



Office of the Superintendent of
Financial Institutions Canada

Bureau du surintendant des
institutions financières Canada

Office of the Superintendent of Financial Institutions

Internal Audit on Supervision Sector: Deposit-Taking Group: Non- Conglomerates

April 2014



OSFI
BSIF

Canada 

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1. Background

Introduction

Internal Audit conducts assurance work to determine whether the Office of the Superintendent of Financial Institutions Canada's (OSFI's) risk management, control, and governance processes, as designed and represented by management, are adequate and functioning in a manner to ensure risks are appropriately identified and managed, and to ensure compliance with such requirements as policies, plans, procedures and applicable laws and regulations.

The audit of Deposit-Taking Group: Non-Conglomerates was approved by the OSFI Audit Committee and the Superintendent for inclusion in the OSFI 2013-2014 Internal Audit Plan.

This report presents the results of that audit based on audit work completed at the end of February 2014.

This report was presented to the OSFI Audit Committee on April 10, 2014 and approved by the Superintendent on April 17, 2014. The Deputy Superintendent, Supervision Sector, and DTG-NC Senior Management, have reviewed this report and provided their comments.

Why this audit is important

The Deposit-Taking Group: Non-Conglomerates (DTG-NC) is part of OSFI's Supervision Sector and is the division that has the responsibility for the supervision of smaller and less complex deposit-taking federally regulated financial institutions (FRFIs). Its primary accountabilities include

- accurate risk assessments of all FRFIs consistent with OSFI's Risk Tolerance Framework¹,
- timely identification of problems and effective intervention and feedback, and
- monitoring the financial environment to identify FRFI outliers and emerging trends.

Internal Audit previously completed an audit of Financial Institutions Group – Deposit-Taking Institutions in June 2007.

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¹ OSFI's Risk Tolerance Framework as of April 2004

1. Background, Continued

DTG-NC and risk-based supervision

DTG-NC supervises FRFIs in accordance with OSFI's *Supervisory Framework*, and OSFI's *Guide to Intervention for Federally Regulated Deposit-Taking Institutions*. The *Supervisory Framework* is supplemented by the Supervisory Framework Rating Assessment Criteria and various supervisory guides and documentation templates, which DTG-NC follows as well.

DTG-NC adjusts the level of supervisory intensity applied to each FRFI in accordance with its assessment of the FRFI's risk profile, taking into consideration the size and complexity of the FRFI. Escalating levels of supervisory intensity are applied to those FRFIs where OSFI has identified some areas of risk or some level of threat to the FRFI's financial viability or solvency.

The DTG-NC portfolio

As at October 2013, DTG-NC has 123² deposit-taking FRFIs in its portfolio which included domestic banks, foreign bank subsidiaries, foreign bank branches, trust companies, loan companies, cooperative credit associations, and cooperative retail associations.

Supervisory responsibility for the 123 FRFIs in the DTG-NC portfolio is split between four OSFI offices: OSFI's Toronto/Ottawa offices, the Vancouver Regional Office and the Montreal Regional Office. Three Managing Directors manage Relationship Managers at their respective offices. Relationship Managers are in turn, assigned accountability to supervise a number of FRFIs in each office's share of the portfolio.

² Per "Who We Regulate" on OSFI's external website on October 28, 2013

2. About the Audit

Audit Objective The objective of the audit was to provide reasonable assurance that higher risk non-conglomerate deposit-taking FRFIs are consistently identified, and appropriately supervised and monitored across the DTG-NC portfolio in accordance with OSFI's supervisory methodology. Specifically the audit examined whether:

1. At the portfolio-level, management has adequate and timely oversight processes to monitor the identification and ongoing supervision of higher risk FRFIs,
2. At the FRFI-specific level,
 - a. rationale supporting OSFI's risk assessment of the FRFI (i.e. logic and flow) is clear and kept adequately up to date, and
 - b. The Supervisory Strategy for the FRFI is commensurate with the OSFI risk assessment and is adjusted as the risk assessment changes.

Audit Scope The scope of this audit included the full DTG-NC portfolio.

Recognizing that the supervisory process is a cumulative knowledge process and is continuously evolving, the audit focused on key management oversight activities and risk assessment process for supervisory plan years 2012-13 and 2013-14.

Where appropriate, other sources of information and input (e.g. supervisory documents outside of the audit review period) were reviewed.

Follow-up of Internal Audit recommendations from the 2007 Internal Audit of Financial Institutions Group – Deposit-Taking Institutions was part of this audit.

Audit Approach The audit evaluation criteria, as set out in [Section 4 – Audit Results](#), were used for assessing DTG-NC. These criteria are based on internationally recognized Enterprise Risk Management - Integrated Framework recommended by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The approach to conducting the audit included discussions with key personnel, walkthroughs with the DTG-NC supervisory teams and examination of supervisory documents and management reports.

3. Conclusion

Statement of Conformance

The audit was conducted in conformance with internal audit standards of the Government of Canada, as supported by the results of the Quality Assurance and Improvement Program. The evidence was gathered in compliance with Treasury Board policies, directives, and standards on internal audit and the procedures used meet the professional standards of the Institute of Internal Auditors.

Conclusion

Overall, IA is reasonably assured that higher risk non-conglomerate deposit-taking FRFIs are consistently identified, and appropriately supervised and monitored across the DTG-NC portfolio in accordance with OSFI's supervisory methodology. Specifically we found that:

1. At the portfolio level, management has quarterly and annual oversight processes to monitor the identification and ongoing supervision of higher risk FRFIs,
2. At the FRFI-specific level,
 - a. rationale supporting OSFI's risk assessment of the FRFI (i.e. logic and flow) is generally clear and kept adequately up to date, and
 - b. the Supervisory Strategy for the FRFI is commensurate with the OSFI risk assessment and is adjusted as the risk assessment changes.

As outlined in this report, we have one recommendation for management's action. Specifically, evidence supporting OSFI's assessment of the FRFI's oversight functions at the significant activity and enterprise-wide levels should be better demonstrated in supervisory documents.

We wish to recognize the excellent rapport and exchange of views with all involved in the audit. The depth of the review and focusing on what matters would not have been possible without the support received throughout the audit.

Chief Audit Executive, IA

Date

4. Audit Results

The audit evaluation criteria used for assessing DTG-NC are based on internationally recognized Enterprise Risk Management - Integrated Framework recommended by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Audit Evaluation Criteria	What we found
1. Process and Control Activities	
<p><u>Application of OSFI's supervisory methodology</u></p> <ol style="list-style-type: none"> 1. The Risk Assessment Document (RAD) /Risk Matrix are periodically updated for significant developments and changes in the institution and its operating environment on a consistent basis. 2. The rationale for the institution's risk profile and underlying supervisory ratings contained in the RAD are reasonable, adequately supported and properly documented. 3. The analysis and assessments contained in the RAD clearly demonstrate the risk-based thinking and rationale for selecting a particular Supervisory Strategy and Institution Specific Plan (ISP) for the institution, including the appropriateness of its short and longer-term risk focus and anticipated resource requirements, including support groups. 4. Prudential issues that could potentially affect the risk profile of the institution are identified on a timely basis. Where OSFI's risk assessment of a FRFI has materially changed (i.e. change in Intervention Rating), evidence exists to demonstrate that the FRFI's Supervisory Strategy is updated as required. 	<ol style="list-style-type: none"> 1. This criterion was satisfactorily demonstrated through IA's file review. 2. In general, the rationale for the institution's risk profile and underlying supervisory ratings contained in the RAD are reasonable, generally supported and documented. For clarity, where the RAD-only documentation model is adopted, the assessment of the FRFI's oversight function at the significant activity and enterprise-wide levels should be better supported in the supervisory documentation and include evidence supporting key conclusions (<i>Recommendation 1</i>). 3. This criterion was generally demonstrated through IA's file review. Management completed a Quality Assurance review in August 2013 as part of its regular oversight process, which effectively identified some areas for enhancement in DTG-NC's documentation. 4. This criterion was satisfactorily demonstrated through IA's file review. <p>Notably, DTG-NC has various Subject Matter Expert groups where peer groups of FRFIs with similar attributes (e.g. significant activities, business models, etc.) are compared to identify potential risks/ trends and level-set supervisory expectations.</p>

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4. Audit Results, Continued

Audit Evaluation Criteria	What we found
<p><u>Formal review and approval (or recommendation) of supervisory documentation</u></p> <p>Supervisory work is reviewed and approved with the following principles:</p> <ul style="list-style-type: none"> • Risk-focused on matters that are significant from a risk standpoint, and risk-tailored to the nature, size, complexity and risk profile of the FRFI, to the expertise of the individuals carrying out and reviewing the work, and to the “newness” of the supervisory practices, • Reviewed and approved by line management within the accountability structure of the supervisory group, • Performed with professional scepticism and rigor, • Escalated depending on the seriousness of the supervisor concerns, and • Used as a coaching opportunity to build staff’s technical industry knowledge, enhance their understanding of the application of OSFI’s supervisory methodology, and develop their supervisory judgment. 	<p>This criterion was satisfactorily demonstrated through IA’s file review.</p>
<p><u>Assessment of Significant Activities</u></p> <ol style="list-style-type: none"> 1. Rationale supporting OSFI’s net risk assessment of the FRFI’s significant activity (i.e. logic and flow) is clear and based on an assessment of inherent risk and quality of risk management (i.e. operational management and relevant oversight functions), 2. Where appropriate, the work of others (e.g. oversight functions) is used to reduce the scope of supervisory work and minimize duplication of effort, and this use of work is properly demonstrated, and 3. Key conclusions from OSFI’s assessment of the significant activity are aligned to OSFI’s risk assessment of the FRFI (i.e. RAD). 	<ol style="list-style-type: none"> 1. Rationale supporting OSFI’s net risk assessment of the FRFI’s Significant Activity is generally clear and based on an assessment of inherent risk and quality of risk management. An opportunity to improve exists to demonstrate that the assessment of oversight functions focuses on how well the functions execute their roles (Recommendation 1). 2. Supervisors documented the use of work of third parties if the third party assessments informed the risk assessments. 3. This criterion was satisfactorily demonstrated through IA’s file review.

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4. Audit Results, Continued

Audit Evaluation Criteria	What we found
<p><u>Overall Assessment of Oversight Functions</u></p> <ol style="list-style-type: none"> Rationale supporting OSFI’s assessment of the oversight function is based on an assessment of characteristics (i.e. Supervisory Framework Assessment Criteria) and performance (i.e. aggregation of the oversight function’s effectiveness ratings developed during the Significant Activity reviews), Key conclusions from OSFI’s assessment of the oversight functions are aligned to OSFI’s risk assessment of the FRFI (i.e. RAD). 	<ol style="list-style-type: none"> This criterion was generally demonstrated through IA’s file review. For clarity, where the RAD-only documentation model is adopted, the assessment of the FRFI’s oversight function at the significant activity and enterprise-wide levels should be better supported in the supervisory documentation and include evidence supporting key conclusions (Recommendation 1). This criterion was satisfactorily demonstrated through IA’s file review.
<p><u>Follow-Up Process</u></p> <p>The Follow-Up Document (FUD) for the FRFI is updated on a timely basis to track recommended / required actions that the FRFI needs to take to close out identified recommendations.</p>	<p>This criterion was satisfactorily demonstrated through IA’s file review.</p>
<p><u>Panel Review Process</u></p> <p>Analysis and decisions made resulting from panel discussions are incorporated into the supervisory file, including the rationale for any rating changes resulting from the meeting.</p>	<p>This criterion was satisfactorily demonstrated through IA’s file review.</p>
<p>2. Monitoring and Management Reporting</p>	
<p><u>Annual Planning Process</u></p> <p>Management practices are in place to oversee the planning process and ensure adequate coverage based on risk. Where risks to the plan are identified during the year, adjustments are made.</p>	<p>This criterion was satisfactorily demonstrated through IA’s file review.</p> <p>Notably, DTG-NC follows the established annual Supervision Sector planning process and the monthly work-plan process to track progress against the plan consistently.</p>

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4. Audit Results, Continued

Audit Evaluation Criteria	What we found
<p><u>Monitoring Process</u></p> <p>Management reporting practices and tools are in place (e.g. quarterly monitoring process) to identify higher risk FRFIs that require more supervisory intensity on a consistent basis, and allocate supervisory resources accordingly.</p>	<p>This criterion was satisfactorily demonstrated through IA’s file review.</p> <p>Notably, DTG-NC management established oversight controls over higher risk FRFIs, including additional quarterly reporting for higher risk FRFIs, as well as establishing the criteria for watch-listing FRFIs and for panel reviews. Importantly, these processes are generally understood by DTG-NC supervisors and are followed.</p>
<p><u>Watch-list Process</u></p> <ol style="list-style-type: none"> 1. Formal “watch-list” guidance is developed and appropriately communicated to all DTG-NC staff, 2. Management monitors watch-listed FRFIs to determine the appropriateness of the watch-list status, and 3. Appropriate documentation is maintained and approval received to support the basis for watch-listing and de-watch-listing decisions. 	<ol style="list-style-type: none"> 1. This criterion was satisfactorily demonstrated through IA’s review of guidance documents and discussions with supervisors. 2. This criterion was satisfactorily demonstrated through IA’s review of management’s quarterly monitoring process. 3. This criterion was satisfactorily demonstrated through IA’s file review.

5. Observation and Recommendation

Observation 1 **Observation: Assessment of FRFI's Oversight Function at the Significant Activity and Enterprise-Wide Levels**

Supervisory
Framework
Expectations

OSFI assesses the FRFI's oversight functions both at the significant activity, and at the overall enterprise-wide levels in accordance with the Supervisory Framework (Framework). The main responsibility of these functions is to provide independent, enterprise-wide oversight of operational management. Operational management, in turn, is responsible for the day-to-day management of risks inherent to significant activities that are fundamental to the FRFI's business model and its ability to meet overall objectives.

OSFI's Framework is predicated, in large part, on its ability to use the work of the oversight functions to inform OSFI of the effectiveness of operational management in the FRFI. As a result, evidence supporting OSFI's assessment of the FRFI's oversight functions is an important input to demonstrate the effectiveness of OSFI's supervisory process.

Supervisory
Documentation
Structure

Per the Supervision Sector's documentation structure, the assessment of the oversight functions, at both the significant activity and overall enterprise-wide levels, can be documented in supervisory documents called "section notes". Section notes, in turn, feed into the key supervisory document called the "Risk Assessment Document" (RAD), which contains OSFI's current assessment of the overall risk profile of a FRFI and its key drivers. For some FRFIs designated as small and less complex (*small FRFIs*) where less extensive documentation is required, section notes are discretionary and supervisors may adopt a RAD-only documentation model for their assessments.

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5. Observation and Recommendation, Continued

**Supervisory
Documentation
Structure**
(continued)

Regardless of the documentation format, IA expected to see that key conclusions on the effectiveness of the oversight functions would be supported by contextual information and sufficient evidence. However, we noted the following through our review:

What IA found

1. For small FRFIs where the RAD-only model was used, we found some instances where key conclusions were drawn on the effectiveness of oversight functions at both the significant activity and overall enterprise-wide levels without including evidence that supports those conclusions. Given the various sources supervisors assess and analyze to arrive at the key conclusions, the linkage between the supporting evidence and the assessments should be clearer.
2. For FRFIs where section notes were used to document the oversight function's performance in significant activities, we found some instances where the evidence supporting OSFI's assessment of the oversight functions did not appropriately demonstrate the function's effectiveness in overseeing operational management. In those instances, IA noted the rationale supporting the effectiveness was based on characteristics, such as mandate, organization structure and resources, rather than focusing on how well the functions execute their oversight roles.

Recommendation:

Evidence supporting OSFI's assessment of the FRFI's oversight functions both at the significant activity and overall enterprise-wide levels should be better demonstrated in supervisory documents (i.e. in section notes or the RAD).

Action Plan:

We undertake to address these concerns through ongoing staff training, and reinforce them through coaching and feedback via our regular quality control review process for supervisory assessments and documents.

Internal training sessions to reinforce the application of supervisory methodology and to improve the documentation of supervisory assessments are underway and will be completed by March 2015.

Responsibility: Managing Director, DTG-NC, Managing Director, Vancouver Regional Office, and Managing Director Montreal Regional Office.

6. Management Response

Overview This report has been reviewed by the Senior Management of DTG-NC and the Deputy Superintendent, Supervision Sector, who acknowledge its recommendation.

Response DTG-NC wishes to express thanks to the audit team for the professional, clear and transparent way in which it conducted its audit.

We are pleased that Internal Audit has concluded that management has fully addressed the observations in the June 2007 *Financial Institution Group – Deposit-Taking Institution Internal Audit* report.

DTG-NC is committed to continuous improvement in carrying out its supervisory work.
