Risk based supervision

"*Enhancing Integrity in the Dutch Carribean*"

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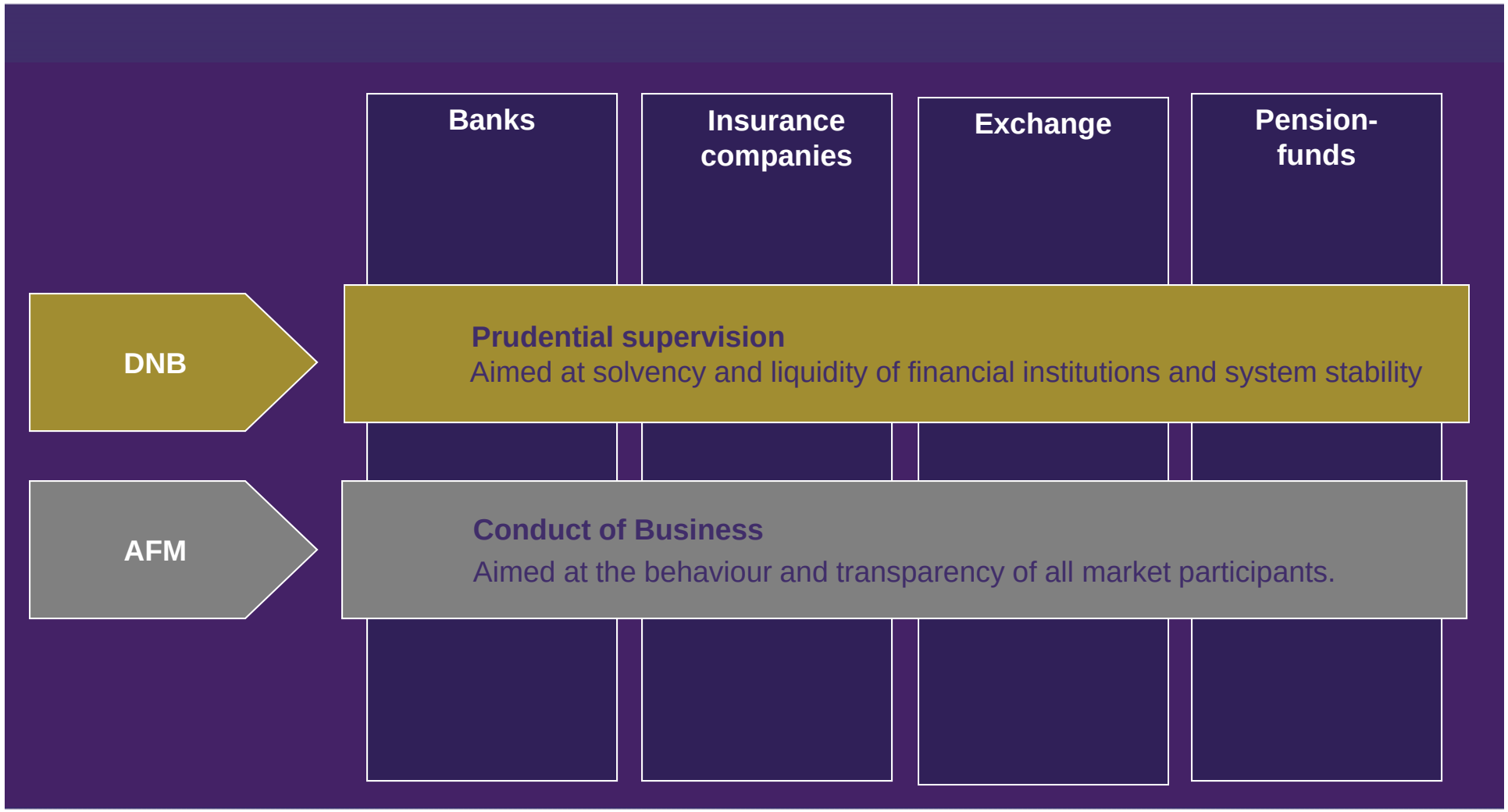
AGENDA

i. AFM and conduct of business supervision

ii. Risk based supervision

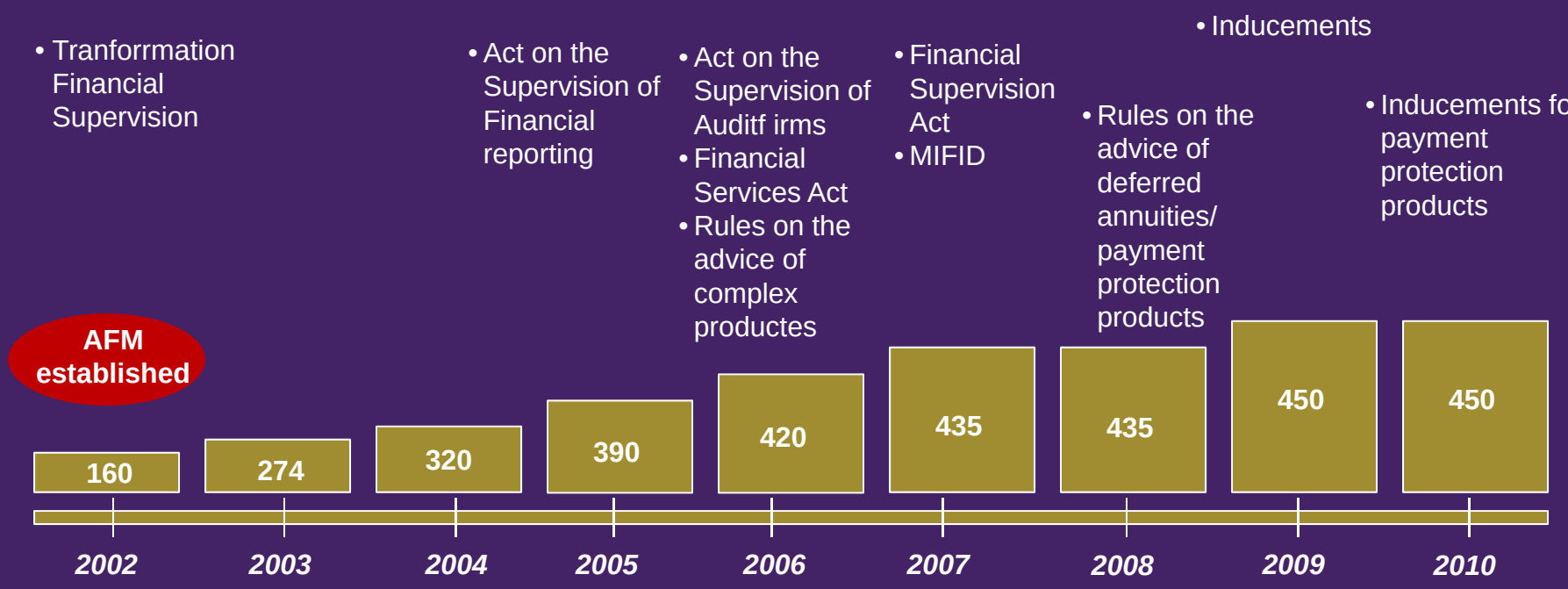
iii. A few cases

Netherlands one of the few economies to adopt twin peaks supervisory model



Conduct of business regime has evolved rapidly over past eight years

Important milestones



Scope of the AFM supervisory landscape is quite broad

Financial services

Capital markets

Range of tasks is varied

Financial services

- Transparency
- Duty of care
- Quality of advice
- Conflicts of interests
- Best execution
- Integrity/competency of board members and directors
- Conduct of businessrules

Capital markets

- Primary markets (emissions,take-overs)
- Secondary markets (manipulation, insider trading)
- Financial reporting by listed companies
- Auditors
- Clearing & Settlements
- Payments
- Integrity of participants

Fraudulent/criminal financial activitities

Large number of financial institutions under supervision requires a smart approach

Type of institution	Number
Banks	210
Insurance companies	571
Investment companies	264
Investment funds	121
Pensionfunds	547
(Insurance) intermediaries	9,000
TOTAL	10713

Mix of regular activities en project-based problem oriented work

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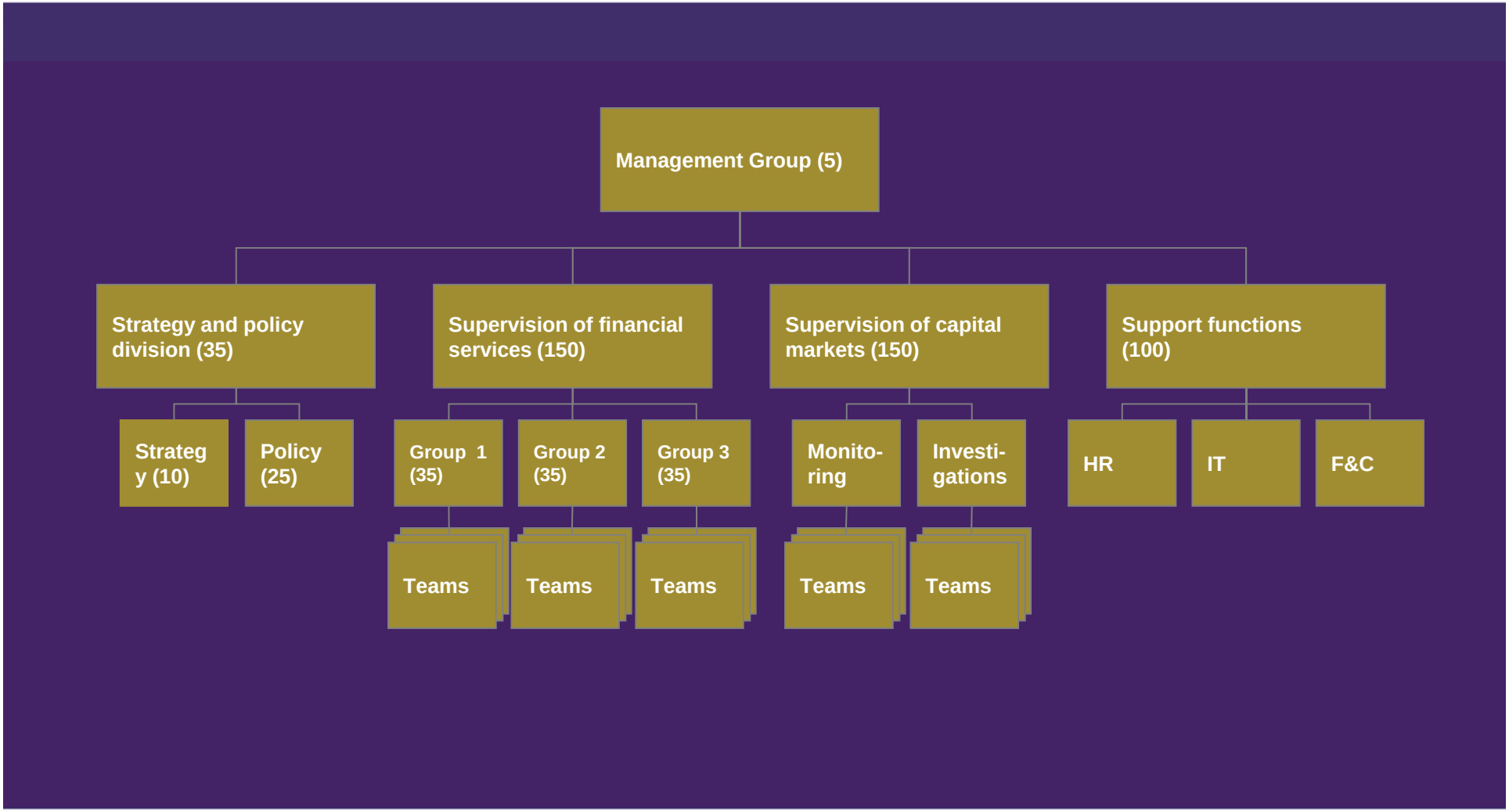
We have implemented problem based (or risk based) supervision in specific part of AFM

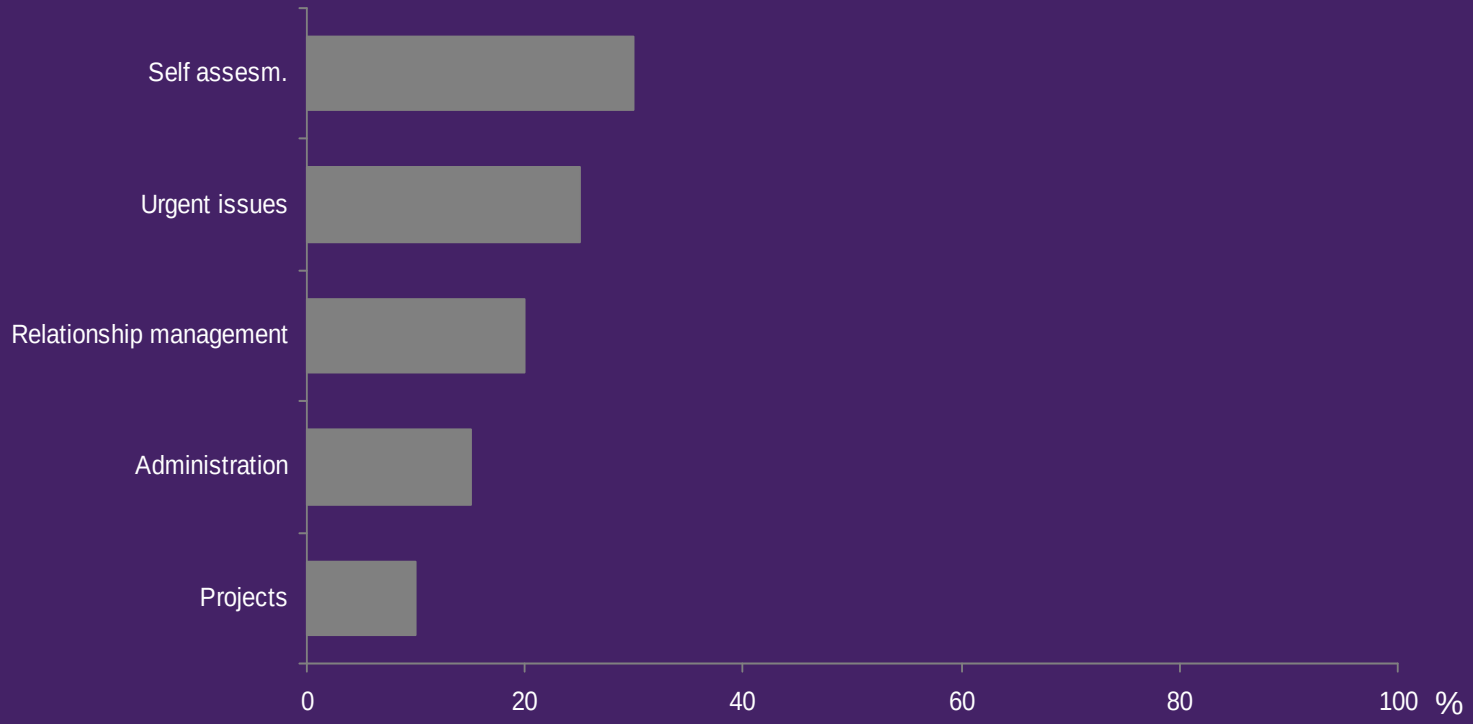


Mode of operation of financial services teams in 2006

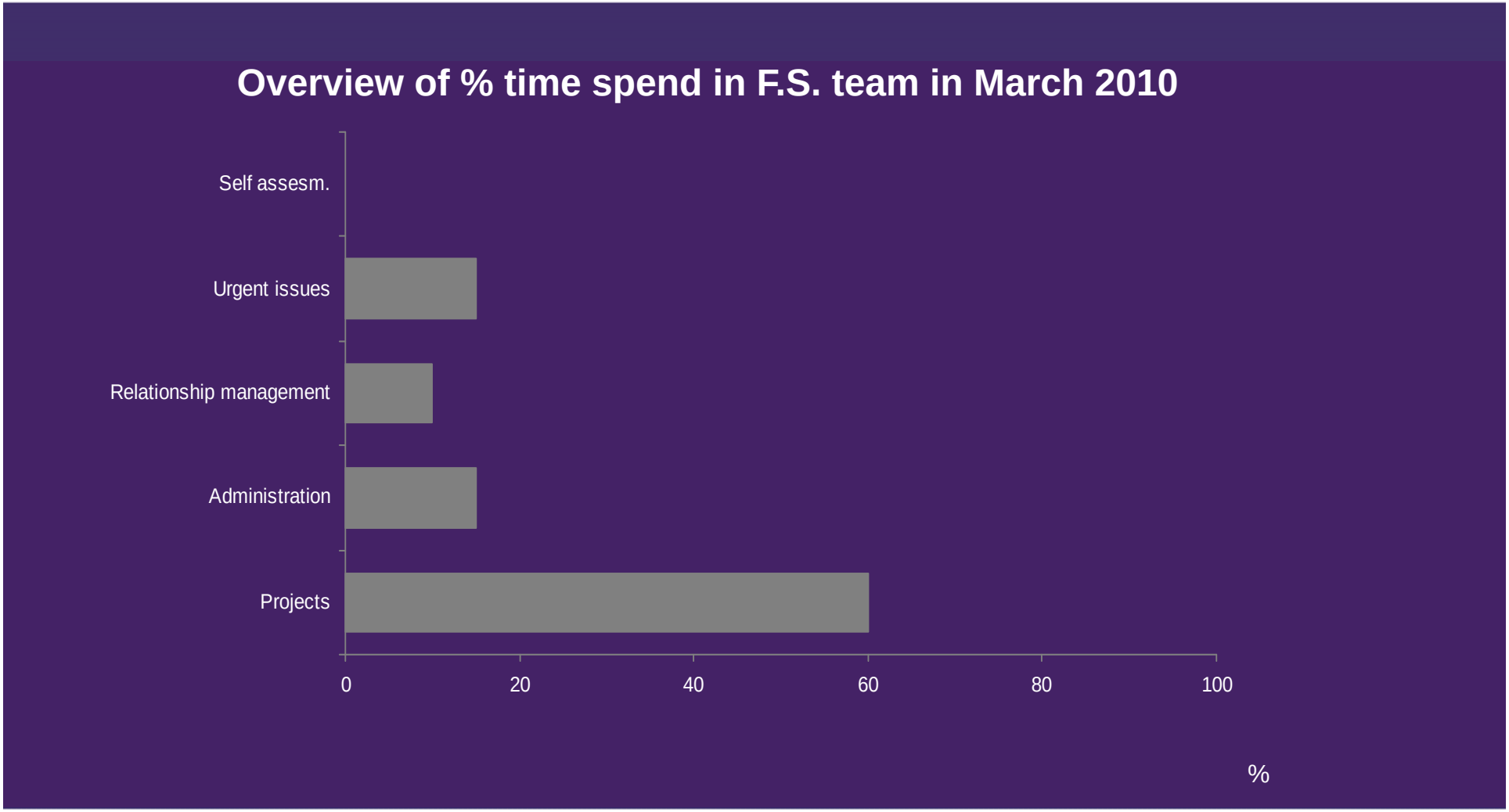
Institution / Activity	Assess self-assessment model	Assess management letter	Assess annual account	Regular board meetings	Small investiga-tions	Large investiga-tions
Team A						
• ING	✓	✓	✓	✓	✓	
• Delta Lloyd	✓	✓				
• Mid size co.	✓	✓	✓	✓	✓	✓
• Small size co.	✓	✓				
• Etc	✓	✓				
Team B						
• Fortis	✓	✓	✓	✓	✓	✓
• SNS Reaal	✓	✓	✓	✓		
• Mid size co.	✓	✓				
• Small size co.	✓	✓	✓	✓	✓	
• Etc	✓	✓				

Where did we find the capacity for our new approach?

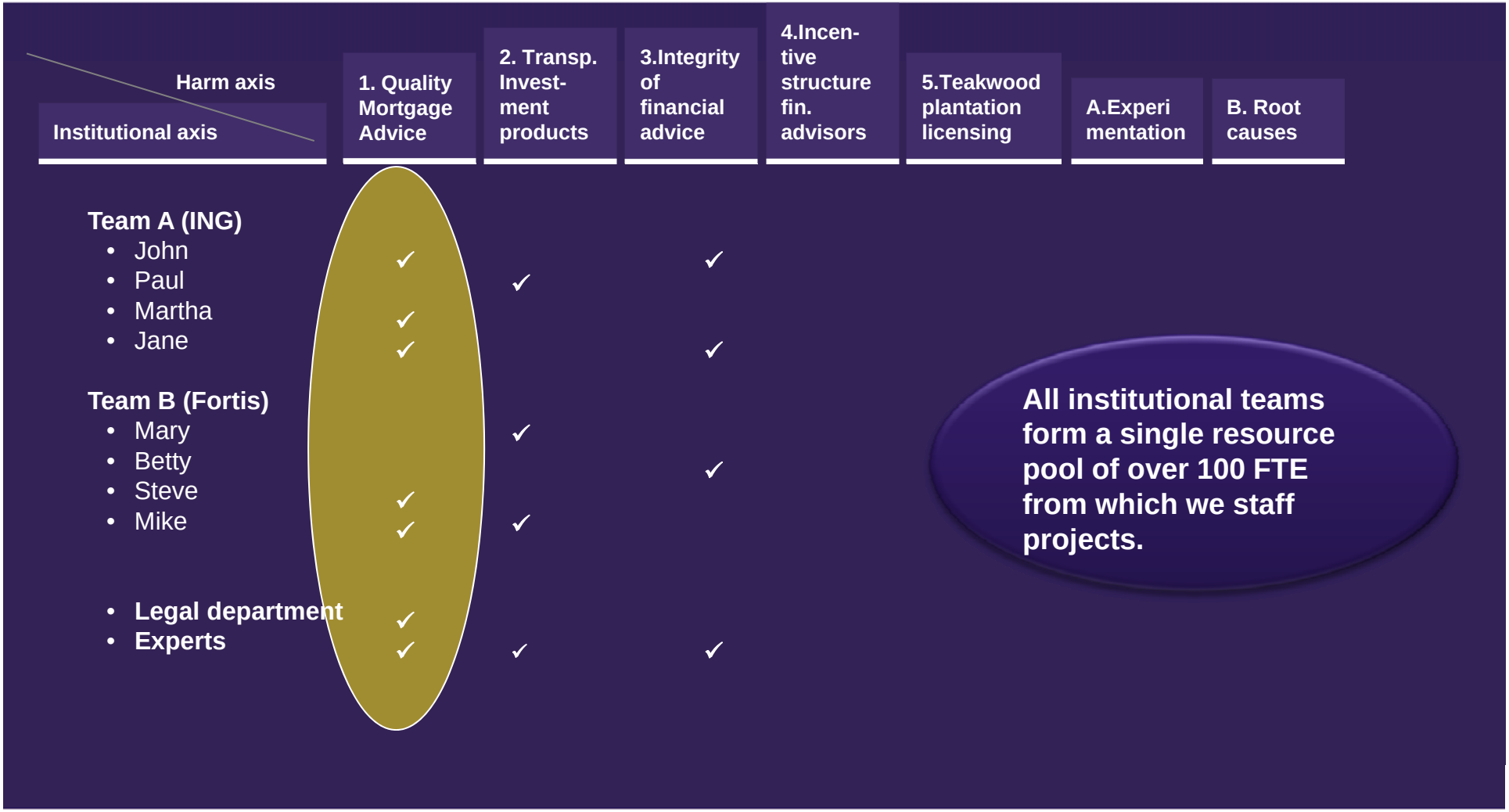
Overview of % time spend in F.S. team in September 2006



Specific circumstances enabled radical shift



How do we staff the selected problems?



Problem-solving: Essential Infrastructure

Nomination System:	**generating and funneling nominations**
Selection System:	**comparative assessment/selection**
Assignment System:	**for committing personnel/resources**
Project Records:	**project files, paper or electronic**
Oversight and Review:	**for monitoring and adjustment during the course of a project**
Reporting System:	**channeling project accomplishments into the agency's routine performance accounts**
Support System:	**for Teams/Managers, access to consultants or specialists in the problem-solving art**

Problem-solving: Essential Infrastructure

A Reward System:	**to provide recognition for project teams that achieve important results.**
A System for Learning:	**to provide broader access (within the organization and across the profession) to knowledge acquired: what works, what doesn't, what resources are available within and outside the agency, contact information, keyword-searchable databases of projects, etc.**

The Six Stages of Problem Solving

Stage 1:	**Nominate Potential Problem for Attention.**
Stage 2:	**Define the Problem Precisely**
Stage 3:	**Determine How to Measure Impact**
Stage 4:	**Develop Solutions/Interventions.**
Stage 5(a):	**Implement the Plan**
Stage 5(b):	**Periodic Monitoring/Review/Adjustment**
Stage 6:	**Project Closure, and Long Term Monitoring/ Maintenance.**

What is our approach to (problem based) supervision?

Guiding principles:

- Pick the most important problems → Our mission is leading: consumer protection and fair and orderly markets
- Carry out an integral problem analysis → Need to have deep understanding of the size and the shape of het problem
- Generate creative solutions → Often a mix of interventions is required
- Influence behaviour in an effective manner → Enforcement is means,not an end in itself

How do we select harms we want to control?

Signal and risk analysis

- Monthly 400 to 500 new signals
- Which will be screened, assessed and assigned
- Risk analysis based on signals and market trends

Selection of harms

- Nomination system for generating and funneling nominations
- Selection system for comparative assessment and selection of harms:
- Priority session is held twice a year

Project planning

- Project office has assignment system for committing personnel / resources

AFM Infrastructure has grown in three phases

Phase 1

- nomination and selection ‘on the spot’
- ‘top down’ orientation
- spreadsheet for basic planning

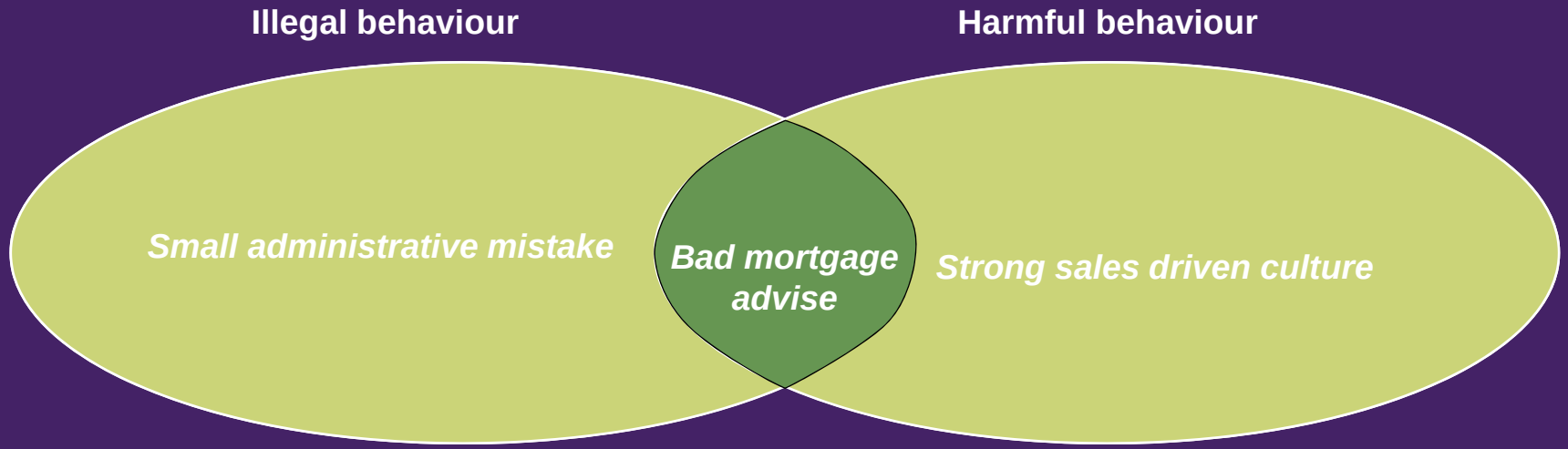
Phase 2

- structured meetings for nomination and selection
- managers and team leaders involved
- more spreadsheets for planning and staffing

Phase 3

- elaborate preparation of problem selection
- all supervisory staff involved through funnel
- standardized management information

On what type of problems should we focus?



Source: Sparrow, 'The Regulatory Craft' (2000). Adapted by AFM

How do we select specific harms that we want to control?

<u>Outcome of brainstorming sessions (in no particular order)</u>

1. Quality of mortgage advice
2. General compliance level at a large institution
3. Possible insider trading issue
4. Transparency of insured investment products
5. Integrity of financial advisors
6. Incentive structures for financial advisors
7. 'Best execution' policy in equity trades
8. Integrity of new mutual fund trading system
9. Teakwood plantation licensing
10. Quality of life insurance advice
11. Etc.

What criteria should we use to select some harms and not others?

<u>Criteria we considered</u>

A. Number of customers affected
B. Position on political agenda
C. Degree to which harm is under AFM influence
D. Level of effort needed to control the harm
E. Probability of early success
F. Urgency of the harm
G. Impact per customer
H. (Number of customers x (impact/customers))/effort needed to control
I. Probability that the harm does materialize
J. Etc

We tried to select 'big problems'

AFM

Criteria we used	Projects we chose
A. Number of customers affected	1. Quality of mortgage advice
B. Position on political agenda	4. Transparency of insured investment products
F. Urgency of the harm	5. Integrity of financial advisors
G. Impact per customer	6. Incentive structures for financial advisors
	9. Teakwood plantation licensing

What are the main pitfalls we encountered?

1. Too many harms selected	-	‘we simply over-ate’
2. Not enough diversity in size/type of harm	-	‘they were all big and long term’
3. Not enough focus on metrics	-	‘can we measure afterwards?’
4. Stickiness of old structures/habits	-	‘I always go to small co. once a year’
5. Deterioration of signaling function	-	‘we were too busy with problems!’
6. Lack of skills!	-	project mgmt., analytics, creativity
7. People issues	-	'have I been wrong so far?'
8. Lack of tools	-	‘ so you want me to call customers?’
9. Resistance to ambiguity/uncertainty	-	‘what axis do you want us to focus?’
10. Organizational difficulty of matrix structure	-	….!
11. Results take long time to materialize	-	‘ but..the issue isn’t solved…’
12. People find it difficult to see ‘big picture’	-	‘ why is my role/work important?’
13. Training new staff takes time	-	‘ can I go to Harvard too?’

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Three cases

Will discuss three cases, all with an integrity dimension.

One illustrates the result from regular monitoring by our dedicated integrity department

The others are an example of our problem oriented project work

Case: Teakwood investments

What was the problem?	• Perception gap • Push product • Low ethical standards
What did we do?	Phase 1: Separate the wheat from the chaff Phase 2: Improve information to investors, emphasis on *guidance* Phase 3: Improve risk awareness consumers, emphasis on enforcement
What has been the effect of our actions?	• Number of new investors reduced since 2006 • Total inflows reduced as well • Only 3 sales organisations still active

Case: Quality of Mortgage advice

What was the problem?	• High percentage of inadequate advices (too expensives, product not suited for customers, etc) • crediting
What did we do?	Mortgageadvice project (2007) confirmed our assumptions. Actions taken: •Assesment framework •Lower part of the intermediary market (revoke license) •Publish Guidelines •Publish online-tool for consumers (checklist) •Engage softwaredevelopers •Focus on providers of product (eg banks)

Case: Quality of Mortgage advice

What has been the effect of our actions?

Mortgageadvice project 2010:

- **Percentage moderate and inadequate advice declined from 24% to 15%**
- **Less crediting**
- **More attention for risks regarding loss of income**

Case: “Sunny Investment’: Caribbean Comfort Luxury Resort

END OF PRESENTATION

QUESTIONS?