Superintendencia
de Bancos
e Instituciones
Financieras
Chile

Chilean Model of Risk-Based Supervision

Superintendence of Banks and Financial Institutions of Chile

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1. INTRODUCTION

One of the greatest lessons stemming from the financial crisis that affected Chile in the early 1980s was the importance of having suitable risk management by banks, along with a supervisory agency capable of assessing the adequacy of such management and of promoting the necessary corrective actions. For this reason, once the banks' solvency had been reestablished by means of government bailouts and strict regulations on the quality of assets were introduced, the Superintendence of Banks and Financial Institutions (SBIF) started reviewing its supervision process, gradually including models aimed at identifying and mitigating risks in a timely manner.

In this context, the SBIF has sought since the mid-1990s to implement a Risk-Based Supervision model (RBS). By the end of 1997, this initiative was enshrined in the General Banking Law (GBL), which introduced a model for classifying the quality of management by banks.

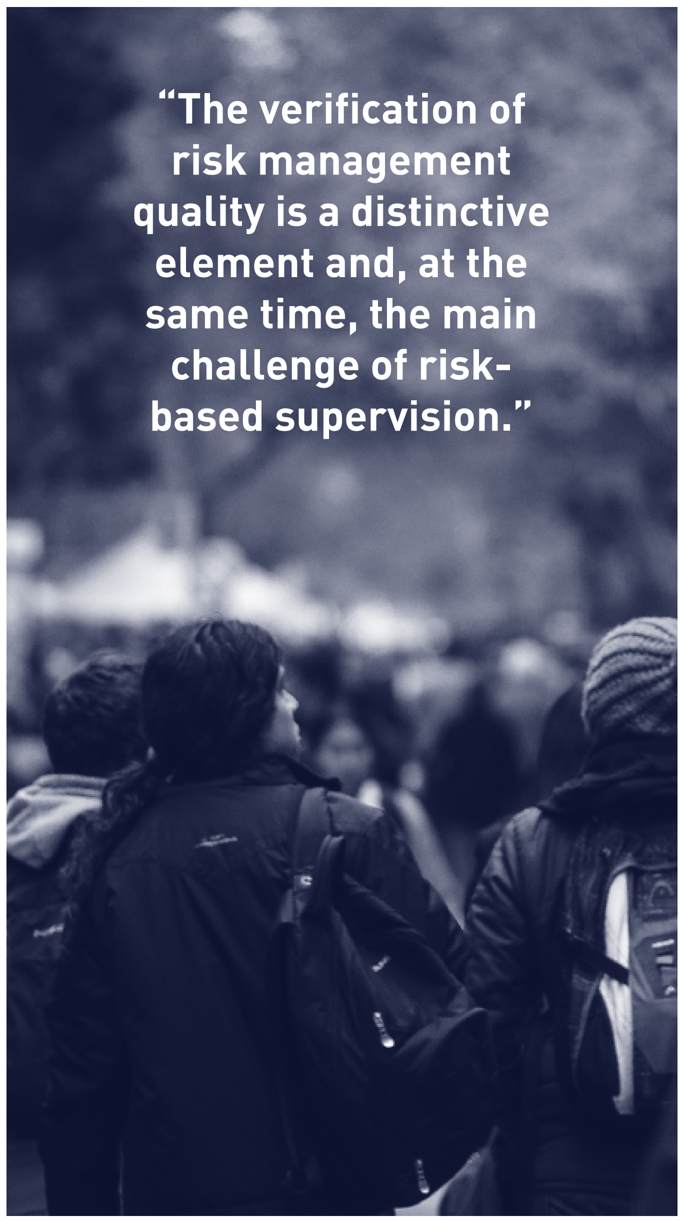
The legal changes made in 1997 were complementary to the powers that were already held by the SBIF that were necessary for the application of a traditional banking supervisory approach, with the assessment of the banks' management as one of its central elements. In other words, the legal changes added to the monitoring of regulatory compliance, and to the use of prudential criteria in the valuation of assets, a fundamental preemptive function in modern banking supervision, which consisted in the monitoring of the adequacy of risk management in financial institutions.

Nowadays, it is evident that the effectiveness of a banking supervision model depends to a great extent on the supervisor's capacity to (a) monitor the adequacy of risk management by banks and, stemming from this, (b) promote the implementation of the corrective measures needed to strengthen such management.

The implementation of an effective RBS approach, whose differentiating characteristic is the introduction of management quality assessment to traditional supervision work, poses a challenge for supervisors, since it requires them to complement the supervision based on the fulfillment of regulations with a supervision based on the compliance with risk management principles.

Accordingly, the implementation of an RBS approach requires a precise combination of, on one hand, a flexible framework of general principles and assessment criteria, and, on the other hand, qualified supervisors who are able to appropriately evaluate management quality and to apply their expert judgment within such framework.

The purpose of the following document is to make public the distinctive features of the RBS model employed by the SBIF in the Chilean banking system, especially regarding the assessment of the quality of management carried out by banks. For this purpose, the general reference framework for RBS is described in the second section. The third section expounds the model of risk management assessment employed by the SBIF. Finally, the fourth section provides a summary of the main lessons of the RBS process that emerge from the SBIF's experience.



1. GENERAL REFERENCE FRAMEWORK

The banking industry is one of the most regulated sectors of the economy on the international level. On one hand, this is due to the important role of the industry in financial intermediation and the risks associated with its activities, and, on the other hand, to the impact the financial sector has on the rest of the economy.

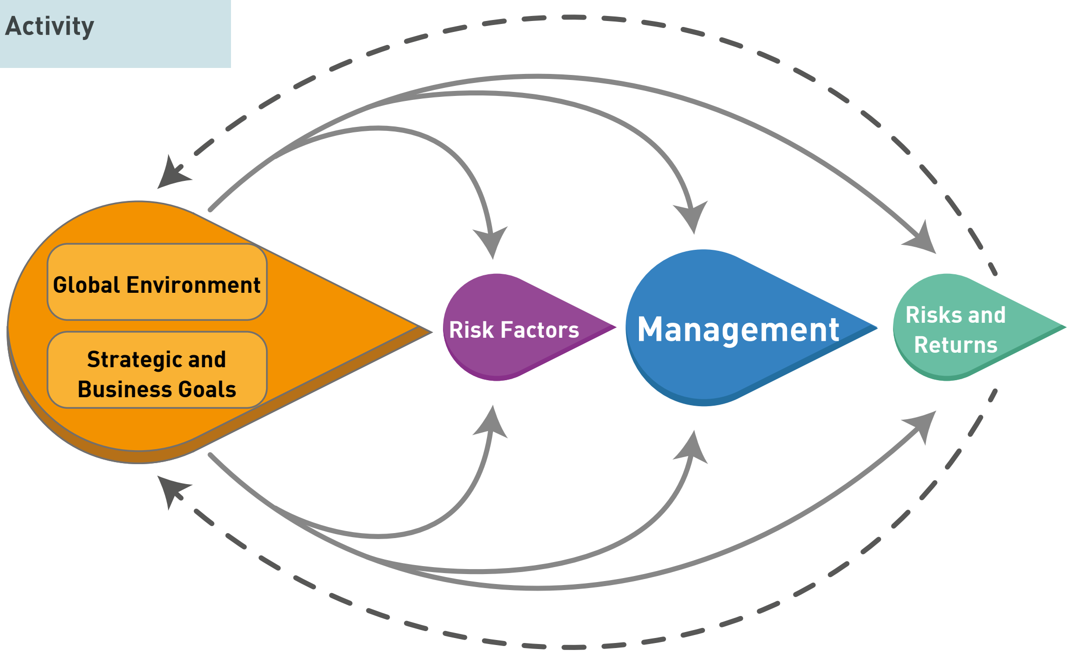
Over the course of decades, the banking industry has become more and more complex in terms of its business organization structures, its activities and the related risks that it is exposed to. In order to keep up with this process, supervision has had to evolve —not always as fast as it should— by complementing more traditional and prescriptive approaches with more dynamic and flexible ones.

Banking Activity

A bank's activity fundamentally consists in managing the risks related to financial intermediation. This activity can be shown schematically as the combination of its determining elements, as represented in Figure 1.

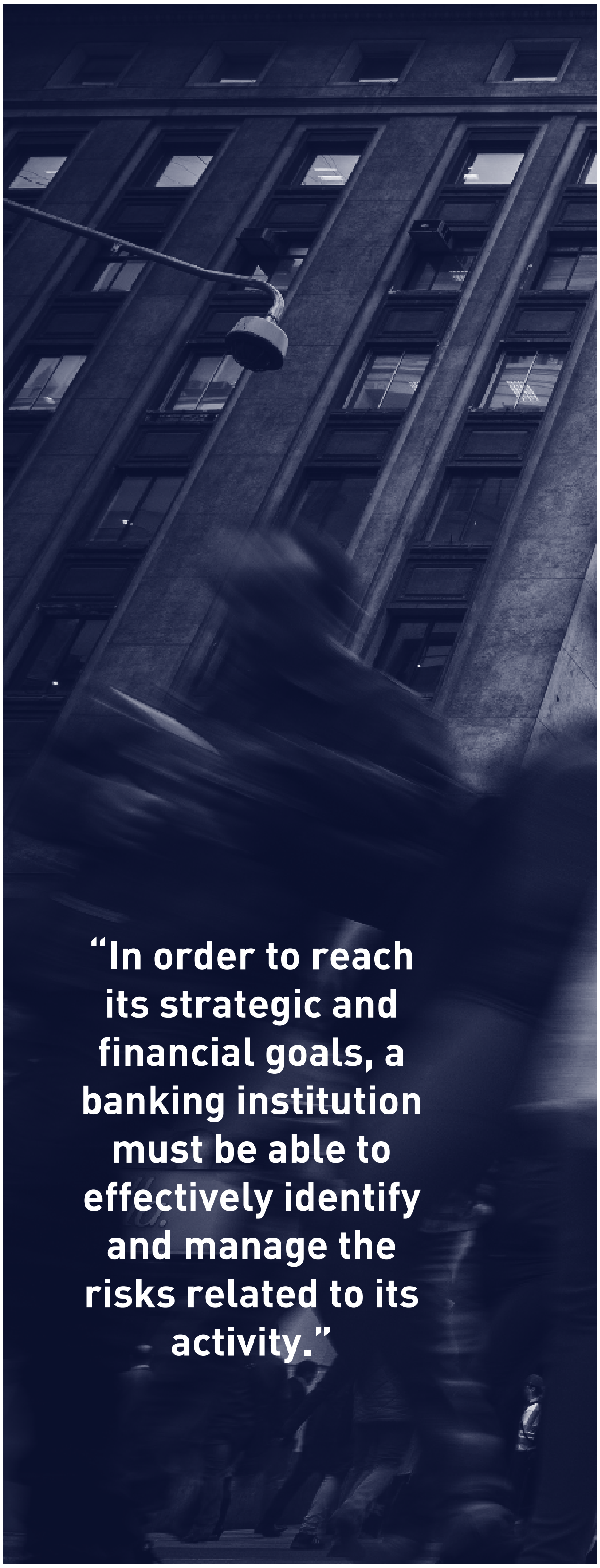
The global environment refers to those elements that can directly or indirectly affect banking activity. For instance, let us consider those related to the performance of macroeconomic variables, like GDP growth, inflation and interest rates, employment level and exchange rates, among others. Regulatory aspects are also important, like the current legal framework or draft bills that may impact the institutions that regulate the economy in general or particular sectors of it, as well as the banking sector's own regulations. Social elements are also part of the environment, such as the country's security level and sectoral or regional pressures that may affect banking activity, among others.

Figure 1: Banking Activity



Strategic and business goals refer to the definitions made by a bank's shareholders, or by their representatives, concerning its business orientation and strategic goals.

Risk factors represent environment variables that determine the risk level a bank is exposed to, which is the product both of its business activities and the way in which they are performed. By their very nature, risk factors cannot be controlled by the bank, but their volume and expected development can and should be estimated.



Management refers to the way in which the bank's administration performs its activities seeking, on one hand, to reach its strategic and business goals and, on the other, to mitigate the risks related to such activities in order to protect the bank's own viability.

Finally, risks and returns represent the result achieved by management, which are reflected in its financial statements and other quantitative performance reports, as well as the bank's level of exposure to the different risks inherent to its activity[1].

Risk Management

Risk management refers to the tools at a bank's disposal to manage risks related to its activities within limits that are compatible with achieving its expected results and ensuring its own viability.

Banks functionally manage risks by means of four main pillars that interact with each other:

- **The Board of Directors.** It is the main governing authority responsible for leading the financial institution. As such, along with establishing and monitoring the achievement of its strategic and business goals, the Board ensures that the risks incurred fall within the defined risk appetite, which is compatible with the shareholders' goals and the entity's long term viability.
- **Policy Framework.** It refers to the set of internal norms that guide the bank's activities. In particular, this set of regulations establishes the decision-making processes used to achieve the strategic and business goals of the company, as well as to appropriately mitigate the risks related to them.
- **Risk Function.** It refers to the area responsible for identifying, measuring, monitoring and controlling the risks the bank is exposed to, so that such risks fall within the limits set by the Board and are compatible with the bank's long term viability.
- **Auditing Function.** It refers to the department or function that is, independent from the risk-taking areas, responsible for ensuring compliance with the internal guidelines and norms set by the bank, as well as with the external regulations in place. It also ensures that there is an appropriate risk control environment.

The proper functioning of each of the aforementioned pillars, as well as the interaction and coordination between them, are a necessary condition to foster an appropriate environment for risk management within a bank.

1 The risks that a bank is exposed to are not necessarily expressed in their financial statements. Such is the case, for example, with the risks of business continuity and information security.

Management Supervision

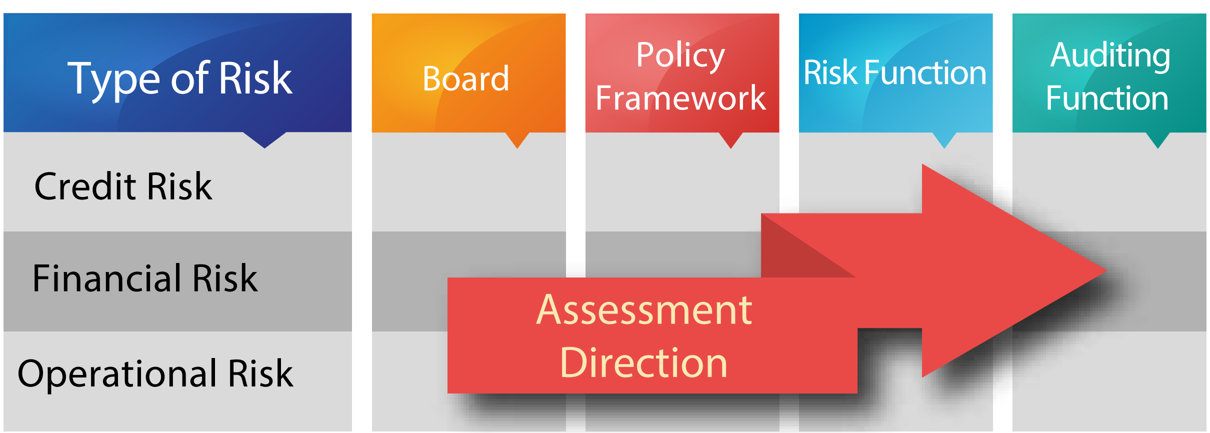
From the point of view of financial stability, the desired goal is that banks manage their own risks effectively. It is thus understood that the supervisor's assessment should be centered on the most relevant risks, namely those whose proper management is a necessary condition for the bank's stability.

Credit risk, financial risk (market, liquidity and structural interest rate risk) and operational risk, are the risks that most often threaten the stability of a banking institution and are those which the banks assign the greatest amount of management resources.

It is important to point out that a supervisor's attention should be focused on risk management, and not on risk level. In fact, the level of risk taken by a bank is determined by its business strategies and commercial goals, which are defined by its shareholders or their representatives. Insofar as those definitions fall within the prudential regulatory framework (allowed activities, capital charges, provisioning and other prudential limits), the supervisor must, among other things, judge whether the related risks are being appropriately managed (identified, measured, monitored and controlled).

Therefore, a supervisor's assessment involves judging the adequacy of risk management according to the pillars mentioned in the previous section. This is represented in Figure 2.

Figure 2. Management Assessment Model



For each risk, management competence must be assessed according to the four pillars, so that

- The Board leads the bank effectively. To do so, they should keep themselves informed about the bank's activities and related risks. Moreover, the Board is expected to periodically review and determine the extent to which the bank's strategy and goals have been achieved. Its role in the definition of the bank's risk appetite is particularly important, for which it should have effective monitoring and control mechanisms.

- The Policy Framework is an effective guide for the bank's activities and internal decision-making processes. This framework should be formally established and approved by the Board, as well as updated in response to any changes taking place in the bank's relevant environment.
- The Risk Function is an effective counterpart to the commercial areas and preemptively fulfills the tasks of identifying, measuring, monitoring and controlling risks in the bank's dynamic environment.
- The Auditing Function effectively exerts control and the independence it needs to carry out its functions. Its tasks are aimed at controlling the bank's compliance with the internal and external norms it is subject to and, additionally, constantly reviewing and perfecting the control environment under which its activities are performed.

The way in which each of the pillars described above is assessed constitutes an important challenge for the modern banking supervisor, especially when it requires a new supervision approach, different from the ones which have traditionally prevailed in the banking industry.

In fact, a substantial amount of supervision efforts has traditionally been placed on two fundamental tasks: (i) monitoring regulatory compliance, and (ii) examining and adjusting the asset prices to fair values. The first task requires standardized verification systems and a limited level of complexity. On the other hand, the examination and adjustment of prices to fair values is a task which has a greater level of complexity, but is supported using commonly accepted economic and financial methods, which makes it easier to apply. Most supervision tasks in this field are related to adjusting the value of the loan portfolio administered by the banks, whenever the supervisor judges that the risks involved have not been properly identified by these entities.

Both tasks can be said to fall within what is known as compliance-based supervision (check list), whose main feature is the use of standardized supervision methods and a lower complexity level.

On the other hand, risk management assessment demands a supervisory approach that is less prescriptive, and is based on the supervisor's technical capacity, experience and expert judgment.

This approach consists in verifying the banks' compliance with general principles of effective risk management. It is precisely this aspect (principles instead of rules) which makes risk-based supervision approaches more complex, as it demands that the supervisor have a comprehensive understanding of the business activities and the risks that each bank is exposed to and the ability to identify the minimum management standards needed by each bank, depending on their specific characteristics. Box 1 describes the scope of the SBIF's RBS approach.

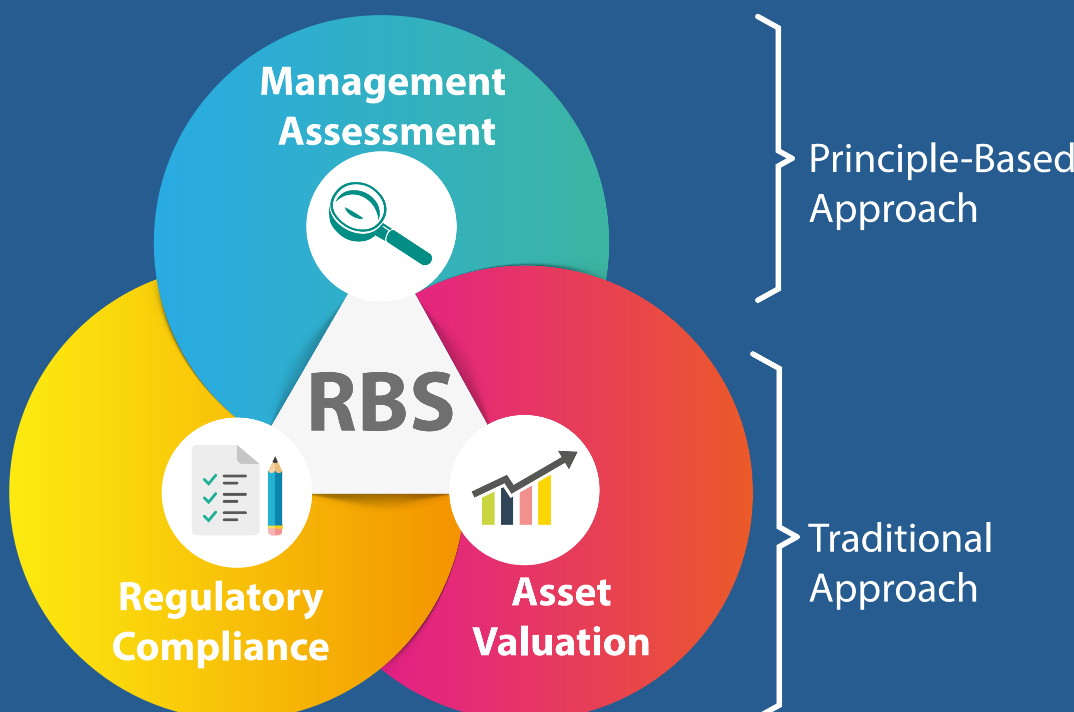
The following sections of this document describe the way in which the SBIF has approached this challenge.

Box 1

Scope of Risk-Based Supervision

For the SBIF, Risk-Based Supervision combines three supervision approaches:

- Compliance Supervision consists of a set of supervisory actions aimed at verifying compliance with the legal and regulatory frameworks that supervised entities are subject to.
- Capital Value Supervision consists of a set of supervisory actions aimed at adequately adjusting the asset value of a bank, so that the capital on its balance sheet represents its actual equity ownership.
- Management Quality Supervision consists of a set of supervisory actions aimed at verifying the adequacy of risk management within supervised banks and promoting the pertinent corrective actions.



- In this context, an appropriate RBS model involves a balance between the three above-mentioned approaches. Notwithstanding this, all RBS models are characterized and differentiated from other models by including the verification of management quality as an integral part of the supervisory process.

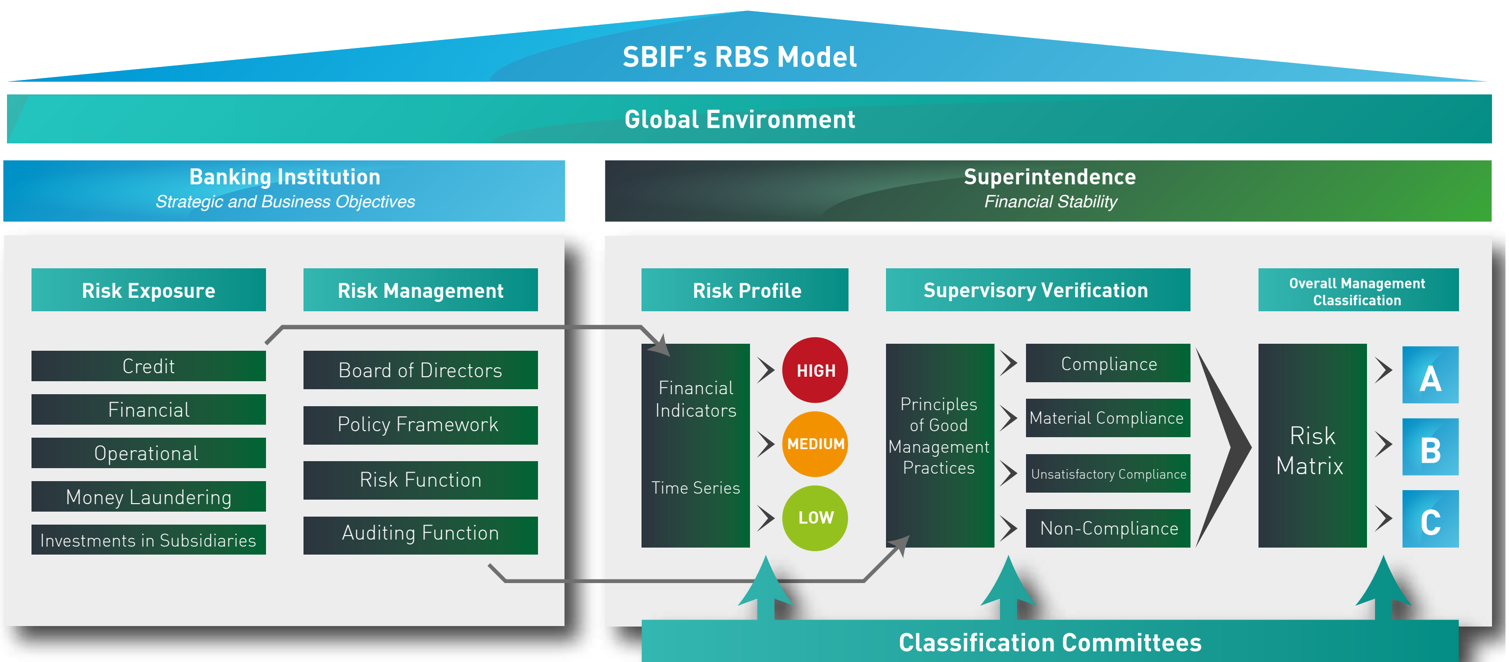
3. RISK MANAGEMENT ASSESSMENT MODEL

The SBIF's supervision model involves off- and on-site activities. The former are aimed at permanently monitoring all supervised financial institutions with the purpose of identifying in a timely manner situations that may require more intrusive supervisory actions. This monitoring process is based on a complete and detailed information system created by the SBIF for this purpose.

On the other hand, on-site activities consist of examining all banking institutions, at least once a year. The SBIF implements its RBS approach through these reviews.

The general supervision model employed by the SBIF is represented graphically in Figure 3. The risks under assessment, as well as the main stages and committees of the supervision process, are highlighted in this model.

Figure 3. Supervision Model



The main elements of this model are explain in the following sections.

Risks under Assessment

The process of management assessment conducted by the SBIF considers five main topics or risks to be evaluated. (Figure 4).

Figure 4. Risks Assessed for RBS Purposes

From a general perspective, the aim of management assessment for each of these risks is as follows.

- **Credit Risk.** The assessment involves the review of credit risk management and its main supporting processes. The assessment focuses on the involvement of the Board of Directors in establishing and monitoring compliance of the bank's strategic and business goals; in the review, approval and monitoring compliance of the banks' policies; and the timely monitoring of risks and the forward looking view regarding risks for the entity. It is also important to verify the adequacy of the policies and procedures in relation to the volume and complexity of the bank's operations. Likewise, mechanisms and methodologies for identifying, measuring, monitoring and controlling risks are assessed, as well as the sufficiency of provisions to cover them. Additionally, the effectiveness of the risk and internal audit functions on the subject are also assessed.
- **Financial Risk.** The assessment considers the management framework for liquidity risk, structural risk of interest rates and market risk, as well as the management of treasury operations. The assessment focuses on the key elements that ensure an appropriate identification, measurement, monitoring and control of these risks. The role of the Board is particularly important in the review and approval of the policies aimed at managing risks, the efficacy of the structural limits in place to contain risks the effectiveness of the monitoring systems, the methods of financial engineering employed and the strength of operative controls. The functional division between the risk-taking, monitoring and operational areas; the compatibility between the risk management methods employed and the level and complexity of the operations performed; the quality of both strategic and operational information; and the effectiveness of the risk and internal auditing functions are all also reviewed.

- **Operational Risk.** The assessment's purpose is to issue an opinion concerning management quality in each of the related areas: (a) Process Risk; (b) Business Continuity; (c) Information Security; and (d) Outsourcing of Services. For each of these areas, the role of the Board of Directors and senior management in managing risks is examined. Furthermore, the existence, sufficiency and compatibility between the bank's policies and established procedures are verified, as well as the way in which the institution's administration takes part in the approval and compliance monitoring of such policies. The methodologies employed to identify, measure, monitor and control each risk are also reviewed. Additionally, the effectiveness of the risk and internal auditing functions are assessed.
- **Risk associated with Investments in Subsidiaries.** The assessment focuses on the effectiveness of the bank's management and control mechanisms, in its head office over its branches and its operations abroad, in subsidiaries and banking activities support companies. The assessment is focused on the governing framework established for these purposes, as well as on the tools and information systems employed by the bank to manage the risks taken by the subsidiaries and other companies under its control. Likewise, the sufficiency of the policy framework established by the bank concerning investments in subsidiaries and intra-group operations are assessed.
- **Money Laundering Risks.** The assessment in this area includes the analysis of the role played by the Board of Directors concerning the activities aimed at preventing money laundering and financing of terrorism, as well as the adequacy of policy and procedural framework, which should be commensurate with the size and complexity of the bank's operations. The "know-your-client" procedures, the role of the compliance official, the functioning of a system that detects unusual operations and the independence of the auditing function (responsible for regularly evaluating compliance with policies and procedures) are assessed.

Risk Profile

Risk profiling is a tool aimed at identifying and measuring the risk exposure of a banking institution according to the activities it performs, through the analysis of both quantitative and qualitative aspects. This stage demands in-depth knowledge of the bank's business model.

In order to obtain the profile for each kind of risk, a set of financial indicators and variables are considered, which enable the establishment of thresholds for each of the ratios or indicators, defined by means of analysis of the industry's historical and comparative patterns.

Subsequently, the final category for each risk profile is determined (if applicable) by the examination of qualitative aspects that are not adequately captured by the analysis of quantitative variables, for instance those related to the expected tendency of the relevant risk factors that determine the most probable environment the industry will face in the short and medium term.

Thus, the resulting risk profile level can be classified in one of the following categories: high, medium or low, which represent the level of exposure to each of the risks assessed (see Figure 5).

Figure 5. Risk Profile

Supervisory Verification

The risk management assessment performed by the SBIF considers the supervised institutions' level of compliance with a set of principles, understood as general guidelines for best practices in the management of different risks. More concretely, this assessment involves reviewing, assessing and giving a well-founded opinion based on this set of principles.

The compliance with these principles in each area considers the following assessment scale:

1. **Compliance (C).** The bank fully complies with the best practices and the application of healthy principles that characterize adequate management, without any significant deficiency.

2. **Material Compliance (MC).** The bank significantly complies with the best practices and the application of sound principles that characterize adequate management. Even though some weaknesses in specific processes are identified, they are considered to be limited. In any case, these weaknesses must be corrected by the institution, with the purpose of meeting the highest standards of risk management.

3. **Unsatisfactory Compliance (UC).** The bank does not reasonably comply with the best practices and the application of sound principles that characterize adequate management. Weaknesses in the processes of different functions are identified, among which some are significant. It is considered important to correct these weaknesses for the bank to improve performance.
4. **Non-Compliance (NC).** In a significant way, the bank does not comply with the best practices and the application of sound principles that characterize adequate management. It is considered imperative to correct these weaknesses in order to not affect the bank's performance.

For the purposes of clarification, the following box details the principles which in the SBIF's opinion characterize adequate management. The assessment involves rating compliance level in relation to each of these principles.

Box 2

Management Principles

Credit Risk

- Principle 1. The Board has established and is actively involved in the governance framework used to manage credit risk.
- Principle 2. The bank has a risk function that is an effective counterpart to the commercial areas.
- Principle 3. The banking institution performs its activities in accordance with credit policies that appropriately cover the risks taken.
- Principle 4. The bank has a verifying mechanism that ensures its policy compliance.
- Principle 5. The bank has an appropriate control environment for operations with related parties.
- Principle 6. The banking institution performs its activities according to procedures that are compatible with credit policies.
- Principle 7. The bank has the appropriate tools to identify and measure the credit risks it is exposed to, which are commensurate with the size and the complexity of its operations.
- Principle 8. The auditing function effectively controls credit activities and their related risks.

Financial Risk

- Principle 9. The Board of Directors has established an appropriate governance framework to manage financial risks.
- Principle 10. The committees in charge of financial risks effectively manage these risks.
- Principle 11. The bank has a risk function that is an effective counterpart of the areas in charge of managing financial risks and running the bank's businesses.
- Principle 12. The bank performs its activities according to policies aimed at sound management of financial risks.
- Principle 13. The bank performs its activities according to procedures which are compatible with financial policies.
- Principle 14. The bank has an appropriate process to identify and measure financial risks.
- Principle 15. The bank has appropriate processes for trading activities and for the recording and management of treasury operations.
- Principle 16. The auditing function effectively controls the activities involving financial risks and treasury operations.

Box 2

Management Principles
(continuation)

Operational Risk

- Principle 17. The Board of Directors has established an appropriate governance framework to manage operational risks.
- Principle 18. The bank has a structure of functional committees regarding the main operational risks that it is exposed to.
- Principle 19. The bank has a risk function that is an effective counterpart for the risk-producing areas, which is responsible for designing and maintaining an appropriate system for identifying, assessing, monitoring, controlling and mitigating operational risks.
- Principle 20. The bank performs its activities according to policies that appropriately cover the risks taken.
- Principle 21. The bank performs its activities according to procedures that are compatible with operational risk policies.
- Principle 22. The bank possesses methodologies to identify, assess, monitor, control and mitigate internal and external risks that affect operational risk.
- Principle 23. The bank has a methodology that enables it to effectively manage business continuity.
- Principle 24. The bank appropriately manages information security, safeguarding its confidentiality, integrity and availability.
- Principle 25. The bank has an appropriate methodology to manage outsourcing of services.
- Principle 26. The bank has a technological infrastructure that enables it to cover its current and projected business needs, as well as the appropriate technological processes to support its business activities.
- Principle 27. The auditing function effectively controls the management of operational risks.

Risk associated with Investments in Subsidiaries

- Principle 28. The Board of Directors has established an appropriate governance framework to control the risks related to the subsidiaries in which it invests.
- Principle 29. The bank effectively monitors the risks of the different subsidiaries which comprise the banking conglomerate.
- Principle 30. The bank manages the subsidiaries in which it invests according to policies and procedures commensurate with their size and complexity.

Box 2

Management Principles
(continuation)

- Principle 31. The tools employed by the bank to identify and measure risks (credit, financial, operational, AML) consider the exposure produced by its subsidiaries.
- Principle 32. The bank has an information system that enables it to monitor the different kinds and degrees of exposure to the risks of its subsidiaries.
- Principle 33. The auditing function effectively controls the subsidiaries' activities and their related risks.

Money Laundering Risks

- Principle 34. The Board of Directors has established an appropriate governance framework to manage the risks related to money laundering and the financing of terrorism.
- Principle 35. The bank has committee(s) for Anti Money Laundering (AMLFT) which are commensurate with the complexity of its operations.
- Principle 36. The bank has a compliance function that appropriately monitors the AMLFT system.
- Principle 37. The institution performs its activities according to a policy framework that enables it to appropriately manage the risk of Money Laundering (ML) and the Financing of Terrorism (FT).
- Principle 38. The bank has a policy regarding operations with politically exposed people (PEP).
- Principle 39. The banking institution performs its activities according to procedures which are compatible with AMLFT policies.
- Principle 40. The bank has a methodology to classify its clients' ML and FT risk.
- Principle 41. The bank has a system to monitor its operations, which is commensurate with its size, based on the ML and FT risk profile and which covers all its products.
- Principle 42. The bank has a formal and regular training process for its entire staff.
- Principle 43. The auditing function effectively controls AMLFT activities.

Overall Management Classification

The assessment of these principles results in the management classification of each assessed risk and produces the basic elements used to assign the bank an overall classification. Such classification is performed according to the elements considered in one of the three levels or categories defined by law. For a better understanding of the methodology, we present a conceptual definition of these categories:

- **Category A.** This category considers institutions that display high compliance levels regarding management principles for each of the pillars, the Board of Directors, policy framework, risk function and internal auditing function, for each of the risks assessed.
- **Category B.** This category considers institutions that in general display good compliance levels regarding management principles for most of the assessed risks, although there are weaknesses in some of them which should be corrected to avoid the gradual deterioration of the institution's stability.
- **Category C.** This category considers institutions that display low compliance levels regarding sound management principles for most of the assessed risks or for a very significant risk, which must be corrected promptly to avoid the impairment of the institution's stability.

It is important to bear in mind that the three categories described above represent the SBIF's well-founded opinion concerning a bank's management quality within the normal functioning framework for its activities. In other words, the kind of management weaknesses related to each category should be understood as characteristic of any functioning company. Insofar as these weaknesses are not adequately corrected, the bank's financial performance could deteriorate and if they persist over time, they could trigger some of the legal actions related to bank resolution (for example, minimum capital). That is to say, the category C is not enough per se to presume financial instability and therefore apply extraordinary legal measures to banking institutions in trouble.

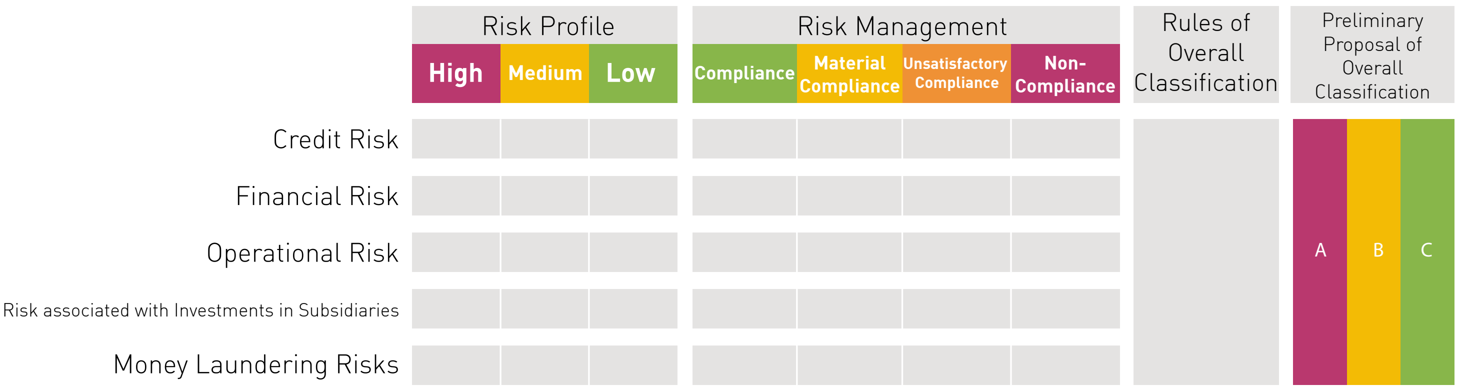
It should be noted as well that the management categories assigned to banks are not publicly available. They are only known by the SBIF and the assessed institution.

Risk Matrix

The process of overall management classification is based on a risk matrix which incorporates the individual assessment of each institution in an orderly manner.

The matrix synthesizes the information of the risk profile and the risk management assessment and by combining these two aspects puts forward an overall management classification for each bank. The combination of such information follows the rules based on the experience accrued over the years during which the RBS model has been applied (see Figure 6).

Figure 6. Management Classification Matrix



The whole process demands an integral view of each banking institution, where the supervisor's capacity to assess the banks' management practices, the understanding of the different management practices applied in the financial system and also the SBIF's experience and historical knowledge of each supervised entity are essential. To facilitate this integral view, several committees are responsible for discussing and agreeing on the institutional vision of each bank.

Classification Committees

Complementing the methodological framework described above, the SBIF has established committees for joint inter-area analysis at different levels, with the purpose of ensuring that management classification is the result of a supervision process that meets all the scope and depth standards specified in its internal manuals. Likewise, the relevant institutional knowledge of each bank should be incorporated into the classification decisions.

The committees are detailed below.

Risk Profile Classification Committee

This Committee is constituted by the Deputy Superintendents of the Supervision and Risk Divisions, who analyze and define the risk profile as determined by the tool used for this purpose. This committee is also responsible for determining the criteria used to build this tool.

Risk Management Classification Committee

This Committee is constituted by the Supervision Intendance heads (Deputy Superintendent, Directors and Managers). Its goal is to review during the year the risk assessments performed on site, examining the compliance with the principles for each assessed risk.

When the Committee meets, each Manager in charge of the institution under assessment, together with the Risk Managers that participated in the corresponding inspection, present the risk characteristics and profile of the bank and their assessment of its compliance with management principles. Considering all the aforementioned elements, a classification proposal is submitted for each of the assessed risks, which the Committee should then ratify or modify. With this recommendation, the Superintendence accepts the respective decision, which is later delivered to the bank in a letter stating the main conclusions of the assessment. The bank's Board of Directors should then take the corrective measures needed to solve the observed deficiencies, and inform the SBIF about them for further monitoring and control.

Overall Classification Committee

This Committee is constituted by the SBIF's Senior Management, including the Superintendent, Deputy Superintendents and Directors. It meets at least once a year and its purpose is to analyze the principles of classification for overall management for all banks in the financial system.

Bearing all this in mind, the Superintendence determines the classification assigned to each bank. By the end of each year, the results are delivered by post to the banks' general managers, who in turn convey them to their respective Boards.

4.- MAIN LESSONS

More than two decades' experience applying an RBS approach has enabled the SBIF to identify five key elements which have contributed to its success: (a) the availability of a broad and detailed information system, which enables the timely monitoring of risks; (b) the application of an intrusive supervision process, involving regular on-site monitoring of all institutions; (c) the systematic deployment of a set of principles of best management practices to assess banks; (d) the formation of governing bodies that classify the banks in the different stages of the supervision process; (e) and the constant revision and updating of the model.

Information System

The assessment of risk exposure and risk management not only relies on the on-site evaluation of banks, but also relies significantly on the off-site work needed to monitor their performance in a timely manner.

For that reason, the SBIF has a broad and solid set of standardized information which should be updated by the banks daily, monthly, quarterly and annually. This enables the SBIF to know in general and in detail banking operations on the level of clients, products, regions, etc.

This information system has enabled the SBIF not only to have an updated vision of the risk profile of each bank, but also to produce internal modeling of risk quantification and standards that facilitate the identification of risk sources and guide supervisory actions.

Intrusive Supervision

The SBIF performs extensive on-site reviews of all banking institutions with the purpose of classifying their management at least once a year. Moreover, the SBIF maintains ongoing contact with their main counterparts at the banks as part of its monitoring process, in order to have an updated view of their management in terms of business, organization, products and risk development.

This practice has made the supervision process more effective, since the permanent proximity to supervised institutions has been a key factor in promoting discipline and self-regulation.

Set of Principles

In the supervision model employed by the SBIF, the assessment of the adequacy of risk management is based on the verification of the level of compliance with a set of principles that were established based on the best practices in risk management. Specifically, this set of principles clearly specifies the SBIF's expectations regarding the conditions that should be met by banks in managing the risks they are exposed to.

This practice has enabled the SBIF to define and make transparent the scope of the its assessment regarding the management of banks and it has facilitated the application of a systematic and homogeneous supervision process to all supervised institutions.

Governing Bodies

The SBIF's supervision model employs knowledge, experience and expert judgment as pivotal elements in most of its supervision process. For this reason, it has been deemed necessary to form internal committees, so that everything that requires expert judgment is jointly analyzed and duly substantiated.

This practice has facilitated the application of homogeneous assessment criteria to the different supervised institutions and, at the same time, has promoted the formation of supervisory judgment based on objective and institutionally agreed elements.

Constant Review of the Model

The dynamicand complexity of banking activities, the experience accrued in the supervision process and the constant evolution of the tools of knowledge determine that the RBS model must be constantly reviewed and updated to maintain its efficiency.

In fact, the current RBS model employed by the SBIF is the result of successive modifications made over the course of many years. To facilitate this process, an area has been recently created within the SBIF which, among other things, constantly reviews the model. This involves verifying its correct application and identifying the changes needed to keep it up-to-date and thus ensure its effectiveness. Box 3 briefly describes the latest adjustments made to the supervision model in the past years in order to better focus supervisory resources and increase the effectiveness of the process.

Box 3

Risk-Based Supervision Model Improvements in Chile

2000

- 7 assessment areas are established: **credit risk, operational risk, foreign resources, investment control, strategic planning and business management information systems.**
- General principles are established for each area.

2005

- 2 subject areas are merged (investment control and foreign resources) and 3 new ones added: **money laundering, customer service quality and auditing function.** The area of management information systems is removed.
- A 5-category scale is created to assess each area: **Total Compliance, Material Compliance, Acceptable Compliance, Unsatisfactory Compliance and Non-Compliance.**

2015

- The risk assessment subject areas are reduced from 8 to 5: **credit risk, financial risk, operational risk, investments in subsidiaries and money laundering.**
- The categories of the assessment scale are reduced from 5 to 4, **removing the intermediate category of Acceptable Compliance.**

2016

- Different internal committees are established to assess all areas and classify the yearly performance of banks.

2017

- A risk matrix is formalized, which establishes the management principles for assessment in each area, in conjunction with a methodology to determine the risk profile of each bank.

Superintendencia
de Bancos
e Instituciones
Financieras
Chile

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