

Lao People's Democratic Republic: Technical
Assistance Report-Risk-Based Banking
Supervision



THE LAO PEOPLE'S DEMOCRATIC REPUBLIC

TECHNICAL ASSISTANCE REPORT—LAO PEOPLE'S DEMOCRATIC REPUBLIC—RISK-BASED BANKING SUPERVISION

October 2019

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

RISK-BASED BANKING SUPERVISION

Hee Kyong Chon (MCM) with Joel Hefty and Richard Nun (External Experts)

October 2019

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GLOSSARY

BoL	Bank of the Lao P.D.R.
BSD	Bank Supervision Department
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
FIRST	Financial Reform and Strengthening Initiative
FSI	Financial Soundness Indicator
IP	Institution Profile
LAK	Lao kip
MCM	IMF Monetary and Capital Markets Department
NPL	Nonperforming Loan
RAS	Risk Assessment Summary
RBS	Risk-Based Supervision
ROX	Report of Onsite Examination
SOCB	State-Owned Commercial Bank
TA	Technical Assistance

PREFACE

The IMF's Monetary and Capital Markets Department (MCM) technical assistance (TA) mission visited Vientiane, Lao People's Democratic Republic (P.D.R.) during the period March 4–15, 2019, to assist the Bank of Lao (BoL) in enhancing its risk-based supervision (RBS). The mission comprised Hee Kyong Chon (MCM mission chief), Joel Hefty and Richard Nun (external experts). The mission was conducted within the framework of the TA program, being provided to the BoL to enhance RBS and strengthen capacity of the staff. The mission was financed by the Financial Reform and Strengthening Initiative (FIRST).¹

The mission team held discussions with senior officials of the BoL and staff from the Banking Supervision Department (BSD). The mission team is grateful to BoL's management, staff for their excellent cooperation, productive discussions, and warm hospitality, which greatly facilitated its work.

¹ A TA project was approved in December 2015 with funding from the FIRST. For the tasks of the project, periodic TA missions assisted BoL in developing RBS framework during the period from 2016–2017. To maintain the commitment of BoL in enhancing RBS framework, a new TA project was approved in December 2017 with the FIRST funding as a Phase II project.

EXECUTIVE SUMMARY

At the request of the Bank of Lao, and in continuation of the FIRST TA project, this TA report provides advice towards implementing risk-based supervision (RBS). The BoL is in the process of implementing its risk-based approach to supervision to make the banking system more stable and sounder. This mission looked at the full cycle of onsite and offsite supervision process and provided advice related to applying the RBS manual, drafting and utilizing Institution Profile (IP) and Risk Assessment Summary (RAS), writing an effective examination report, the use of a risk-based approach to internal systemic reporting, and developing a supervisory response framework.

The bulk of the mission time was spent on formal hands-on training sessions. During the mission, training was provided to BSD staff in small group discussions, and a more formal seminar was organized for all offsite and onsite BSD staff, which focused on reviewing the underlying RBS concepts and the elements of RBS manuals.

The development of BoL’s RBS manual and other tools represents a significant improvement in its supervisory approach. Incremental progress has been made over the last two years in transitioning from compliance-based supervision to RBS. Initial efforts of BSD staff using RBS methods indicate the need for more emphasis on risk analysis, and practical application. Special attention needs to be given to:

- **Expediting the formal approval of the RBS manual and fully implementing RBS methods in practice.** Although this could be delayed due to other supervisory priorities, it is considered essential as the quality of supervision is improved by the practical application of RBS tools and learning-by-doing.
- **Strengthening risk analysis and supporting comments related to RBS documents, including the Institutional Profile (IP), the Risk Assessment Summary (RAS), and the Report of Onsite Examination (ROX).** The root causes of risks should be better identified, and greater attention should be paid to well-reasoned analysis of risks and the accompanied supervisory action. In addition, the mission advised additional modification of these documents to enhance its usefulness and quality.
- **Improving some areas in the current Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS) rating framework.** Examiners often misunderstood a “3” rating to indicate medium or moderate risk, but the mission indicated that such a rating would be less than satisfactory. The RBS manual should reflect the more descriptive meanings for each rating. With respect to foreign-branch supervision, special consideration should be given to the extent of adequate oversight by the branch head office, supervision by the home supervisor, and overall financial condition of the foreign banking group. The mission provided examples of qualitative criteria for foreign-branch rating.
- **Strengthening banking sector analysis and systemic reporting.** BSD staff have prepared draft quarterly summary reports for the aggregate banking system combining CAMELS and

RAS analyses. The mission clarified good practices regarding aggregate reporting and provided detailed observations and recommendations to improve it (see Annex I). New reports should provide BSD and BoL senior managers with a clearer view of the banking system's soundness, both in aggregate using key performance ratios, and by individual banks using CAMELS and risk-based conclusions.

Targeted onsite examination, and/or limited-scope inspections, should be conducted in a prompt manner for banks that have not had onsite presence for long intervals. Special attention should be given to systemically important banks. In addition, operational efficiency of onsite examination in BSD could be enhanced by ensuring that enough and consistent time is allocated for each stage of the examination process. Annex II is an example of an onsite examination timeframe that the mission suggests.

The development of an internal policy for applying response and corrective measures is recommended. A well-defined structure for responding to examination findings will support effective RBS. The new banking law specifies various legal remedies and sanctions that may be applied, but even before problems rise to that level, the BSD should be able to apply consistent informal measures. The mission provided a basic outline in Annex III that BSD can use to begin developing a policy.

The BoL should build the core skills of risk-based banking supervision. As a follow-up to this TA mission, one more TA mission should be provided in 2019. The TA approach will shift to more intensive hands-on and on-the-job training. The specific timing and topics will be discussed with BoL at a later stage.

Table 1. Mission's Main Recommendations

Recommendations	Priority	Timeframe¹
Implementation of RBS tools		
1. Officially approve RBS manual; make minor revisions/updates (if needed) at one- or two-year intervals.	High	Near-term/ongoing
2. Continue to complete and update IP and RAS documents for banks, using the improved format for all new and revised versions.	High	Ongoing
3. Adjust the organization of RBS documents to keep and expand business profile, corporate governance system, and log of important events in the IP while focusing CAMELS, risk analyses, and the supporting matrix in the RAS.	Medium	Medium-term
4. Use the ROX format as recommended and discussed with staff, giving emphasis to content and a well-reasoned analysis of risks: <ul style="list-style-type: none"> Improve the quality of risk assessment in the ROX to reflect a greater understanding of risks in each bank and to promote the execution of a robust supervisory action. 	High	Ongoing
5. Prepare a first draft for the bankers' seminar, and feedback can be provided either before or during the next TA mission.	Low	Near-term
Supervisory ratings framework (CAMELS)		
6. Amend the RBS Manual to reflect the more descriptive meanings for the 1-to-5 ratings used for CAMELS	High	Near-term
7. Strengthen the qualitative assessment when assigning CAMELS rating: <ul style="list-style-type: none"> Offsite analysts should consider the level, trend, and inter-relationships of the individual components and financial ratios. Onsite examiners should discuss tentative ratings with bankers at the wrap-up meeting and then disclose the final rating in the ROX. 	High	Ongoing
8. Develop the qualitative criteria for foreign-branch rating considering mission's suggested example.	High	Near-term
Banking sector analysis		
9. Strengthen banking system reporting to include a table showing the banking system averages for key financial ratios over time; add peer group averages to illustrate the influence of each group on the system (see Annex I).	High	Near-term
10. Support the banking system summary report with the most recent RAS for the largest banks and all problem banks.	Medium	Near-term
Onsite examination schedules and timeline		
11. Conduct targeted and/or limited scope inspections as soon as possible for banks that have not had an onsite presence for long intervals; give special attention to systemically important banks	High	Near-term
12. Adopt internal BSD policy with defined criteria for onsite examination scheduling and timeline (see Annex II).	Medium	Medium-term
Supervisory response		
13. Formalize the early intervention regime for weak banks by adopting an internal policy for applying supervisory response and corrective measures that precede formal sanctions and penalties	High	Medium-term

¹Near-term: < 12 months; Medium-term: 12 to 24 months.

I. BACKGROUND

A. Introduction

1. **As part of an ongoing program improving its RBS framework using IMF TA, the following areas have been identified as priorities:**

- Assisting in implementing RBS manual;
- Assisting in strengthening the regulatory framework to effectively implementing RBS; and
- Providing training and building capacity of supervisory staff through close interaction with BSD staff.

2. **This mission focused on implementing RBS manual and improving supervisory skills of staff.** The mission provided BSD task force team members with formal hands-on training sessions related to applying RBS manual (including CAMELS), revising the IP and RAS, advising on writing an effective examination report (ROX), and reviewing BSD reporting to the senior management based on systemic analysis, and discussing appropriate supervisory responses. The bulk of the mission time and effort was spent on the training.

3. **The Lao P.D.R. financial system is largely concentrated in commercial banks.** The gross assets of banking sectors are LAK 130,387 billion, representing approximately 86 percent of GDP. The banking sector consists of 42 commercial banks and 1 specialized bank. The banking sector is concentrated in the three state-owned commercial banks (SOCBs), which constitute about 40 percent of banking assets. Those in operation include 8 subsidiary banks (8 percent), 20 foreign bank branches (21 percent), 8 private banks (19 percent), 3 joint-venture banks (9 percent), and 1 specialized bank (3 percent).

B. Progress Since the Last TA Mission in May 2018

4. **The BSD continues to embrace and implement RBS methods.** It is encouraging to note that BSD staff are applying RBS methods more broadly. Since the last TA mission, an IP and RAS were prepared for additional banks, the ROX format was used on a test basis in the inspection of several banks, and risk has been a primary factor in developing the scope, and schedules for onsite inspections.

5. **The BoL has begun drafting quarterly reports for the aggregate banking system incorporating CAMELS ratings, risk matrix results, and system averages for the key Financial Soundness Indicators (FSIs) used in support of RBS.** Supporting risk analysis must still be strengthened in the high-level summary; however, the steps taken to improve systemic reporting were welcomed.

6. **Incremental progress has been made in the adoption of RBS; however, some momentum may have dissipated.** BoL staff are working on several initiatives to strengthen financial sector supervision. These include implementing a new banking law and drafting enabling

regulations and processes to implement parts of the Basel II capital accord. Each of the additional tasks is important for the BoL’s success. Nevertheless, a solid foundation in RBS has not yet been achieved.

7. **Initial efforts of BSD staff using RBS methods indicate the need for more emphasis and training on risk analysis.** The content of inspection reports focuses mainly on compliance issues rather than analysis of risks. Compliance-based methods and reporting are most familiar to staff and their training in risk-based methods has been minimal, so full transition to risk-based methods will take time and require significantly more assistance.

Table 2. The Last Mission’s Main Recommendations

Recommendations	Status
Formally approve RBS manual and supporting tools.	Planned for end-2018, but manual still in “testing” phase. Approval by BSD and BoL senior management still pending
Continue practical application of RBS methods to strengthen risk-focused analysis and examination skills of BSD staff.	Ongoing.
Draft an internal BoL policy for applying appropriate responses and corrective or enforcement actions.	Not completed; still pending.
Prepare and utilize IP and RAS for all banks.	Partly completed: Q4: 2017: 50% completed Q2: 2018: 64% completed Q1: 2019: 72% completed
Incorporate peer group benchmarks in analysis and commentary in IP and RAS documents.	Partly completed; included in analysis process but not in commentary.
Include system average FSIs and supporting risk analysis in quarterly banking system analyses; use peer group averages to contrast performance of domestic versus foreign banks.	Partly completed; selected system average indicators included in quarterly report; no domestic/foreign split.
Add consolidated supervision concepts to risk analyses.	Not completed.
Develop an internal BoL policy establishing appropriate criteria for scope, frequency, timing, and other relevant criteria for onsite examinations	Partly completed.
Review progress and update onsite examination schedule for 2018; prepare 2019 schedule during Q4:2018, using appropriate risk priority criteria.	Attempted.
Apply RBS tools to plan and conduct onsite examinations.	Ongoing.

II. PACE OF RBS TOOLS IMPLEMENTATION

A. RBS Manual

8. **The RBS manual continues in a “testing” phase pending formal approval by BSD senior management.** Further testing of RBS methods is desired by BSD management before seeking final approval from BoL senior management. Meanwhile, BSD staff is using RBS methods more broadly for both offsite and onsite activities and early results are encouraging. Over time and with more training and experience, it is anticipated that staff will develop more skill using expert judgement.

9. **Refinements to the RBS manual may be needed in the future.** The RBS manual is sufficiently complete that it can be officially approved for use. Once RBS methods are fully implemented into the on- and offsite activities of BSD, and after the new banking law becomes effective, some refinements to the manual may be necessary. This is normal, and it will be helpful to keep a log of possible revisions for updating the manual at one- or two-year intervals.

Recommendation

- Complete the approval of the manual as soon as possible and fully implement RBS methods in practice. Track minor possible revisions to the manual on an ongoing basis and make updates/revisions at periodic intervals, e.g., one or two years.

B. IP and RAS

10. **The implementation of RBS tools in the offsite supervision continues, but the pace of implementation has slowed.** BSD has completed IP and RAS documents for 72 percent of banks. Additional effort is needed to complete these documents for the remainder of the banks to have a complete picture of the banking system using the RBS framework.

11. **The mission reviewed a sample IP and RAS provided by the BoL.** These RBS documents identified risk levels and trends for the subject institution, but there is a need to strengthen supporting comments and analysis. Specifically, risk observations should be better supported with ratio levels and trends, root causes of risks should be better identified, and greater attention should be paid to the recommended supervisory response. Focus must continue to shift toward risk and its root causes.

12. **During RBS implementation, some changes were made to a combined IP/RAS document; additional modifications may be useful.** The changes by the BoL offered staff an opportunity to test separate IP and RAS documents, and this methodology is being implemented. The mission outlined with BSD staff possible ways to streamline reporting to make the IP more static and the RAS more dynamic. For example, CAMELS analysis and the risk matrix are included in both the IP and RAS, and these documents are updated quarterly. The mission proposed keeping the CAMELS analysis, risk-specific analysis, and the risk matrix in the RAS while reorganizing the content of the IP.²

13. **IP should focus more deeply on the bank's capital and group structure, corporate governance systems, business profile and strategy, risk and challenges facing the bank, and the trend of supervisory rating.** It is important for supervisors to keep track of events and changes in risk exposure and strategy through IP's as maintaining updated information of each bank is critical for assisting onsite examiners. IP's should be prepared and updated as and when major developments occur. Contents that could strengthen the current IP include:

² IP also should contain supervisory ratings but show the trend of ratings over the longer period, while RAS should focus more on recent data.

- Contact information: relevant contact persons or groups with the bank.
- Corporate governance: a brief profile of each board of directors, the CEO, and general managers (for foreign branches).
- Audit information: the latest audit information including the dates, auditor, and audit opinion.
- Background of banking business operation, business strategy, main products, and services offered.
- History of examinations; dates, scopes, main findings/unresolved issues.
- Log of events: additional information about the bank, which is important.

The suggested changes would not affect the RBS framework provided in the manual,³ and they could help to improve the pace of implementation.

Recommendation

- Continue to complete and update IP and RAS documents for all banks.
- Offsite analysts should consider the level, trend, and inter-relationships of the individual components and financial indicator ratios when assigning CAELS ratings.⁴
- Adjust the organization of RBS documents to keep and expand business profile, corporate governance system, and a log of important events in the IP while focusing CAMELS and risk analyses and the supporting matrix in the RAS.

C. FSI Benchmarks

14. **BSD offsite team has developed a series of benchmarks and performance ranges for key FSIs based on CAELS components.** The benchmarks were developed using data reported by banks together with BoL's existing prudential requirements and ranges of good performance. In addition to the common benchmarks that apply to the whole banking system, BoL drafted two separate sets of benchmarks for possible testing of peer groups comprising domestic versus foreign banks (foreign branches and subsidiaries). However, disparate results from these groups appear to be more confusing than helpful. The new benchmark ranges for foreign banks do not appear to provide useful perspective for comparative analysis.

³ The proposed RBS manual includes a general section about the framework which the BoL plans to share with supervised institution, and implementing procedures, which the BoL plans for internal use only. Suggested changes to the IP and RAS would affect the internal procedures.

⁴ CAELS refers to the components of the CAMELS rating without the "M" component.

15. **The mission and BSD offsite management agreed that peer groups could be more effective based on an institution's status as a full bank versus that of a foreign branch, rather than domestic versus foreign banks.**⁵ Development of these groups and testing of results for usefulness is recommended. For now, the mission encouraged the offsite group to retain and reference the original set of benchmarks (banking system) until revised benchmarks can be redrafted, tested and approved.

Recommendations

- Exclude the drafted domestic versus foreign bank benchmarks from Appendix 2 of the RBS Manual (internal use only).
- Research, develop and test the usefulness of benchmarks for banks vs. foreign branches.

D. ROX

16. **RBS approach and the ROX format are used in conducting onsite inspections.** Following advice provided at previous TA missions, the annual schedules and scope of activities for onsite inspections are prepared using risk-profile data about banks, and more recent reports of examination have been drafted in the ROX format.

17. **Initial results using the new approach shows that analysis of risks is limited.** To support prompt and robust supervisory actions, the quality of risk assessments in the ROX must be improved. The mission reviewed with BSD staff the report for a recent onsite examination and noted that the content was largely compliance-related rather than a thorough analysis of risks, and the CAMELS component ratings and conclusions were not consistent with actual examination findings. These weaknesses were discussed in detail with staff, and specific recommendations offered that:

- **The Format** can be improved for clarity by following that which was originally recommended, for example it is preferable to show onsite CAMELS rating at current examination and at previous examination; showing ratings assigned by offsite and onsite creates conflicting conclusions if there are differences.
- **The Content** should discuss the most important risk issues supported by facts and the focus must be a critical analysis of risks, the underlying causes, and the potential for adverse impact if problems are not timely addressed and corrected. For instance, narrative comments for each risk area should address level and trend, not only in respect of regulatory minimums, but also to identify cause and probable impact so that appropriate supervisory strategies can be applied

⁵ Foreign branches in the Lao P.D.R. have allocated capital.

Recommendation

- Use the ROX format as recommended and discussed with staff, giving emphasis to content and a well-reasoned analysis of risks. Also, the bulk of “General and Administrative Information” can be excluded from the ROX and retained in examination workpapers.

E. Training

18. **The mission provided training in the use of RBS methods and the manual.** During the mission, training was provided to BSD staff in small group discussions, explaining in greater detail how to properly analyze and rate various risks and how to write appropriate comments in IP, RAS, and ROX documents. In addition, a more formal seminar was provided for all offsite and onsite BSD staff, reviewing the underlying RBS concepts and particularly what ratings mean and how they are assigned.

19. **Following formal adoption of the RBS manual, an informational seminar for bankers is planned.** The benefit of an information seminar for bankers to explain RBS concepts, methods and expectations was discussed at the previous mission and remains a priority for BoL. The mission supports this and can assist BSD staff in preparing materials for the seminar.

Recommendation

- BSD staff should prepare a first draft for the bankers’ seminar, and feedback can be provided either before or during the next TA mission.

III. THE SUPERVISORY RATING FRAMEWORK (CAMELS)

20. **CAMELS ratings are used both in the offsite and onsite supervisory processes.** The CAMELS rating is a useful vehicle for identifying problems or deteriorating banks, as well as for categorizing banks with deficiencies in each component area. CAELS ratings (excluding the “M” component) are being assigned by offsite and included in RASs, but the ratings appear predicated on only a few FSIs. Onsite examiners have started assigning CAMELS ratings in 2019 but only internally; the ratings are not yet disclosed in the ROX nor to bankers in wrap-up meetings. It is encouraging to note, however, that examiners seem to be approaching the component ratings in a more holistic manner rather than in isolation from other components.

21. **There are some areas to improve in the current CAMELS rating framework.** While supervisory judgement can be considered in this process, the methodology is not clear on how the composite rating should be decided. When assigning a composite rating, some components may be given more weights than others depending on the extent of supervisory concerns in the peer group or banking industry. For example, as for SOCBs or banks with large loan portfolios, the component “A” could be deemed more important than component “E” when considering an increasing concern

about NPL ratios while ROA's remain relatively high. In this case, BoL could consider adjusting the component weights to reflect that judgement.⁶

22. **Ratings assigned so far often incorrectly use the “3” rating.** When assigning ratings for the individual CAMELS components and for the overall composite rating, examiners often have misunderstood a “3” rating to indicate medium or moderate. This is partly due to the 1-to-5 CAMELS rating methodology and partly a matter of translation. The meanings of the different ratings were discussed in detail with BSD, explaining that “1” and “2” ratings were acceptable while “3,” “4,” and “5” ratings indicated varying degrees of unacceptable. It was agreed with BSD that more appropriate descriptive words would be: Strong for a “1” rating; Satisfactory for “2;” Less than Satisfactory for “3;” Weak for “4;” and Poor for “5.” The RBS Manual should be strengthened to reflect these ratings clarifications.

23. **Branches of foreign banks require special consideration when assigning CAMELS ratings.** When assigning the CAMELS rating for the branches of foreign banking group, special consideration should be given to the extent of adequate oversight by its head office, supervision by the home supervisor, and overall financial condition of the foreign banking group. These qualitative assessments are especially needed in areas where quantitative parameters do not appropriately reflect the bank's financial condition and operations. These factors should be evaluated and explicitly included in the qualitative assessment of component “M (management)” of the CAMELS ratings. As for a “simple and handy” indicator, the strength of support from the parent could be assessed based on the parent banks' credit ratings (from internationally recognized credit rating providers), which can be updated on a regular basis. In addition, the examiner should consider the system of supervision in the branch's home country and the record of home country government support of the banking system. The assessment on these factors will provide a good basis for a more efficient utilization of supervisory resources in BoL.

Recommendation

- Onsite examiners should assign CAMELS ratings and discuss tentative ratings with bankers at the wrap-up meeting and then disclose the final rating in the ROX.
- Amend the RBS manual to reflect the more descriptive meanings for 1-to-5 ratings used for CAMELS.
- Qualitative criteria for foreign branch rating should be developed considering the following examples:
 - The level and quality of Head Office global capital and overall financial condition.

⁶ For example, BoL may consider following weights for SOCBs: C (20 percent); A (25 percent); M (15 percent); E (10 percent); L (15 percent); S (15 percent). Also, BoL may want to consider applying a different set of CAMELS component weights for foreign branches and private banks, respectively.

- Access to sources of capital, including extent of parent support.
- The level of home supervisor’s branch oversight, and the quality and adequacy of supervisory reviews.
- The level of profit for head office repatriation (when assessing “E” component).
- The level of head office funding support (when assessing “L” component).

IV. SELECTIVE ISSUES ON SUPERVISORY PROCESS

A. Banking Sector Analysis

24. **The BSD has begun strengthening systemic reporting for the banking sector.** Aggregate data is being summarized by offsite supervisors, and new reports have been drafted summarizing the health of individual institutions. New reports should provide BSD and BoL senior managers with a clearer view of the banking system, both in aggregate using key performance ratios, and by individual banks using CAMELS and risk-based conclusions. Both aggregate average and institutional summary reports can promote effective communication with senior management, especially if presented together.

25. **The BSD has prepared an aggregate RAS report referencing key financial indicators.** The report aims to evaluate the banking sector using system averages and trends, and provide insight regarding risks and the areas requiring supervisory attention. The mission clarified good practices regarding aggregate reporting, and provided detailed observations and recommendations to improve it. The mission recommends that the system report include a table showing the averages for key financial ratios over time. Peer group averages could be added to illustrate the influence of each group on the system. Other detailed observations and recommendations are presented in Annex I.

26. **The BSD has also drafted a summary level report for all banks combining CAMELS and risk-based conclusions from RAS analyses.** When fully implemented, the report will summarize each bank’s financial health, risk areas requiring attention and overall risk level. The mission recommended that this report be supported by the most recent RAS for the largest institutions and all problem banks.

Recommendation

- Strengthen banking system reporting to include a table showing the banking system averages for key financial ratios over time; add peer group averages to illustrate the influence of each group on the system (please see Annex I for detailed recommendations).
- Support banking system summary report with the most recent RAS for the largest banks and all problem banks.

B. Annual Onsite Examination Schedules and Timeline

27. **The mission reviewed the onsite examination schedules for 2018 and 2019.** Using advice from earlier missions, BSD managers prepared an annual examination schedule for 2018 and for 2019 utilizing four basic criteria: (i) level and trend of NPLs; (ii) extent of unresolved issues—mostly compliance-related – from the previous examination, (iii) interval since the last examination, and (iv) market share. In practice, it appears that NPLs and unresolved issues are the primary drivers for scheduling onsite examinations. The mission was informed that 16 examinations were conducted in 2017, 18 in 2018, and 17 inspections are planned for 2019.

28. **Several banks have not had an onsite presence by the BSD in two years or more.** The nine largest banks by market share, comprising a large portion of banking system assets, have not had an onsite inspection in almost two years. A dozen other banks have had longer intervals although each is small on a stand-alone basis, and their combined market share is also quite small. Offsite information does not indicate any material weaknesses or problems; however, it remains necessary to verify the banks' conditions, especially for systemically important banks.

29. **Examinations are comprehensive in scope but focus on specific risks.** Onsite examinations are nominally “full-scope” but in practice are targeted to address specific risks such as asset quality/credit risk, foreign exchange risk, or problems involving management. Similarly, the duration of most inspections is two weeks for domestic and subsidiary banks, and one week for foreign bank branches; however, the actual duration of onsite examination activity is flexible to fit the circumstances. As the BSD further implements RBS, the integration of offsite perspectives about risks and risk management in the onsite examination planning process will strengthen the focus and effectiveness of onsite examinations.

30. **The mission reiterates the benefits of adopting an internal policy for conducting onsite examinations.** The BSD is using risk-based criteria to set the schedule and scope of onsite inspections, and these efforts are viewed favorably. In this regard, the BoL is encouraged to formally adopt an internal policy for the BSD that sets more explicit criteria for the frequency, scope, timeline, staffing and follow-up for examinations. For example, inter alia, an appropriate policy would specify criteria for full-scope vs. limited-scope and targeted inspections, the maximum desired interval between inspections for systemic/non-systemic banks and problem/non-problem banks, coordination with home country authorities and obtaining parent company information for branches and subsidiaries of foreign banks.

31. **The operational efficiency of onsite examinations can be enhanced by ensuring that enough and consistent time is allocated for each stage of the examination process.** The BSD has an internal policy that sets forth the general timetable for various actions inherent in conducting onsite inspections. For example, when pre-inspection documents are requested from the bank, which examiners are responsible for different portions of the examination; when to hold wrap-up meetings with bank management; the process for writing, reviewing and finalizing the ROX within BoL; and meeting with bank senior officials to discuss the findings and conclusions, and initiate a corrective program. This process is good but can be further improved by incorporating more explicit details and timing as suggested in Annex II of this report. The proposed timeframe provides

a target for completion of the examination report and submission to the supervised banks, which will help ensure that reported examination findings and recommended supervisory action remains current.

Recommendation

- Give greater emphasis to offsite RAS and CAELS ratings and to systemic importance when preparing and updating the annual onsite examination schedule.
- Conduct targeted and/or limited scope inspections as soon as possible for banks that have not had an onsite presence for long intervals; give special attention to systemically important banks.
- Develop and/or formally adopt an internal policy setting appropriate criteria for scope, frequency, timeline, etc. of onsite examinations. With respect to the timeline, refer to the “onsite examination timeframe” as provided in Annex II.

C. Supervisory Response

32. **A well-defined structure for responding to examination findings will support effective RBS.** To maximize the efficacy of corrective measures, the BSD must respond to examination findings in a prompt and consistent manner. The new banking law specifies various legal remedies and sanctions that may be applied, but even before problems rise to that level, the BSD can apply informal measures. Adopting an internal response policy—like an internal policy for examination scope and frequency—will help ensure that responses to examination findings are consistent and effective. The mission provided a basic outline that BSD can use to begin developing a policy; more specific advice will be provided at a future TA mission.

Recommendation

- The BSD should begin developing an internal policy for applying response and corrective measures. Refer to the “Sample Framework for Supervisory Response Policy” as provided in Annex III.

V. NEXT STEPS

33. **In continuing the TA project, in 2019, MCM will assist BoL with one more mission.** Now that the manual is essentially complete, the TA approach must shift to more intensive “hands-on” training, emphasizing practical application of RBS methods and learning-by-doing. This is best accomplished by TA experts working with front-line examiners and analysts when planning examinations; identifying and evaluating risks; preparing well-written, properly documented reports; drafting appropriate response measures; and following up to ensure that problems are timely resolved. Thus, the future TA missions should focus on on-the-job training in onsite examination and offsite supervision providing hands-on guidance to the teams. Timing, topics, and modalities regarding on-the-job training will be discussed with BoL at a later stage.

Annex I. Detailed Observations on Systemic Reporting

The BSD requested detailed comments and observations about its draft systemic reports. New reports are planned to provide BSD and BoL senior managers with a clearer view of the banking system, both in aggregate using key performance ratios, and by individual banks using CAMELS and risk-based conclusions. Many of the observations below were made during discussions with BSD colleagues. The mission team appreciates the opportunity to review and provide comments and suggestions on ways to strengthen offsite systemic reporting. The mission asked about the users of the systemic summaries and discussed preparation of the reports. BSD shared two draft documents:

1. One report presented selected aggregate banking system ratios and indicators as though they were associated with one institution. Data and comments were presented in the form of a “systemic” RAS.
 - Systemic report ratios should be derived from aggregate data, i.e., determined by summing all raw data for the numerators and dividing the result by the sum of all raw data for the denominators for an individual ratio. The result is the system average which also gives greater weight to larger institutions.
 - The first page of systemic reporting should contain an executive summary based on the analysis of the financial data by discussing the overall trend of banking sector soundness, the financial deterioration, or supervisory concern.
 - Systemic average ratios could be expanded to show banks (including joint ventures and foreign subsidiary) and foreign branches as separate peer groups. Separating entities in this way could show the influence of each group on the system average.
 - Further, the report would benefit from analyzing the performance of each subgroup of the banking sector based on the types of institutions, e.g., SOCB’s, foreign branches, private banks (including foreign subsidiaries), and joint ventures, respectively. Banks in each category appear to perform quite differently, and the senior management of the BoL should be informed of the banks that have major prudential concerns.
 - Since the report is intended for internal use within the BoL, the preparer could cite specific banks where underperformance may threaten the bank’s viability. (e.g., Bank X, Y, and Z’s Capital Adequacy Ratio declined by 1.0 percent, 2.0 percent, and 3.0 percent, respectively and they are below the supervisory minimum threshold). Supervisory actions taken or planned could also be discussed.
 - The use of the RAS format with CAMELS and risk categories provided reason to discuss each component or risk type. Some observations were nicely supported with system average data—including level, trend, and qualitative support. These observations were helpful.

- Other aspects of the RAS format, such as providing an estimated “banking system CAMELS rating” and “banking system risk type ratings” (e.g., market risk) were not so useful. Due to the large number of institutions and business models, it would be difficult to determine a system average using either of these rating frameworks which are intended for microprudential conclusions. The “M” component of the banking sector would be difficult to assess in the systemic reporting.
- The report could be stronger without the “ratings,” and with greater emphasis on the data points. A table of selected key ratios showing the system average over time, along with supporting commentary would be a useful output. (e.g., earnings performance as measured by return on assets declined due to high provision expense at most banks).
- Graphs and tables could be added to the analysis to illustrate important trends.
- Report formats should be flexible and should strive to summarize the most important data. Sometimes the data reported may vary from the standard.

2. A second report focused on regulatory assessments for each of the 42 banks or foreign branches. The report listed each bank by name, asset size, CAMELS rating (all components), date of last onsite examination, and summary-level risk assessment (risks by type and overall level). The preparer also estimated the overall risk for each institution with a final composite score (ratings one to five).

- The mission team recommended that given systemic importance, the RAS for each of the five largest banks should be available for the user’s review. The team also suggested that the RAS for banks rated “four” or “five” be attached as well.
- If a composite “CAMELS + Risks score” is to be used, a methodology to make this determination should be described. Even if the methodology is “reviewer judgment,” that should be disclosed.
- For this microprudential summary to be most effective, RAS reports must be completed for every bank in the system.
- Simple but meaningful analytical information could be calculated and summarized including the following:
 - Number of banks or percentage of system assets rated one, two, three, four, or five.
 - Number of banks or percentage of system assets evaluated as “high” risk.
 - Number of banks with significant credit/market/liquidity/operational risk.
 - List of banks for which no CAMELS rating or no RAS is available.

Reference:

Some jurisdictions provide aggregate and/or individual bank data on their webpage. Here are links to examples from Cambodia, Canada, the Philippines, Thailand, the United States, and Vietnam.

Annex II. Onsite Examination Timeframe¹

	Process Steps	Suggested Timeframe
1	Scoping meeting conducted <ul style="list-style-type: none"> - Purpose, process, outcome agreed - Scope agreed - Agree roles and responsibilities - Draft agenda formulated - Pre-review material required determined - Scoping document finalized 	6 weeks prior to commencement of examination
2	Letter to bank drafted and sent	4 weeks
3	Pre-examination material received	2–4 weeks
4	Pre-examination material assessed <ul style="list-style-type: none"> - Pre-examination meeting conducted - Highlight key risks and issues - Confirm roles and responsibilities 	1–2 weeks
5	Conduct onsite examination <ul style="list-style-type: none"> - Opening session - Conduct closing meeting with banks 	Duration of examination depends on the types of banks and scope
6	Conduct post-closing meeting <ul style="list-style-type: none"> - Assessment of risks and issues - Identify supervisory response 	1 week after conclusion of onsite work
7	Prepare onsite examination report <ul style="list-style-type: none"> - Draft the report - Review the report by examiner-in-charge - Confirm assessment of risks, issues, ratings by onsite division manager 	2–3 weeks
8	BSD Director reviews/approves examination report	4 weeks
9	Report sent to bank	5 weeks
10	Receive response from the bank (about measures being taken to rectify problems)	2 weeks from date examination report received by bank
11	Progressive update on outstanding findings	Quarterly
	Follow-up with institution	Ongoing

¹ This is an example and BoL may customize it as necessary. For instance, the onsite examination for small branches may need less time, and as for large and complex ones, more time may need to be allocated.

Annex III. Sample Framework for Supervisory Response Policy

Preamble [Briefly describe rationale and use of this policy.]

1. **Identification** [Describe methodology for identifying banking problems, i.e. RBS]
 - **Offsite surveillance**
[Explain the offsite surveillance process, what data and how it is analyzed, and what reports or documents are generated following analysis.]
 - **Onsite examinations**
[Explain the onsite examination process, what data and how it is analyzed, and the report generated following analysis.]
 - **Supervisory categories**
[Define categories that banks will be deemed to be in based on offsite or onsite findings, and how the category will be used to apply consistent responses.]
2. **Types of Responses** [Briefly describe basic types of supervisory responses.]
 - **Informal responses**
[Define nature, when, and how informal responses will be used.]
 - **Formal actions**
[Define nature, when, and how formal responses will be used.]
 - **Penalties and Fines**
[Define nature, when, and how monetary fine and penalties will be imposed.]
3. **Implementation Procedures** [Brief introduction of implementation procedures.]
 - **Discussion and documentation**
[Describe how/when problems are discussed with bankers and documented.]
 - **Determining type of response**
[Describe criteria for deciding type of response. Table showing typical minimum responses for each supervisory category is helpful.]
 - **Preparing and Issuing Responses**
[Describe process for preparing/issuing response, including key elements.]