

RISK MANAGEMENT AND RISK BASED DISCLOSURE IN SECURITIES FIRMS

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WHAT DOES EVERYBODY HATE EXCEPT COMPETITORS

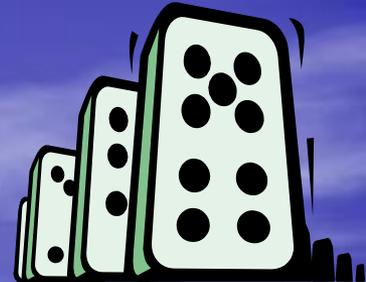
- IN GOOD TIMES;BAD REPUTATION
- IN BAD TIMES;BANKRUPTCY
- EVERYBODY? SECURITIES FIRMS AND REGULATORS



EVERBODY HURTS SOME TIME (SOME LEVEL)

- REGULATORS LIKE THE GUYS WHO MANAGE THEIR RISKS EFFECTIVELY
- EFFECTIVE INTERNAL CONTROL AND RISK MANAGEMENT SYSTEMS ARE THE TOOLS AFFECTING THE OWNERS AND REGULATORS' POW
- BUT REGULATORS STILL NEED TO CARE THE INDUSTRY; Minimized and managed wrongs do not rescue the system as a whole

DOMINO EFFECT



- **Systemic risk** refers to (1) the scenario that a **disruption** at a firm, in a market segment, or to a settlement system could cause a "domino effect" throughout the financial markets, (2) a "**crisis of confidence**" among investors, creating illiquid conditions in the marketplace. Systemic risk encompasses the risk that failure in one firm or one segment of the market would trigger failure in segments of or throughout the entire financial markets.
- As a statutory objective, **regulators** target to manage systemic risk in an acceptable/sustainable level by using some tools such as monitoring, enforcement, external audit, disclosure etc.

RISK MANAGEMENT AND DISCLOSURE

- **Regulatory Side of the Story;** The question is whether disclosure and effective risk management systems make positive contributions to the market efficiency, investor protection and systemic risk management.



DOES RM MATTER?

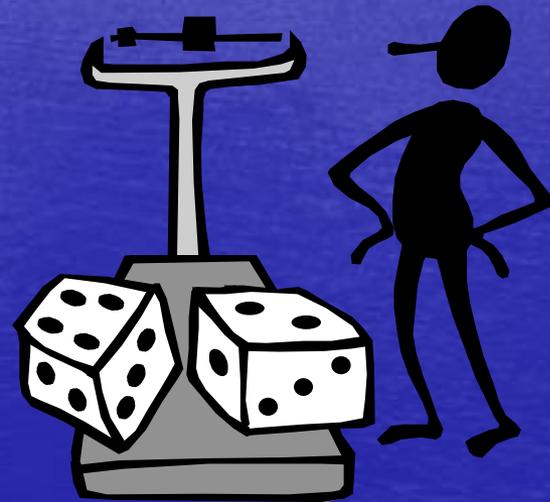
Rationales For RiskManagement

- The essential motive of risk management for a SF is to preserve and increase the profit or expected shareholder value.
- The SF employs volatility reducing strategies, which have the effect of reducing the variability of earnings.
- The financial marketplace strength, as a whole, ultimately depends upon individual firms' ability to cover unexpected losses with capital reserves.
- The implementation of strong and effective risk management and controls within securities firms promotes stability throughout the entire financial system.



MISSION: Volatility Reducing Strategies

- risks that can be eliminated or avoided by business practices;
- risks that can be transferred to other participants;
- risks that must be actively managed at the firm level.



RISK TYPES-I:INTEREST RATE RISK



- **Interest Rate Risk;** the effect of unanticipated changes in interest rates on portfolios of financial instruments, whether they be assets or liabilities.
- Regulatory bodies and SFs have to evaluate those three elements very carefully; term structure of the government-bond portfolio, concentration of the government bond portfolio in the asset side of a SF balance sheet, management of the maturity mismatching

RISK TYPES-II:MARKET RISK

- **Market Risk:**uncertainty of an FI's earnings resulting from changes in market conditions such as the price of assets, interest rates, market volatility and market liquidity
- **The VAR** approach evaluates how prices and price volatility behaved in the past to determine the range of price movements or risks that might occur in the future.
- methodology as good predictors for potential losses, and these models will be accepted for purposes of calculation of capital charges by banks and securities firms as from the end of 1997

RISK TYPES-III:CREDIT RISK



- **Credit Risks:**the risk of loss arising from the failure of a counterparty to perform its obligations under a contract.
- **For Credit Risk Manegement:**
 - The diversification reduces the individual firm specific credit risk but SF still exposed to systematic credit risk.
 - Sufficient collateral and marked to the market.
 - Strong reserves and sufficient equity capital which is proportional to the risk bearing by the SFs

RISK TYPES-IV-LIQUIDITY RISK



- **Definition;** SFs have sufficient funds to meet obligations as they arise without selling assets. SFs have to fund their commitments not only their effective economic life but also in the time of liquidation.
- **Leverage Effect;** The use of leverage (derivatives, margin and other forms of borrowing) can give rise to liquidity risk
- **Liquidity Risk Management;** critical in protecting capital, maintaining market confidence and ensuring profitable business opportunities.
- **Stress testing, scenario analysis;** are applied to evaluate potential cash requirements arising from early termination, collateral. Particularly turbulent markets.

RISK TYPES-V

OFF-BALANCE SHEET RISK

- By definition does not appear on the current balance sheet
- Other off-balance-sheet activities are positions in forward, futures, swaps, options and other derivatives.

RISK TYPES-VI

Technology risk



- Technology risk occur when technological investment do not produce the antipated cost savings in economies in scale or scope.
- Operational risk is partly related to technology risk and can arise whenever existing technology malfunctions or back-office support systems break down.

RISK TYPES-VII

Operational Risk

- **Definition**;the risk of loss resulting from inadequate or failed internal processes such as unauthorized trading, fraud in trading or in back office functions including inadequate books and records and a lack of basic internal accounting controls, inexperienced personnel...
- **Barings and Daiwa Case; Old But Still Meaningful Stories**
 - separate front and back office functions
 - well-defined limits on the activities
 - require confirmation of each transaction booked



Foreign Exchange and CountryRisk

- **Foreign exchange rate risk** arises when a financial institution has assets and revenues denominated in one currency(or group of currencies) and liabilities and costs in another currency(or group of currencies)
- **Country or sovereign risk** is the risk that repayments from foreign borrowers may be interrupted because of interference from foreign governments.

RISK TYPES-IX

Legal Risk, Discrete Risks, Agency Risk

- **Legal risk** arises from the possibility that an entity may not be able to enforce a contract against another party.
- **Discrete risks** involve the sudden and unexpected changes in financial markets due to tax, war, revolution, or sudden collapse.
- **Agency risk** closely related with the operational risk arises from existing conflicts of interest between the principal (firms and their shareholders) and agents (managers and/or employees)

Effective RM and Control System Components

- An effective risk management and control system requires;
 - Setting an Risk management and control strategy**; Analyse the business and risks+ set the quantitative risk exposure limits+support the risks by adequate capital
 - Policies and Procedures to Accomplish the Strategy**;Develop Specific Guideline
 - Risk measurement systems**, VAR should include sensitivity analysis and stress testing. A contingency plan to be followed in adverse circumstances and worst-case scenarios should be developed.

Measurement Problem; Legal/Operational/Reputational/Agency Risk?

- Compliance monitoring and reporting**,
- Regular assessment of the effectiveness of the policies and procedures.

Effective RM and Control System Elements-I

- **Control Environment;**

- Firms need to establish a mechanism to ensure that they have internal accounting controls and risk management controls.
- Responsibility for monitoring controls is clearly defined; and senior management promotes a culture of controls at all levels within a firm.
- The control environment's effectiveness is influenced by several variables
 - Management's attitudes, beliefs, and practices
 - Degree of external oversight.
 - Nature and scope of the governing body and management committees

Effective RM and Control System Elements-II

- **Nature and Scope of The Controls;** Firm guidance and guidance from supervisors should cover both internal accounting controls and risk management and controls.
- **Implementation;** Firm guidance+written documentation about their control procedures.
- **Verification;** The verification procedures should include --- Internal audits, which should be independent of the trading desks and the revenue side of the business,
 - External audits by independent accountants.
 - For supervisors, additional verification would be accomplished through an examination process.

Effective RM and Control System Elements-III

- **Reporting;** Firms need to establish and supervisors should require mechanisms to report material inadequacies or breakdowns in controls to senior management and supervisors on a timely basis



Disclosure for SF's Customers-I

Shareholder vs. SF's Customer

- **The idea;** Disclosure may provide all related parties such as current and prospective customers with greater transparency and enhances market discipline in the SF's industry.
- **The risk is still risk;** However the risks of the publicly held company's shareholder and a SF's customer are in the different context, both of them can face to serious financial troubles due to lack of sufficient information.
- **Poor Guys;** The essential difference between a shareholder a SF's customer, shareholder can access much more updated information, therefore, we assume that the shareholder has a clear idea of his investment risks.

Disclosure for SF's Customers-II

Voluntarily-Regulatory Risk Disclosure

- **Voluntarily Risk Disclosure;** is a tool for ensuring or enhancing investor confidence. The Board may promote it.
- **The question is** whether SFs self-disclosure practices can give enough information (or their business secrets) for investor protection. So,
- **Regulatory Risk Disclosure;** The most effective way for investor protection and market discipline.



Disclosure for SF's Customers-III

Regulatory Risk Disclosure-NASD Rules

- **NASD Conduct Rule 2270(Disclosure of Financial Condition to Customers);** A member shall make available to inspection by any bona fide regular customer, upon request, the information relative to such member's financial condition as disclosed in its most recent balance sheet.
- **NASD Rule 2910(Disclosure of Financial Condition to Other Members);** Any member of the Association who is a party to an open transaction or who has on deposit cash or securities of another member shall furnish upon written request of the other member a statement of its financial condition as disclosed in its most recently prepared balance sheet

Disclosure for SF's Customers-IV

Regulatory Risk Disclosure-NASD Public Disclosure Program

The reported information is publicly available and has falls into two broad categories:

- **Administrative** - information about the types of business a firm engages in, background information about a firm or broker, registrations and licenses held, etc
- **Disclosure** - information about regulatory and disciplinary actions, criminal proceedings, certain civil and financial proceedings and, in the case of brokers, customer complaints and related arbitration or judicial proceedings
- **That is not enough**; there is no sufficient disclosure periodic financial reports and the risk management evaluations, disciplinary information can represent only current and historical legal problems.

Disclosure for SF's Customers-V

Regulatory Risk Disclosure Exchange Act

- Form BD;
- the uniform application for broker-dealer registration,
- publicly available,
- The essential business information and legal disclosures such as criminal disclosure, regulatory action discl. Etc
- Legal disclosures are well designed,
- There is no sufficient disclosure periodic financial reports and the risk management evaluations like NASD's Public Disclosure Program.

Disclosure for SF's Customers-VI

Regulatory Risk Disclosure Exchange Act

- **Section 17(e)(1)(B) and Rule 17a-5(c);**
- A broker-dealer that carries customer accounts must generally send its full balance sheet (including footnote disclosures required by GAAP) to each of its customers twice a year (once audited and once unaudited)
- a footnote disclosing the amount of net capital the broker-dealer held as of the balance sheet date and the minimum amount of required net capital the broker-dealer to hold as of that date.

Disclosure for SF's Customers-VII

Regulatory Risk Disclosure Exchange Act

- **SEC Proposed Rule, Release No. 34-46920;** the proposed amendments would allow a broker-dealer that elects to take advantage of the exemption instead of sending its full balance sheet,
- to send a financial disclosure statement, consisting of its net capital information and information on how to obtain its full balance sheet, to its customers twice a year,
- as long as the broker-dealer also posts its balance sheet on its website and promptly sends its balance sheet to its customers who request it via a toll-free number.

Disclosure for SF's Customers-VIII In TURKEY

- SFs disclose their semi-annual and annual financial reports without detailed info. This disclosure could not get much attention in investment community.
- These reports also do not include the risk assessment of the firm for example the relevant reports do not provide information of the capital adequacy reports.
- The independent audit reports is also unobtainable material by the investors.
- Investors have no inspection rights related to the latest financial information of the SFs.



Disclosure for SF's Customers-IX In TURKEY

- A SF customer can get some information from the the Board and the ISE web-sites which contain the essential business information of SFs such as business address, phone numbers, branches, the name of the CEO, the final criminal sanctions etc.
- The information about the SFs is very limited for the average investors.



Regulation Recommendations

General Disclosure Form-I



- As a part of broader disclosure concept, the Board may adopt a **General Disclosure Form**. The form should include,
 - the essential business information (business history- ownership structure, names-address-phones-branches-BoD- CEO-licences-foreign investments etc)
 - the latest legal problems and the information on any past securities violations of the SF, like Form BD and Form U-4
 - the latest financial information (the latest audited financial information and capital adequacy report results, the summary of the latest risk management reports),
 - The Form should be updated and easy to reach via internet and customers e-mail
 - The Form should send the customers on a quarterly basis.

Regulation Recommendations

General Disclosure Form-II



- As a broader disclosure concept, general disclosure form referring a publicly available document covering both the disciplinary information and the latest financial information including the securities firm's overall risk assessment.
- As a specific part of the broader disclosure idea, the concept of risk-based disclosure has hybrid characteristics; importance of the implementation of the effective risk management and control systems and the risk-based disclosure to current and prospective customers of securities firms.

The Role Of Regulators in Risk Management



- **CMB have heavily focused its traditional job;** market surveillance, setting levels of capital reserves, auditing of firms' etc.
- **Risk management needs particular attention.**
- CMB may promote the better risk management practices in the industry; seminars, training programs, and a regulation.

Regulation Recommendations-I



- We believe that either the article 32 of the Serial:5, Number:46 or an independent regulation of the Board should contain these additional points in the below related to the effective use of risk management technics in the SFs.
 - the clear definition and the purpose of risk management
 - the clear definitions of the responsibilities of the risk management unit,
 - the requirement of SF guidance and guidance from supervisors should cover both internal accounting controls and risk management and controls,
 - the requirement of the each SF has to establish its independent risk management unit and organizational structure of a SF must provide adequate resources to the unit

Regulation Recommendations-II



- the requirement of the each SF has to define both its firm-specific risks and general risks (such as market risk, interest rate risk, liquidity risk, legal risk etc),
- the requirement of the independent risk management unit should support by the independent staff named as risk managers,
- the requirement of the each risk controller must be licensed by the Board,
- the requirement of the each SF has to define both its firm-specific risks and its risk exposures, the requirement of the risk management unit of a SF has to report impact and likelihood analysis on a periodical basis,
- the requirement of the summary basis disclosure of the risk management report to the prospective customers and other related parties

Regulation Recommendations-III



- the requirement of the summary basis report delivery to the current customers on a quarterly basis,
- audit requirement to the quarterly basis risk management reports,
- requirement of the risk management reports should prepare and send to CEO of a SF in a daily, weekly, monthly, quarterly, semi-annually and annually basis.
*The SF must define the contents of each report type according to its own needs and risk management goals.
- The monthly and quarterly risk management reports should also send the Board as a summary basis.

Regulation Recommendations-IV



- The management of the firm should announce its current or prospective customers whether there is a serious problem or not in terms of firm's risk exposure.
- Semi-annual and yearly basis internal risk management reports can also overview by a audit firm in a part of its usual audit process.
- In addition to other information explained in subsection 7.1., essential points of report should also disclose to the public as part of the firm's latest financial condition.



Regulation Recommendations-V

- The report should cover and the answer all points related with the risk management such as,
 - Whether the data produced by the internal accounting system is accurate,
 - Whether all risk types are covered and all current and potential problems related those risks are presented in the report,
 - whether balance sheet risks are suitable to the firm's risk management goals or risk profile, in other words whether the firm expose excessive risks,
 - whether there is a outstanding trend or significant changes in a particular risk type and overall risk level of the firm,

Regulation Recommendations-VI



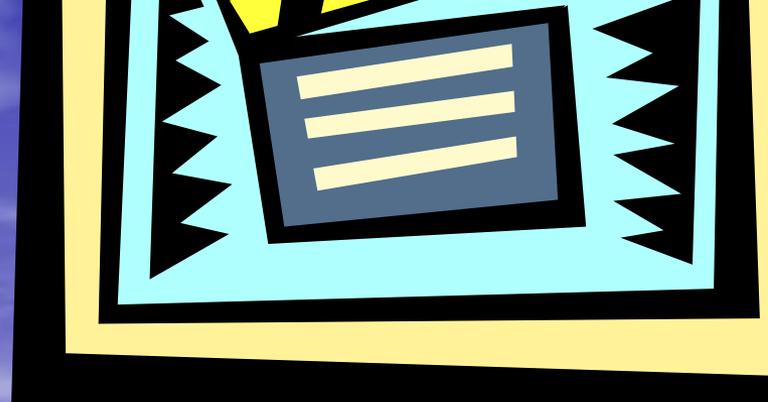
- whether potential risk exposure and capital of the firm periodically overviewed by using the stress tests, scenario analysis and other risk management technics,
- whether SF has sufficient capital proportional to its risk level,
- whether there is a material inadequacies, breakdowns or extra-ordinary developments in the system,
- whether there is an unexpected events made negative impacts to the business such as serious civil action or a regulatory action,
- whether there is a negative expectation related to securities business and its potential impacts to the balance sheet of the SF



Regulation Recommendations-VII

- whether there is a problem in terms of the Board's risk management criteria such as negative developments in the capital adequacy reports in the near future,
- Whether audit firm approve the results of the quarterly basis risk management report.

SOME REALITIES



- Risk management and controls are not a substitute for adequate capital requirements and they could not be enough for systemic risk management. So, shows must go on.
- It could not be easy to achieve regulatory objectives of the Board by using risk management and control systems and disclosure as policy instruments, if the auditing system does not really work well.
- As a value added activity, strong internal control and risk management environment protects SFs from unexpected losses and capital inadequacy problems. BUT, if you have not sufficient control culture or your senior management does not really care it, this is just a best wish.

THANKS...

