Risk-Based Supervision: Why It's Important?

Financial regulators globally previously utilised traditional supervisory approaches to market regulation which focused on a Rules-Based System of control. This approach also known as Principles or Compliance-Based Supervision, is *"a method of regulation which involves checking for and enforcing compliance with rules – legislation, regulations or policies – that apply to an entity"* (as defined by the Financial Services Commission of Barbados).

More recently there have been developments toward risk-based approaches to regulation, which began gaining prominence in the early 2000s. In a 2014 report on the Indian banking industry, Deloitte stated that Risk-Based Supervision (RBS) can be described as a procedure "*designed to work as a structured process that identifies the most critical risks faced by an individual bank and systemic risks in the financial system"*. Similarly, securities industry regulators will use such approaches to identify the most critical risks faced by each of their registrants and ensure that registrants develop strategies to reduce the probability of such events occurring.

As seen in "The Development of Risk Based Regulation in Financial Services: Canada, the UK and Australia, (Julia Black, 2004)" the change to an RBS framework was in response to several factors not limited to the following:

- Political pressure following financial collapses;
- The need to create a new organisational culture within a recently formed regulatory body;
- The need to align supervisory practices with developments in financial institutions' operations and risk management practices;
- The need to deliver 'integrated' financial regulation;
- The need to improve internal managerial control, to prioritise resources and shift regulation; and
  to a more proactive footing.

With the RBS approach, organisations will continue to be monitored for rules compliance, but there will also be heavy focus on the robustness of their risk management policies and procedures. Any compliance failure and weakness identified in the risk management regime will be addressed in accordance with the appropriate legislation. In an RBS regulatory system, the following activities typically take place:

- Exposure of contraventions of the legislation, with the regulatory response guided by the materiality and seriousness of the contravention;
- Heavy focus on collection and reconciliation of relevant market and registrant data to uncover trends and financial and economic risks;
- Assessment of the registrant's business strategy through:
  - financial analysis;

- on-site inspections; and
- use of market intelligence;

- Assessment of the registrant's management style, attitude to risk and control environment.

Trinidad and Tobago Securities and Exchange Commission (TTSEC) is mandated under Section 6(*l*) of the Securities Act, 2012 to "*assess, measure and evaluate risk exposure in the securities industry*". It is also empowered under Section 7(1)(*l*) of the Act to "*monitor the risk exposure of registrants and self-regulatory organisations and take measures to protect the interest of investors, clients, members and the securities industry*". To fulfill these functions, the TTSEC utilises an RBS Framework to identify, assess, monitor, and mitigate risks associated with registrants operating within the securities industry of Trinidad and Tobago. The use of this RBS Framework inevitably facilitates a more pro-active approach to regulatory development and supervision and enables the TTSEC to:

1. Assess the adequacy of a registrant's risk management processes;
2. Identify, monitor and mitigate systemic risks within the securities market;
3. Implement a systematic approach to ongoing dynamic supervision;
4. Allocate supervisory resources to where risk is more pertinent;
5. Continuously review the perimeter of regulation; and
6. Address the overarching goal of investor protection.

The RBS approach can be quite complex; however, the *diagram* below helps to simplify the stages of TTSEC's approach to RBS.

The key principles of the supervisory approach adopted by the TTSEC are as follows:

1. It is risk and principle based, forward-looking and outcome focused.
2. It recognises that the Board of Directors and Senior Management of institutions are primarily responsible for compliance with the law, including ensuring financial soundness, prudent management and conduct of business.
3. It is intended to reduce the risk of failure or inappropriate behavior by institutions; but balance the extent of regulatory oversight against the risk that excessive oversight would result in inefficiencies and excessive regulatory burden for the industry.
4. Supervision of institutions is conducted on a consolidated basis, utilising information from and coordinating with other regulators. This includes an assessment of all material entities, both national and international.
5. The application of sound judgment to identify and evaluate risks as this is central to the effectiveness of the supervisory approach.
6. Where appropriate, TTSEC leverages the work of the institution's corporate oversight and governance functions to minimise duplication of effort.
7. Communication of assessments and recommendations to institutions that are risk focused and timely.

8. A method and frequency of supervision and intervention that depends on the risk profile of the institution. Institutions that are well managed relative to their risks and/or only engage in activities that raise few risks of concern will require less supervision. Not all areas within an institution need to be reviewed every year.
9. Current assessments of the risk profile of an institution will be maintained and an objective basis for allocating supervisory resources across institutions and within an institution will be provided.
10. The reliance on external auditors for the fairness of the financial statements when it is reasonable to do so and utilising their work to modify the scope of its reviews to minimise duplication of effort as appropriate.

The key benefits of this supervisory approach are:

a) Closer integration of macro and micro prudential supervision, with focus on early identification of emerging risks to facilitate timely interventions;
b) Parallel assessments on managed institutions;
c) Better risk evaluation due to individualised assessments of inherent risks and risk management processes. These result in a deeper understanding of an institution's operations, its risk appetite and the key drivers of its risk profile;
d) Early identification of institutions and areas within institutions with prudential issues and concerns;
e) Cost effective utilisation of resources through prioritisation of supervision based on risks;
f) Reporting risk focused assessments to institutions for desired outcomes;
g) Reducing regulatory burden on well-managed institutions;
h) Encouraging a strong risk management culture within institutions; and
i) Providing flexibility for supervisors to use professional judgment within a structured approach.

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