Risk-Based Supervision

Denise Dias and Juan Carlos Izaguirre in their article, 'Risk-Based Supervision Is Key to Financial Inclusion in 2020 & Beyond', stated that, "Despite its importance for financial inclusion and innovation, financial supervision attracts far less interest and resources than regulation". The authors point out that while efforts have been spent designing effective regulations which are critical to the growth of the financial markets, supervision in developing economies is often ineffective and risks neutralising regulatory reforms.

Risk-Based Supervision (RBS) identifies the critical risks encountered by a firm, as well as the systemic risks operating within the financial market. RBS assesses the firm's management of those risks along with its financial vulnerabilities. This process is fundamentally different from compliance-based approaches as the latter focuses on the extent to which firms adhere to rules and requirements, often involving a rigid on-site inspection schedule and penalties for non-compliance. Rather than conducting periodic, one-size-fits-all compliance checks, RBS identifies incipient problems and facilitates prompt intervention.

RBS has several defining characteristics which distinguish it from other approaches.

1. Risks are addressed in a systematic manner giving priority to what matters most. By addressing both prudential and conduct risks, the focus is on the promotion of good outcomes, such as ensuring that investors are treated fairly, and the avoidance of those that are adverse.
2. RBS considers a combination of the impact that these risks would have and the likelihood that they will occur.
3. RBS recognises that risks can originate from a variety of sources. Risks arising in the wider economy (macroeconomic) or at an industry or sector-wide level (macroprudential) also need to be considered. For example, a change in the interest rate environment will have an impact on savings or an asset's returns. Although firms cannot directly control these wider issues, they have potential implications for their risk profiles, and as such they need to be recognised and their consequences managed.
4. RBS is dynamic and forward looking, identifying emerging areas of risk and the adequacy of management and financial resources to address these. This supports early intervention by supervisors, who can now assess the effectiveness of their interventions and adjust these, if necessary, to minimise the impact of any adverse outcomes.
5. RBS supports improved decision making and the most effective use of scarce supervisory resources. The supervisory process will significantly focus on continuous collection of data from registered entities and a robust off-site surveillance mechanism.

This is expected to enhance the supervision bandwidth and move towards a risk indicator based early warning system.

The RBS Process

The RBS process typically incorporates the following steps.

1. Development of a framework for assessing impact
   It is important to identify the processes and mechanisms to develop a risk-based framework aligned to the objectives and characteristics of the firms and the securities market. The framework should present two dimensions of risk – the impact of adverse outcomes and the likelihood of their occurrence. Firms will typically be classified based on the potential impact of problems, with high impact firms receiving more attention than those with a lower impact.

2. Identification of areas or activities for risk focus
   RBS recognises that not all firms operating within the securities market pose the same level of risk and not all activities are equally risky. It is therefore essential to identify which activities within firms pose the greatest risk and therefore warrant the most attention. The highest impact firms, as well as activities will be those which are deemed to be a potential source of systemic risk, such that their failure would result in extensive losses to participants as well as contribute to a wider economic impact

3. Identification of risk exposures
   Having identified the appropriate activities on which to focus, it is necessary to identify the types of risk that are inherent to these activities, such as market risk, liquidity risks and operation risks.

4. Assessment of the risks' severity
   Having identified the types of inherent risk, their severity can now be assessed, which will typically be reflected in a rating. Where numerical data exists, this assessment may be quantitative in nature. But the overall assessment will also reflect qualitative judgement about economic and market conditions, target investors and other relevant factors. Categories such as high, medium high, medium low and low work best in this context – that is, an even number of categories to avoid the tendency to default to a central 'medium' rating.

5. Valuation of controls, management, and governance.
   The steps described in points 1-4 were aimed at identifying 'inherent' risks such as credit, operational, etc. and the severity of these. However, the firm's overall risk will also depend critically on how they are controlled and managed. Inherent risks should be assessed separately from the adequacy of controls, management, and governance. Firms may, for example, have high levels of inherent risk but also implement stringent controls resulting in moderate or even low overall or net level of risk (residual risk). In some cases, weak controls and management may amplify inherent risks rather than reduce them.

6. Assessment of the firm's financial resources required to support its net risk

This assessment of net or residual risk leads naturally to the question of whether the firm's financial resources are sufficient to support its level of net risk. This will require an assessment of the following:

a) The current firm's earnings as well as its source, stability, and reliability of future earnings streams.

b) The firm's capital adequacy, as the higher the firm's net risk, the more capital/solvency will be required to mitigate this. However, it should be noted that the solution to an unacceptably elevated level of net risk is to reduce it. Capital provides an important palliative but cannot provide a long term offset to excessive net risk.

Since 2014, the Trinidad and Tobago Securities and Exchange Commission (TTSEC) has been utilising a risk -based supervisory approach for the supervision of its registrants, to accomplish the following objectives;

1. Reduction of the risk of failure or inappropriate behaviour by registrants without the use of excessive regulatory burden.
2. Sound judgement in the evaluation of a registrant's risk management in the context of its business activities.
3. Continuous assessment of the risk profiles of registrants and provide an objective basis for allocating supervisory resources.
4. The promotion of good corporate governance by placing the responsibility for risk oversight on registrants' board and management.

The TTSEC hopes to enhance its RBS framework within the upcoming months. By implementing this new framework, the TTSEC can enhance its thrust of mitigating systematic risk within the securities market while enabling its growth and development.

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For more information on the securities market and the role and functions of the TTSEC, please visit our corporate website at www.ttsec.org.tt. To become a smart investor, download our IPA via the Google Play and Apple Stores. You can also take the investor education online course on our investor education website, www.InvestUcateTT.com, and test your knowledge in our interactive investing game InvestorQuestTT at www.InvestorQuest-tt.com, and remember, to connect with us via Facebook; Twitter, Instagram, LinkedIn or You Tube.

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