Risk Based Approach in Financial Supervision

The Hungarian Case

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Financial Regulation

Not all risks should and could be covered by regulation

Risks to be monitored:
- Usually risks, which may cause significant harm to the economy
- Risks taken by an economic agent but causing much more damage to others than for itself.
- Examples from other sectors: energy supply, food safety, transport etc.
- Managing risks in financial regulation = to make sure that general good will not be seriously damaged in the economic competition among participants

The role of financial regulators, is to set limits to FI’s risk taking in order to ensure the safety of others
Risks in the Financial Sector (1)

- Risks in business operations with FIs
  - Credit risks
  - Market risks
  - Liquidity risks
  - Operational risks (legal risks, IT risks, reputational risks, human risks, criminal risks)
  - Natural (or other) catastrophe risk

These risk should be managed by the FI and the supervisor makes sure that relevant rules are appropriately observed by the FI!

Risks in the Financial Sector (2)

- Individual institutional business risks may have spill-over effects on “innocents”
  - Depositors, investors
  - The money FIs are working with are not their own money

- This needs special safety nets

Guarantee schemes, prudential rules and the supervisor should check their observance
Risks in the Financial Sector (3)

- **Systemic risks**
  - Financial sector has become an indispensable infrastructure to the economy (and to households)
  - Failure of certain participants may endanger the proper functioning of the whole infrastructure
  - The failure of one specific institution may be unimportant in itself however the damage it may cause for other players and the economy as a whole may be huge
  - Stability of the financial sector may be endangered – spill-over effects on other financial sector participants and real economy!

  *Systemic risk assessment requires special attention and co-operation with central banks!*

How to decide about risks to be covered by regulation in the financial sector?

- Make sure that cost of regulation is not higher then the potential damage of the risk
- Regulation should not jeopardize competition in, and the smooth functioning of the sector
- Assess the potential impact of the risk and its probability on the economy or on the sector concerned
- Bigger the potential impact more it may need regulation and supervision
How to decide about risks to be covered by regulation in the financial sector? (2)

- Identify asymmetrical situations where consumers (entrepreneurs) are exposed to high risks due to this asymmetry vs. banks (asymmetry in information, in reaction-time, in power etc) – market imperfections

- Consider discrepancy in short term and long term perspectives (pension funds)

**However, regulation should not take over all risks from the end-user! (Moral hasard)**

Prudential rules in banking – based on potential risks

- Strict rules for the establishment of a bank (initial capital, transparency of ownership structure, not too fragmented ownership etc.)

- High requirements for the managers of a bank (the integrity and the high professional qualification of persons)

- Level of own funds should be adapted to the level of risks the bank is facing in the economic environment

**THIS SHOULD ALWAYS BE MEASURED BY THE BANK!**
Prudential rules in banking (2)

Conditions for the operation and the way of management of a bank:

- clear decision making processes, clear responsibilities, board decisions, supervisory board, four eyes principle,
- strict internal rules, efficient internal controls
- compliance with legal rules, supervisory decisions
- quality of the bank's risk management is key!

The Guardian of Regulation: the Financial Supervisor

It oversees the individual institutions:
- their compliance in legal terms,
- In quantitative manner: capital requirement correctly calculated and applied, basic economic indicators are good – everything is in place and prudential regulation is fully observed – that is only the minimum, but not enough!
- In a qualitative manner – assessment of the quality of risk management, of internal ruling, market informations, professional quality of staff and the management, policy setting, quality of policies in place - judgement!
The Guardian of Regulation: the Financial Supervisor (2)

- Oversees the sector developments: always new types of risks are building up – typical to actors (in Hungary: loans on CHF, JPY and EUR basis)
- Oversees the cross-sectoral risks and their potential impacts (capital markets, stock prices, insurance)
- Monitors new products on the market and the new types of risks they may imply
- It should understand “moving risks” within financial groups
- Importance of sectoral approach!

Risk assessment at the HFSA

- Since year 2000 the supervisor in Hungary (HFSA) is integrated (banking, insurance, pension funds, capital markets)
- All sectors have been supervised in one institution with harmonized methodology and approach
- Capacities had to built up with the supervisory agency
- After 8 years of integration: it proved to be the right solution in Hungary
- Better placed and better equipped to oversee:
  - cross-sectoral risks,
  - potential regulatory arbitrage,
  - emergence of new risks at sector wide level
  - to perform group level supervision
Risk assessment at the HFSA (2)

• FIs have been reporting a large set of data (monthly and quarterly) – data reporting framework – targeted selection
• Out of this data simple and integrated indicators were formed to signal growing risks – risk assessment framework
• When certain indicators, or a group of indicators reached a threshold value, they were ”ringing”.

Risk assessment at the HFSA (3)

• On quarterly basis the calibrated IT system produced some „automatic” evaluation of firms through the indicators (for smaller firms – less data, simplified method)
• Calculated results were assessed against qualitative analysis of the firms and their situation – risks were identified!
• Certain key institutions were subject to stress-testing to simulate extreme conditions
• The IT system was capable of performing „data mining” in regard of FIs if specific interest emerged
Risk assessment at the HFSA (4)

- Reactions when the system indicated unusual values - depending on the case:
  - Further information was asked from the bank to fully understand the situation (2 way communication)
  - Targeted on-site inspection was launched
  - Immediate supervisory action could take place
  - Certain targeted corrective measures were requested from the firm
  - Some firms were put under strict monitoring, given warning, without specific action at the time

Risk assessment at the HFSA (5)

On-going supervision implications:

- After 2 years of operation of this IT supported supervisory indicator system, the HFSA has had a risk profile on each supervised firm.
- On the basis of this risk profile the comprehensive examination of the firm (including on-site visits) could take place, concentrating supervisory resources on these areas – efficiency gain!
- The system, however, has been calibrated regularly.
Supervisory Discretion

May supervision be automatised?

- All IT backed indicators, red „blinking” signals should be checked against empirical knowledge and evidence of the supervisor
- All quantitativ information should be assessed in the context of qualitative information of the supervisor about the firm concerned.
- Any supervisory decision may only be taken when both aspects underly the need for action
- During the assessment there has been continuous communication

Preconditions of ensuring supervisory discretion:

- Strong legal and professional background for the supervisory agency
- Involvement of the supervisor in the rule making process
- Independence of the supervisor
- Accountability of the supervisor
- Competitive, high quality staff for the supervisor
- A good real-time knowledge of the sectors and market developments by the supervisor
Supervisory Discretion (3)

- Laws, and regulations are rigid by their nature
- Not all market situations maybe foreseen in laws
- Markets and products are evolving – so do risks
- As seen earlier, all supervisory assessments involve subjective decisions and judgements
- Legal mandate should ensure rapid, early and effective actions on the part of the supervisor
- Action should be timely and flexible – within the limits of the law – discretion is a must.

Supervisory Discretion (4)

Why discretion is a tabou? Have anyone questioned the supervisory discretion of a football referee?

**No Discretion**

**Too much discretion!**

I'm sure it's a violation, but I can't find it in the rule book.
Discretion (of the referee)

When the referee is on the playing field:

- he must be highly professional,
- monitors that all relevant rules be observed, in advance he knows the risk profile of the teams
- he must run with the players to have the best possible information about developments on the field on real-time basis,
- he has the power to intervene and to apply sanctions,
- his decisions should be implemented immediately
- sometimes he must decide in a very short time,
- At the given moment his decisions cannot be challenged
- A good referee must enjoy the confidence of the teams, of the public and that of the football league (he should not be popular)
- A football referee is accountable, there are ways to ask for remedies for inappropriate decisions – but not during the match

Traditional Supervisory Challenges

- Financial market is about competition; to remain competitive, banks (and other financial institutions) should be innovative (they are!)
- The financial landscape is evolving constantly – always new products are emerging with new risks – to be followed closely and assessed by the regulator!
- Regulation and supervision should set limits to excessive and harmful risk taking, however it should not block innovation!
- Communication with the FIs is key, however the role of the supervisor and the supervised firm should always be clearly distinguished
New challenges for the supervisor

- To make distinctions when banks have liquidity problems and when they have solvency problems.
- New phenomenon in recent crisis: well capitalized, well functioning banks with strong fundamentals got in serious trouble due to liquidity problems on the market.
- With time products are becoming more complex, more difficult to assess their risk content and their potential impacts.
- How to educate the consumer to be clever (and prudent) when using financial services, to try to understand the products?
- How to reestablish confidence of consumers vs banks?

New challenges for the supervisor (2)

- Financial markets are international, institutions and their products are cross-border, however regulations and supervisors remain national.
- Some banks are subsidiaries of giant global financial groups, small for the group, but important (systemic) for the given country (asymmetry of significance).
- International supervisory co-operation: how to find equilibrium between the home and host supervisors' concerns?
Conclusions

- No financial regulation without risk assessment – risk monitoring
- Risk assessment is key, but not enough
- Good identification of risks, measurement of risks – needs constant data
- Risk profile and risk factors are evolving, one has to keep pace
- To assess the case rightly communication and human judgement is needed
- To correct the situation discretion is required