SUPERVISORY INTERVENTION FRAMEWORK

FOR THE LICENCED FINANCIAL INSTITUTIONS

EASTERN CARIBBEAN CENTRAL BANK

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EASTERN CARIBBEAN CENTRAL BANK (ECCB) SUPERVISORY INTERVENTION FRAMEWORK FOR THE LICENCED FINANCIAL INSTITUTIONS (LFIs)

I. INTRODUCTION

The objective of the intervention process is to enable the ECCB to identify areas of concern at an early stage and intervene effectively to protect depositors and the financial system in the Eastern Caribbean Union (ECCU). The Supervisory Intervention Framework outlines ECCB's supervisory approach and activities; provides a description of the five stages of supervisory intervention; and promotes awareness and enhances transparency of the intervention process used by the ECCB to supervise LFIs.

The ladder of supervisory intervention in this guide has been aligned with the ECCB's Risk-based Supervision (RBS) Framework[1], which describes the principles, concepts, and core process that the ECCB uses to guide its supervision of the LFIs. The Risk-based Supervision Framework supports the Basel Committee on Banking Supervision's Basel II-Pillar 2 Supervisory Review Process[2]. The Pillar 2 supervisory review process is intended to ensure that banks not only have adequate capital to support all the risks in their business but also develop and use better risk management techniques in monitoring and managing these risks. In addition, under Pillar 2, supervisors evaluate how well banks assess their capital needs relative to their risks and take measures, where appropriate. Therefore, the supervisory assessment is intended to generate an active dialogue between LFIs and supervisors, so that when deficiencies are identified, prompt and decisive action can be taken to reduce risk, address deficiencies or restore capital.

II. THE EASTERN CARIBBEAN CENTRAL BANK'S RISK-BASED SUPERVISORY (RBS) APPROACH

The ECCB assesses the safety and soundness of the LFIs by evaluating the LFI's risk profile, financial condition, risk management practices and compliance with applicable laws and regulations in the ECCU, to identify issues or areas of concern to intervene in a timely manner.

[1] https://www.eccb-centralbank.org/p/financial-system-of-the-eccu

[2] BCBS, International convergence of capital measurement and capital standards: a revised framework, June 2004, https://www.bis.org/publ/bcbs107.pdf

The ECCB's supervisory approach to Risk-based Supervision is based on the following concepts, and principles, which are considered as essential for an effective functioning of the financial system.

- **CONSOLIDATED SUPERVISION**

  The supervision of the LFIs is on a consolidated basis. Consolidated supervision evaluates the strength of an entire group, taking into account all the risks which might affect the LFI. This group-wide approach to supervision, where all the risks of a banking group are considered, goes beyond accounting consolidation. The ECCB cooperates, shares information with other national/foreign supervisors, and uses information available from other supervisors as appropriate.

- **CONTINUOUS ASSESSMENT OF THE RISK PROFILE**

  The RBS Framework requires a continuous/on-going assessment of the LFI's risk profile to be maintained current. Supervision of LFIs includes both on-site examinations and off-site monitoring which are integrated into the process such that each one feeds into the other.

- **PRINCIPLES-BASED, FORWARD LOOKING SUPERVISION AND EARLY INTERVENTION**

  Principles-based supervision applies sound judgment in identifying and evaluating risks to the effectiveness of the supervisory approach and distinguishes the complexity as well as diversity among the LFIs avoiding a "one size fits all" approach. Risk assessment is forward-looking. This view facilitates the early identification of issues or problems, and timely intervention where corrective actions need to be taken, so that there is a greater likelihood of the satisfactory resolution of issues.

- **FOCUSING ON MATERIAL RISKS**

  The risk assessment ECCB performs in its supervisory work is focused on identifying material risks and the drivers of risks. It assesses LFIs not just against current risks, but also against those that could probably arise in the future. Supervisors are expected to use sound judgment, based on evidence and analysis, in the risk identification and assessment process.

- **DIFFERENTIATING INHERENT RISKS AND RISK MANAGEMENT**

  The risk assessment requires differentiation between the risks inherent to the activities undertaken by the LFI, and the LFI's management of those risks – at both the operational and oversight levels. This differentiation is crucial to establishing expectations for the management of the risks and to determining appropriate corrective action, when needed.

- **QUALITY OF RISK MANAGEMENT**

  The Quality of Risk Management is assessed at two levels: the Three Lines of Defence and Corporate Governance.

  - **THREE LINES OF DEFENCE**

    A single line of defence is not adequate to assure effective risk management in the LFIs. The RBS Framework requires LFIs to have the three lines of defence model depending on the nature, size and complexity of their business.

    - **Operational Management** is considered as the first line of defence, owns and manages risks in a LFI and is responsible for planning, directing and controlling the day-to-day operations of a LFI's activities/business lines in line with the policies and processes.
    - **Risk Management and Compliance** functions are considered as the second line of defence and are responsible for providing independent, enterprise-wide oversight of Operational Management, the first line of defence. They are also responsible for the development and implementation of the internal control and risk systems as well as assuring oversight for the Board and Board Committees.
    - **Internal Audit function,** as the third line of defence, provides independent review and objective assurance of effectiveness of the first and second lines of defence; the risk governance framework; strategic and business planning; compensation policies and decision-making process.

- **CORPORATE GOVERNANCE**

  The Board and Senior Management, as part of corporate governance, give support and direction for the effective implementation of the three lines of defence model. The Board is responsible for providing stewardship, including direction-setting and general oversight of the management and operations of the entire LFI. Senior Management is accountable for implementing the Board's decisions, and is responsible for directing and overseeing the operations of the LFI.

  The Board and Senior Management are primarily responsible and ultimately accountable for the LFI's financial safety, soundness, compliance with laws, regulations and supervisory guidance. The Board and Senior Management are expected to be proactive in providing ECCB with timely notification of and response to significant matters affecting the LFI.

- **HOLISTIC ASSESSMENT**

  The application of the RBS Framework culminates in a consolidated assessment of risks to an LFI. This holistic assessment combines an assessment of capital and earnings in relation to the overall net risk from the LFI's significant activities, as well as an assessment of the LFI's liquidity, to arrive at the composite risk.

III. RISK ASSESSMENT AND INTERVENTION

There is a direct link between a LFI's overall risk profile assessment; the level of supervision; and the degree of intervention. The level and intensity of supervision will reflect the LFI's potential impact on the stability of the financial system in the ECCU. The level and frequency of supervision and the degree of intervention will depend on the nature, size, complexity and risk profile of the LFI. The ECCB will aim to intervene, when necessary, at an early stage.

The Supervisory Intervention Framework sets out levels of intervention commensurate with the LFI's risk profile. It helps determine and organize supervisory actions, outlines clear timetables and identifies problems, which pose a risk to depositors. All assessments made throughout the intervention process consider the unique circumstances of the LFI including nature, scope, complexity and risk profile.

The Composite Risk Rating (CRR) is an assessment of the LFI's overall risk profile, after considering the impact of liquidity, capital and earnings on its Overall Net Risk. It reflects ECCB's assessment of the safety and soundness of the LFI. The CRR is assessed for a specified time frame, depending on the LFI's circumstances, and the business and economic environment. See Appendix I for CRRs.

A fundamental aspect of risk-based supervision is the relationship between the risk assessment/profile of a LFI and the supervisory action taken in response. The CRR is a significant factor in determining the supervisory response and supervisory plan for the LFI.

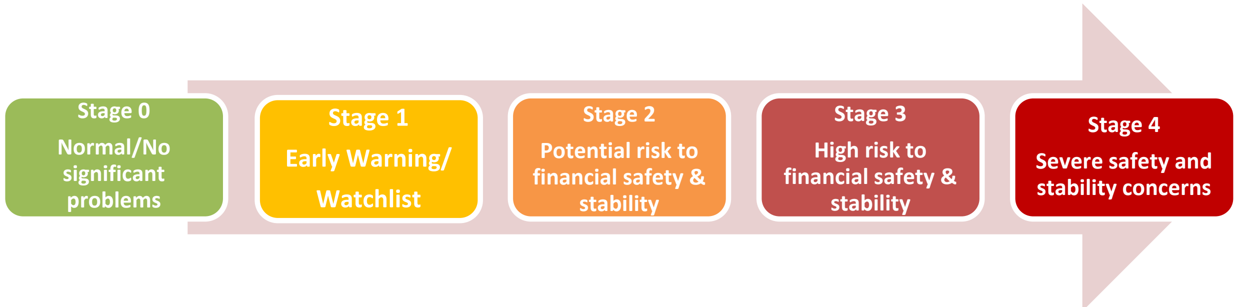
The degree of supervisory intervention should correspond to the CRR. The CRR of an LFI will be used in determining its stage of intervention.

The table below shows the relationship between CRR and Intervention Rating.

INTERVENTION RATING (IR)	**COMPOSITE RISK RATING (CRR)**			
	LOW	MODERATE	ABOVE AVERAGE	HIGH
0-Normal/No significant problems				
1-Early warning/Watch list				
2-Potential risk to safety/stability				
3-High risk to safety/stability				
4-Severe safety and stability concerns				

IV. STAGES OF INTERVENTION

The ECCB has identified five (5) stages of intervention as below:



The Supervisory Intervention Framework describes the risk profile for each stage rating and indicates supervisory actions that typically occur at any given stage.

The ECCB's intervention process is neither rigid nor prescriptive under which every LFI or every situation is necessarily addressed with a predetermined set of actions. The ECCB will consider qualitative and quantitative factors when assessing and determining measures to be undertaken by LFIs. The Framework aims to communicate at which stage an action would typically occur. However, the actions described at one stage are also used in later stages and, in some situations, certain actions may also take place at earlier stages than set out in the Framework. Staging occurs at the discretion of the ECCB.

It is important to note that the primary responsibility for addressing and resolving issues/weaknesses rests with LFI's Board of Directors and Senior Management. Their effective oversight is the fundamental element of ensuring a safe, sound and successful LFI.

The table below outlines risk profiles and typical supervisory actions for each stage rating:

<u>Stage 0</u> **Normal –** **No Significant Problems**	**Risk Profile** • The LFI has a sound financial position and good governance and risk control frameworks for its nature, scope, complexity and risk profile. • The combination of the LFI's Overall Net Risk, Capital and Earnings makes the LFI resilient to most normal adverse business and economic conditions. • LFI's practices do not indicate significant problems or control deficiencies with most key indicators comparable or in excess of industry norms. • The LFI may have access to additional capital and is able to address supervisory concerns that might arise. • The LFI is not expected to fail or pose any undue loss to depositors and financial system in any foreseeable circumstance. • The LFI has strong or satisfactory liquidity levels and is not vulnerable to funding difficulties. **Typical Supervisory Actions** Stage 0 actions **<u>may</u>** include: • Conducting periodic risk-based supervisory on-site reviews (at least once every 36 months); • Assessing the financial condition and operating performance of the LFI; • Reviewing/Monitoring of information received on a monthly, quarterly and annual basis (including Board packages and Board Committee meetings); • Conducting regular (semi-annual) meetings with the LFIs; and • Other supervisory activities as required.

<u>Stage 1</u>
Early Warning-Watch List
	Risk Profile
	• The LFI categorized at this stage has deficiencies in its financial condition, policies or procedures or the existence of other practices, conditions and circumstances that could lead to the development of problems described at Stage 2 if they are not promptly addressed.
	• The combination of the LFI's Overall Net Risk and its capital and earnings compromises the LFI's resilience and the LFI has issues in its risk management or has control deficiencies that although not serious enough to present a threat to financial viability or solvency could deteriorate into more serious problems if not addressed.
	• The LFI's liquidity levels may be in need of improvement. The LFI may not access to sources of funds on reasonable terms to meet present and anticipated liquidity needs.
	• The LFI is not expected to fail or pose any immediate undue loss to depositors; however, there are aspects of its risk profile that may create vulnerabilities under adverse circumstances and as such requires more extensive oversight by ECCB.
	• At stage 1, the LFI is expected to implement a Memorandum of Understanding (MoU) to address identified concerns and deficiencies in the Supervisory letter and commit to reducing its stage rating.
	
	The deficiencies in this stage maybe evidenced by:
	• Breaches to statuary and regulatory requirements;
	• Declining asset quality, liquidity, earnings, or capital; and
	• Weakness in Quality of Risk Management
	    ○ Three Lines of Defence and/or
	    ○ Corporate Governance.

	Typical Supervisory Actions In addition to Stage 0 (normal) activities, Stage 1 actions **<u>may</u>** include: • More frequent and/or more targeted on-site reviews (at least once every 24 months); • More frequent and detailed collection and analysis of data; • Communicating concerns to Directors, Senior Management and Internal and External Auditors; • Meeting with Senior Management, Board of Directors (or a committee of the Board) to outline concerns and discuss remedial actions; • Requests for stress testing, revised business plans and risk appetites; • Establishing Memorandum of Understanding (MoU); undertaking compliance agreement.
<u>Stage 2</u> **Potential Risk to Financial Safety and Stability**	**Risk Profile** • The LFI categorized at this stage has situations or problems that, although not serious enough to present an immediate threat to financial viability or solvency, it could deteriorate into serious problems if not addressed promptly, as evidenced by: ▪ concerns over the LFI 's ability to meet capital requirements on an ongoing basis; ▪ deterioration in the quality of or value of assets (loan and/or investment portfolio); ▪ undue exposure to off-balance sheet risk; ▪ poor earnings/growing operating losses or questionable reporting of earnings or expenses; ▪ low level of accessible liquidity, or poor liquidity management; ▪ deficiency in management procedures or controls; ▪ failure to implement MoU; and

	▪ other concerns arising from: o a financially weak owner; o non-compliance with regulatory requirements; o rapid growth; o credit rating downgrades; o systemic issues. • The LFI is unlikely to fail in the short-term but this expectation relies on ECCB's view that supervisory intervention is necessary to help avert any failure. • At stage 2, the LFI must address identified problems or implement improvements. The LFI's Board and Senior Management must demonstrate a commitment to improvement by establishing urgent timelines. ECCB expects the LFI to reduce its stage rating within this timeframe. **Typical Supervisory Actions** In addition to activities in preceding stages (0-1), Stage 2 actions **<u>may</u>** include: • requiring the LFI's Board/Senior Management to enhance Quality of Risk management (Corporate Governance and Three Lines of Defence) via the development and implementation of policies and procedures to address weakness/deficiencies identified in the Supervisory letter; • conducting follow-up supervisory reviews more frequently (at least once every 18 months); • enhancing monitoring as to frequency of reporting requirements and/or level of detail of information submitted; • requiring recovery or restructuring plans; • monitoring progress of remedial measures via reporting requirements and/or follow-up examinations;

	• increasing capital; • issuing other orders; • placing conditions or prohibitions on business authorization; and • appointing an Observer under Section 85 of the Banking Act.
<u>Stage 3</u> **High Risk to Financial Safety and Stability**	**Risk Profile** • Situations or problems described in Stage 2 are at a level where, in the absence of mitigating factors such as unfettered access to financial support from a financially strong parent, unless effective corrective measures are applied promptly, they pose a material threat to future financial viability or solvency. • The LFI has severe safety and stability concerns and is experiencing problems that are expected to pose an undue loss to depositors unless corrective measures are promptly undertaken. The LFI failed to remedy the issues identified in stage 2 and its situation is worsening. • At stage 3, the LFI will be directed to immediately resolve issues or implement mandated improvements. ECCB expects immediate actions to reduce its stage rating. **Typical Supervisory Actions** In addition to activities in preceding stages (0-2), Stage 3 actions **<u>may</u>** include: • communicating to Senior Management and the Board of Directors of the LFI the importance of considering resolution options such as restructuring the LFI or seeking a prospective purchaser; • requesting capital injections by the shareholders to increase the LFI's capital base in line with its risk profile; • placing the LFI under "official administration" if statutory conditions have been met;

	• depending on the circumstances, business restrictions may be enhanced or additional ones imposed on the LFI's business activities; • monitoring of the LFI may be further enhanced as to frequency of reporting requirements and/or level of detail of information submitted to monitor progress of remedial measures; • enhanced examinations maybe carried out focussing on particular areas of concern such as asset valuations. Such examinations may involve any of the following: substantial increase in sampling of credit files; more in-depth review of files to assess certain areas such as quality of loan security, asset values, appropriateness of provisions and liquidity contingency plans, etc.; • business plans must reflect appropriate remedial actions to rectify problems within a definite time frame to avoid triggering impaired viability or solvency procedures.
<u>Stage 4</u> **Severe safety and stability concerns**	**Risk Profile** If LFI is categorized as Stage 4, ECCB has determined that it is experiencing severe financial difficulties and has deteriorated to such extend that: • the LFI has failed to meet regulatory capital requirements in conjunction with inability to rectify situation on an immediate basis; • the statuary conditions for taking control have been met; and or • the LFI has failed to develop and implement an acceptable business or strengthening plan, resulting in either of the two preceding circumstances inevitable within a short period of time. At Stage 4, ECCB has determined that the LFI will become non-viable on an imminent basis. **Typical Supervisory Actions** In addition to activities in preceding stages, Stage 4 actions **<u>may</u>** include:

	• ECCB notifies Senior Management and Board of Directors of the LFI of intended regulatory intervention measures that will be taken unless situation rectified quickly; • placing LFI into “receivership and compulsory liquidation” if statuary conditions have being met; • pressure to rectify situation is exerted on Senior Management and Board of Directors of the LFI through frequent meetings with Senior ECCB officials; and • if the LFI meets any of the statuary requirements that would make it eligible to be liquidated, the LFI itself may voluntarily request approval for liquidation.

APPENDIX I: COMPOSITE RISK RATINGS

LOW COMPOSITE RISK
✓ The LFI is strong, well-managed and very resilient to potential shocks without an impact on its risk profile. ✓ The performance of Quality of Risk Management has been steadily effective. ✓ LFI complies with laws and regulations, most key indicators are better than its peers/industry norms, and generate additional capital through earnings.
MODERATE COMPOSITE RISK
✓ The LFI is sound, generally well-managed and resilient to adverse changes in business and economic conditions without a material impact on its risk profile. ✓ The performance of Quality of Risk Management has been satisfactory. ✓ LFI comply with laws and regulations, key indicators are similar to its peers/industry norms and generate reasonable additional capital through earnings.
ABOVE AVERAGE COMPOSITE RISK
✓ The LFI is vulnerable to adverse business and economic conditions and has issues that indicate an early warning or that could lead to a risk to its financial viability and solvency. ✓ The performance of Quality of Risk Management is unsatisfactory or deteriorating. ✓ LFI partially comply with laws and regulations, some key indicators are marginally below than its peers/industry norms and is unable to generate additional capital within a short period. ✓ Although the LFI does not present an immediate threat to financial viability or solvency, could deteriorate into serious problems if the corrective measures are not promptly undertaken.
HIGH COMPOSITE RISK
✓ The LFI has severe safety and stability concerns and is not resilient to most adverse business and economic conditions, which poses a serious threat to its financial viability and solvency if the corrective measures are not promptly implemented. ✓ The performance of Quality of Risk Management is poor. ✓ LFI partially comply with laws and regulations, most key indicators are below than its peers/industry norms and is unable to generate additional capital within a short period of time.