

FOCUS!

A new trend in the international supervisory approach

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Last year, the Dutch Central Bank (DCB) introduced a new supervisory approach, FOCUS! This approach is the result of the DCB reform process, which was based on an evaluation of the DCB and external organisations such as the International Monetary Fund (IMF) and mainly aimed to integrate a more effective and powerful supervision. This new approach includes a transition from a national-oriented supervisory approach to an international one, in line with the EU model

FOCUS! has two key characteristics. Firstly, it includes a more qualitative analysis of the risks of financial institutions, based on concepts such as strategy and business model, risk appetite and risk culture. Secondly, FOCUS! is able to monitor implementation of, and compliance with, (new) international rules and regulations including IORP II, AIFMD and FATCA.

The impact of FOCUS! is mainly reflected in the supervisory scope of the DCB which, before the introduction of this new approach, was essentially focused on monitoring core quantitative ratios such as solvency and liquidity.

As part of its expanded capabilities, the DCB will also be able to evaluate qualitative aspects, for example the institution's strategy, risk culture and risk appetite. This means that Dutch financial institutions have to make these less tangible aspects explicit, to be able to include them in their internal control systems and explicitly report on them.

Deloitte's recent benchmark of Dutch pension funds and asset managers demonstrates that a fast majority of the respondents have not yet taken sufficient notice of these new developments, despite potentially a more than significant impact on organisational design, day-to-day execution and reporting.



This benchmark applies to the Dutch pension fund and asset management market, however FOCUS! is aligned with the supervisory approaches of other regulators such as the UK, Australia and the EU supervisory model. It is therefore relevant on a global basis.

FOCUS!

FOCUS! enables the DCB to perform a qualitative assessment of a newly defined set of risk drivers. Managing and monitoring these risk drivers adds an extra dimension to the pension and asset management market, because most of a pension fund's activities are outsourced to pension service providers (pension administrators, asset managers, etc.). The board of a pension fund continues to be accountable for the outsourced activities and therefore also continues to be responsible for the management and monitoring of the FOCUS! risk drivers throughout the entire pension value chain.

The most important qualitative risk drivers are:

- Macro economic and sectorial developments. What is the impact of these developments on the pension funds when these developments are related to internal (inherent) risks? Is the board able to form an integral vision on how to manage and respond to these external and internal risks adequately and effectively?
- Business model and strategy. Are the business model and strategy realistic and in line with current market perspectives?

- Translation of the business model and strategy into a sound and clear risk appetite, which is formulated explicitly by management and implemented throughout the business including risk indicators and limit setting
- Governance structure, risk culture and level of integrity of the pension funds and pension service providers

Future supervisory evaluations will be based on the outcome of the assessment of these risk drivers. The main challenge is how pension funds manage these risk drivers and take responsibility for effectively integrating them into their risk management system, given that most of their activities with embedded risk are outsourced to pension service providers.

The development and use of qualitative risk drivers as part of the supervision of the DCB is in line with an international trend. As indicated earlier, FOCUS! is in line with supervisory approaches used by other regulators such as in the UK, Australia and Canada. In addition, the newly developed FOCUS! approach is also in line with the EU supervisory model, which is applicable to financial institutions and sets the standards for a European pension funds regime.

How to act

The question of 'How to act?' is a legitimate and complex one. Pension funds and pension service providers have to redesign their current risk management system to enable pension funds to assess macro economic risks as well as internal risks and combine these assessments in order to (periodically) determine compliance with their risk profile.

The result is that the current level of information, as reported under SLA's and contracts, will prove to be insufficient, because this information is mostly quantitative and addresses qualitative elements to a lesser extent. Given these developments, pension funds will ask for more detailed information with regard to the qualitative risk drivers, but also to the design of the risk management system of the pension service provider, in order to be able to integrate their risk management activities into the risk management system of the service provider and vice versa. Furthermore, the pension fund will also increasingly require the pension service provider to deliver periodic or even ongoing assurance about the operational effectiveness of their risk management system, enabling the pension fund board to rely on the risk management information of their pension service provider.

In addition, pension funds will translate their strategy and long term goals into a risk appetite and test the strategic boundaries of macro economic developments. Eventually their risk appetite will have to be cascaded down into the pension value chain through the implementation of risk indicators and risk limits into the business of the pension service provider. Pension service providers are obliged to adopt these limits and report to the pension fund about the current risk levels in relation to the limits set by the pension fund.

FOCUS! enables the DCB to perform a qualitative assessment of a newly defined set of risk drivers

Finally, the pension service providers will be held accountable for the way they ensure that the risk culture and integrity of their organisation is aligned with the risk profile desired by the client. To this end, the management of the pension administrator should identify and implement control activities which enable them to actively influence the culture of their organisation.

We believe that the relationship between pension funds and pension service providers needs thorough adjustments in order to rebalance and integrate their current risk management systems in light of the FOCUS! risk drivers. A holistic approach is required.

Conclusion

In conclusion, the supervisory body has developed a methodology that looks beyond ratios and model calculations. This new way of thinking requires the industry to establish a vision of how to manage their inherent risks and relate this to macroeconomic and industry developments, but also actively manage the human element, which is essential for effective risk management.

If the industry does not adopt these key characteristics in their risk management system, pension funds will receive lower supervisory ratings and will experience difficulties with the implementation of future legislation.



Pension funds will ask pension service providers to integrate their risk management system with the risk management requirements of the pension funds. If, for example, an asset manager does not proactively adapt their systems to these future requirements, each client will expect their individual requirements to be met by their asset managers, resulting in multiple reporting and governance structures and significant cost increases. For this reason it is key for asset managers to develop their system in such a way that it will account for all (future) client requirements.

With the introduction of FOCUS!, the regulator is ready for the future. It is now up to the market to adopt this new way of thinking and make this the standard for market practice in the near future.

To the point:

- A majority of the pension funds and asset managers have not yet taken sufficient notice of the new developments regarding FOCUS!
- Pension service providers will be held accountable for the way they ensure that risk culture and integrity in their organisation is aligned with the risk profile desired by the client
- With the introduction of FOCUS!, the regulator is ready for the future. It is now up to the market to make this the standard for market practice

