contractually repriced (variable rate instruments). Such differences may be referred to as the maturity gap or maturity transformation gap.

3.2.2 Foreign exchange risk

Foreign exchange risk arises from exposure to movements in the rates of exchange of foreign currencies and results from an institution carrying net open positions, spot and forward, on and off-balance sheet, in one or more foreign currencies.

3.3 Operational Risk

Operational risk arises from exposure to difficulties in the performance of business functions or processes resulting from technology failures, internal control deficiencies or breakdowns, staff deficiencies, human error, dishonesty, or natural disasters.

3.4 Liquidity Risk

Liquidity risk arises from the exposure of an institution to the possibility that it will be unable to obtain the financial resources necessary to enable it to honour its contractual obligations, on and off-balance sheet, as they fall due.

3.5 Legal Risk

Legal and regulatory risk arises from an institution's non-compliance with legal and prudential requirements, standards of governance or contractual obligations in the jurisdictions where it operates.

3.6 Reputation Risk

Reputation risk may arise from the possibility that negative publicity regarding the institution and its business practices, in the territory or elsewhere through related entities, and whether accurate or not, will adversely impact the operations and position of the licensed financial institution. Reputation risk may also arise from an institution, or an affiliate, being domiciled in a jurisdiction where the legal and organizational framework for the regulation and supervision of financial institutions is generally viewed as failing to meet international standards for the protection of consumers of financial services and for the prevention of sheltering the proceeds of organized crime.

3.7 Strategic Risk

Strategic risk arises from the inability of an institution to devise and implement appropriate business plans and strategies, make effective decisions, develop appropriate organizational structures or adapt to changes in its business environment in a timely way.

3.8 Conglomerate Risk

Conglomerate risk arises from the potential that exposures to components of a group of related financial and non-financial enterprises will result in losses due to failures in other components of the group to honour their commitments to the institution.

4.0 Implementing Risk Management

To determine the most effective risk management process, a licensed financial institution needs to consider the scale, nature and complexity of the risks to which it is exposed, all within the context of the size and nature of the firm.

Regardless of the risk management process in a licensed financial institution, it is essential that the process has the full involvement of the board of directors and senior management.

As risk management entails the planning and controlling of the impact of the risks assumed by a licensed financial institution on its operations and financial position, a sound risk management process, apart from active board and senior management oversight, should address:

- identification of risks
- development of systems for the measurement of risks
- establishment of policies and procedures for the management of risks
- development of risk tolerance limits and monitoring of positions against limits
- reporting of risk monitoring results to senior management and the board
- comprehensive internal controls

4.1.. Level of Responsibility

The first level of responsibility is with management, which must ensure that a comprehensive risk management process, which identifies, monitors, and controls different types of risks, is in place. It should establish prudential norms for different risks which may not be breached lightly. The board of directors must carefully review and approve the adequacy of the risk management policies, systems and procedures proposed by management. This is an important task for the board of directors and, if deemed necessary, it should seek expert advice from outside the financial institution. While all institutions should have policies and procedures that address their significant activities and risks, management is expected to ensure that these policies and procedures are modified when necessary to respond to significant changes in the institution's activities or business conditions. The board of directors should periodically review management's performance in controlling the risks in accordance with established policies and the risk appetite and tolerance of the licensed financial institution. Any departure from the acceptable prudential norms should be supported, rationalized and approved by the board of directors. However, deviations from the acceptable prudential norms should be avoided.

4.2 The Role of the Board of Directors in Risk Management

The board of directors has a number of oversight responsibilities with respect to risk management. Effective board practices include that the board of directors:

- must have a general understanding of the types of risks to which the licensed financial institution may be exposed and of the techniques used to measure and manage those risks;

- carefully reviews and approves the business strategy and significant policies of the institution including those related to taking and managing risks. In the review, the Board of Directors could seek expert advice from outside the institution. The BOG expects the board of directors to be aware of material changes to the institution's business strategies or risk tolerance and the limits within which individuals are authorized to act;

- reviews and approves significant policies or changes in policies for assessing, monitoring, managing and reporting on the significant risks to which the licensed financial institution is exposed;

- requires that management has a process for determining the desired level of capital, taking into account risks assumed, and for ensuring that capital management strategies are in place;

- requires from management timely and accurate reporting on significant risks faced by the institution, the procedures and controls in place to manage these risks, and the overall effectiveness of the risk management process. The board of directors should be aware of, and be satisfied with, the manner in which material exceptions to policies and controls within the institution are identified and monitored, the nature of reporting to the board, and the consequences within the institution, when exceptions are identified;

- assures itself that the risk management activities of the institution, however organized, have sufficient independence, status and visibility and are subject to periodic reviews;

- ensures that the licensed financial institution's policies and systems are effective enough to achieve a prudential balance between the risks and potential returns to the shareholders;

- includes in its reviews of changes in strategies or new business initiatives, a review of requisite/related changes in risk management process and controls.

The board of directors should not treat the above list of responsibilities simply as a checklist of criteria requiring extensive, documented policies and procedures. Rather, the BOG is of the view that these general attributes of board performance are important for board effectiveness. It

is recognized that individual institutions will adopt different approaches to board oversight of risk management, taking into account the nature, scope, complexity, and risk profile of the institution.
In order to facilitate its work, the board of directors may establish a specialized risk management committee, with the mandate to review the adequacy of risk management policies and systems, and to monitor the effectiveness of those policies and systems. Policies should be well-documented.

5.0 Risk Management Control Functions

A sound risk management system will include a number of independent control points or functions.

5.1 Operational Management

Operational management is responsible for planning, directing and controlling the day-to-day operations of the business activities of a licensed financial institution including the development of documented operational plans, the appointment of competent and adequate staff and the implementation of reliable and secure information systems.

5.2 Financial Analysis

Insightful analysis of the operating results and financial position of a licensed financial institution and the timely reporting of the results of the analysis to the senior management is a key function in the risk management process, providing essential input to the making of business decisions.

5.3 Compliance

Compliance is determined by the set of activities within a licensed financial institution which

a) confirms adherence to the policies and procedures of the legal and regulatory requirements in the jurisdictions where the licensed financial institution operates;
b) monitors the licensed financial institution's compliance with its internal policies and procedures, and
c) reports on compliance matters to senior management

5.4 Internal Audit

Internal audit is an independent function within a licensed financial institution that assesses adherence to, and effectiveness of, operational and organizational controls. Internal audit may also assess adherence to, and effectiveness of, compliance and risk management policies and procedures. These functions are in addition to the basic internal audit function to protect the assets of the licensed financial institution.

5.5 Senior Management

Senior management is responsible for planning, directing and controlling the strategic direction and general operations of the licensed financial institution. Key responsibilities include:

- ensuring that organizational and procedural controls are appropriate and effective
- ensuring compliance with approved policies and procedures
- developing and implementing strategies and plans to achieve approved strategic and business objectives
- developing sound business practices, culture and ethics in the licensed financial institution.

5.6 Board of Directors

The Board of Directors is responsible for providing management oversight of the licensed financial institution and accepting fiduciary responsibility for the stewardship of its assets. Normally, the board of directors and senior management will delegate responsibility and accountability for day-to-day management of specific activities to Operational Management. The carrying out of that responsibility entails the assurance that the policies, procedures, controls, reporting requirements and levels of qualified staff are sufficient to effectively compensate for the risks inherent in the particular activities. The organizational structure and control mechanisms must be effective in preventing material errors or irregularities, or in detecting them should they occur.

Key responsibilities include:

- ensuring management is qualified, competent and of good character
- reviewing and approving organizational and procedural controls
- ensuring that principal risks are identified and effectively managed
- reviewing and approving policies and procedures for the principal activities of the licensed financial institution
- reviewing and approving strategic and business plans
- receiving an independent assessment of risk management controls

6.0 Bank of Guyana's Assessment of Adequacy of Risk Management

The risk management practices of a licensed financial institution would be evaluated by the Bank of Guyana. The evaluation may include most of the following:

- oversight by the board of directors and senior management
- documented risk management policies and procedures
- documented procedures to ensure compliance with corporate and regulatory requirements
- documented operational plans
- adequacy and competency of staff

- regular and timely analysis and reporting of results
- effective and independent internal audit
- independent external audit

The extent to which the evaluation is applied in any licensed financial institution will depend largely on the size and complexity of its operations.

The extent to which the Bank of Guyana needs to review the operational risk management practices will depend upon the presence and effectiveness of other control functions; for example, evidence of well-documented risk management procedures together with a sound internal audit programme.

6.1 Characterization of Sound Risk Management

When assessing the adequacy of a licensed financial institution's risk management systems for identified functions or activities, the Bank of Guyana will place primary consideration on findings related to the key elements contributing to sound risk management, such as:

- Active board of directors and senior management oversight
- Adequate policies, procedures, and limits
- Adequate risk management, monitoring and management and information systems;
- Comprehensive internal controls.

The Bank of Guyana will consider these elements and assess the relative strength of the risk management process and controls for each identified function or activity. Relative strength will be characterized as "Strong", "Acceptable" or "Weak based on the following criteria:

6.1.1 **Strong Risk Management** indicating that:

- Management effectively controls all major types of risk posed by the relevant activity or function.
- The board of directors and senior management participate in managing risks and ensure that appropriate policies and limits are in place, and the board of directors understands, reviews, and approves them.
- Policies and limits are supported by risk monitoring procedures, reports and appropriate management information systems.

- Internal controls and audit procedures are appropriate to the size and activities of the licensed financial institution.

- There are few exceptions to established policies and procedures, and none of these exceptions are likely to lead to a significant loss to the licensed financial institution or deterioration in its overall risk profile.

6.1.2 **Acceptable Risk Management** indicating that:

- The licensed financial institution's risk management system although largely effective, may be lacking in some modest degrees.

- The licensed financial institution's risk management system reflects an ability to cope successfully with existing and foreseeable exposure that may arise in executing the institution's business plan.

- While the licensed financial institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed.

- Overall, board of director and senior management oversight, policies and limits, risk monitoring procedures and management information systems are considered effective in maintaining a safe and sound licensed financial institution.

- Generally, risks are being controlled in a manner that does not require more than normal supervisory attention.

6.1.3 **Weak Risk Management** indicating that:

- Risk management systems are lacking in significant ways, resulting in the need for more than normal supervisory attention.

- Internal controls may be lacking in significant respects as evidenced by continued control exceptions or failure to adhere to written policies and procedures.

- The deficiencies associated with these systems could have adverse effects on the safety and soundness of the licensed financial institution or could lead to material mis-statement of its financial statements if prompt corrective actions are not taken.

The conclusions reached by the Bank of Guyana will be discussed with the board of directors and senior management of the licensed financial institution.

APPENDIX

The questions in this Appendix, taken from the Supervision Guideline No. 8 - Corporate Governance, are examples of those that the members of the board of directors could ask senior management of their institution on risk governance and risk management of the institution.

The questions below touch on the following broad areas:

- Strategic Planning and Risk: identifying, analyzing and assessing business risks and opportunities

- Risk Management Process: designing and implementing strategies for managing business risks

- Risk Monitoring and Reporting: implementing processes to monitor and communicate business risks.

Questions 1 – 12 deal with the organization as a whole and the members of the board of directors may choose to use them in discussions with the Chief Executive Officer and other members of the senior management team. Alternatively, these questions can provide the basis for one or more presentations to the board of directors.

Questions 13 – 19 are primarily directed at the board of directors itself and may be more appropriate for discussion among the members of the board.

1. What are the licensed financial institution's key business risks as a deposit-taking institution and delivering banking business and or financial business?
2. How effective is the licensed financial institution in identifying and assessing its business risks?
3. How does the licensed financial institution integrate risk management in developing its corporate strategic direction and plan?
4. How is risk management coordinated across the licensed financial institution?
5. How is the licensed financial institution managing its business risks to ensure an appropriate level of risk is established for approval by the board of directors?
6. Does the licensed financial institution's senior management have a good understanding of its business and operational risks?
7. How does senior management ensure that risk management is an integral part of the planning and day-to-day operations of individual business units of the licensed financial institution?
8. How do the members of the board of directors ensure that their expectations for risk management are communicated to and followed by management and the employees?
9. How do the members of the board of directors ensure that the executives and employees of the licensed financial institution act in the best interests of the licensed financial institution?

10. How do the members of the board of directors ensure that the licensed financial institution is performing according to the business plan and within approved risk tolerance limits?
11. How do the members of the board of directors monitor and evaluate changes in the external environment and their impact on the strategy and risk management practices of the licensed financial institution?
12. What information about the risks facing the licensed financial institution do the members of the board of directors get from management to help them fulfill their stewardship and governance responsibilities?
13. How do the members of the board of directors ensure that the information they get from senior management on risk management is appropriate, accurate and reliable?
14. How do the members of the board of directors and senior management take advantage of the organizational and operational learning opportunities that result from the establishment of an integrated risk management programme in the licensed financial institution?
15. What are the priorities of the members of the board of directors in the oversight of risk management?
16. How do the members of the board of directors handle their responsibility for the oversight of opportunities (approval of large new loans, new businesses etc.) and risks?
17. How do the members of the board of directors ensure that at least some of their members have the requisite knowledge and experience in risk management?
18. How do the members of the board of directors, as a board, help establish the "tone at the top" that reinforces the licensed financial institution’s values and promote a "risk awareness culture"?
19. Are members satisfied that the system of feedback from internal audit and operational staff is adequate?