Risk-Based Supervisory Framework

Knowledge of Business and Identification

of Significant Activities Guide

For the Egyptian Insurance Supervisory Authority

November 16, 2006

This publication was produced for review by the United States Agency for International Development. It was prepared Ron Bergeron

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TECHNICAL ASSISTANCE FOR POLICY REFORM II
CONTRACT NUMBER: 263-C-00-05-00063-00
BEARINGPOINT, INC.
USAID/EGYPT POLICY AND PRIVATE SECTOR OFFICE
NOVEMBER 16, 2006
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DELIVERABLE COMPONENT: B.

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Overview

The purpose of the Knowledge of Business and Identification of Significant Activities (KOB) guide is to describe an approach to developing an **understanding of an institution's environment, industry and business profile**. Regardless of where a supervisor decides to begin the analysis (environment, industry or business profile), the approach is an iterative one, embracing all three dimensions. The understanding derived from this analysis **provides the basis for identifying activities** that are significant to the achievement of an institution's business objectives.

The "environment" refers to the external conditions in which an institution is operating. It includes the prevailing economic, social, demographic, political and regulatory conditions. "Industry" refers to the financial services sector in which an institution is operating; e.g., life insurance or banking sectors. "Business profile" refers to the nature, scope, and complexity of an institution's operations. An institution's business profile is shaped by its business objectives, strategies and risk tolerance. The Knowledge of Business (KOB) of an institution is an understanding of its business profile and the environmental and industry factors that affect it. The KOB provides the broad context for understanding and assessing an institution's risk profile (i.e. its Composite Risk).

Developing the KOB of an institution requires answers to questions like: **What is the institution trying to achieve? How does it go about doing this? Which activities are the key drivers of its business profile? How do changes in the environment and industry affect the achievement of its objectives?**

To develop the KOB, we review the environment and industry in which an institution is operating, to identify opportunities and threats that support or restrict it in pursuing its objectives. We review its business profile to identify the activities that are significant to the achievement of those objectives. This understanding and analysis is documented clearly and concisely in the KOB section note and provides the context for the assessments made throughout the supervisory process.

The approach described below is intended to provide general guidance only. Supervisors need to tailor their approach to individual cases based on the nature, scope, and complexity of an institution's operations and the environment and industry in which it is operating.

1.0. Introduction

1.1. The approach to developing the KOB of an institution is based on the following Supervisory Framework concepts:

- *Consolidated Supervision* – Institutions are supervised on a consolidated basis, where applicable.
- *Risk Focused* – The KOB is a risk-based analysis of an institution's operations.
- *Holistic Approach* – A holistic understanding of an institution's environment, industry and business profile provides the context for assessing its risk profile.
- *Iterative Process* – Understanding an institution's environment, industry and business profile is an iterative process whereby a greater understanding of one, leads to a deeper understanding of the others.
- *Dynamic and Continuous Process* – Supervising an institution is a dynamic and continuous process requiring periodic up-dates of its business profile and an ongoing re-evaluation of it's risks and risk management practices.
- *Supervisory Judgement* – Sound and informed judgement is critical in developing a supervisory approach to the KOB analysis.

1.2. The approach described in the guide should be used for both a consolidated entity, as well as entities assessed on a stand-alone basis. This is discussed further in section 5.0.

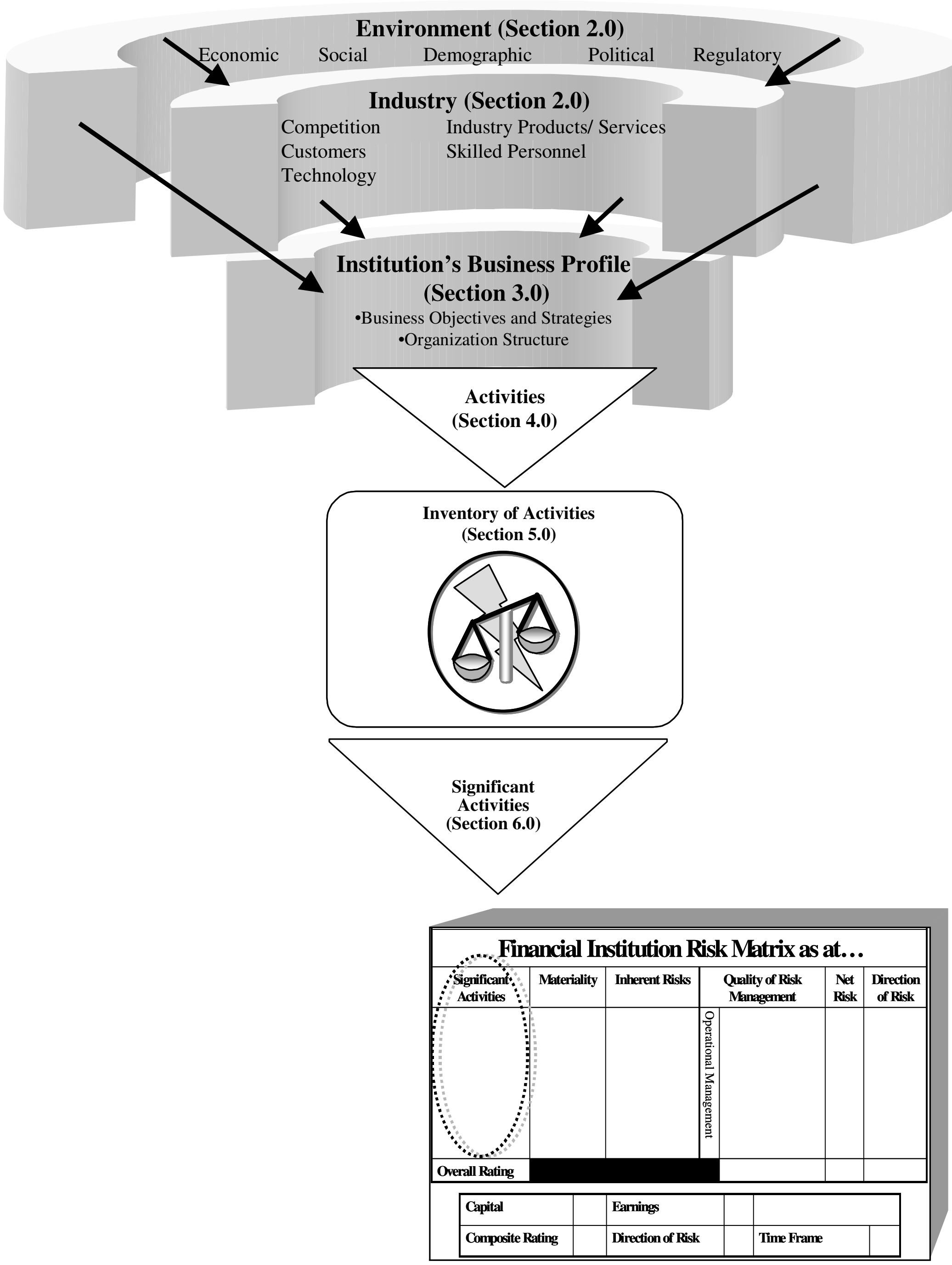
1.3. Financial institutions play a key role in the economy by participating in and funding business activities and taking on risks. The activities they engage in, and their associated risks and risk management practices, determine the risk profile of an institution. These activities and risks are affected by factors external and internal to the institution.

1.4. External factors, such as general economic, political and industry conditions are beyond the control of an institution, yet they can have a significant affect on its ability to achieve its business objectives and can contribute significantly to its risk profile.

1.5. A supervisor needs to identify and understand the various environmental and industry factors that affect an institution's business objectives, strategies and activities as a prelude to an effective assessment of its risk profile.

1.6. An institution usually organizes itself to manage and control risks inherent in its activities in order to achieve its business objectives.

1.7. The following schematic depicts an approach to developing the KOB of an institution, considering its environment, industry and business profile.



1.8. In performing a KOB analysis, a supervisor can either start by reviewing the environment and industry in which an institution operates, and then move to understanding its business profile; or, review an institution's business profile, and then look to the industry and environment to identify factors that are likely to impact its operations. This is an iterative process and may require moving back and forth between the three dimensions to build the requisite knowledge. Irrespective of where a supervisor begins the KOB analysis, he/she needs a basic understanding of all three dimensions.

1.9. Because of the dynamic nature of the three dimensions, the supervisory process requires an ongoing re-evaluation of the risk profile of an institution. This includes continual monitoring of changes in the institution's environment, industry and business profile, and assessing their potential impact on its operations. In doing so, the focus should be on the factors that are likely to have a material impact on the institution's risk profile. The necessary knowledge can be gained by reviewing readily available information. Examples of the sources of information are included in Appendix 2.

2.0. Understanding an institution's environment and industry

2.1. Environmental and industry factors may exert external pressures on an institution, over which it has little or no control. Such pressures may directly or indirectly affect an institution's operations, requiring management to revise its strategy, possibly altering its risk profile. An institution's risk profile may also be affected by its inability to respond successfully to the external challenges.

> For example, a weak economy may substantially reduce the demand for an institution's products and services, causing it to cut costs by reducing the number of employees. Job losses and uncertainty, may in turn, lead to low morale, increased errors and a disregard for policies and procedures, or result in inadequate resources to perform, supervise or oversee business activities properly.
>
> Similarly, external pressures, such as a buoyant economy, may entice an institution to undertake new initiatives to increase market share and/or introduce new products and services. In addition, economic growth could create a shortage of skilled personnel which could lead to increased errors due to lack of knowledgeable and/or sufficient Operational Management and/or failure to build an appropriate infrastructure to meet the new requirements.
>
> A volatile economy may also lead to pressures, such as rising interest rates, reduced liquidity, increased counter-party defaults and slimmer margins.

2.2. Environmental and industry knowledge is obtained and applied in a continuous and cumulative manner, over time. The deeper a supervisor's understanding of the relevant environmental and industry factors is, the more readily he or she will be able to analyze and assess the impact of those factors, and changes in the factors, on an institution. The level of environmental and industry knowledge needed to understand an institution's business profile will depend on the nature, scope and complexity of the institution's operations.

> For example, supervisors will require a broader and deeper understanding of environmental and industry factors for larger, more complex institutions than for smaller, mono-line companies. A conglomerate operating in more than one industry; e.g., banking, insurance and securities, and across a number of jurisdictions (Canada, U.S., Europe and the Far East), will require an understanding of the banking and insurance industries, as well as the securities industry in order to assess how industry factors and conditions might affect the consolidated institution.
>
> Similarly, supervisors would need to have a basic understanding of the economic, regulatory and political conditions in each of the jurisdictions in which the conglomerate operates to identify those factors that may affect the institution's business objectives and strategies.

2.3. Appendix 1 provides examples of environmental and industry factors that would need to be considered. Supervisors should scan and distil relevant information from readily available sources. This information can be used to identify the factors (i.e. environmental and industry) that are relevant for the institution. Where additional research and analysis are required, supervisors should discuss their needs with the Manager to determine who will do the work and the scope of the work to be undertaken.

3.0. Understanding an institution's business profile

3.1. An understanding of the environment and industry in which an institution operates provides the supervisor with a broad context for understanding its business profile.

3.2. To gain an understanding of an institution's business profile, supervisors need to understand its business model i.e. its business objectives and strategies, and organization structure.

Business objectives and strategies

3.3. Business objectives and strategies provide management with the roadmaps needed to achieve profitability and create shareholder value. A supervisor needs to understand how an institution plans to achieve its objectives, in order to identify the types of business activities in which it engages. For instance, where an insurance institution decides to shift its core business from individual life insurance to wealth management, the types of activities it engages in will change overtime.

3.4. "Risk tolerance" is the level of risk that an institution is willing to accept in its business activities, either individually or collectively. It is sometimes expressed in terms of the maximum acceptable exposure to loss an institution is willing to accept at any time, from a given activity or from all activities taken together. Risk tolerance underpins an institution's business objectives and strategies. An institution would be expected to have approved policies for its risk tolerance levels.

> Following are examples of the types of questions a supervisor would need to consider in understanding and assessing an institution's risk tolerance:
>
> - How conservative are the institution's overall business objectives, and objectives for its mission-critical activities?
> - Is management conservative or aggressive in the strategies it has established to achieve its business objectives?
> - Are the institution's business objectives and strategies realistic, given the conditions in the environment and the industry, and the financial condition of the institution?
> - How conservative are the risk tolerance limits approved by the board?
> - What are the institution's capital constraints and opportunities?
> - What are the nature and complexity of business activities undertaken?
> - Who are the institution's major competitors?
> - Does the institution have or can it readily obtain the skills and expertise needed to carry out its business objectives and strategies?

3.5. Information on the institution's business objectives and strategies should be obtained from senior management and from the institution's strategic plan. Discussion with management should cover the institution's competitive strengths and weaknesses, opportunities and threats, and risks that are likely to affect its near-and-mid-term performance.

> Following are examples of the type of questions a supervisor would need to consider in understanding and assessing an institution's strategies:
>
> - Is the institution a market leader or follower in setting strategic direction?
> - Has the institution been successful in executing its strategies?
> - What are the frequency, nature and purpose of the changes in strategy and the related activities in which the institution engages?
> - How responsive has the institution been to environmental and industry threats and opportunities?

3.6. Where an institution is a subsidiary or a branch of a foreign entity, its objectives and strategies are often determined or influenced by the parent or home office. Still, the regulator's supervisory focus needs to be on the best interest of the domestic subsidiary or branch. Supervisors need to understand how significant the institution is to worldwide operations and the extent to which the parent or home office influences the institution's activities and risk tolerance.

For example, a foreign reinsurance company has a significant wholly owned Domestic subsidiary. The parent considers the subsidiary integral to its overall strategy and ongoing success. It directly oversees the subsidiary and its strategic direction. In essence, the subsidiary is managed like a division. In this situation, the strategy, and, consequently, the nature and scope of activities the Domestic subsidiary engages in, would be significantly influenced by the group's worldwide strategy and initiatives.

Organization Structure

3.7. An institution's organization structure describes how it is organized to carry out its business objectives and strategies. It would include its legal and operational configuration, as well as its divisional accountabilities and reporting lines.

3.8. In order to achieve its objectives, an institution needs to align its organization structure with its strategies. Therefore, a review of an institution's organization structure may provide supervisors with valuable insight into the activities that management consider critical to the attainment of its business objectives, and may identify weaknesses in it's accountability structure.

Following are examples of information that could be gleaned from reviewing an institution's organization structure and discussing it with senior management:

- Its legal and ownership structure
- If part of a group, its position in the group and relationship with other members of the group.
- The manner in which the institution is organized;
  - Functionality (marketing, underwriting, claims, investments, treasury, etc.);
  - By product line (mortgages, deposit accounts, mutual funds, whole life, term life, disability insurance, automobile insurance, property insurance, etc.);
  - By target markets (personal and commercial lines, private client, corporate banking, retail banking, small business, national accounts, etc.);
  - By region (U.K., U.S., Asia, etc.);
  - By distribution channel (agents, brokers, branch network, electronic, etc.);
- Which activities are mission critical and are allocated the most resources?
- Which activities are the key drivers of the institution's business profile?
- How new markets and activities are integrated in the organization structure? and
- Extent to which the institution outsources its activities.

4.0. Identifying an institution's activities

4.1. An understanding of an institution's business profile enables a supervisor to identify its activities.

4.2. An institution's activities would include any line of business, business unit or enterprise-wide process.

4.3. A line of business is a revenue-generating activity through which an institution executes its strategy.

> For example, an insurance institution's lines of business may include automobile insurance or individual life insurance. For a deposit-taking institution, they would include corporate lending or retail banking.

4.4. A business unit is an organizational group responsible for providing a product or service. It may be a legal entity or a cost or profit centre organized along geographical lines, by product, service, market segment, or a combination thereof.

> For example, an insurance company may organize its protection lines by region such as Atlantic Region / Western Region or Domestic/US operations and its wealth management business by legal entity; a bank may organize its operations along product, service or market segment, such as wealth management, retail banking, corporate banking, etc. These units may be organized as subsidiaries or cost or profit centers.

4.5. An enterprise-wide process refers to those activities that are not a line of business, business unit or risk management control function (RMCF) as defined in the Supervisory Framework. A process is considered enterprise-wide when it operates across a number of significant lines of business and/or business units.

> Enterprise-wide processes may include treasury and balance sheet management or strategic management. Processes such as information systems may also be considered enterprise-wide processes if they are managed centrally and cover a number of activities. They are defined as discrete activities that operate and are managed independently from the business activities they support. As discrete activities, they have their own unique inherent risks.
>
> For example, each business unit may be responsible for its own information systems. Conversely, responsibility for enterprise-wide information technology may be centralized with only limited responsibility given to business unit management. In the former case, information technology would be assessed as part of the business unit's Operational Management; in the latter case, information technology, being an enterprise-wide process, would be considered and assessed as a Significant Activity.

5.0. Developing an inventory of activities

5.1. Activities identified by analysing an institution's business profile would enable a supervisor to develop an inventory of activities to be considered and assessed for their significance in the context of the institution's business objectives. The following principles should be considered when developing an inventory of activities and in grouping activities for assessment purposes.

5.2. *Organization Structure:* An inventory of activities should be developed in the context of the consolidated entity, where applicable. This requires supervisors to consider how best to include activities carried out within and across legal entities (i.e. through subsidiaries, including other regulated entities) in the inventory of activities to achieve the level of scrutiny considered necessary for assessing the institution's risk profile. A range of options is available to supervisors.

> For example, a banking conglomerate may have one or more mortgage subsidiaries, and the bank itself may engage in mortgage related activities. As a result, the consolidated institution may manage its mortgage business as a line of business, disregarding legal entity boundaries. In such a case, it may be appropriate to assess the group's mortgage activity in the way it is managed, assuming it is a significant activity for the group.
>
> Conversely, a banking conglomerate may have a wholly owned trust company. The trust company may engage in many different activities that are unique to the entity. In this case, how the entity and its activities are assessed would depend on the materiality of the subsidiary and its lines of business to the consolidated entity.

5.3. In cases where regulated entities are assessed as part of a consolidated group, at a minimum, supervisors would need to ensure that each financial institution meets the capital and other material regulatory requirements that are applicable to its operations.

5.4. There may be instances where it is necessary to assess one or more of the regulated entities in a group on a stand-alone basis as well. In these cases, the results of the assessments should be documented in a separate supervisory file, and incorporated into the assessment of the consolidated entity.

5.5. *Business Strategy*: All activities that are part of an institution's business strategies should be considered, as should enterprise-wide processes.

5.6. *Accountability and Reporting*: The grouping of activities should generally follow lines of accountability and reporting. **How an institution is organized and managed is a useful basis for identifying and defining its activities**. This will ensure that information necessary for assessing the activities is readily available. Grouping or separating activities on a basis other than how they are managed by the institution may compromise the availability of information needed to assess the activity effectively.

For instance, if an institution manages an activity by region but the supervisor combines all the regions for risk assessment purposes, then the information required for assessment may not be readily available.

5.7. Where supervisors find it necessary to group activities differently than the institution, they should clearly document the rationale for doing so and the linkages (i.e. audit trail) to the institution's grouping of activities.

5.8. *Completeness:* The inventory should be reasonably complete, with activities combined or separated in a meaningful way; e.g., considering homogeneity, accountability, management's view, etc.

These are not intended to be all-inclusive nor are they intended to imply that activities should be aggregated or disaggregated into the categories set out in the standard file index. Supervisors should develop the inventory of activities based on what they consider to be the most meaningful and effective way to assess the risk profile of the institution.

6.0. Identifying Significant Activities

6.1. The inventory of activities should be used to identify an institution's Significant Activities.

6.2. Sound and informed judgement is used to determine the significance/materiality of an institution's activities, including its subsidiaries.

6.3. Materiality is a measure of the relative significance of an institution's activities to the attainment of its business objectives. It is multi-dimensional, current and prospective, and considers both qualitative and quantitative factors.

6.4. The materiality criteria used to determine the significance of an activity would not necessarily be the same for all activities.

6.5. Following are examples of quantitative and qualitative criteria that may be considered for determining the significance/materiality of an activity.

Examples of quantitative criteria:

- Assets generated by the activity in relation to total assets (both on-and-off balance sheet);
- Risk-weighted assets generated by the activity in relation to total risk-weighted assets;
- Revenue generated by the activity in relation to the total revenue;
- Net income before tax for the activity in relation to total net income before tax;
- Internal allocation of capital to the activity in relation to total capital;
- Insurance underwriting exposure in relation to capital; and
- Reserves held as a percentage of total reserves.

Examples of qualitative criteria include brand value or reputational impact, strategic importance and significance of an enterprise-wide activity.

6.6. Activities identified as significant by a supervisor would generally parallel those considered significant by the institution's management. Supervisors should discuss with management, the appropriateness of the activities they have identified as being significant to the institution.

6.7. It may be appropriate to group or sub-divide activities to provide an effective and efficient risk assessment. This is referred to as granularity.

6.8. Granularity is an important consideration because combining different activities into a single activity for assessment purposes may mask the risks inherent in each activity and/or may create difficulties in assessing the effectiveness of operational management and risk management control functions as they apply to the "combined activity". If activities are grouped at a higher level, the number of Significant

Activities may be reduced; but it may result in Significant Activities that mask the underlying inherent risks, making supervisory assessments difficult or misleading.

> For example, assessing the risks inherent in the lending activity may result in different ratings if lending were assessed as a single activity rather than sub-divided into its major components such as commercial lending or personal line of credit lending. Alternatively, certain retail banking activities may be combined if the nature of risks inherent in the activities is similar. For example, certain types of consumer lending and lending to very small businesses are similar activities because the primary risk is credit and the key factor underlying the level of risk is normally the strength of the customer.

6.9. Conversely, if activities are divided too finely, it could cause inefficient and/or ineffective supervision. In addition, file documentation would become fragmented, making it difficult to arrive at an overall understanding and assessment of the institution's risk profile.

6.10. Materiality and granularity are both important determinants in identifying and defining Significant Activities.

6.11. Supervisors should ensure that all activities are appropriately considered. The result should be such that activities that have not been identified as being significant are not material, individually or collectively, to the institution's business or risk profile.

6.12. The inventory of activities should be reviewed on an ongoing basis to ensure that it remains up to date so that Significant Activities are appropriately identified and included in the risk matrix for assessment purposes.

7.0 Documenting the Knowledge of Business analysis and identification of Significant Activities

7.1 A supervisor's assessment of an institution's business profile, the environmental and industry factors that impact its operations and a listing of its activities are documented in the KOB section note.

7.2 The KOB section note includes the following sections:

a) *Environmental and industry considerations*: This section should briefly describe the environmental and industry factors that affect the institution's business profile.

b) *Business Profile*: This section should briefly describe the business profile of the institution under the following headings:

- Business objectives and strategy
- Organization structure.

c) *Inventory of Activities*: The activities identified and included in the inventory should be listed with a brief description (a line or two) of each activity, its significance, and the considerations for determining its significance or materiality. The inventory should be divided into two parts – Significant Activities and Other Activities. Those listed under "Significant Activities" should be the ones carried forward to the Risk Matrix.

7.3 The nature and level of information to be included in the KOB section note would depend on the size and complexity of an institution. However, sufficient and appropriate information should be provided to convey clearly and concisely, at a high level, an institution's business profile, and the nature and significance of its activities. It should help set the context for assessing the risk profile of the institution.

7.4 Given the rate of change in the financial services sector and the speed with which an institution's financial condition and risk profile can change, supervisors should periodically review and update the KOB section note.

7.5 Where information comes to light that changes the key factors considered in the identification of Significant Activities, supervisors should consider updating the KOB section note and the listing of Significant Activities.

7.6 Supervisors would also need to determine the type and frequency of the information needed to keep an institution's business profile current. In determining the type of information required, supervisors would need to consider the nature, scope and complexity of the institution's operations, changes in it's business objectives, strategies, organization structure, and supervisory concerns, if any.

For example, if an institution is planning to undertake, or has engaged in, a new activity that a supervisor is not familiar with, it will be necessary for the supervisor to acquire knowledge of the activity and the affect of industry and environmental factors to understand the significance of the activity in the context of the institution.

Similarly, if an institution has expanded an existing activity into a new jurisdiction, the supervisor would need to understand how that jurisdiction's economic, political, social, regulatory, and industry conditions affect the attainment of the institution's objectives.

Appendix 1 – Examples of Environmental and Industry Factors

The following table provides examples of environmental factors that may need to be considered for their impact on an institution's operations when performing a KOB analysis:

Economic	Social & Demographic	Political	Regulatory
▪ Level of economic activity at home and abroad ▪ Market Volatility ▪ Interest rates ▪ Inflation, foreign exchange rates ▪ Monetary and fiscal policy	▪ Population concentration, migration, aging and lifestyles ▪ Emerging diseases ▪ Advances in medical science ▪ Availability of skilled personnel ▪ Consumer, investor and business confidence ▪ Demand for products/services ▪ Advocacy groups	▪ Stability, or volatility ▪ Competition Policy	▪ Regulatory climate; ▪ Nature and Extent of regulation ▪ Number of regulatory bodies and complexity of legislation ▪ Pace of change in the regulatory environment

The following list provides examples of industry factors that may need to be considered for their impact on an institution's operations.

- Nature and extent of the laws and regulations affecting the financial service sector e.g., environmental regulations; restrictions on business and powers, pricing and product restrictions, etc.;
- Nature and extent of competition e.g., new entrants; consolidation; introduction of alternative products or services; ease of entering or exiting the market, etc.;
- Cyclical or seasonal nature of products and services;
- Life cycles of products and services;
- Elasticity of demand and pricing;
- Susceptibility of customers and markets to adverse environmental conditions;
- Customer loyalty;
- Availability of skilled personnel; and innovations in technology.

Appendix 2 – Sources of Information

Knowledge and understanding of the environment and industry in which an institution operates can be gained over time from various external and internal sources of information. Following are some examples of sources readily available to supervisors.

1.1

External

- General business press, economic and industry publications, reports prepared by market experts, rating agency reports, corporate and regulatory filings;
- Institutional management: e.g., Senior Management, risk managers, internal auditors, compliance officers and operational management;
- Work performed by external auditors and appointed actuaries;
- Other regulators (including economic or industry papers published by regulators)

Internal

- Analysis of industry performance

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