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Trust Less, Verify More

Financial Supervision in the Wake of the Crisis

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This is the fifth in a series of policy briefs on the crisis—assessing the policy responses, shedding light on financial reforms currently under debate, and providing insights for emerging-market policy makers.

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Financial supervision will need to change in response to the causes of the financial crisis and the regulatory proposals arising from it. Supervisors will need to take a tougher and more challenging approach to the firms they regulate, exercise more supervisory judgment, involve themselves in macro-prudential oversight, and participate more actively in the supervision of firms with cross-border activities. Supervisors in all countries need to take up these challenges—notwithstanding differences in the style of supervision, in culture and legal tradition, in institutional and organizational structure, and in the powers and resources available to the supervisory agency.

The causes of the financial crisis have been extensively analyzed, and many proposals have been put forward to prevent another such crisis in the future. Most of these proposals relate to regulation—the requirements imposed through legislation, rules, and guidance on regulated firms and on market participants to promote safety and soundness and prevent market abuse and financial crime. But less attention has been paid to supervision—the people and processes that monitor compliance with these regulatory requirements and intervene when they are not being met. This policy brief sets out four areas in which financial supervision will need to change in response to the causes of the crisis and the regulatory proposals arising from it.[1]

Shift in supervisory philosophy

Supervisory approaches differ significantly across countries. Generally, however, there has been a shift over time from detailed examination of banks' loan books to greater emphasis on banks' policies and practices, on the adequacy of their internal systems and controls, on their senior management and boards of directors, and, most recently, on their internal models for the calculation of capital requirements for market, credit, and operational risks. This shift has reflected changing perceptions about the effectiveness of different supervisory approaches; changes in and the increased complexity of the activities undertaken by banks; and the growth of the financial sector. Much the same evolution has taken place in the audit sector.

The main focus of supervision in many countries has therefore been on the quality of a firm's senior management, the strength of its systems and controls, and the adequacy of its financial resources (capital and liquidity). Moreover, the senior management of regulated firms has generally been trusted to correct compliance failures. These developments are well documented in the principles and other guidance issued by the Basel Committee on Banking Supervision over the past 20 years.[2]

One reason for the shift in supervisory emphasis is that in many countries the prevailing philosophy of supervision has increasingly been based on two assumptions: that market forces and market discipline keep both the economy and regulated firms broadly on track, and that the senior management and boards of directors of regulated firms have a strong and long-term interest in firms performing well. But the financial crisis has undermined both these assumptions (see, for example, FSA 2009). Market forces and senior management have failed to prevent large write-downs and losses at many banks (and other financial institutions), inadequacies in risk management and other internal controls, and poor corporate governance.

As former U.S. Federal Reserve Chairman Alan Greenspan commented in a February 17, 2009, speech to the Economic Club of New York,

> All of the sophisticated mathematics and computer wizardry essentially rested on one central premise: that enlightened self-interest of owners and managers of financial institutions would lead them to maintain a sufficient buffer against insolvency by actively monitoring and managing their firms' capital and risk positions. When in the summer of 2007 that premise failed, I was deeply dismayed.

One lesson from the financial crisis is therefore that supervisors need to be less trusting and more challenging (recognizing, of course, that countries start from different places). This means:

- Being significantly less trusting of firms' senior management, boards of directors, and internal systems and controls
- Testing outcomes (for example, the quality of a bank's loan book and the value of its financial assets) rather than relying on a firm's internal systems and controls and on reports produced by the firm
- Being more intensive and intrusive (for example, in the depth of on-site testing)
- Developing a more comprehensive understanding of the business of a firm and how it operates
- Placing greater emphasis on the performance of boards in fulfilling their duties, including the qualifications of board members and how the board sets the firm's risk appetite, links business strategy to risk, and monitors and controls the firm's risks
- Being more challenging of firms' business models and of the ability of firms to survive stresses and alternative scenarios
- Focusing more on systemwide risks and the ability of individual firms to withstand them
- Shifting the "burden of proof" on how well a firm is run so that this falls more on the firm, rather than on the supervisor to provide evidence to the contrary
- Imposing more demanding requirements on firms that may be deemed to be "too big to fail," to offset any commercial advantages (for example, a lower cost of funding) that this status might bring
- Expanding the scope of supervision to address opportunities for regulatory arbitrage and to ensure that a consolidated view is taken of a firm's business
- Considering whether to introduce more product regulation, such as preapproval for complex products (derivatives, securitizations) and limits on loan-to-value or loan-to-income ratios on lending for home purchases

In summary, supervisors need to rely less on market discipline and more on regulatory and supervisory discipline. There needs to be a shift from "trust but verify" to "trust less, verify more."

Greater exercise of judgment

Some of the proposals for stricter regulation do not require a major shift in supervisory approach. For example, supervisors could continue to monitor compliance with tougher capital requirements (shifting the emphasis to Tier 1 capital, imposing higher minimum capital levels, introducing an automatic rules-based countercyclical capital requirement, and imposing a leverage ratio), and to intervene as necessary to correct any noncompliance, without significant changes to the style, intensity, or structure of supervision. Indeed, if stricter regulation succeeds in making banks more "boring" and less involved in complex activities, supervision could theoretically even be scaled back accordingly.

But one driving force for a significant shift in supervision is that many of the proposals for stricter regulation will require supervisors to exercise more judgment across a wide range of areas, including capital, liquidity, stress testing, and remuneration. In addition, some supervisors are being given increased powers to intervene earlier and more decisively to deal with a problem bank (such as by moving it into a "special resolution regime").

For example, Principle 14 of the Basel Committee's most recent liquidity principles requires supervisors to "regularly perform a comprehensive assessment of a bank's overall liquidity risk management framework and liquidity position to determine whether they deliver an adequate level of resilience to liquidity stress given the bank's role in the financial system" (2008, p. 4). Supervisors are therefore required to form a judgment about each bank's liquidity, taking account of its individual position and its role in the financial system. Some supervisors already form such judgments, but others rely on a more limited range of quantitative liquidity measures.

Similarly, the Basel Committee (2009) and Financial Stability Forum (2009b) principles on stress testing require supervisors to exercise more judgment on the adequacy of banks' stress tests and on the implications of these tests for the setting of Pillar 2 capital requirements under the Basel II framework. In addition, the Financial Stability Forum (2009a) principles on remuneration arrangements in regulated firms require many supervisors to focus for the first time on the appropriateness of banks' remuneration policies. Indeed, to some extent these principles on stress testing and remuneration policies will require supervisors to reach a judgment on the business models and strategies of individual banks.

Even supervisors currently following a more judgment- and principles-based approach may find this broader exercise of judgment demanding, especially when combined with the more challenging and less trusting supervisory approach discussed in the previous section. Moreover, in many countries the legal and administrative framework makes it difficult for supervisors to enforce anything other than detailed and prescriptive rules. So these countries in particular will need to convert the higher-level principles as far as possible into more detailed rules. This will be difficult in such areas as remuneration systems, stress testing, and liquidity, where supervisors will need to take account of the circumstances of each firm and where detailed and prescriptive rules are unlikely to capture the full range of judgments required under the Basel Committee and Financial Stability Forum principles. It may also be difficult to make some types of "prompt corrective action" fully automatic.

Macro-prudential oversight

One of the lessons of the financial crisis is that supervision had focused too much on individual firms and not enough on systemwide developments and risks. It was difficult for supervisors to identify—and to respond effectively to—problems that might arise across the system as a whole, such as an excessive growth in credit or a sharp dislocation in financial markets. The April 2009 proposals of the G-20 countries therefore emphasize the importance of improved macro-prudential analysis to identify systemwide risks to financial stability, to undertake appropriate actions to address and mitigate these risks, and to ensure that these actions are implemented.

This has four key implications for supervisors. First, supervisors will need to engage actively in macro-prudential analysis. Supervisors will be well placed to contribute to the identification of risks to financial stability because of the data they receive from regular reporting and because of their knowledge and understanding of the firms they supervise. But to do this effectively, supervisors will need to become more aware of the types of systemwide risks that can arise, including from the collective actions of financial institutions (even if each firm appears to be controlling its own risks effectively). In addition, supervisors will need to be willing—and have a legal gateway—to share data on individual firms with the central bank's financial stability function or other systemic oversight bodies as appropriate.

Second, supervisors will need to collaborate closely with the central bank. Many countries already have in place arrangements for regular meetings between the supervisors and the central bank (in some cases also including the ministry of finance). These meetings will need to be extended to cover macro-prudential oversight, and it is important that this dialogue focuses not only on discussing risks to financial stability but also on prioritizing them and identifying the actions required to address the most significant ones. Other countries will need to establish such arrangements or, where the supervisors are located in the central bank, to ensure that the "micro" and "macro" departments work effectively together to identify and address systemwide risks. In some cases this may require a change in the objectives or mandate of the supervisory agency.

Third, although some of the actions needed to mitigate risks to financial stability will require policy measures that apply to all firms, supervisors will be on the "front line" in implementing some of these actions. Supervisors may need to demand that specific firms restrict their activities—for example, in lending to consumers or to property companies, in taking foreign exchange positions, in securitizing assets, or in outsourcing—to prevent the collective behavior of firms from generating systemwide risks. Supervisors operating a risk-based system will also need to integrate into their system the risks to financial stability identified through macro-prudential oversight.

Fourth, macro-prudential analysis may identify a need to widen the scope of supervision to include banklike firms that pose a threat to financial stability, for example, consumer finance and mortgage lenders that may not be currently regulated because they do not take public deposits, or insurance firms that undertake banklike activities. Supervisors therefore need to be prepared to take on new responsibilities or to work more closely with other regulators (for example, through closer interaction between prudential and conduct-of-business supervision).

Host country supervision

Concerns about supervision being fragmented (nationally and internationally), and about the ability to resolve problems in international financial groups, are reflected in proposals from the G-20 (2009) to introduce supervisory colleges for all major cross-border financial institutions and to improve the quality and effectiveness of supervisory colleges. These proposals cover the harmonization of information and reporting, coordination and cooperation, clarity of responsibilities, crisis management, and the availability of powers to act if necessary. The intention is that supervisors will become more proactive when participating in supervisory colleges and in their relations more generally with supervisors in other countries.

Another consequence of the financial crisis, however, has been a clear shift in the stance of some supervisors of branches (and, to a lesser extent, subsidiaries) of foreign banks. These supervisors have been seeking greater assurance on:

- The financial soundness of the parent or group
- The willingness of the parent bank to stand behind its branches (and subsidiaries) in other countries
- The adequacy of the liquidity and other resources being held locally by the branch or subsidiary
- The standards of regulation and supervision in the home country of the parent bank
- In some cases, the adequacy of the deposit protection arrangements that would apply to depositors in the local branch

Moreover, macro-prudential oversight may lead to prudential supervision becoming more national in its focus and to supervisors becoming more concerned about the potential contribution of foreign branches and subsidiaries to risks to national financial stability (for example, through lending to specific sectors, aggressive funding activities, or the introduction of risky products to the local market). This shift may occur especially where foreign banks represent a large share of the domestic banking market.

There is therefore a tension here. Host country supervisors may not be able to rely on greater cooperation among supervisors to ensure that they have the information they need from the home country supervisor or to satisfy them that a parent firm will control its branches so that they do not pose a threat to financial stability in the host country. Host country supervisors would then need to introduce tougher requirements for foreign banks operating in their country. These requirements could include the ring-fencing of liquidity, the provision of guarantees by the parent bank that it will stand behind its branches, an insistence that foreign banks operate through subsidiaries rather than branches, or restrictions on their activities.

Implications for supervisory resources and structure

All the issues discussed in the previous sections have implications for supervisory resources. Supervisors will need to be better able to take a more challenging and less trusting approach to firms; to make difficult judgments about a firm's capital, liquidity, stress tests, remuneration policies, and business models; to challenge firms effectively on the basis of these judgments; to engage actively in macro-prudential oversight and in the actions that flow from it; and either to cooperate more closely and actively with overseas supervisors or to take a more interventionist approach to the domestic activities of foreign firms.

These requirements will place extreme pressure on supervisory resources, which in most countries fall short of both the quantity and the quality needed. Supervisory agencies should therefore be seeking additional funding to recruit, train, and compensate supervisors accordingly. In many countries their ability to do so will depend on the adequacy of funding from the ministry of finance.

The financial crisis has also generated important lessons for risk-based supervision: the need to maintain an adequate minimum level of supervisory resources devoted to each systemically important firm, even if the firm seems to be well run and well controlled; the need to maintain oversight of key risks, such as liquidity (which was downplayed by some national supervisors and by global policy makers in favor of negotiating and implementing the Basel II capital accord); and the need to integrate risks identified through macro-prudential analysis into the supervision of individual firms.

In some countries the financial crisis has reignited debate about the optimal institutional structure of supervision—for example, whether to have a single regulator for all financial sectors, whether to separate prudential and conduct-of-business regulation, and whether the central bank should undertake regulation and supervision. But countries with very different institutional structures have had financial institutions fail (or require government support), just as countries with different institutional structures have had their financial system emerge relatively unscathed. So although it remains important for each country to choose an institutional structure that maximizes supervisory effectiveness in the specific circumstances it faces, a more immediate objective is to put into place arrangements for effective macro-prudential oversight that include close cooperation among the supervisors, the central bank, and the ministry of finance.

Conclusion

Supervision needs to become generally more challenging toward, and less trusting of, regulated firms; to become even more judgment based to ensure the effective implementation of proposals for the stricter regulation of the financial sector; to engage actively in macro-prudential oversight; and to create more effective cross-border oversight of financial institutions.

Doing so will be difficult in all countries and especially so in emerging economies with more volatile economic and political environments and weaker institutional structures. It will require increasing the quantity and quality of supervisory resources, effectively translating high-level international principles into national rules and guidance, and implementing effective institutional arrangements for macro-prudential oversight that bring together the contributions of both the supervisors and the "macro" department of the central bank. There may also be a widening of the regulatory—and thus supervisory—perimeter. Public expectations about the positive impact of stricter regulatory requirements and more challenging supervision of firms will make the job of being a supervisor even more demanding.

Notes

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1. While this policy brief focuses primarily on banking supervision, much of it is also applicable to insurance and securities supervision.

2. The Basel Committee Core Principles (2006) emphasize the need for supervisors to satisfy themselves about the adequacy of banks' systems and controls, including board and senior management oversight. Similarly, the adequacy of banks' risk management controls and that of senior management oversight are important criteria for supervisors to assess when banks apply to use the more advanced "internal model" methods for calculating capital requirements.

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