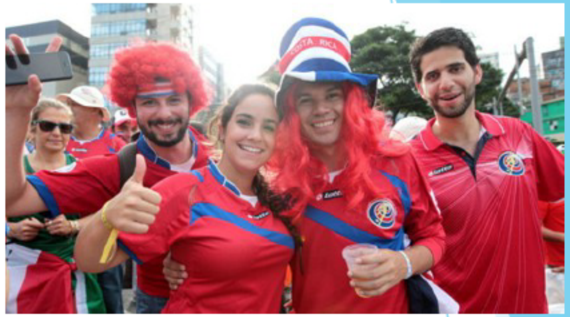
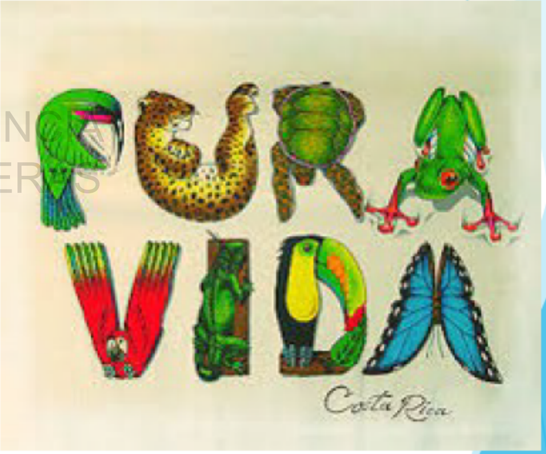
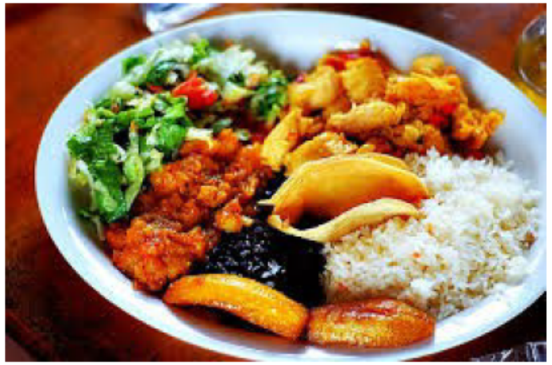
Buenas Tardes



- Delighted to be here to speak to all of you
- Costa Rica is a great country and I love coming here
  - Friendly people
  - Pura Vida
  - Great Food
  - Delicious coffee

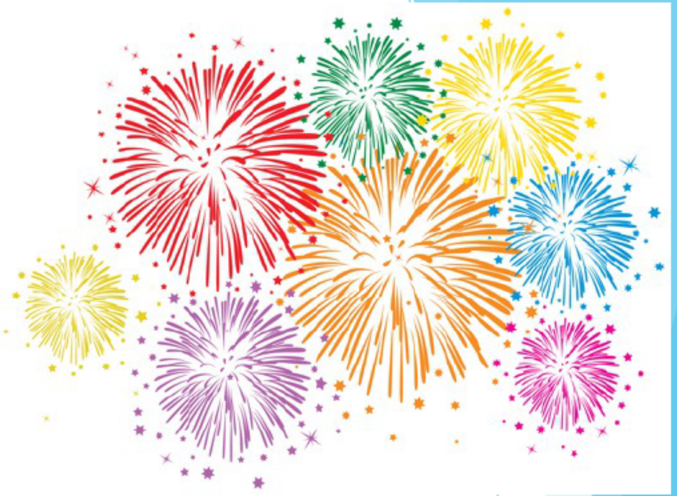




Request from the Superintendente

- The Importance of a Risk Based Supervision Framework (RBS) for Financial Stability
- The benefits and the value added contributions that an RBS supervisory framework brings to the soundness of financial systems in a country
- The vulnerabilities if such schemes are not adopted, in today's global financial environment.

However before I begin…



- A big FELICITACIONES to SUGEF
  - Particularly to the Superintendente Senor Javier Casca
  - The RBS Pilot Team
  - Pilot Banks

- Significant time and effort has been devoted by SUGEF to design an RBS Framework tailored to the Costa Rican financial system
- Today is a major milestone with the official launch of SUGEF’s RBS Framework going live in 2017.

CONGRATULATIONS!!!!

Fantastico

Muy Bien

My presentation today

- What is financial stability
- What is Risk Based Supervision (RBS)
- Compare Traditional Supervision Frameworks to RBS
- Supervisory motivations to move to a new Framework
- Key concepts and principles that are fundamental to RBS
- Benefits of moving to a new supervisory Framework
  - Supervisors
  - Banks
  - Financial stability

What is financial stability and the role of Supervisors (1)

- Financial stability – public trust and confidence in **financial institutions**, markets, infrastructure, and the system as a whole – is critical to a **healthy, well-functioning economy.**
- Do this by…**promoting the safety and soundness of individual financial institutions** (via the Prudential Regulation Authority)

*Excerpts from **Bank of England** website*

What is financial stability and the role of Supervisors (2)

- Recommendations for enhancing the resilience of financial markets and financial institutions.
  - Do this by…Strengthened prudential oversight of capital, liquidity and risk management

*Excerpt from a **Financial Stability Board** Report*

What is financial stability and the role of Supervisors (3)

Basle and BIS

- Basle Core Principles for Banking Supervision is the Supervisors handbook.
- There are 29 principles. Many of these principles speak to RBS concepts for effective supervision

Risk Based Supervision (RBS) Simple Definition

Supervisors:

- Identify the most risky areas of a bank
- Assess if the management of the bank is managing these risks well
- Where they have material concerns or identify major problems they promptly get them fixed.

RBS is a supervisory tool that enables supervisors to more effectively conduct their supervision as outlined above

Definitions

- Inherent Risks
  - Credit
  - Market
  - Operational
  - Others
- Risk Management Oversight
  - Day to day management that run a business
  - Independent oversight
    - ✓ Board
    - ✓ Senior Management
    - ✓ Risk Management
    - ✓ Internal Audit
    - ✓ Compliance

RBS Risk Matrix

Significant Activities	Inherent Risks						Quality of Risk Management								Net Risk	Direction of Risk	Importance
	Credit	Market	Insurance	Operational	Regulatory Compliance	Strategic	Operational Management	Financial	Compliance	Actuarial	Risk Management	Internal Audit	Senior Management	Board			
Activity 1																	
Activity 2																	
Activity 3																	
Etc.																	
Overall Rating																	

	Rating	Direction	Time Frame
Earnings			
Capital			
Liquidity			
Composite Risk			

Intervention Rating	

Strong management and controls mitigate risk

		Inherent risk	
		Low	High
Risk management	Strong		
	Weak		

Traditional Supervision

- 5 supervisory processes
  - Planning
  - Off site or monitoring
  - On site
  - Reporting/Recommendations
    - Internally to seniors
    - Externally to banks with recommendations
  - Follow up if recommendations have been acted on and closed

  Then repeat the cycle

Under RBS, while you still do these processes, how you do them is very different. Thinking is very different. Focus on risk. Whether it is in the business products, changing environment and

Comparison of traditional and RBS supervisory approaches

1. Off site Activities
2. Supervisory Cycle
3. Rules based vs Principles based Regulations and Guidelines
4. Trust but verify
5. CAMEl Ratings

1. Off site activities

- Data was not received on a timely basis and sometimes irrelevant
- Little attention to bank business models, risk appetite and limits
- Elevator analysis on the bank financial data. Rear view analysis

2. Supervisory On site Cycle

- Over a period of 3 to 5 years
  - Review all activities of a bank
  - Review all banks
- Sometime only criteria used was the size of the bank
- In some cases riskiness may have been used

RBS forces supervisors to be more proactive and to dynamically adjust their supervisory activities and to focus on banks or business activities of higher risk. Cycles may exist, but primary driver is now riskiness and not coverage.

3. Principles based versus Rules based supervision

- Principles Based means Supervisory Legislation and guidance is more about….WHAT outcomes does the Authorities want to see from their banks
- Rules Based means Supervisory Legislation and guidance is more about telling banks…. exactly HOW the supervisors want bank management to carry out their work and is much more prescriptive on "You will do this and you will NOT do this." More formal and legal
- Good example is a traffic cop
- Rules based supervision is easier to monitor and enforce

RBS is more Principles based with some rules, where necessary. Thereby, giving bank management some leeway on how best to manage the risks in their banks and business products and demonstrate these to the supervisor.

4. Trust but verify

- Supervisors would enquire from bank Boards, other Risk management functions and day to day management, on the financial condition, riskiness and compliance to Supervisory guidance and internal risk management and internal control procedures
- Prior to RBS frameworks, there was a vast divergence as to what Supervisors would do next. i.e. how much they would trust and the degree to which they would verify
- I.e. If you can trust risk management and believe they do a good job, why duplicate and verify what they do all the time.

RBS starts with focusing on the Significant products and assesses how well management oversees these. If they believe they can rely on the work of Management at banks, they may reduce the scope of work they would do themselves. i.e. verify less.

Question?

Who manages the banks?

5. CAMEL Ratings

- What is a CAMEL rating?
  - C = Capital
  - A = Assets
  - M = Management
  - E = Earnings
  - L = Liquidity
  - S = Systems or Structural Interest Rate risk

- Some drawbacks with this rating approach
  - Does not force supervisors to assess on a granular level and drill down
    - ✓ On either the asset side or the management side
    - ✓ What products are more risky and which oversight is not doing their job
  - Not forward looking

RBS is more granular. Focuses on the significant risky

5. CAMEL Ratings (2)

- What is a CAMEL rating?
  - C = Capital
  - A = Assets
  - M = Management
  - E = Earnings
  - L = Liquidity
  - S = Systems or Structural Interest Rate risk

1. Riskiness

2. Effectiveness

Motivations for supervisory change (1)

- Canada, UK and USA were likely the first to think about how they could better their supervisory processes. Australia, Nederlands, Singapore, Ireland and others followed.
- What were their motivations?
  - Lessons learned from prior crises experiences
    - Why didn't they see it coming? Need to be more **forward looking** and conduct **stress testing** and **identify emerging risks** early and take appropriate actions
    - Did not know the riskiness of bank products. Need to understand bank **business models and risk appetites**
    - Did not know the riskiness of bank subsidiaries or branches. Need to take a more **consolidated approach**.

Motivations for supervisory change (2)

- Internal capacity to assess risks
  - ✓ **Insufficient resources** to look at everything. Need to prioritize work and **focus on significant products** and associated inherent risks i.e credit, market and operational
  - ✓ Don't have the **right experts** for the inherent risks. Need to **build internal capacity** to be effective
- Proactive Management at their banks
  - ✓ **Boards, Senior Management and independent oversight functions** have an important role to play in strong Corporate Governance and proactive management and compliance. Need to clearly specify supervisory expectations and assess and rate them. **Let them demonstrate how they manage themselves appropriately and proactively.** Rely on them where you can.

What is Risk Based Supervision?

- identify and rate the more **"significant and risky"** businesses and processes in a bank, both as they exist today and how these **potentially could change** in the future, then
- assess and rate the **effectiveness** of the **day to day** management and the **independent oversight and corporate governance** over each of these significant and risky businesses and processes,
- Rate the adequacy of capital, earnings and liquidity
- Arrive at an overall rating for the bank
- Use the overall bank rating and concerns to:
  - Recommend banks to the fix the **material weaknesses** identified as soon as possible
  - Identify what **resources to devote** to the bank going forward as part of supervisory planning, offsite and onsite activities

Relationship Manager (RM) Concept (1)

- One weakness many supervisory authorities experienced in the past
  - No one person within the supervisory authority who was accountable for the entire risk profile of a bank
  - Not sufficient supervisory continuity on a bank
  - Banks complained that they did not have one person in the supervisory agency that they could deal with their enquiries. Plus getting multiple directions from supervisors
  - Seniors within the supervisory authority also had this same complaint that there was no one supervisor in their agency that they could go to get the complete picture of a bank

Relationship Manager (RM) Concept (2)

- RBS in many countries now have the RM concept that has served them well
- Just to be clear. The RM is not the Czar and therefore does what he/she pleases. RM is:
  - more of a central point of contact both internally and externally
  - ensures the risk profile is complete
  - ensures it is kept up to date by deciding areas for on site and off site reviews.

Benefits of RBS

- Consolidated Supervision
- Significant Activities
- Dynamic and forward looking
- Assess and promote good and effective corporate governance at their banks relative to the risks in the products they offer
- Single point of contact in the Relationship Manager

Changes you can expect (1)

- While the 5 supervisory processes still remain, frequency of work, depth and scope of work, interaction with bank management and the assessment and rating process will be different.
- Rules and guidance will be more principles based. Expectations on outcomes will be better articulated
- Greater attention on the Significant Activities and processes at your bank. Not review and assess and rate everything.
- More interaction with Board, Senior Management, Risk Management, Internal Audit and Compliance at your banks. The questions supervisors ask will be different.. focusing on material risks and requiring demonstration by bank management that they are proactively managing these risks to their satisfaction
  - Not just Characteristics but Effectiveness of management

Changes you can expect (2)

- The data and information requested will be different. Business model, stress testing, and sufficient data to assess and monitor trends in material businesses and material branches and subsidiaries.
- Enquiries and assessments will be more forward looking
- SUGEF plans to use the same framework for all types of banking institutions. For smaller banks there maybe some minor modifications, however the fundamental principles and assessment and rating approach will be the same.

Changes you can expect (3)

- Ratings and assessments will now be more richer than before
  - Supervisors will be able to articulate better to you on what are the risks in the bank and in specific products that concern them, along with what is not working to their expectations regarding risk management
  - Likely see more focused recommendations related to strengthening risk management to be more pro active in managing your risks
  - However, fundamentals of their recommendations will not be different than what you have been used to.

Concluding remarks

- RBS has many positive benefits for both the supervisor and the banks
- Does contribute to financial stability
- Does come with its own set of different challenges
- It will take a couple of years for both SUGEF and the Banks to fully adapt to the new process.
- Many countries who have implemented RBS, have overcome these
- Wish SUGEF and each of you all the best in operationalizing RBS for the banking sector in Cost Rica and contributing to a healthy financial sector in the country.

MUCHO GRACIAS

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