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OCC Formally Launches Supervision by Risk Program
With Distribution of Large Bank Supervision Handbook

WASHINGTON, D.C. -- Comptroller of the Currency Eugene A. Ludwig this week formally launched the OCC's Supervision by Risk program with the distribution of the Large Bank Supervision Handbook. The handbook outlines how OCC examiners will identify and assess nine basic risks of banking. The handbook implements the Supervision by Risk program announced by Mr. Ludwig in a speech at Georgetown University in September 1995.

"Today, sound risk management by banks and effective supervision of the most important risks facing banks are crucial if we are to ensure the long-term strength and vitality of the national banking system," Mr. Ludwig said.

OCC examiners responsible for supervising large national banks (those with total assets of \$1 billion or more) will use the new handbook to develop their supervisory strategies and plans for future examinations. While the OCC has been examining banks based on a variety of risks for several years, Mr. Ludwig said, the new handbook marks the national standardization of this process. It is designed to focus OCC's examinations on the areas of highest risk in a bank's activities and will be implemented at a time when banks themselves are increasingly using risk management techniques to track their own risks.

The large bank handbook, distributed this week to bankers and examiners, details the factors examiners will use to evaluate the following categories of risk: credit, interest rate, liquidity, price, foreign exchange, transaction, compliance, strategic and reputation.

Within each risk category, examiners will assess the quantity of risk and quality of risk management, and identify whether risk is increasing, stable, or decreasing in each bank. This assessment incorporates both a current and prospective view of an institution's overall risk profile. The new handbook also emphasizes two-way communication about bank risks between bankers and examiners.

"By delineating and defining each risk, bankers and examiners will, for the first time, be able to use the same terminology when discussing risk-related issues, and examiners will be more consistent in their approach to similar institutions," said Comptroller Ludwig.

To obtain copies of the Large Bank Handbook, send a written request along with a check for \$6.00 per booklet to the Office of the Comptroller of the Currency, P.O. Box 70004, Chicago, Illinois, 70673-0004.

Attachment

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The OCC charters, regulates and examines America's approximately
3,000
national banks and 75 federal branches and agencies of foreign banks
in the
U.S. Together, these institutions hold more than half of the
nation's bank
assets. The OCC's mission is to ensure the safety and soundness of
the
national banking system.

Categories of Risk

The OCC has defined nine categories of risk for bank supervision purposes. These risks are: Credit, Interest Rate, Liquidity, Price, Foreign Exchange, Transaction, Compliance, Strategic and Reputation. These categories are not mutually exclusive; any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

Credit risk is the most recognizable risk associated with banking. This definition, however, encompasses more than the traditional definition associated with lending activities. Credit risk also arises in conjunction with a broad range of bank activities, including selecting investment portfolio products, derivatives trading partners, or foreign exchange counterparties. Credit risk also arises due to country or sovereign exposure, as well as indirectly through guarantor performance.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. The economic perspective focuses on the value of the bank in today's interest rate environment and the sensitivity of that value to changes in interest rates. Interest rate risk arises from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting bank activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest related options embedded in bank products (options risk). The evaluation of interest rate risk must consider the impact of complex, illiquid hedging strategies or products, and also the potential impact on fee income which is sensitive to changes in interest rates. In those situations where trading is separately managed this refers to structural positions and not trading portfolios.

The assessment of interest rate risk should consider risk from both an accounting perspective (i.e., the affect on the bank's accrual earnings) and the economic perspective (i.e., the effect on the market value of the bank's portfolio equity). In some banks, interest rate risk is captured under a broader category of market risk. In contrast to price risk, which

focuses on the mark-to-market portfolios (e.g., trading accounts), interest rate risk focuses on the value implications for accrual portfolios (e.g., held-to-maturity and available-for-sale accounts).

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the bank's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

As with interest rate risk, many banks capture liquidity risk under a broader category of market risk. Liquidity risk, like credit risk, is a recognizable risk associated with banking. The nature of liquidity risk, however, has changed in recent years. Increased investment alternatives for retail depositors, sophisticated off-balance sheet products with complicated cash-flow implications, and a general increase in the credit sensitivity of banking customers are all examples of factors which complicate liquidity risk.

Price Risk

Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking activities in interest rate, foreign exchange, equity, and commodity markets.

Many banks use the term price risk interchangeably with market risk. This is because price risk focuses on the changes in market factors (e.g., interest rates, market liquidity, and volatilities) that affect the value of traded instruments. The primary accounts affected by price risk are those which are revalued for financial presentation (e.g., trading accounts for securities, derivatives, and foreign exchange products).

Foreign Exchange Risk

Foreign Exchange risk is the risk to earnings or capital arising from movement of foreign exchange rates. This risk is found in cross-border investing and operating activities. Market-making and position-taking in foreign currencies should be captured under price risk.

Foreign exchange risk is also known as translation risk and it is sometimes captured as a component of market risk. Foreign exchange risk arises from accrual accounts denominated in foreign currency, including loans, deposits, and equity investments (i.e., cross-border investing). Accounting conventions require quarterly revaluation of these accounts at current spot rates. This revaluation translates the foreign

denominated accounts into U.S. dollar terms.

Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.

Transaction risk is also referred to as operating or operational risk. This risk arises on a daily basis in all banks as transactions are processed. It is a risk that transcends all divisions and products in a bank.

Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested. Compliance risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

Compliance risk is often overlooked as it blends into operational risk and transaction processing. A portion of this risk is sometimes referred to as legal risk. This is not limited solely to risk from failure to comply with consumer protection laws; it encompasses all laws as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of banking, traditional and nontraditional.

Strategic Risk

Strategic risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities.

Strategic risk focuses on more than an analysis of the written strategic plan. It focuses on how plans, systems, and implementation affect the bank's franchise value. It also incorporates how management analyzes external factors that impact the strategic direction of the company.

Reputation Risk

Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services, or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Reputation risk exposure is present throughout the organization and is why banks have the responsibility to exercise an abundance of caution in dealing with their customers and community. This risk is present in activities such as asset management and agency transactions.

The assessment of reputation risk recognizes the potential impact of the public's opinion on a bank's franchise value. This risk is inherent in all bank activities. Banks which actively associate their name with products and services, such as with fiduciary services, are more likely to have higher reputation risk exposure. As the bank's vulnerability to public reaction increases, its ability to offer competitive products and services may be affected.

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