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Is there a need to rethink the supervisory process?

By John Palmer and Caroline Cerruti¹

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Abstract

By now, there seems to be general acceptance that ineffective financial regulation and supervision in several countries has been an important contributing factor to the current financial crisis. Financial supervisors in many instances did not understand the business models of the institutions they were supervising and the nature and extent of risk-taking that was occurring. As a consequence, they failed to take appropriate remedial actions, such as forcing institutions to curb risky practices and increase capital requirements and loss provisions.

There are many reasons why regulation and supervision failed. They include the policy choices made by the governments of which the supervisors formed a part, a set of widely held beliefs that markets were benign and institutions could be trusted to manage their own risks, and the mandates and incentives of supervisory bodies. They also included, in many cases, a concept of regulation and supervision that is outdated and ineffective – a concept that places greater reliance on rules such as capital requirements and high level monitoring of compliance with those rules, than on proactive, interventionist supervision with a strong on-site component, in order to understand the risks institutions are taking and to take appropriate actions when the risks are not properly managed.

How to encourage the adoption of a more contra-cyclical, interventionist and results-oriented approach to supervision is a difficult question. Such approaches exist in a

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number of countries and the results in those countries during the current financial crisis have been encouraging. In other countries, there are legal, institutional and cultural barriers to the adoption of similar supervisory approaches. While there is no single solution that will cause the necessary changes to take place, the authors believe that strengthening of standards and codes to reflect the desired approach to supervision will help, accompanied by continuing efforts through IMF/World Bank FSAP's and the IMF Article IV reviews to encourage adoption of the strengthened standards. Organisations like the Toronto Leadership Centre also have a role to play in helping supervisors to understand the importance of contra-cyclical and pro-active supervision.

Introduction

As many have commented, the current financial crisis is, by almost any measure, the most serious nearly all of us have experienced in our lifetimes. The damage caused by the crisis and the deep recession that followed is not yet possible to measure, but we know that it will be extraordinarily high in terms of lost GDP growth, business failures, job losses and shattered lives. The damage may be long-lasting for reasons that include heavy fiscal costs which could take years to absorb. All who have been involved in financial systems, including politicians, central bankers, treasury officials, financial regulators (including one of the authors), and officers and directors of financial intermediaries, bear a heavy collective responsibility for the damage that has been caused.

What is particularly distressing about this crisis is that we thought we were better prepared to prevent, mitigate and/or manage such a crisis than ever before. We believed we had learned the lessons from the Asian Financial Crisis and the other crises of the nineteen nineties. International financial institutions and central banks had accepted the challenge of contributing to financial stability and were actively carrying out macro-prudential surveillance to identify emerging threats and risks to financial systems. Financial supervisors were practicing risk-based supervision and were armed with new regulatory tools such as the incoming Basel II capital rules. Financial intermediaries were parceling out their risks and distributing them across the financial system by means of financial derivatives and reinsurance, reducing the exposure of any one institution.

The search for the guilty and the need to understand "what went wrong" is giving rise to an avalanche of studies and papers authored by academics and other experts as well as enquiries by various legislative bodies. While the crisis is far from over and it may be too soon to reach final conclusions on what caused or contributed to the crisis, it seems clear, sadly, that weak financial regulation and supervision had a major role to play.

The focus of this paper is on financial regulation and supervision, principally the latter, with a view to recommending approaches that could strengthen the effectiveness of financial supervision and reduce the chances that financial supervisors would miss or fail

to deal with the emerging symptoms of another such crisis. In order to discuss improvements, it will be necessary to discuss some of the more important causes, but this paper is not intended to provide a comprehensive analysis of the manifold ways in which financial regulation and supervision contributed to the financial crisis.

Much of the focus of the many studies now under way is on improving rules and regulations, such as capital adequacy rules for banks (including higher quality tier I capital, imposition of leverage ratios, inclusion of through-the-cycle estimates in Pillar II), better aligning incentives for financial institutions with behaviour consistent with soundness and stability such as by regulating executive compensation, and on improving certain supervisory practices, such as consolidated supervision, cooperation between home and host supervisors and macro-prudential supervision. Many of these initiatives are of great importance and a few will be referred to in this paper. However, this paper will place a heavier emphasis on supervisory culture and behaviour - factors that may have contributed to the flawed rules and practices - because, in the view of the authors, differences in these areas were more important in shaping differing supervisory outcomes in the lead-up to the current financial crisis.

We also do not intend to address the issue of regulatory structure and organization. While this seems to have been an important causal factor in the regulatory failures that occurred in the United States, the impact of regulatory structure and design issues (integrated vs solo regulation; separation of banking supervision from the central bank) seems less clear in other countries.

Although references will be made throughout this paper to studies now underway and to some of the available literature on financial regulation and supervision, many of the observations and conclusions are derived from the practical experiences of one of the authors as a financial supervisor. Such observations and conclusions may require the reinforcement of empirical research and comparative case studies to provide clearer guidance for future action within the supervisory community.

The terms “regulation” and “supervision” tend to be used interchangeably by financial regulators or supervisors, but they have different meanings. “Regulation” consists of setting the framework of laws, regulations, rules and best practice guidelines within which financial actors must operate. “Supervision” consists of monitoring the behaviour of the financial actors and intervening when needed to ensure they are acting in ways that are consistent with the letter and spirit of the regulatory framework. The terms “financial regulator” and “financial supervisor” will be used interchangeably as is common practice, when discussing the regulatory/supervisory body, but the above definition will be observed when referring to “regulation” and “supervision”.

A. Did financial regulation and supervision fail?

The evidence of regulatory and supervisory failure in many countries, particularly in North America and Europe, seems overwhelming. Failed banks, systemically-important banks and at least one insurance group on government life-support systems, hundreds of billions of dollars of public money at risk to support struggling financial institutions: all point to serious regulatory and supervisory failure. Some may argue that financial supervisors cannot prevent the failure of financial intermediaries (indeed some mandates of financial supervisors say explicitly that failures cannot be prevented²) but the pervasiveness and depth of the problems affecting financial institutions in a number of countries do suggest some fundamental flaws in the regulatory and supervisory systems in those countries and perhaps others.

Heads of important agencies in at least a few of those countries have acknowledged weaknesses in the performance of their agencies and have offered a variety of explanations. Some legislators have been critical of the performance of regulatory bodies in their countries³.

B. How did financial regulation and supervision fail?

There has been considerable discussion and much written on how financial regulation and supervision failed. The purpose of this paper is not to examine this topic in any detail, but to try to concentrate on the causes of such failures. However, to understand the causes, at least a cursory examination of the ways in which regulation and supervision failed is needed.

Federal Reserve Chairman Bernanke has provided a helpful summary, in his speech to the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition on May 7, 2009. He concluded that “the events of the past two years have revealed weaknesses in both private-sector risk management and in the public sector's oversight of the financial system”. Although his speech listed needed improvements rather than weaknesses, the recommended improvements imply weaknesses in several areas of public sector oversight, including failing to ensure that banks had:

² OSFI mandate states: “OSFI’s legislation has due regard to the need to allow institutions to compete effectively and take reasonable risks. Our legislation also recognizes that management, boards of directors and plan administrators are ultimately responsible and that financial institutions and pension plans can fail.”

³ Excerpt from the US Congressional hearing on Oversight and Regulation, 23 October 2009: “Chairman Waxman: our focus today is the actions and inaction of Federal- regulators. For too long, the prevailing attitude in Washington has been that the market always knows best. The Federal Reserve had the authority to stop the irresponsible lending practices that fuelled the subprime mortgage market, but it's long-time chairman, Alan Greenspan, rejected pleas that he intervene. The SEC had the authority to insist on tighter standards for credit rating agencies, but it did nothing, despite urging from Congress.”

- capital buffers sufficient to remain well-capitalized and actively lending, in the face of deteriorating macroeconomic conditions;
- effective liquidity strategies to cope with stressed market conditions and to fund off-balance-sheet positions;
- adequate risk-management systems, including effective risk-identification practices and regular stress testing to help detect risks not identified by more-typical statistical models, such as abnormally large market moves, evaporation of liquidity, prolonged periods of market distress, or structural changes in markets;
- processes to comprehensively evaluate the possible unintended consequences of proposed new financial instruments as well as how those instruments are likely to perform under stressed market conditions;
- processes to effectively manage counterparty credit risk, including understanding key linkages and exposures across the financial system, and how banks' own defensive actions during periods of stress might put pressure on key counterparties, especially when other market participants are likely to be taking similar measures;
- compensation practices, including bonuses, that provide incentives for employees at all levels to behave in ways that promote the long-run health of the institution;
- systems for ensuring that managements and boards of directors are well informed about the various risks that confront their organizations and that they are actively engaged in the management of those risks;

In reflecting on the weaknesses of public sector oversight, Dr. Bernanke also stressed the importance of consolidated supervision: “The crisis has demonstrated that effective and timely risk management that is truly firm-wide is vitally important for large financial institutions...” He recommended that “all systemically important financial firms – and not just those affiliated with a bank – should be subject to a robust framework for consolidated supervision”.

He also stressed the need to develop a “more macro-prudential approach to supervision – one that supplements the supervision of individual institutions to address risks to the financial system as a whole” in order “to enhance overall financial stability”. In other words, “our regulatory system must include the capacity to monitor, assess, and, if necessary, address potential systemic risks within the financial system”.

None of the issues raised by Dr. Bernanke represents a totally new insight into the responsibilities of financial regulators and supervisors, with the possible exception of evaluating compensation practices. Most of the others are reflected in existing supervisory standards and codes and in supervisory and related literature. So why didn't financial regulators and supervisors in a number of countries do a better job of addressing these issues? Our task in this paper is to try to answer that question and propose solutions.

C. Why did financial regulation and supervision fail?

We suggest that some of the more important causes include the following:

- Different policy choices in balancing innovation and soundness
- The “madness of crowds”⁴
- Political and market pressure on supervisors
- A “race to the bottom” among supervisors to create institution-friendly regimes
- Weak supervisory governance models and inadequate mandates
- Weak supervisory cultures, along with inappropriate incentives within supervisory bodies
- An inadequate understanding within supervisory agencies of financial institutions and what drives their behaviours
- Inadequate supervisory/central bank mandates and “tripartite” arrangements
- Sub-optimal cooperation among supervisory bodies and ineffective consolidated supervision of large financial groups
- Absence of real, on-site supervision in some supervisory agencies

Each of these points is discussed briefly:

1. Different approaches to balancing innovation and soundness

In some economies, the financial sector has been seen as an important driver of economic growth. In a few of these, an important policy objective has been to maintain or build a dynamic regional or global financial centre. In other economies, financial sector growth and dynamism have not been important policy objectives or have simply been seen as byproducts of other economic activity. More important priorities have been financial stability and soundness. These differing objectives, quite legitimately, have influenced regulatory and supervisory strategies in various countries. In the first group of countries, regulation and supervision tended to be lighter and more flexible to attract intermediaries to locate to such countries and encourage them to innovate and grow. In the second group, regulation and supervision tended to be more risk averse and less flexible. Conceptually, neither approach is right or wrong. Each has costs and benefits. The first is likely to lead to more rapid growth and important economic spin-offs than the second approach, but is also likely to lead to greater volatility and risk of financial crises.

There are other policy issues that have influenced regulation and supervision. For example, in some countries, there is an official or implicit policy of encouraging the development of “national champions” in the financial sector. Within the regulatory

⁴ Andrew Tobias, *Extraordinary Popular Delusions and the Madness of Crowds*, Random House, 1980, originally published as “Memoirs of Extraordinary Popular Delusions” by Charles MacKay in 1841

community, it is well known that financial institutions considered to be “national champions” receive favoured treatment from their home regulators. In the United States, the long-standing goal of making home ownership accessible to all who seek it undoubtedly influenced the response of U.S. regulators to the rapid growth of residential mortgage lending in the years leading up to the financial crisis.

It seems evident that different policy choices have contributed to different outcomes in the current financial crisis. In considering the costs of regulatory and supervisory failures, a rigorous analysis would also consider the benefits of the policy choices that may have contributed to those failures. Such an analysis is beyond the scope of this paper.

2. The “madness of crowds”

It seems clear that nearly all the financial sector actors, whether private or public sector, were deeply influenced by a pervasive and comprehensive system of beliefs about the financial sector, including the abundance of liquidity, ability to rely market discipline, and the effectiveness of financial innovation, including broad redistribution of risk and the reliability of valuation and risk management models.

Box 1: Excerpt from Lord Turner’s comments (Chairman of the UK FSA) at the Select Treasury Committee of the House of Commons, 25 February 2009:

Q2142 Chairman: In your Economist lecture, which was an excellent lecture, you made the point that the “huge inherent system-wide risks and the cycle of irrational exuberance was close to reaching a crisis point”. Do you think the FSA was captured by the markets and captured by the markets in that almost everyone in a senior FSA role comes from a banking background?

Lord Turner of Ecchinswell: I do not think that is at all fundamental to why there was a failure across the world to see that we were at a point of unsustainable irrational exuberance, because I think that failure also existed among many economists, central bankers and finance ministers, who come from a different background; who do not come from a market practitioner background but come from a theoretical economics background. Indeed, I think it is important to realise that up until 2006 and even into 2007 the world was awash with erudite, authoritative arguments put forward not just by bankers who had a self-interest in it but by theoretical economists who thought that they were looking at this in a disinterested fashion, who were arguing that the world, as a result of the development of structured credit and derivatives, had become less risky. That is there in the IMF global financial stability report; that is there in documents produced by Chicago School economists, *etc, etc*. So I think there was a very fundamental intellectual failure. I think it encompassed people who had a self-interest because of their role as bankers themselves but I think it was far, far wider than that.

Source: Treasury Select Committee of the UK House of Commons, Oral Evidence presented by Lord Turner, 25 February 2009

In fact, the reality is somewhat more nuanced than many would now have us believe. Although there was clearly a prevailing set of optimistic beliefs about financial markets, concerns were being raised. Some examples appear in boxes 2 and 3 below:

Box 2: What was the IMF saying in 2006?

It was worried in the Spring

Despite the key role rating agencies play in promoting the acceptance of structured credit products, some questions remain as to whether all investors fully understand the risk profile of these instruments, and how it differs from that of similarly rated corporate bonds. In particular, structured credit products are likely to suffer more severe, multiple notch downgrades paths, relative to the typically smoother downgrade paths of corporate bonds. ***Many investors (and their senior management) may therefore be negatively surprised during the next rating downgrade cycle.*** The rating agencies make an effort to inform investors of these risks through research reports and other programs. ***However, a more differentiated rating scale may be useful for structured credit products, to better ensure that such nuances are clear to investors, as well as to senior management and supervisors.*** (April 2006, p. 61)

It was increasingly worried in the Fall

As has been noted widely, the unexpected resilience of global growth over the past few years—at least relative to the then prevailing market consensus—has been associated with a decline in both risk premiums and volatility. In these circumstances, it is reasonable to wonder whether financial markets might react to less favorable developments in a way that would amplify—rather than dampen—the emerging risks. ***In particular, concerns have been raised about the potential for illiquidity to emerge in response to unexpected stress in markets for new and complex financial instruments, such as structured credit products.*** (September 2006, p. ix)

Furthermore, a repricing of risk could potentially be amplified by illiquid market conditions for many structured credit products [...]. In addition, ***because risk management has widely used value-at-risk (VAR) approaches that rely on recent volatilities, an increase in volatility could boost VAR measures and trigger a reduction in trading positions, thus amplifying price corrections.*** In this context, ***evolving risk management practices by entities such as banks' trading desks and hedge funds should be closely monitored.***" (September 2006, p. 7).

Source: unpublished paper entitled: "A Missing Piece in the Puzzle: A key to a more durable system of global oversight?" prepared by K. Langdon, IMF, November 2008

Box 3: What were others charged with overseeing global financial stability saying about the key factors behind the Crisis?

What was the Committee on Global Financial Stability (CGFS) worried about?

Structured Finance: In 2005, the CGFS published a paper on the role of ratings and structured finance. A key finding was "the working group believes that risks associated with structured products may not have been fully grasped by some investors."

Overheating in the housing market: in 2006, the CGFS published a paper on housing finance in the global financial market. A key finding was " Households may not completely understand their mortgage contracts or how their payments may change in response to interest rate shocks or other developments""central banks could consider conducting their own stress tests as well as encouraging other authorities and market participants to engage in stress testing" and further "an important issue for policy makers is how change in different regulations etc might affect housing markets and in turn the real economy through the housing finance system, with possible feedback effects from global financial markets".

Prescient of what came to pass. In hindsight, it could only have been said with stronger language but would that have meant more action would have been taken? The CGFS was not the only one call for action.

What was the FSF saying?

In early 2006, they were a bit concerned

Forum members noted that market and macroeconomic conditions remain benign and that financial systems have weathered a variety of shocks. Balance sheets and capital levels of financial institutions remain strong, while continued structural improvements in markets appear to have strengthened systemic resilience.

However, members pointed to several developments with the potential to cause strains in financial systems. These included further growth in external imbalances, high levels of household sector indebtedness in some countries, and low risk premia reflecting a high degree of liquidity and the continuing search for yield in markets. (FSF Press Release March 2006)

Members reviewed some areas of ongoing concern, including issues related to counterparty risk management, hedge funds, operational risks, and valuation practices for complex financial instruments. They urged firms to further strengthen their risk management practices, including the comprehensiveness of their stress testing and scenario analysis. (FSF Press Release March 2006)

Later in 2006, they appeared much more concerned....

Members pointed to several areas of concern with the potential to cause strains in financial systems. These include the capacity of households in some countries to manage rising debt levels and possible adjustments in housing markets, the rapid pace of leveraged buyouts and debt-financed acquisitions, the growing complexity of financial instruments, and persistent global current account imbalances. ***Financial market participants need to take account in their risk analysis and pricing of the full implications of a possible reversal of the current benign conditions, including less liquid markets.*** (FSF Press Release September 2006)

The FSF encouraged financial firms to further strengthen their risk management practices, in particular in ***running stress test scenarios involving low probability, high impact events or in which several vulnerabilities crystallise in combination.*** (FSF Press Release September 2006)

"These are just a few examples of issues that were raised publicly as significant vulnerabilities in the financial system. One could reasonably expect that these concerns were even more strongly expressed behind closed doors. There are also other examples that pre-date 2006: the clear and forceful concern expressed publicly in 2004 by Alan Greenspan then Chairman of the U.S. Federal Reserve about Fannie Mae and Freddie Mac. Concerns about the growing size and potential impact of these Government Sponsored Enterprises (GSEs) were also expressed much earlier albeit privately in multilateral groupings such as the FSF and the BIS as early as 2000".

Source: unpublished paper entitled: "A Missing Piece in the Puzzle: A key to a more durable system of global oversight?" prepared by K. Langdon, IMF, November 2008

The fact is that cracks were appearing in the optimistic belief system. Questions were being raised, but for the most part, they were being raised in muted tones, without a ringing call to action. And when occasional calls to action did ring out, they were sometimes met with intolerance and a reluctance to recognise evidence that challenged conventional wisdom.

Box 4: The inability to challenge the madness of crowds

At another hearing of the Treasury Select Committee of the UK House of Commons, on February 10 2009, it was alleged that Sir James Crosby, the then Deputy Chairman of the FSA and former CEO of HBOS, the leading UK mortgage lender, had ignored a risk alert and personally fired the head of HBOS risk management in 2005. This latter wrote in his Testimony to the Select Committee:

“When I was Head of Group Regulatory Risk at HBOS, I certainly knew that the bank was going too fast (and told them), had a cultural indisposition to challenge (and told them) and was a serious risk to financial stability and consumer protection (and told them). I told the Board they ought to slow down but was prevented from having this properly minuted by the CFO. I told them that their sales culture was significantly out of balance with their systems and controls. (...) After I was dismissed and to prove just how seriously HBOS took risk management, I was replaced by a new Group Risk Director who had never carried out a role as a risk manager of any type before.

Source: Written Evidence to the Treasury Select Committee of the UK House of Commons, Ev 434, Fifth Report, Banking Crisis: The Impact of the Failure of the Icelandic Banks, April 2009 (Volume II page 441)

Julie Dickson, the Superintendent of Financial Institutions in Canada summarised both the prevailing belief system and the intolerance of dissent in a recent speech in Beijing. “The key environmental factor that discouraged greater prudence was that times were very good for so long -- and anything that hampered expansion was given short-shrift (look at all the warnings that were expressed in the years leading up to the bursting of the bubble)⁵.”

3. Political and market pressure on supervisors

The pervasive set of beliefs affected financial supervisors both directly and indirectly, To the extent that supervisors shared the beliefs, and it is clear that many did⁶, regulatory and supervisory practices were shaped accordingly. To the extent that they had doubts or concerns, they had to contend with influential parties which had no such doubts, sometimes including their political masters, other arms of governments and the financial intermediaries that they supervised. The belief system referred to above, coupled with ideological factors such a commitment to deregulation, and financial sector policies that included a drive to encourage financial sector growth and development, often gave rise to pressure on supervisors to create more hospitable regulatory environments for financial institutions by reducing regulatory restrictions and supervising less intrusively.

⁵Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada (OSFI) to the Asian Banker Summit 2009 Beijing, China, 12 May 2009

⁶ Not all supervisory bodies shared such beliefs, see Appendix A.

Box 5: Excerpt from Lord Turner’s comments (Chairman of the UK FSA) at the Select Treasury Committee of the House of Commons, 25 February 2009:

“It fairly overtly said that it was not the function of the regulator to cast questions over the overall business strategy of the institution. You may find that surprising and I think, with hindsight, I find it surprising, but that is the case, and I think it is also the case that that existed within a political philosophy where all the pressure on the FSA was not to say: “Are you looking more closely at these business models?” but to say: “Why are you being so heavy and intrusive? Can you not make your regulation a bit more light touch?”

Source: Treasury Select Committee of the UK House of Commons, Oral Evidence presented by Lord Turner, 25 February 2009

Box 6: Excerpt from the US Congressional Hearing on Oversight and Regulation, 23 October 2008

“Chairman Waxman: the question I had for you is you had an ideology. You had a belief that free, competitive--and this is shown—your statement, do have an ideology. “My judgment is that *free, competitive markets are by far the unrivalled way to organize economies. We have tried regulation, none meaningfully worked.*” That is your quote. You have the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. Now, our whole economy is paying its price. You feel that your ideology pushed you to make decisions that you wish you had not made?”

Dr. Greenspan: *I found a flaw in the model that I perceived is the critical functioning structure that defines how the world works.”*

Source: US Congress, Congressional Hearing on Oversight and Regulation, 23 October 2008

4. A “race to the bottom” among supervisors to create institution-friendly regimes

The pressure on supervisors, sometimes self-induced, to create institution-friendly regulatory and supervisory regimes tended to lead to a “race to the bottom”, as supervisors were pressed by the institutions they supervised and others in authority to match or exceed liberalisation measures granted by other regulators. There are many examples, including:

- Allowing debt instruments that could be converted to common equity under stressful circumstances to qualify as Tier I capital and then relaxing the criteria for such qualification;
- Reducing overall capital requirements;
- Relaxing loan to value ratio requirements on property lending;
- Allowing securitization arrangements to reduce or eliminate capital requirements;
- Allowing hedging arrangements to reduce capital requirements.

The end result was a considerable weakening of prudential rules, including a sharp deterioration in both the quantum and quality of bank capital in a number of countries, a deterioration that contributed to the near failure of several systemically important banks.

One chapter in this story of decline and fall deals with the evolution of innovative Tier I capital. For banks and their advisors, this was the “Holy Grail” – debt with tax deductible

interest that would do the work of equity without diluting earnings per share and return on equity. The pressure on regulators first to allow innovative Tier I and then to expand its permitted use was relentless because of the impact on earnings and earnings-based compensation. A few regulators, chiefly those now dealing with failed banks, were in the forefront of concessions to the banks, thereby increasing the pressure on other, more cautious regulators to make similar concessions. The standard setters played a rear-guard action, attempting to hold the line on further concessions but generally forced to modify the standards to legitimise the new status-quo.

Box 7 shows the Basel Committee stepping in at the request of some of its members as the growth of innovative Tier I threatened to get out of hand, in order to draw a “line in the sand” regarding the minimum criteria for innovative instruments to qualify for Tier I treatment and the maximum quantum of innovative Tier I allowed.

Box 7: Instruments eligible for inclusion in Tier 1 capital, excerpt from the BIS guidelines

As its starting point, the Committee reaffirms that common shareholders' funds, i.e. common stock and disclosed reserves or retained earnings, are the key element of capital. (...)

In order to protect the integrity of Tier 1 capital, the Committee has determined that minority interests in equity accounts of consolidated subsidiaries that take the form of SPVs should only be included in Tier 1 capital if the underlying instrument meets the following requirements which must, at a minimum, be fulfilled by all instruments included in Tier 1:

- issued and fully paid;
- non-cumulative;
- able to absorb losses within the bank on a going-concern basis;
- junior to depositors, general creditors, and subordinated debt of the bank;
- permanent;
- neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors; and
- callable at the initiative of the issuer only after a minimum of five years with supervisory approval and under the condition that it will be replaced with capital of same or better quality unless the supervisor determines that the bank has capital that is more than adequate to its risks.

National supervisors expect banks to meet the Basle minimum capital ratios without undue reliance on innovative instruments, including instruments that have a step-up. Accordingly, the aggregate of issuances of non-common equity Tier 1 instruments with any explicit feature - other than a pure call option - which might lead to the instrument being redeemed is limited - at issuance - to 15% of the consolidated bank's Tier 1 capital.

Source: BIS Press Release, instruments eligible for inclusion in Tier 1 capital, 27 October 1998

The Basel Committee clarification still allowed room for interpretation from national regulators as how to define the border between non-innovative Tier 1 and Innovative Tier 1. Box 8 provides an example of the use of such national discretion. In this particular case, in addition to lowering the Tier I limit to be met before issuing innovative capital, the regulator considered issues incorporating settlements by the issue of ordinary/preference shares as innovative Tier 1.

Box 8: Example of national regulators' clarifying the definition of Tier 1 capital

Except from the UK FSA: Tier 1 capital for banks, November 2003:

- The Tier 1 limit that a bank must meet before issuing Innovative capital is to be reduced from 6% to 4%.
- All indirect issues of Tier 1 capital through a special purpose vehicle should be classified (at most) as Innovative Tier 1 on a solo (i.e. solo-consolidation) and consolidated basis (i.e. through the creation of minority interests).
- If a minority interest arises other than through a special purpose vehicle, then this will be assessed on a case-by-case basis to determine classification as Core or Innovative Tier 1 for group capital requirements.
- All issues incorporating principal settlement by issuing ordinary shares or preference shares should be treated as Innovative Tier 1 capital so long as they do not exceed a 200% redemption ratio.

Source: UK FSA PS: Tier 1 capital for Banks, update to IPRU (Banks), November 2002

5. Weak supervisory governance models and inadequate mandates

Weak supervisory governance models, uncertain traditions of supervisory independence, and/or inadequate legal protection, have, in some cases, made it difficult for supervisors to resist political and market pressures. This issue has a number of dimensions. A core-principles-compliant governance model with de jure independence from elected officials has not always been sufficient to protect a supervisory agency from political pressures or from succumbing to the “madness of crowds”, particularly if the leadership of the supervisory agency has been too “politically attuned”. More than the right governance structure has been required. Without strong, independent-minded leadership and the right incentives, it has been difficult for some agencies to take the supervisory actions that should have been taken. The legal protection issue, although unlikely to have been a factor in the weak performance of regulatory agencies on either side of the Atlantic, has been and continues to be a serious handicap in other regions.

One of the main findings of the IMF/World Bank evaluation of the Financial Stability Assessment Program (FSAP) in February 2005 was that “**Financial sector oversight agencies in some countries have weak governance structures.** A growing number of countries request assistance in reforming their supervisory infrastructure in order to address governance issues such as the institutional structure, decision-making, independence, and accountability.”⁷

Inadequate supervisory mandates may include explicit or implicit responsibility for financial sector development and may not empower the supervisor to supervise proactively, such as the prompt corrective action mandate in the U.S. or the “early intervention” requirement in Canada⁸.

⁷ IMF, World Bank, Financial Sector Assessment Programs: Review, Lessons, and Issues going forward, 28 February 2005.

⁸ OSFI's mandate requires OSFI to: “promptly advise institutions and plans in the event there are material deficiencies and take or require management, boards or plan administrators to take necessary corrective measures expeditiously”. It is described on OSFI's website: “The mandate stresses the importance of early intervention to carry out OSFI's objectives”. The US Code Collection, title 12, section 16, # 1831 states: “each appropriate Federal banking agency and the Corporation (acting in the Corporation's capacity as the insurer of depository institutions under this chapter) shall carry out the purpose of this section by taking prompt corrective action to resolve the problems of insured depository institutions”.

Table 1 contains excerpts of mandates of two supervisory agencies. References to developmental mandates are shown in italics.

Table 1: financial sector development in supervisory mandates

<p>Excerpt from the UK FSA “Principles of good regulation”</p> <p>Innovation <i>The desirability of facilitating innovation in connection with regulated activities: this involves, for example allowing scope for different means of compliance so as not to unduly restrict market participants from launching new financial products and services.</i></p> <p>International character <i>The international character of financial services and markets and the desirability of maintaining the competitive position of the UK: we take into account the international aspects of much financial business and the competitive position of the UK. This involves co-operating with overseas regulators, both to agree international standards and to monitor global firms and markets effectively.</i></p>	<p>Excerpt from the guidelines for Financial Market Regulation of the Swiss regulatory agencies</p> <p>Safeguarding the attractiveness of the financial centre as a location <i>The regulatory authorities take cost implications for the international context into consideration and take care not to restrict the innovativeness and competitiveness of the financial sector. They appraise the usefulness of implementing international standards, as well as the appropriateness of differentiating or harmonising regulation, as the case may be.</i></p>
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<http://www.fsa.gov.uk/pages/About/Aims/Principles/index.shtml>; <http://www.finma.ch/e/regulierung/Pages/regulierungsprozess.aspx>

6. Weak supervisory cultures, along with inappropriate incentives within supervisory bodies

Little has been written about differing cultures and incentives within supervisory agencies. Nevertheless, it is the conclusion of the authors, based on one of the authors’ work with other supervisors over many years in a variety of contexts (as a member of the Basel Committee on Banking Supervision, Chair of the Working Group on Banking Supervision of the Executives Meeting of East Asia-Pacific Central Banks, a member of the Integrated Financial Supervisors Group and a participant in many cross-border supervisory initiatives) that supervisory cultures and both explicit and implicit incentives vary significantly among agencies. Some supervisors are pro-active and interventionist, taking remedial action at the earliest possible moment to prevent more serious problems later. Others are more reactive and passive, waiting until evidence of problems accumulates to the point of certainty before contemplating action.

To a certain extent, such differences can be explained by differing legal contexts. Common law jurisdictions can allow the supervisor more latitude and the ability to exercise a degree of judgement and discretion. Roman law jurisdictions tend to have more prescriptive legal frameworks requiring the supervisor to prove breaches of requirements before action can be taken and to be prepared to defend his judgements in court. However, there appear to be significant cultural differences between financial supervisors even within similar legal contexts. For example, the Bank of Spain, operating within a Roman framework, appears to have been a relatively proactive and

interventionist supervisor, perhaps more so than some regulators operating in common law jurisdictions.

An example of diversity in the way supervision is conducted, although not a particularly important one in prudential terms, can be found in a report from the Committee of European Banking Supervisors (CEBS) in April 2009 on the use of supervisory powers. It shows that the use of sanctions varies widely from country to country in the European Union. Some supervisors imposed virtually no sanctions in 2006-2007 (e.g. Czech Republic, Finland, Lithuania) while others imposed more than 100 sanctions a year (e.g. Germany, Spain, Denmark). The CEBS suggests that legal, judicial and administrative systems may explain the different approaches in the use of sanctioning powers.

Table 2: number of sanctions relating to banking supervision or AML in the European Union

Number of sanctions relating to banking supervision or AML taken in 2006, 2007 and first quarter of 2008			
0 per year	≤ 25 per year	25 to 60 per year	>100 per year
BI, CZ, FI, IE and LT	AT, BG, CY, EE, FR, LU, LV, SI and SK	NL, PT, RO and SE	DE, DK, ES, GR, HU and IT

Source: CEBS, *Mapping of supervisory objectives and powers, including early intervention measures and sanctioning powers*, CEBS 2009 47, March 2009

The subject of differing supervisory cultures and styles and the incentives that influence them merit further study.

7. An inadequate understanding within supervisory agencies of financial institutions and what drives their behaviours

Another observation from interactions with a variety of regulatory agencies over many years is that the senior people in such agencies often have a weak understanding of financial institutions, what drives their behaviours and the way they respond to regulatory and supervisory initiatives. This has often led to insufficient scepticism of financial sector activities and their underlying motivations. Factors contributing to this have included:

- Executives and staff within supervisory agencies who have little or no direct financial sector experience, including a growing number of lawyers in some agencies;
- Under-resourcing of supervisory agencies, making it difficult to recruit/retain experienced qualified staff and to maintain robust on-site examination cycles;
- Insufficient numbers of product and risk specialists in supervisory agencies and/or ineffective use of such specialists by the senior management of such agencies.

The table below summarises the professional backgrounds of the heads of a number of supervisory agencies. Most of them do not appear to have worked in financial institutions.

Table 3: Qualification of the heads of the banking supervisors, selected examples

Institution	Country	Chairman	Financial Sector Experience (Private Sector)	Financial Sector Qualifications
OCC	USA	John C. Dugan	No	Lawyer, specialized in financial institution regulation
Federal Reserve Bank of NY	USA	William C. Dudley	Yes	Economist
FDIC	USA	Sheila C. Bair	No	Lawyer, specialized in banking sector
OSFI	Canada	Julie Dickson	Yes	Economist
FSA	UK	Lord Adair Turner	Yes	Economist
BAFIN	Germany	Jochen Sanio	No	Lawyer
Bank of Spain	Spain	Miguel Fernandez	No	Lawyer and Economist
Commission Bancaire	France	Christian Noyer	No	Civil Servant
FSA	Japan	Takafumi Sato	No	Economist

Source: regulators' websites, IOSCO

8. Inadequate supervisory/central bank mandates and “tripartite” arrangements

There has been widespread comment on arrangements amongst financial sector authorities (central banks, financial supervisors and treasuries) that have not assigned clear responsibilities for action to promote systemic stability and where there has been insufficient cooperation among the authorities in such areas as macro-prudential surveillance, information sharing and coordination of remedial actions.

As an example, the failure of Northern Rock in September 2007 and the enquiry by the British House of Commons that followed highlighted several shortcomings in the tripartite agreement among the UK Treasury, the FSA and the Bank of England. In particular, the agreement did not determine the leading institution in case of bank failure, and did not clearly assign responsibilities for communicating with the public in such a situation⁹.

9. Suboptimal cooperation among supervisory bodies and ineffective consolidated supervision of large financial groups

It seems evident that there were coordination failures in a number of countries where different domestic regulators failed to keep their colleagues informed of emerging risks. It also seems apparent that some regulators had an inadequate understanding of the group-wide risks within large financial conglomerates that included the specific institutions for which they had regulatory/supervisory responsibility. Examples include some of the financial groups of which the major investment banks formed a part and, of course, American International Group (AIG). There are at least two reasons for this. One is a reluctance to accept the principle of consolidated supervision, particularly on the part of insurance and securities regulators. The second is sub-optimal cooperation among supervisory bodies (banking, insurance and securities regulators; home and host supervisors) in the supervision of financial conglomerates.

⁹ Treasury Select Committee of the UK House of Commons, Fifth Report: The Run on the Rock, January 2008.

The Basel Core Principles explicitly require that banking supervisors supervise banking groups on a consolidated basis and encourage cooperation and information-sharing between home and host supervisors to achieve this goal. The Insurance Core Principles issued by International Association of Insurance Supervisors (IAIS) contain language that covers the same ground, but is weaker. In the view of the authors, this reflects a lack of acceptance by many insurance supervisors of the concept of consolidated supervision. There is no direct reference to consolidated supervision in the Core Principles of the International Organisation of Securities Commission (IOSCO). See table 6 in section F.4.

10. Absence of real, on-site supervision in some supervisory agencies

Supervisory best practices call for on-site supervision as well as off-site monitoring but one of the authors has observed that approaches to on-site supervision vary significantly among supervisors. Some restrict on-site supervision to short visits to an institution lasting no more than a few hours. Others carry out on-site inspections or examinations that may last several weeks or months. Some U.S. supervisors maintain permanent on-site teams at large institutions. A few supervisors in the first category outsource on-site supervision to external auditors and other “expert persons”. In the experience of one of the authors, short visits and delegation of more intensive work to external auditors is not sufficient to provide supervisors with an adequate understanding of what is really taking place within financial institutions. Auditors have expertise in forming judgements on the accuracy and appropriateness of financial reporting but do not have sufficient expertise or the incentives to assess the quality of risk management or detect other weaknesses in an institution’s business model. Regulatory capture becomes easier when regulators’ dealings with financial institutions, particularly “national champions”, take place at a superficial level and do not permit an understanding of how institutions are “gaming the system”.

Box 9: Use of external auditors: example of the Swiss supervisor

“Under the dual supervisory system, FINMA’s supervisory activities draw heavily on the work of recognized audit firms. As an extended arm of FINMA these firms conduct regular audits of banks and financial intermediaries and are therefore responsible for their direct supervision. They report the findings of their audits to FINMA. Insurance intermediaries are the only group subject to direct FINMA supervision. As a consequence of the dual supervisory system, the Banks/Financial Intermediaries division has limited staff resources in relation to the number of institutions it supervises. These resources are primarily deployed for institutions that require extra attention based on their risk profile”

Source: <http://www.finma.ch/e/finma/taetigkeiten/Pages/banken.aspx>

D. Where does regulatory/supervisory reform appear to be headed?

The evident weaknesses of financial regulation and supervision in a number of countries have served as a catalyst for a flurry of activity on the part of international and national authorities to strengthen regulation and supervision. At the recent meeting of the G20 Leaders in London, important decisions were taken and recommendations made for strengthening financial systems, some of which pertained to financial regulation and supervision. For example:

- The Financial Stability Forum has been rechristened the Financial Stability Board. It will play a more active leadership role in monitoring vulnerabilities in the global financial system, promoting supervisory cooperation, and supporting cross-border crisis preparation and management;
- The IMF has been asked to enhance its surveillance mandate and strengthen its resources, while at the same time building on ongoing reforms to increase the voice of emerging and developing countries in the institution;
- The scope of regulation and supervision will be expanded to provide oversight over hedge funds and credit rating agencies;
- Prudential regulation will be strengthened, inter alia, to address such issues as building counter-cyclical capital buffers, ensuring that off-balance sheet exposures are included in capital requirements and establishing frameworks for liquidity buffers.

Box 10: G20 Declaration on Strengthening the Financial System, 2 April 2009, main proposals

- Broaden the mandate of the Financial Stability Board (FSB) which takes over from the Financial Stability Forum (FSF). The FSB will assess vulnerabilities in the financial system, promote co-ordination among supervisors, monitor market development, set guidelines for supervisory colleges, support contingency planning for cross-border crisis management, and collaborate with the IMF to conduct early warning exercises.
- Strengthen international cooperation: establish the remaining supervisory colleges for cross-border institutions by June 2009; implement the FSF principles for cross border management, have the FSB and IMF launch an early warning exercise at the 2009 Spring Meetings.
- Strengthen prudential regulation: increase buffers above required minima once recovery is assured, build capital buffers in good times to mitigate procyclicality, supplement risk-based capital requirements with a non-risk based measure to take into account off-balance sheet exposures, develop by 2010 a global framework promoting liquidity buffers.
- Increase the scope of regulation: all systemic financial institutions should be subject to oversight; FSB and BIS to develop macro-prudential tools, FSB and IMF to produce guidelines to assess the “systemic” importance; hedge funds or their managers will be registered and their leverage monitored; FSB to develop cooperation mechanisms to ensure oversight of hedge funds regardless of their location by end 2009; establishment of central clearing counterparties in credit derivatives market by autumn 2009.
- Compensation: endorsement of FSF principles on pay and compensation and integration into the BSBS risk management practice by autumn 2009.
- Tax havens and non-cooperative jurisdictions: countries to adopt the international standard for information exchange reflected in the UN Model Tax convention. FATF to revise the review process for assessing compliance by jurisdictions with AML/CFT standards.
- Accounting standards: accounting standards setters to take action by end 2009 to reduce the complexity of standards for financial instruments, strengthen accounting recognition of loan-loss provisions, improve standards for off-balance sheet exposure and provisioning, make progress toward a single set of international standards, ensure consistency in application.
- Credit Rating Agencies to be subject to a regulatory oversight regime that includes registration by end 2009.

Source: G20, Declaration on Strengthening the Financial System, London, 2 April 2009

There are many more initiatives under way at the international and national levels. For example, in Europe, the UK and the US, reforms have been put forward in line with the G20 proposals including the EU Commission proposals on financial supervision published on 27 May, 2009¹⁰.

While all are well intended, some are absolutely essential, and most are likely to do some good, it is the authors’ view that few of these initiatives will address the root causes of regulatory/supervisory failure in the current crisis. This is because the causes are largely

¹⁰ Communication from the European Commission, European Financial Supervision, COM(2009) 232, 27 May 2009.

centred on the behaviour of financial regulators and supervisors and the factors that drive those behaviours. We will explore, in Section F, how those factors might be influenced to improve regulatory/supervisory behaviour in future.

E. Why regulation and supervision appear to have coped better in some countries than in others

In rethinking the supervisory process, it will be important not just to understand the causes of regulatory/supervisory failure, but also to understand what appears to have worked and why. There are always unintended consequences when radical change takes place (Basel II), and as we try to redesign the supervisory process, it will be important, where possible, to build the new design on tested foundations. In addition, the “successes” (at least in relative terms) may provide some guideposts for regulatory/supervisory reform more generally.

In this context, it is important to note that financial regulation and supervision have not (or not yet) failed in many countries. To this point in time and in this crisis, regulatory and supervisory failures have been largely confined to developed countries on either side of the North Atlantic. To date, there has been little evidence of such failures in countries that might have been regarded as failure-prone in the past, including countries in Asia, Latin America, and Africa. In addition, even in the countries of the North Atlantic area, regulatory/supervisory performance seems to have varied. While regulators and supervisors have struggled in a number of such countries, others have coped more successfully. These include financial regulators/supervisors in Spain and in Canada. A few other regulators whose financial systems experienced conditions similar to those in the developed countries of the North Atlantic, including those in Australia and Singapore, also seem to have fared relatively well.

Why do some regulators and supervisors appear, to this point at least, to have avoided the pitfalls into which their developed country peers have fallen? Our tentative answers will concentrate largely on Canada’s federal financial regulator, the Office of the Superintendent of Financial Institutions (“OSFI”), Australia’s federal prudential regulator, the Australian Prudential Regulation Authority (“APRA”) and Singapore’s central bank, The Monetary Authority of Singapore (“MAS”), which is also responsible for prudential and market conduct supervision, because of the involvement of one of the authors in regulatory and supervisory initiatives in those countries¹¹. It seems evident that the Bank of Spain should be high on the list of regulators/supervisors that performed relatively well in the lead up to the financial crisis. However, with no direct exposure to the good work of the Bank of Spain, the authors will, for the most part, leave it to the Spanish authorities to explain their successes.

¹¹ Mr. Palmer served as Superintendent of Financial Institutions in Canada from 1994 to 2001 and as Deputy Managing Director of the Monetary Authority of Singapore from 2002 to 2005. He also carried out a study of the role of the Australian Prudential Regulation Authority (APRA) in the failure of HIH Insurance and made recommendations for improvement of APRA’s supervisory practices in his report.

1. Crises or other supervisory trauma, requiring strengthening of regulatory and supervisory processes (Canada and Australia)

Canada suffered a deep recession at the beginning of the nineteen nineties, driven in part by a real-estate bubble fueled by rapid credit growth. Several financial institutions either failed or were taken over by other, larger institutions. At the newly-formed OSFI, important improvements in supervision were already being made before and during the crisis, but OSFI's mandate was unclear and its powers were inadequate. In the wake of the crisis, the federal authorities took steps to strengthen financial regulation and supervision, including a new mandate for the federal financial supervisor and expanded supervisory powers¹².

In Australia, fundamental changes were made to the system of regulation and supervision in response to the recommendations of the "Wallis Commission", including the creation of a Federal prudential regulator, APRA. The failure of HIH insurance and the recommendations of a Royal Commission that investigated the failure contributed to more improvements. The result was a considerable strengthening of both prudential regulation and supervision¹³.

In both countries, it seems likely that earlier strengthening of systems of regulation and supervision left the authorities there better prepared to address the behavioral excesses that contributed to the current financial crisis and to serious consequences in other developed countries.

2. A degree of acceptance at the political level of the importance of robust regulation and supervision unfettered by developmental objectives (Singapore Australia and Canada)

Table 1 above showed the developmental objectives within the mandates of the U.K. FSA and the Swiss regulatory agencies. As shown from the mandates of OSFI, MAS and APRA in table 4, none has an explicit developmental mandate:

¹² Canada Federal Department of Finance, Enhancing the Safety and Soundness of the Canadian Financial System, discussion paper, February 1995; See also Appendix B for a broader outline of the regulatory and supervisory changes in Canada.

¹³ Wallis Commission, Financial System Enquiry Final report, March 1997. John Palmer, Review of the role played by the Australian Prudential Regulation Authority and the Insurance and Superannuation Commission in the collapse of the HIH Group of Companies, 15 July 2002. The HIH Royal Commission, The failure of HIH insurance: a corporate collapse and its lessons, April 2003.

Table 4: Mandates and Objectives of APRA, OSFI, MAS

APRA	OSFI	MAS
Mission: “To establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.”	Mandate: “The legislated mandate made it clear that OSFI’s primary responsibilities were to help minimize undue losses to depositors and policyholders and to contribute to public confidence in the Canadian financial system. At the same time ...it was recognized that OSFI cannot, and should not, be expected to prevent all financial institution failures. The mandate also recognizes the important role and responsibility of boards of directors and management in ensuring that risks are managed properly. The mandate stresses the importance of early intervention to carry out OSFI’s objectives and establishes the framework to serve as the basis for OSFI’s strategic goals, priorities and strategies.”	MAS Mission: To promote a sound and progressive financial services sector.” MAS Objectives” -Stable financial system -Safe and sound intermediaries -Safe and efficient infrastructure -Fair, efficient and transparent markets -Transparent and fair-dealing issuers and offerors Well-informed and empowered consumers”

Source: APRA, OSFI and MAS websites. <http://www.mas.gov.sg/resource/publications/monographs>

The use of the term: “competitive financial system” suggests that APRA is expected not to over-regulate and supervise, but this falls well short of the requirements to facilitate innovation and safeguard the attractiveness of the financial centre that appear in the British and Swiss mandates.

The word “progressive” in the MAS Mission does reflect that fact that MAS has a developmental interest as well as more traditional regulatory and supervisory objectives. However, because a tradition of strong, interventionist regulation and supervision is deeply rooted in the MAS culture and enjoys support at the highest levels of government, the developmental issue does not undermine effective regulation and supervision.

3. An understanding of the need to lean against the cycle

Spain’s counter cyclical provisioning and Canada’s increases to capital and provisioning requirements in the late nineties¹⁴, both discussed below, reflected an understanding of the need for financial regulators to encourage institutions to build prudential cushions during buoyant phases of the financial cycle. Banks in Spain, Canada and Singapore had strong capital cushions and loan loss provisions at the onset of the financial crisis.

¹⁴ See Appendix B, Speech by John Palmer, Superintendent of the Financial Institutions of Canada, 8 June 2000.

4. Contingency planning and crisis simulations (Canada and Singapore)

As the financial cycle continued on its long up-trend, both OSFI and MAS carried out contingency planning exercises and crisis simulations to enhance the ability of supervisors to detect and manage an emerging crisis. These initiatives reflected the counter-cyclical thinking referred to above. The simulations tended to increase awareness of potential causes of a future crisis and to enhance supervisory sensitivity to warning signals. APRA has also carried out contingency planning for liquidity and pandemic scenarios.

Both MAS and OSFI focus on contingency planning at the level of the individual financial institution. MAS' guidelines on risk management practices indicate that: "each institution should have a contingency plan for handling liquidity crisis situations"¹⁵. At OFSI, contingency planning is part of the "ladder of intervention" described in E.11. As soon as stage 2, "risk to financial viability" is reached, OSFI may start to carry out institution-specific contingency planning.

5. Effective cooperation between the central bank and the supervisory authority on macro-prudential surveillance and related matters (Canada and Singapore)

In Canada, cooperation among, inter alia, the central bank and the prudential supervisor (OSFI) is mandated under the OSFI Act through the Financial Institutions Supervisory Committee (FISC) chaired by the Superintendent of Financial Institutions. The Committee meets regularly to exchange information about the financial sector, discuss industry trends and review issues affecting specific institutions, particularly those of systemic importance.

In Singapore, financial supervision and other central banking activities are carried out within the MAS. Macro-prudential supervision is carried out by the Macro-economic Surveillance Department, which works closely with research, monetary policy and supervisory functions.

In both countries, the cooperation between supervisory and central banking functions on both macro and micro-prudential matters has generally been effective.

In Australia, a Council of Financial Regulators was established in 2004 to bring together the Central Bank, APRA, the Securities and Investment Commission and the Treasury Secretary. It aims to ensure appropriate coordination for responding to sources of financial instability and help to resolve issues where members' responsibilities overlap. In September 2008, the Council released a MOU outlining the responsibilities of each institution in a financial crisis.

¹⁵ Monetary Authority of Singapore, Guidelines on sound risk management practices, 30 October 2002.

6. Sceptical approach to financial innovation, including off-balance sheet vehicles and innovative Tier 1 instruments (Canada & Singapore; also Spain)

Both OSFI and MAS were followers, not leaders in granting capital relief for hedged exposures and the securitisation of assets. Each also took a cautious approach in allowing banks to make use of innovative Tier 1 instruments and in accepting various forms of such instruments. OSFI went further than some other regulators by denying capital relief for banks required to provide liquidity support for special purpose vehicles, even if such support was limited to systemic events¹⁶. Similarly, where banks extended standby facilities or credit enhancements to securitization vehicles, MAS denied capital relief except where the banks complied with regulatory restrictions on such support¹⁷.

Until recently, the Bank of Spain had taken the strongest position amongst developed economy regulators on securitization, denying any capital relief for assets transferred to off-balance sheet special purpose vehicles. That position changed in May 2008 with the implementation of Basle 2. Securitized assets are now included in risk weighted assets¹⁸.

7. Robust capital rules, including higher than Basel minimum requirements, supervision of compliance with capital rules (Canada and Singapore), and simple leverage test (Canada)

In the late nineteen nineties, OSFI raised its minimum capital adequacy standards to require a minimum of 7% tier I capital and 10% total capital, well in excess of the Basel minimums. This was a considered response to efforts by Canadian banks to reduce capital levels via share buy-backs in order to increase return on equity and earnings per share. OSFI also resisted considerable pressure from banks and regulatory peers to drop a long-established leverage (asset/capital ratio) test. Although the capital adequacy standards were relaxed in late 2007, they allowed Canadian banks to build strong capital cushions¹⁹. MAS, too, maintained considerably higher capital adequacy requirements than the Basel minimums, in part to reflect regional operating environments, although these requirements were

¹⁶ Excerpt from OSFI, Capital Adequacy Requirements- Simpler Approaches, November 1997: "Banks are required to hold regulatory capital against all of their securitisation exposures, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in asset-backed securities, retention of a subordinated tranche, and extension of a liquidity facility or credit enhancement, as set forth in the following sections."

¹⁷ MAS Notice 628 on Securitisation.

¹⁸ Bank of Spain, Circular 3/2008, de 22 de mayo, a entidades de crédito, sobre determinación y control de los recursos propios mínimos.

¹⁹ Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada (OSFI) to the Langdon Hall Life Insurance Forum, November 13, 2008.

adjusted somewhat in 2007 in response to improving economic conditions within the region²⁰.

8. Conservative approach to provisioning (Canada and Singapore, but most notably Spain)

The MAS has always maintained a prudent approach to provisioning, including requiring banks to make additional provisions for country risk. In the late nineteen nineties, OSFI required Canadian banks to increase their loan loss provisions despite improving economic conditions, to ensure that historical loan loss experience was taken into account when estimating future default expectations. The Bank of Spain and a number of Latin American regulators introduced dynamic provisioning, which more explicitly built historical loan loss experience into provisions.

Box 11: Dynamic Provisioning: Concept and Spanish Application

Dynamic provisioning uses a statistical method to allow for losses inherent within the portfolio which have not yet materialised.

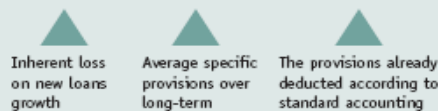
- In economic upswing, it builds up a buffer by requiring provisions higher than recognised by standard 'incurred loss' accounting
- In economic downswing, it allows some losses to be met from the accumulated buffer.

Dynamic provisions can be either deducted from published Profit and Loss (P&L), or from regulatory capital, or both.

In June 2000 the Banco de España introduced a dynamic (also known as 'statistical') provision for Spanish banks and other credit institutions. It aims to ensure that aggregate annual provisioning – including the dynamic provision – equals average annual net losses suffered by the banking system in the last decade.

The current Spanish (post 2005) dynamic provision takes the form:

$$\text{Dynamic Provisioning Change}_t = \alpha * \Delta C_t + \beta * C_t - \Delta \text{ Specific Provision}$$



Where C_t = stock of loans α = inherent loss in each unit over the cycle
 β = average specific provisioning rate over a long estimated period

Source: UKFSA, *The Turner Review: a regulatory response to the global banking crisis*, March 2009

9. Emphasis on the regulation and supervision of liquidity (Singapore)

It is well known that lack of liquidity has been a more frequent cause or trigger for bank failures than lack of solvency. MAS has, for some time, placed a strong emphasis on bank liquidity, an emphasis that has included both regulatory and supervisory

²⁰In February 2007, the tier 1 ratio was lowered from 7% to 6% while the total CAR ratio remained unchanged at 10%.

requirements. MAS has imposed a general minimum liquidity requirement on banks, which it has been prepared to relax in favour of a bank-specific requirement if, on supervisory assessment, MAS is satisfied that a bank's liquidity management framework meets the criteria established by MAS²¹. OSFI introduced a liquidity guideline for banks in 1995, which has formed the basis for the supervision of bank liquidity management in Canada since that time²². More recently, APRA introduced a prudential standard for deposit-taking institutions covering liquidity²³.

10. Commitment to on-site supervision with a relatively high degree of supervisory intensity (Singapore, Canada and Australia)

MAS, OSFI and APRA carry out robust and relatively intense on-site supervision, using their own supervisory staff. Although each may require regulated institutions to engage external specialists to review areas of potential weakness, it is the understanding of the authors that none of them subcontracts the responsibility for carrying out on-site inspections or examinations to third parties.

“Supervisory intensity” means the number and quality of supervisory resources (people) allocated to the supervision of financial institutions. Supervisory intensity is difficult to measure. Various attempts have been made to do so by comparing supervisory resources to assets and revenues supervised, but comparisons are handicapped by different supervisory scope (some supervisors responsible only for prudential supervision and others responsible for both prudential and market conduct supervision;), different institutional mixes (large vs small institutions, domestic vs foreign) and different spans of responsibilities (home supervisors for global or regional institutions, home supervisors of smaller domestic institutions, host supervisors of branches or subsidiaries of foreign institutions), different experience levels within agencies and different cost structures (which complicate salary cost comparisons.).

However, in the experience of one of the authors, it is possible to make some general observations based on discussions and joint supervisory work amongst supervisors, particularly between home and host supervisors of the same institutions.

A purely anecdotal hierarchy of supervisory intensity might be as follows (from most to least intense):

1. U.S. Federal Reserve and Office of the Controller of the Currency (continuous supervision; supervisory teams permanently stationed at larger banks);
2. MAS (on-site inspections that can occupy several person-months);
3. OSFI (on-site examinations that can occupy several person-weeks);

²¹ MAS Website, MAS Notice 613: Minimum Liquid Assets.

²² OSFI Website, Guideline B6 – Liquidity.

²³ APRA Website, APS 210: Liquidity for ADI's.

4. APRA (on-site reviews carried out by risk specialists);
5. UK FSA (on-site work consisting of short visits to institutions; more in-depth on-site work outsourced to “expert persons”).

11. Risk-based approach to supervision and discretionary powers to allow supervisor to exercise supervisory judgment (Canada and Singapore)

Merely placing more supervisory “boots on the ground” is not enough to ensure effective supervision. What supervisors do when they go “on-site” is just as important. Supervision in Canada, Singapore and Australia is largely risk-based. Each regulated financial institution is subject to regular and comprehensive risk assessments which form the basis for supervisory strategy and the allocation of supervisory resources to the institution. The risk assessment takes into account prudential risks and, in Singapore and Australia, also considers the systemic importance (impact) of the institution. A starting point for the risk assessment is a deep understanding of the institution’s business model and appetite for risk in each main business line. Such an understanding is a precondition for evaluating the quality of risk management in the institution, which is also an important part of the risk assessment process.

Evaluations of the quality of risk management are necessarily judgmental and difficult to prove. They can lead to supervisory action that can range from requests for remedial action from the institutions to directions to scale back risky activities and requirements for additional capital²⁴.

By way of contrast, consider the comments of Lord Turner quoted in box 5 concerning the FSA’s previous approach to the assessment of an institution’s business strategy.

There is an important corollary to the risk-based approach to supervision followed by OSFI, MAS and APRA: the compliance component of supervision in these countries is small. Compliance supervision tries to ensure that an institution remains in compliance with applicable laws and regulations. It is often detailed and labour-intensive. Findings from compliance supervision, while important in and of themselves, are often unrelated to safety, soundness and the propensity of the institution to fail. A proxy for the extent of compliance supervision tends to be the proportion of lawyers making up front-line supervisory teams. At MAS, OSFI and APRA, to the best of the authors’ knowledge, there are no or few lawyers involved in front-line supervision.

²⁴ OSFI website, Supervisory Framework and related Assessment Criteria. MAS website, Framework for Impact and Risk Assessment of Financial Institutions. APRA website, Probability and Impact Rating System (PAIRS).

12. A results-oriented supervisory style, which emphasized early intervention and prompt correction of weaknesses (Canada, Singapore and Australia)

As noted above, OSFI has been given a mandate for early intervention. This means that it is expected to take action when weaknesses first become evident in the practices of financial institutions or when financial problems first emerge, in order to prevent further deterioration and stimulate improvement. To help it to carry out this mandate, OSFI places each institution on a “ladder of intervention” based on its assessment of the institution’s financial health and making use of its accumulation of supervisory knowledge of the institution. The ladder of intervention for federal deposit-taking institutions was first published jointly by OSFI and the Canada Deposit Insurance Corporation (CDIC) in 1995 and updated in 2008²⁵. Similar ladders are used for the other entities supervised by OSFI. There are five positions on the ladder, the first of which is labeled “no significant problems”. Below this position are four “stages” of intervention, of which the first is labeled “early warning” and the last is labeled “non-viability/insolvency imminent.” At each stage, the various remedial actions likely to be undertaken by OSFI and CDIC are set out. OSFI has used these ladders for various purposes, one of which is to discipline itself to push for improvement in the financial health of each “staged” institution. This has contributed to a results-oriented supervisory style that seeks to address weaknesses and problems before they become serious threats to the health of the institutions affected.

In 2002, APRA introduced a similar framework: Supervisory Oversight and Response System (SOARS), under which supervisory intervention is determined by the rating assigned to the financial institution²⁶.

The MAS uses a similar approach and also follows a results-oriented supervisory style. In its monograph on risk-based supervision published in 2007, MAS states that its supervisory plan for each financial institution is outcome-oriented. MAS makes use of a broad range of supervisory tools to achieve specific results. For example, diagnostic tools are used to identify problems at institutions at an early stage and to monitor risks, and remedial tools are used to mitigate risks and remedy shortcomings before they escalate to become serious problems.

F. Rethinking the Supervisory Process: Summoning the Will to Act

A note of realism

Economic cycles and human behaviour are inextricably linked. Indeed economic cycles are largely a product of human behaviour and the psychology that drives it. As many

²⁵ OSFI Website, Guide to Intervention for Federal Deposit-Taking Institutions.

²⁶ APRA, IMF –Financial Sector Assessment Program, Supporting Material for Assessment Against the Basel Core Principles, September 2005.

have observed, mindsets and behaviour differ at various stages of an economic cycle. At the bottom of the cycle, memories of the consequences of the downturn are fresh and painful. Authorities and market participants are cautious and risk averse. There is widespread acceptance of the need for strong, intrusive regulation. Then, as the cycle moves into a period of prolonged prosperity, recollections of the downturn recede, risk appetites grow, and pressure builds for less interference from regulators. Regulators themselves come to believe that risk levels have dropped and lighter regulation and supervision are warranted. This pattern is predictable, deeply rooted in our neuron pathways and very difficult to break.

It is worth noting that, in the wake of the Asian Financial Crisis and the other regional crises of the nineteen nineties, there were calls for changes to the global financial architecture, including improvements in financial regulation and supervision. Some important steps were taken including the formation of the Financial Stability Forum, the development and enhancement of supervisory standards and codes, the widespread adoption of macro-prudential surveillance by the IMF and many central banks and the introduction of the IMF/World Bank FSAP programme. There was considerable momentum in the wake of the crises, but as the crises receded and the world passed almost unscathed through the collapse of the “dot com” bubble in 2001, the momentum ebbed and complacency set in. This could happen again.

We can see that, in the wake of this crisis, regulators and financial sector actors have become cautious and there is public pressure for demonstrably tough regulation and supervision. However, if and when we move into another sustained boom period, a new generation of players may come to believe that the world has entered a new paradigm, justifying greater faith in markets and lighter regulation. Regardless of our best efforts, it will be difficult to change human nature. However, this does not mean we should not try. The more favourable outcomes in this crisis experienced by countries that struggled through earlier financial crises and consequently strengthened their systems of regulation and supervision may give some basis for optimism that more than short-term improvements can be achieved.

What the authors are calling for is a different concept of supervision than appears to have been adopted in many countries, including countries whose financial systems have been most seriously impacted by the crisis. In some of those countries, the emphasis seems to have been on rule-setting (capital adequacy) and on high-level monitoring to check compliance with those rules rather than on in-depth, on-site supervision. Without dismissing rule-setting, the concept of financial supervision that we are recommending is intense, risk-based, proactive and results-oriented. It embraces and links both macro-prudential and micro-prudential approaches. It begins with a deep understanding of the financial system and business models of supervised institutions, including major risks and risk management practices. It encourages pre-emptive initiatives by the supervisor to curb excessive risk-taking both across the financial system and by individual institutions. It facilitates flexible but robust supervisory responses, tailored to the circumstances of each financial institution. It requires and enables the use of supervisory judgment in assessing risks and supervisory discretion in taking remedial action.

The recommendations in this section concentrate, for the most part, on steps that might help encourage effective regulation and supervision throughout the economic cycle and discourage pro-cyclical behaviour by regulators. A primary focus of the recommendations is on altering supervisory culture, on the logic that if the culture is right, many of the other desired outcomes will follow. It is not easy to change cultures. To do so may require changes in mandates, governance frameworks, incentives, and in people, particularly those in leadership roles. Such changes will not occur simply by recommending them. In the view of the authors, the most effective way to encourage broad-based changes in supervisory cultures is to strengthen those standards that can affect the cultures. Standards will not, in and of themselves, change behaviours quickly, but if supported by the IMF/World Bank FSAP process, which, in the experience of one of the authors, has often been effective in encouraging changes in supervisory agencies, they could have a positive impact.

Not surprisingly, the recommendations will be influenced by regulatory and supervisory factors that seem to have worked well in current crisis, including those discussed in Section E above. For the most part, the recommendations will not address the technicalities of improvements to capital adequacy rules and other regulations that are now underway. These are very important, but, in the view of the authors, are second order changes. If the regulatory/supervisory cultures and the mandates and incentives that drive them are not changed, then the newly-strengthened rules will weaken over time (see section C4 – “race to the bottom”) as the regulatory cycle described above reasserts itself.

Recommendations

1. Leaning against the cycle

Ensuring that authorities and market participants will challenge conventional wisdom during buoyant economic times and lean against the cycle to curb risk-taking and build cushions against future shocks is the central challenge of efforts to reform financial regulation and reduce the risk of major financial crises in the future. It is also the most difficult.

There seem to be at least two elements in successfully leaning against the cycle. The first is having enough information to know that a cycle could reach a dangerous stage and therefore requires mitigating action. The second is having the will to take action, usually in circumstances where such action may be highly unpopular, including among powerful interest groups. There is probably no single “silver bullet” that will address either of these elements. Some of the measures now in train may help address the “information” issue. They are discussed in this section and in Section 3: “Strengthening macro-prudential surveillance and mitigating pro-cyclicality”. The “will” issue is discussed in Section 2: “Strengthening the context in which supervision takes place”.

- a) As noted in box 10 above describing some of the recent G20 proposals, the newly-christened Financial Stability Board has been given an ambitious new mandate that will include assessing vulnerabilities in the financial system, promoting coordination among supervisors, monitoring market development, setting guidelines for supervisory colleges, planning for cross-border crisis management, developing mechanisms to ensure the oversight of hedge funds and collaborating with the IMF on a variety of initiatives such as early warning exercises, developing macro-prudential tools and producing guidelines to assess systemic importance.

This mandate is a natural extension of the mandate of the FSB's predecessor, the Financial Stability Forum (FSF), and the FSB is the most logical body to set direction in the areas recently assigned to it. However, the FSF had no direct authority over its members and few resources of its own. Staff resources were obtained via short term transfers from member organizations and work was directed by working groups and task forces also drawn from senior levels of member organizations and other agencies willing to support the FSF. To the extent the FSF has obtained results, it has done so by moral suasion and building consensus among its members.

It is not clear that these approaches will be sufficient to enable the FSB to achieve the results expected of it. It seems likely that, to carry out its new mandate, the FSB will require more resources of its own and some mechanisms to exercise authority over its members. This may require undertakings on the part of its members to implement FSB recommendations on a timely basis.

- b) The IMF has also been challenged by the G20 to enhance its surveillance mandate and its resources, while at the same time building on ongoing reforms to increase the voice of emerging and developing countries in the institution. As noted in a), the IMF will be expected to work closely with the FSB on stability initiatives. This direction is also a logical one. The IMF has considerable experience in carrying out macro-prudential surveillance and in overseeing regulation and supervision in its member countries under the FSAP programme.

Despite this enhanced mandate, there is still no obligation on the part of an IMF member to abide by the recommendations of the institution. The G20 leaders have committed to encourage "candid, even-handed, and independent IMF surveillance of our economies and financial sectors and of the impact of our policies on others" but there is no suggestion of binding mechanisms to ensure this. It is also not clear what mechanisms will be put in place to ensure effective collaboration between the FSB and the IMF. This latter issue should be addressed by the G20 countries through their FSB representatives and IMF Executive Directors.

Box 12: G20 Proposals on the reform of the IMF

a) In the short term:

- The IMF to take a leading role in drawing the lessons from the crisis
- Increase the resources available to the IMF through immediate financing of USD 250 billion, and the support of a general SDR allocation of USD 250 billion
- Adapt IMF lending instruments: leaders welcomed the new Flexible Credit Line and the reformed lending and conditionality framework
- Enhance the IMF/FSF collaboration

b) In the medium term:

- strengthen IMF surveillance and better integrate the reviews in the joint IMF/World Bank FSAP
- greater voice and representation in the IMF for emerging markets and developing economies: leaders committed to implement the quota reform agreed in April 2008, and called on the IMF to complete the next review of quotas by January 2011; head and senior leadership of the IFIs should be appointed through an open transparent and merit-based selection process.
- enhance IMF capacity building for emerging markets and developing economies in assisting with the broad adoption of a strengthened financial regulatory framework
- strengthen partnerships with donors in delivering technical assistance

Source: G20 Progress Report on the Washington Action Plan, 2 April 2009; G20 Working Group 3: Reform of the IMF, 4 March 2009

Box 13: Will the IMF be heard?

The IMF has shown a strong determination to carry out its surveillance role with a new voice.

Quote from the Managing Director of the IMF “*Looking ahead, we intend to do better in the area of early warnings. These new early warnings must be strong, candid, credible, and even-handed. They must not shy away from “naming and shaming” where appropriate. Early warnings that are ignored by policymakers have limited value*” (source: *Speech at the SAIS in Washington DC, 23 April 2009*)

What could make it change?

- The IMF has the strong backing of the G20 to carry out its enhanced role;
- It will not be the only one “warning” countries but will have to work with the FSB;
- All the FSB members have committed to undertake a peer review via the FSAP process. In particular the US formally requested an FSAP in 2008 after apparently resisting it until then.

Given the frail state of the financial systems in most countries, it can be assumed that the IMF voice will be heard in the short and medium term. In the long-term, one of the challenges is to increase the legitimacy of the institution, requiring another potentially long and painstaking quotas reform.

- c) In the emerging proposals, there seems to be a disconnect between macro-prudential surveillance and regulatory/supervisory steps to mitigate pro-cyclicality within the financial system. This could hamper the effectiveness of efforts to avert future crises.

“Surveillance” in the proposals seems to include the monitoring of market developments, the assessment of vulnerabilities, support for contingency planning and early warning exercises. Counter-cyclical initiatives such as building capital

and liquidity buffers and loan-loss provisions are grouped under “prudential supervision” and some of the proposals for building such buffers seem to contemplate that they will be formula-driven and independent of the output of various surveillance initiatives. In the view of the authors, there must be a close, even a seamless, linkage between surveillance findings and prudential initiatives. Mechanisms need to be developed among central banks and prudential supervisors for ensuring that there can be timely and effective supervisory responses to vulnerabilities identified in the course of macro-prudential surveillance activities. We address aspects of this apparent disconnect in subsequent recommendations.

- d) The World Bank-IMF FSAP process can be an important mechanism for enhancing future financial stability, just as it has helped to improve the standards of financial supervision in many countries since it was put in place nearly a decade ago. However, the FSAP is based largely on an assessment of compliance with standards and codes (but see (e) below). To assess the effectiveness of such financial stability-oriented practices as macro-prudential surveillance and counter-cyclical capital and provisioning practices, the standards will have to be updated to ensure that these issues are covered. This will include the IMF’s *Code of Good Practices on Transparency in Monetary and Financial Policies* (MFPT) and the Basel Committee’s *Banking Core Principles (including Preconditions for Effective Supervision)*. Such revised supervisory standards should also give financial supervisors an explicit responsibility to work with central banks to identify emerging threats and risks and to implement appropriate actions to avert or mitigate them where possible.

Box 14: G20 and the FSAP process

The progress report on the actions of the Washington Action Plan, released at the G20 meeting on 2 April 2009, calls for a minor reform of the FSAP process:

“to improve the FSAP process, the basis upon which countries are assessed should be expanded to encompass macro-prudential oversight, the scope of regulation, and supervisory oversight of the influence of the structure of compensation schemes at financial institutions on risk taking”

In addition, all members of the FSB have agreed to undergo peer reviews using the FSAP instrument.

Source: G20, Progress Report on the Actions of the Washington Plan, 2 April 2009

- e) The FSAP process will be useful in assessing compliance with enhanced standards of central banking and supervisory practices, but the effectiveness of the FSAP process could be improved by broadening the focus to include a greater emphasis on implementation and outcomes as well as the existence of standards and functions. Generally, macro-prudential surveillance did nothing to prevent the financial crises, not because of bad analysis (although there was some of this) but because of the absence of calls to action and follow-up.
- f) Expansion of the scope of the FSAP process may raise a practical issue: given the strong increase in lending from the IMF, its enlarged mandate on surveillance, an expanded FSAP template and the agreed FSAPs for the US and China, the Fund may outstretch its resources, leading to a backlog in the completion of FSAP’s. It

will be important to ensure the FSAP programme is properly resourced and funded.

- g) While important steps are underway at the international level to enhance financial stability and to encourage counter-cyclical thinking and action, much of the action will still have to take place at the country level. Enhanced FSAP's, when they take place, will stimulate action and improvement by individual economies, but it will take a number of years for a complete cycle of FSAP's to take place, and the time for action is now, while memories of the financial crisis are still fresh and painful. Thus every opportunity should be used by international organisations like the FSB, the IMF, the World Bank, and other bodies to urge their members and clients to take action now. In addition, the IMF should make use of its annual Article IV programme to monitor actions by member countries to improve macro-prudential surveillance and other actions to strengthen financial stability.

2. Strengthening the context in which supervision takes place

As discussed earlier in this paper, it seems likely that, in a number of countries, factors such as supervisory independence, governance, leadership, mandate and accountability influenced supervisory performance. These may need to be strengthened in order to reduce the risk of future supervisory failures. To encourage such strengthening, our recommendations place heavy reliance on the enhancement of relevant standards and codes, supported by the IMF/World Bank FSAP process to evaluate implementation of the enhanced standards.

We would also suggest that the FSB and the relevant standard-setting bodies give consideration to the introduction of a *self-assessment process*, akin to the self assessments now carried out by many countries in preparation for a pending FSAP. Under such a new self-assessment process, countries would be required to report annually on their compliance with designated standards and codes, including those deemed most important for financial stability purposes. Such reports would include explanations for instances of non-compliance and plans for achieving compliance. IMF members might be required to submit such reports to the IMF where they could be discussed as part of the annual Article IV reviews.

a) Independence

If an analysis were made of those regulators which appear to have performed well in this crisis and those which have not, it would not likely be possible to directly correlate weak performance with weak supervisory independence. Some supervisory bodies that appear to have struggled in the lead-up to the crisis have had independent boards of directors and de jure independence from government. Others that seem to have fared better enjoy less de jure independence than some of their peers. There appear to be too many factors contributing to weak supervisory performance to isolate the impact of this one variable. However, the experience of one of the authors is that independence from government and from

political influence, including budgetary independence, can be an important supervisory success factor. Another impression based on experience is that the concept of supervisory independence does not seem to be as well accepted at the political level as, for example, the concept of the independence of the central bank. It is recommended that the opportunity presented by the crisis be taken wherever possible to strengthen supervisory independence and the understanding of the importance of this factor.

The Basel, Insurance and IOSCO Core Principles and their assessment criteria all highlight the need for “operational independence”. Only IOSCO mentions a stable source of funding for the supervisor to enhance its independence, although the others refer to “resources” or “financial resources”.

Table 5: Excerpts from the Basle, IOSCO, IAIS Core Principles on supervisory independence

Basle Principles	IOSCO Principles	IAIS Principles
<p>Principle 1 – Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>	<p>6.1. Principles Relating to the Regulator 1 The responsibilities of the regulator should be clear and objectively stated. 2 The regulator should be operationally independent and accountable in the exercise of its functions and powers. 3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. 4 The regulator should adopt clear and consistent regulatory processes. 5 The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality. (...) The regulator should be operationally independent <i>from external political or commercial interference</i> in the exercise of its functions and powers and accountable in the use of its powers and resources. Independence will be enhanced by <i>a stable source of funding</i> for the regulator. In some jurisdictions, particular matters of regulatory policy require consultation with or even approval by, a government, minister or other authority. The circumstances in which such consultation or approval is required or permitted should be clear and the process sufficiently transparent or subject to review to safeguard its integrity. Generally, it is not appropriate for these circumstances to include decision making on day-to-day technical matters.</p>	<p>ICP 3 Supervisory authority The supervisory authority: · has adequate powers, legal protection and financial resources to exercise its functions and powers · is operationally independent and accountable in the exercise of its functions and powers · hires, trains and maintains sufficient staff with high professional standards · treats confidential information appropriately.</p> <p>Explanatory note 3.3. To support the independence and integrity of the supervisors, there should be provisions for the legal protection of staff, as well as clear rules for appointment and removal of the head of the supervisory authority. These should be publicly disclosed. The supervisory authority should be <i>operationally independent from external political and commercial interference in the exercise of its functions and powers</i>. Independence enhances the credibility and effectiveness of the supervisory process. The existence of an appeals mechanism through the courts helps ensure that regulatory and supervisory decisions are made within the law consistently and are well reasoned.</p>

Source: Basle Committee, *Core Principles for Effective Banking Supervision* October 2006. IAIS, *Insurance Core Principles and Methodology*, October 2003. IOSCO, *Objectives and Principles of Securities Regulation*, May 2003

In assessing compliance with these standards, FSAP's have tended to focus on *de jure* independence. In addition to *de jure* independence, it is important for supervisors to have *de facto* independence from governments and political interference. This can be difficult to ensure. Governments, even those with independent supervisory bodies, can select politically "safe" and "aligned" candidates to serve as leaders and/or directors of such bodies. The existence of *de jure* independence may not stop governments from applying pressure to supervisors to achieve politically desirable outcomes. In the current financial crisis, as treasuries, central banks and supervisors have worked together to manage and counteract the fallout, some supervisors appear to have lost influence to the other authorities. Recapturing influence and independence once the crisis recedes may prove difficult.

Another aspect of *de-facto* independence is independence from the financial lobby (ie commercial interference) which has been pointed out in the US²⁷. Commercial interference in financial regulation and supervision is a sometimes subtle phenomenon that can range from various forms of corruption and intimidation (particularly in those jurisdictions in which supervisors lack legal protection – see below) at one extreme to supervisory capture or feelings of inferiority vis-à-vis financial institution experts on the other.

There are no easy recipes for achieving *de facto* supervisory independence. Awareness can help, and the FSB and IMF can play roles in raising awareness. Also, if the emphasis of the FSAP process can be shifted, as suggested above, to include implementation and outcomes as well as existence of standards, FSAP examiners may have the opportunity to enquire into and comment on the quality of the working relationship between the financial supervisory body and other arms of governments, and the relationship between the supervisor and supervisees and with the latter's owners, including the *de facto* independence of the supervisor.

The resources issue is also crucial. In the experience of one of the authors, most heads of supervisory agencies would admit that regulatory/supervisory resources and capabilities are their biggest challenge. There is a need for sufficient numbers of trained and experienced supervisors to conduct a robust and extensive supervisory programme that includes monitoring of the financial system and intensive on-site supervision of financial institutions, particularly those of systemic importance. It is important to have a critical mass of staff members who have worked at middle and senior levels of financial institutions, including in risk management functions or with equivalent experience. In most cases, supervisory agencies are subject to budgetary constraints that do not allow them to employ sufficient numbers of supervisory staff with the necessary levels of experience. Some are further handicapped by policies that benchmark pay scales to those in

²⁷ Simon Johnson, *The Quiet Coup*, published in *The Atlantic* in May 2009.

the larger public service, making it almost impossible to pay enough to attract specialists from industry.

As noted, the issue of resources is addressed in the Core Principles. However, more attention should be paid to this issue in the IMF/WB FSAP's.

A crucially important element of independence in many countries is still the issue of legal protection for supervisors to ensure that they are not vulnerable to civil or criminal actions for carrying out their work in good faith. The requirement for such legal protection is clearly set out in the Basel, IAIS and IOSCO core principles, but some countries have yet to respond, despite FSAP findings that show them to be non-compliant with this requirement. Although this gap is unlikely to have been a factor in the difficulties experienced by supervisors in those developed countries at the centre of the financial crisis, it will almost certainly undermine the ability of supervisors in other countries to take necessary actions as this crisis continues and future crises emerge.

b) Qualifications of leaders and overseers of supervisory agencies

Another important aspect of operational independence of regulators not referred to in the Core Principles beyond references to “adequate resources” is the issue of the qualifications of the leaders of supervisory agencies and those (boards of directors) who oversee them. In an ideal world, supervisory agencies would be headed by mature, financially independent individuals, with some private financial sector experience and knowledge, and the character and confidence to take firm actions that may displease important stakeholders. In this ideal world, they would be advised by experienced overseers who also understand the financial sector and how financial actors behave, and who have a capacity for contrarian thinking and challenging conventional wisdom.

How can such an ideal world be achieved? The answer is: “With great difficulty”. A first step, however, would be to amend the above Core Principles to include:

- guidance on qualifications of members of governing bodies of supervisory agencies, recommending the addition of experts with a record of contrarian thinking to challenge accepted beliefs. The Core Principles might also make recommendations regarding the establishment of external supervisory advisory boards (in the absence of governing boards) that would include members with such qualifications;
- guidance regarding the qualifications of the head of the supervisory agency (maturity, strong character, financial sector experience and financial independence);

c) Mandate to promote financial sector development

An issue that can be more clearly linked to weak supervisory performance is the explicit mandates given to some financial supervisors to promote or facilitate financial sector development. Although some financial supervisors like the MAS appear to have been able to encourage financial sector development without compromising supervisory effectiveness, others have evidently not been able to balance developmental and prudential priorities as successfully.

Consideration should therefore be given to amending the Basel, IAIS and IOSCO Core Principles to recommend against giving supervisors an explicit or implicit mandate for financial sector development or, failing that, to ensure that such a mandate is balanced by an overriding responsibility to ensure that development initiatives do not subsume goals to contribute to prudential soundness and financial stability.

3. Strengthening macro-prudential surveillance and mitigating pro-cyclicality.

The apparent failure of the macro-prudential surveillance “industry” that gained such momentum following the Asian Financial Crisis has attracted much attention from policy-makers and academics. Improving the quality and effectiveness of macro-prudential surveillance going forward is evidently a central focus of the recent G20 initiatives, and others are weighing in with proposals for achieving this goal. The direction seems right, and many of the proposals for doing so, including those cited in Section D, above, seem sensible and worth implementing. However, there are some pitfalls to be avoided. One of these, as noted in section 1 (c), above, is not to treat macro-prudential surveillance as something separate and distinct from the mitigation of pro-cyclicality. Steps to mitigate pro-cyclicality should be triggered by the outputs of macro-prudential surveillance, including the identification of growing risks and vulnerabilities in financial systems that should be counteracted by various measures including prudential initiatives.

Box 15: Current Proposals on Macro Prudential Supervision

1/ G20 Proposals

G20 leaders have agreed to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds. In particular they have agreed:

- to amend regulatory systems to ensure authorities are able to identify and take account of macro-prudential risks across the financial system including in the case of regulated banks, shadow banks, and private pools of capital to limit the build up of systemic risk. FSB to work with the BIS and international standard setters to develop macro-prudential tools and provide a report by autumn 2009;
- that large and complex financial institutions require particularly careful oversight given their systemic importance;
- to ensure that national regulators possess the powers for gathering relevant information on all material financial institutions, markets, and instruments in order to assess the potential for their failure or severe stress to contribute to systemic risk.
- that in order to prevent regulatory arbitrage, the IMF and the FSB will produce guidelines for national authorities to assess whether a financial institution, market, or an instrument is systemically important by the Spring Meetings. These guidelines should focus on what institutions do rather than their legal form.

In addition, the IMF and FSB will collaborate to provide early warning on macroeconomic and financial risks.

2/ Proposals of the High Level Group on financial supervision in the EU:

a) A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up with the following responsibilities:

- The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR (level 3 committees in charge of supervisory convergence in the EU) as well as one representative of the European Commission.
- The ESRC should pool and analyse all information pertaining to macro-economic conditions and to macro-prudential developments in all the financial sectors.
- A proper flow of information between the ESRC and the micro-prudential supervisors must be ensured.

b) An effective risk warning system shall be put in place under the auspices of the ESRC and of the Economic and Financial Committee of the EU (EFC).

- The ESRC should prioritise and issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU.
- If the risks may have a negative impact on the financial sector or the economy as a whole, the ESRC shall inform the chairman of the EFC which will implement a strategy to address the risks.
- If the risks identified relate to a global dysfunction of the monetary and financial system, the ESRC will warn the IMF, the FSF and the BIS in order to define appropriate action at both EU and global levels.
- If the ESRC judges that the response of a national supervisor to a priority risk warning is inadequate, it shall, after discussion with that supervisor, inform the chairman of the EFC, with a view to further action being taken against that supervisor.

Sources: G20 Progress Report in the Actions of the Washington Action Plan 2 April 2009, EU High Level Group on Financial Supervision 25 February 2009

Box 16: Overview of FSF/FSB proposals to mitigate procyclicality, April 2 2009

1/ Capital

- Enhance the Basle capital framework to produce countercyclical capital buffers
- Revamp VaR-based capital estimates
- Supplementary measure to contain leverage
- Use of stress testing in validating capital buffers
- Monitoring capital pro-cyclicality by the BCBS

2/ Provisioning

- The FASB and IASB to issue statement indicating a scope for judgment in existing standards
- The FASB and IASB to analyze alternatives to the incurred loss model to recognize loan losses
- The BCBS to undertake a review of Basle II to reduce disincentives to increase provisions for loan losses and to assess the adequacy of disclosure of loan loss provisioning under Pillar III

3/ Valuation

- Supervisors should use quantitative indicators and/or constraints on leverage and margins as macro-prudential tools for supervisory purposes
- BCBS and CGFS should launch a joint program to measure funding and liquidity risk
- IMF and BIS should collect data on leverage and maturity mismatch
- Accounting standard setters and supervisors should examine the use of adjustments for fair valued financial instruments when data or modelling needed to support their valuation is weak; they should also examine possible changes to relevant standards to dampen adverse dynamics of fair value accounting.

Source: FSF Report on addressing procyclicality in the Financial System, 2 April 2009

Box 17: Example of Macro-Prudential tools

The Geneva Report (CEPR Fundamental Principles of Financial Regulation) indicates that the best measures of an institution's contribution to macro-prudential risk are its leverage, maturity mismatch and rate of expansion. The report suggests some macro-prudential tools:

- Multiplying the Basle II CAR by a macro-prudential factor which would combine weights on leverage, maturity mismatch, credit and asset price expansion.
- A laddered response for counter cyclical regulation: when the capital and liquidity requirements are, say 1% below target value, supervision could be enhanced. When the target is missed by 2%, the institution could in addition be forbidden to pay out dividends or make other forms of equity payouts. A missed target by 3% might disallow any bonus payments to the CEO and other board members. A miss by 4 % could require recapitalization or closure within two months.
- A Mark-to-Funding accounting rule: Pools of assets for which long-term funding is secured can be put in a "hold-to-funding account" and do not have to be marked-to-market.
- Explicit capital charge for liquidity risk: financial institutions who hold assets with low market liquidity and long-maturity and fund them with short-maturity assets should incur a higher capital charge.

Source: CEPR, Fundamental Principles of Financial Regulation, Geneva Report on the World Economy, 6 January 2009

The direction of and intentions behind most of the above proposals are laudable. However, they give rise to at least three additional concerns:

- that criteria for taking action to address systemic risks will become too quantitative and will not allow enough room for judgement;
- that the role of the home supervisor, so important to the supervision of internationally active large and complex groups will be weakened;
- that prudential supervisors will lose authority and independence to central banks, with consequences for the quality of surveillance and supervision.

Each of these concerns will be discussed in turn:

a) Quantitative and non-judgemental approach to addressing systemic risks

The macro-prudential tools proposed by Geneva Report (CEPR Fundamental Principles of Financial Regulation, seem helpful and may prove to be useful diagnostic tests and guidelines for action by prudential supervisors. But it would be most unwise to make them fixed criteria that would require specific actions in specific circumstances and that would preclude action when other macro-prudential weaknesses were identified at either the systemic or the institutional level, including, in the latter case, risky business practices and weak risk-management. There are several reasons for this:

- Mechanisms that tie supervisory action to breaches of quantitative triggers are likely to lead to actions that are too late to be effective. This is because such measures as capital are “trailing indicators”. When the health of a financial institution is deteriorating, there is a time lag before asset values and therefore capital ratios reflect the deterioration, particularly in the context of the backward-looking, event-driven provisioning required by the current international accounting standards.
- Experience shows that it is never possible to anticipate all the conditions that can lead to financial weakness at the systemic and institutional levels. This is why macro-prudential tools should be seen primarily as mechanisms for taking action to address findings from macro-prudential surveillance initiatives and not as tools to be used independent of such findings.
- It is axiomatic that when supervisors supervise largely on the basis of quantitative criteria, institutions will quickly learn how to “game” the system and avoid or minimise the consequences of such criteria.

b) Role of the home supervisor

Macro-prudential regulation coupled with counter-cyclical tools may shift the balance of power away from the home supervisor, undermining efforts to strengthen the leadership role of the home supervisory in the supervision of financial conglomerates.

The Geneva Report points out that the ability to apply counter-cyclical regulation (both to capital and liquidity) implies a shift of the balance of powers towards the host country supervisor, and away from the home country supervisor. It could also

contribute to departures from the level-playing-field ideal. This is because financial prices and asset cycles differ from country to country, so counter-cyclical policy would necessarily need to be assumed by the host country.

This is a valid concern that will need to be taken into account as supervisory colleges gain momentum. As will be discussed below, the role of the home supervisor, including his authority to coordinate the actions of host supervisors, will be crucial to the success of the colleges.

c) Loss of authority of prudential supervisors to central banks

Some of the proposals for strengthening macro-prudential surveillance would give the primary responsibility for both surveillance and resulting actions, such as increasing or decreasing bank capital levels, to the central bank. This raises two dangers for those countries in which there is an institutional separation between central banking functions and banking supervision:

- The market knowledge of the prudential supervisor would not be given appropriate consideration in the surveillance process;
- The authority and effectiveness of the supervisor would be undermined if the central bank became the ultimate authority for setting bank capital adequacy levels.

In the experience of one of the authors, effective macro-prudential surveillance requires a high degree of cooperation between the central bank and the banking supervisor. In that cooperative relationship (in effect, a partnership) the central bank should play the lead role in the surveillance process, but the banking supervisor should be actively involved in order to provide input on what is taking place in institutions and markets. When it comes to action, including adjusting capital adequacy levels in response to systemic developments, the banking supervisor should play the lead role, taking into account the advice of the central bank.

This issue was recently discussed in a U.K. context by Lord Turner of the U.K. FSA in “the Turner Review”:

Box 18: Macro-prudential arrangement: the Turner Review

“There are a number of different ways in which the formal character of the relationship between the Bank of England and the FSA could be defined. These could include:- The Bank of England being the ultimate arbiter of judgements relating to the position in the economic cycle and the definition of macro-prudential risks, but with the FSA making decisions about which regulatory levers to adjust and by how much. The Bank of England could, for instance, write formally to the FSA setting out its analysis of macro-prudential risks; and the FSA could be required to respond setting out what actions it had taken in response.

- The Bank of England being not only the ultimate arbiter of judgements about the macro-prudential position but also able, at the limit and in the absence of agreement, to require the FSA to take specific macro-prudential measures.- The Financial Stability Committee, currently defined as a purely Bank of England committee, being designed as a joint committee of the Bank of England and the FSA, with this committee making the final judgement as to macro-prudential conditions and final decisions as to appropriate policy responses.

In principle there are attractions to the third approach”.

Source: The Turner Review – A regulatory response to the Global Banking Crisis; Financial Services Authority, March 2009

4. Supervising large, complex financial groups operating across borders on a consolidated basis.

The G20 proposals place emphasis on supervisory colleges of home and host supervisors to oversee and coordinate the cross-border supervision of multinational financial conglomerates. Several such colleges have already been formed to coordinate Basel II implementation and the formation of others is being encouraged. This is a promising concept and should be pursued with energy and determination. In an ideal world, supervisory colleges, lead by an effective home supervisor with the powers and resources to practice effective consolidated supervision, would learn to carry out comprehensive risk assessments of the financial conglomerate and create a global supervisory plan in which each home and host supervisor would have a role to play. In this ideal world, information about the activities of the conglomerate and its subsidiaries and branches would be freely exchanged amongst those supervisors with a need to know, and, when threats to solvency materialized, remedial actions would be coordinated amongst home and host supervisors, in the best interests of all.

Over time, the development of active and effective supervisory colleges should help promote greater consistency in supervisory culture and style. If a more active, interventionist supervisory style gains currency in some jurisdictions, it may spread through the colleges as groups of supervisors work more closely together.

Achieving that ideal vision is a long way off, and some important obstacles will have to be overcome before it can be achieved. Two of the most important are ineffective supervisory cooperation, including the reluctance of supervisors in important countries to cede authority to other supervisors, and a lack of commitment to consolidated supervision, particularly among insurance and securities supervisors.

As discussed below, both areas need further attention if we are to reduce the risks of future financial crises.

a) Supervisory cooperation

The Basel Committee formed a working group to study this issue and, in 1992, released the report of the working group entitled: "*Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments*". This has been supplemented by "*Essential elements of a statement of cooperation between banking supervisors*", issued in 2001, "*High-level principles for the cross-border implementation of the New Accord*", issued in 2003 and a number of other standards and guidelines.

In July, 1995, a "Tripartite Group" of Banking, Insurance and Securities Regulators that had been formed to discuss the challenges of supervising international financial conglomerates published a report entitled "The Supervision of Financial Conglomerates". An excerpt from this report appears in Box 19.

Box 19: The Supervision of Financial Conglomerates

In the case of a financial conglomerate, intensive cooperation between supervisors is essential and supervisors should have the right to exchange prudential information. There was general support for the idea of appointing a lead supervisor or "convenor", who would be responsible for gathering such information as they require in order to have a perspective on the risks assumed by the group as a whole (including information on non-regulated entities). Using this data, a convenor would make an assessment of the capital adequacy of the group and would also be responsible for ensuring that the supervisors of individual entities are made aware of any developments which might affect the financial viability of the group. In addition, when supervisory action involving more than one regulated entity is called for, the convenor would be responsible for the coordination of this action. This would not interfere with the power of the solo supervisor to obtain information regarding the group and to act individually when necessary.

Source: The Tripartite Group of Bank, Insurance and Securities Regulators, The supervision of Financial Conglomerates, July 1995

Fourteen years later, the G20 issued its proposals for strengthening cooperation, including the expansion of supervisory colleges for the supervision of cross-border firms.

Box 20: G20 Proposals on strengthening cooperation among national supervisors

Leaders have agreed to establish the remaining supervisory colleges for cross-border firms by June 2009 building on the 28 already in place, and to implement the FSF principles for cross border management.

Those principles require in particular:

a) In preparing for financial crises, the elaboration of common support tools (e.g. key data list, common language, experience library), an annual meeting to consider barriers to coordinated action, the sharing of information (the firm's group structure, its contingency funding arrangements, its interlinkages with the financial system in each jurisdiction of operation).

b) In managing a financial crisis: strive to find internationally coordinated solutions drawing on information, arrangements and plans developed ex-ante; share national assessment of systemic implications, and information at an early stage; share plans for public communication with authorities in the affected jurisdictions.

Other medium-term proposals aim at reinforcing cooperation in the medium-term:

- The G20 supports efforts by the IMF, FSB, World Bank and BCBS to develop an international framework for cross-border bank resolution arrangements.

- The BCBS and national supervisors should develop and agree by 2010 a global framework for promoting stronger liquidity buffers including at cross-border institutions.

- The FSB will promote coordination and information exchange among authorities responsible for financial stability.

Source: G20 Working Group 2, Reinforcing Cooperation and Promoting Integrity in Financial Markets

What happened during the fourteen years that elapsed between the time that the Tripartite Group issued its paper on the supervision of financial conglomerates and the date of the G20 proposals?

The answer is “surprisingly little”, reflecting the difficulties of achieving genuine home-host cooperation in the supervision of financial conglomerates. The Joint Forum of Banking, Insurance and Securities Supervisors, which succeeded the Tripartite Group, for several years debated the concept of “Lead Supervisor or Convenor”, because it became apparent that host supervisors in important countries were not prepared to cede leadership to home supervisors of financial groups. As a result, a successor to the Tripartite Group paper was issued by the Joint Forum in February 1997 called the Coordinator Paper, as part of a broader work on the supervision of financial conglomerates, in which the “Lead Supervisor” concept was watered down to “The Coordinator”, normally the supervisor that carries out consolidated supervision or which is responsible for the largest part of the conglomerate.

The next important event in the supervision of financial conglomerates was the establishment of the concept of “supervisory colleges” by the Basel Committee to coordinate the cross-border implementation of the New Accord. These were narrowly focussed on the Accord, but provide a useful foundation for broader supervisory cooperation going forward.

But this issue of who is in charge still remains, and the supervisory colleges will not accomplish their objectives unless this can be resolved. A lead supervisor will need to be recognised and should be in a position to recommend an overall supervisory strategy for the financial group and expect reasonable cooperation from host supervisors.

b) Consolidated supervision

Although the need to supervise large, complex groups on a group basis has long been recognized within the field of banking supervision and is reflected in relatively robust requirements in the Basel Core Principles, this recognition has been slower to gain ground in the fields of insurance and securities supervision.

Effective consolidated supervision of banking groups is underpinned by three principles in the Basel Core Principles:

- the requirement that groups be supervised on a consolidated basis (principle 24)
- the requirement that home and host supervisors cooperate in the supervision of banking groups (principle 25)
- the principle of “supervisable structures” (principles 3 and 5).

Table 6: Consolidated supervision: excerpts from the Basle, IOSCO and IAIS Core Principles

Basle Principles	IOSCO Principles	IAIS Principles
<p>Cross-border Banking</p> <p>Principle 24 – Consolidated supervision: An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.</p> <p>Principle 25 – Home-host relationships: Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.</p> <p>Principle 3 – Licensing criteria: The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of <i>an assessment of the ownership structure and governance of the bank and its wider group</i>, including the fitness and propriety of Board members and senior management, its strategic plan and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.</p> <p>Principle 5 – Major acquisitions: The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and <i>confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</i></p>	<p>Principles for Cooperation in Regulation</p> <p>11 The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.</p> <p>12 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.</p> <p>13 The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.</p>	<p>ICP 17 Group wide supervision: The supervisory authority supervises its insurers on a solo and a group-wide basis.</p> <p>ICP 5 Supervisory cooperation and information sharing The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.</p> <p>Explanatory note 5.1. Efficient and timely exchange of information among supervisory bodies, both within the insurance sector and across the financial services sector, is critical to the effective supervision particularly in the case of internationally active insurers, insurance groups and financial conglomerates. This is also essential in the context of the effective supervision of the financial system as a whole.</p>

Source: Basle Committee, *Core Principles for Effective Banking Supervision* October 2006. IAIS, *Insurance Core Principles and Methodology*, October 2003. IOSCO, *Objectives and Principles of Securities Regulation*, May 2003

In the Insurance Core Principles of the IAIS, somewhat similar language can be found on Consolidated (group) supervision, supervisory cooperation and supervisable structures, but in most cases it is weaker and accountabilities are less clear (table 6). For example, ICP 17, which deals with Group-wide supervision, states that group supervision is a

merely a supplement to solo supervision. In addition, there is no reference to prudential norms determined on a group basis, including capital adequacy requirements. ICP 5 mentions this in its explanatory notes group-wide supervision, but cites many reasons for taking a group-wide view, including fraud, anti-money laundering and the combating of financing of terrorism.

Recently, there have been discussions within the IAIS regarding the possibility of strengthening the consolidated supervision of financial groups that include insurance entities, but the authors are aware that resistance to the concept persists within the insurance supervisory community. A recent discussion paper confirms the IAIS view that group-wide supervision remains a supplement to solo supervision (box 21).

Box 21: IAIS Issue Paper on group wide solvency assessment and supervision

The IAIS issue paper stresses that *group-wide supervision supplements but does not replace solo supervision*, and acknowledges that there are different approaches to group-wide supervision, depending on the legal and regulatory regimes of the jurisdictions involved and on the circumstances of the group:

- Approach with a legal entity focus: the group is considered as a set of interdependent entities, risks are assessed and capital requirements are determined for each legal entity in the group (e.g. Switzerland, US).

- Approach with a consolidated focus: the group is treated as a single integrated entity for supervision purposes. Significant weight can be given to the management and operational structure (rather than the legal structure), and to the synergies between the entities within the group, the management of risk and capital and the fungibility of capital and transferability of assets among entities within the group (e.g. Canada, Solvency II in the EU).

The paper highlights a number of challenges to assess group-wide supervision as regards intra-group transaction and the gearing of capital, complexity of group structure and the diversity of legal and regulatory frameworks.

Source: IAIS, Issue Paper on Group-wide solvency and supervision, 5 March 2009

Securities regulators generally do not practice consolidated or group-wide supervision, but focus their efforts on the licensed intermediary. There is no direct reference to consolidated or group supervision in the IOSCO Core Principles. However, they expressly state that supervisors need to obtain information about unlicensed and off-balance sheet affiliates of supervised entities. They also state the importance of enhancing cooperation with authorities responsible for supervising other parts of the group and establishing measures to safeguard regulatory capital within the individual firms (principles 11, 12, 13 in table 6).

Recent experience strongly suggests that both insurance and securities supervisors should include consolidated supervision as a core principle or explicitly cede the responsibility for supervising systemically important groups that include insurance and securities firms to a regulator that is capable of discharging that responsibility, and undertake to fully cooperate with that regulator.

5. Strengthening the supervisory process

Strong supervision is not a substitute for a policy/regulatory framework that creates incentives for financial institutions to behave in a prudentially sound manner. But neither should the belief that such a framework is in place, as apparently existed in some of the economies hardest hit by the financial crisis, serve as the basis for adopting the light, high-level supervisory approaches that appear to have been followed in some but not all of those countries. To minimize the risk of financial crises, there is a need for the right policy frameworks and for strong, effective supervision.

As discussed in Section E, the experience of one of the authors suggests that there are some essential elements for effective supervision, including:

- Risk-based supervision, based on a deep understanding of the business model of the regulated entity (E 10);
- Robust on-site supervision carried out by qualified and experienced supervisory staff and not outsourced to external auditors or consultants (E 9);
- A results-oriented supervisory style that attempts to ensure that weaknesses are addressed before they become serious (E 11).

How can supervision be strengthened to embrace these factors in those jurisdictions that follow different approaches?

a) Comparative studies of the impact of different supervisory practices

A first step would be to gather more empirical evidence of the impacts of differing supervisory practices.

Although most supervisors now claim to be carrying out some form of risk-based supervision, in fact, supervisory practices differ significantly among supervisory bodies, influenced by such factors as:

- Differing supervisory objectives such as for prudential and market conduct supervision;
- Institutional differences, reflecting inherent differences between banking, insurance and securities supervision;
- Different legal systems, including British common law and Roman systems;
- Different supervisory philosophies reflecting the degree of reliance placed on market discipline and institutions' own governance and risk management systems.

As a consequence, some supervision tends to be high level and principles-based, while elsewhere it can be highly detailed and rules-based.

Comparative studies could be carried out under the auspices of the FSB. Organisations like the FIRST Trust Fund (Financial Sector Reform and Strengthening Initiative), now

administered by the World Bank, may have the capacity to sponsor or carry them out. Such studies could analyse the structures, cultures and practices of regulatory/supervisory bodies in economies at similar stages of development and which have experienced different outcomes in the global financial crisis with a view to drawing at least tentative conclusions about the effectiveness of different supervisory approaches.

b) Amend core principles to strengthen supervisory standards.

At present, the Banking, Insurance and Securities Core Principles reflect a view of supervision that is well behind best practices in some jurisdictions.

Table 7: Onsite supervision: Excerpts from the Basle, IOSCO, IAIS Core Principles

Basle Principles	IOSCO Principles	IAIS Principles
<p>Principle 21 – Supervisory reporting: Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts</p>	<p>8.2. Inspection and Compliance Programs Supervision of market intermediaries’ conduct through inspection and surveillance helps to ensure the maintenance of high standards and the protection of investors. (...)The regulator should have the power to require the provision of information to carry out inspections of business operations whenever it believes it necessary to ensure compliance with relevant standards. The suspicion of a breach of law should not be a necessary prerequisite to use of inspection powers in respect of authorized or licensed persons. Inspections may be carried out by the regulator itself or another competent authority. Alternatively, the regulator might consider delegating such authority to Self-Regulatory Organizations or using third parties, properly supervised, to carry out some of this inspection work on its behalf. These third parties should also be subject to disclosure and confidentiality requirements. Such inspections must be carried out with adequate instruments and techniques, and these may vary between jurisdictions.</p>	<p>ICP 13 On-site inspection The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements. Explanatory note 13.1. Whether performed by the staff of the supervisory authority or other suitably qualified specialists, on-site inspection is an important part of the supervisory process, closely related to the offsite monitoring process. It provides information that supplements the analysis of the reporting to supervisory authorities sent by the insurer. On-site inspection, however, also needs the support of market information and statistics derived from the analysis of the annual accounts and returns ICP 3 Explanatory note Where supervisory functions are outsourced to third parties, the supervisory authority is able to assess their competence, monitor their performance, and ensure their independence from the insurer or any other related party.</p>

Source: Basle Committee, *Core Principles for Effective Banking Supervision* October 2006. IAIS, *Insurance Core Principles and Methodology*, October 2003. IOSCO, *Objectives and Principles of Securities Regulation*, May 2003

In the above standards, on-site supervision seems to be viewed as a supplement to off-site monitoring. Reference is made to the need for on-site supervision as a means of “independent verification” of reports submitted for off-site monitoring, to supplement “the analysis of the reporting to supervisory authorities” or to investigate “the suspicion of a breach.” The standards all permit outsourcing of on-site work to external experts.

In the view of the authors, the objectives of on-site supervision go well beyond verification, supplementing off-site monitoring and investigating breaches, and should include the following:

- Develop a full understanding of the business model of the regulated institution, including strategies, commercial objectives, significant activities, risk areas and risk management tactics and capabilities;
- Identify gaps between the way the business is portrayed by senior management and the way it actually runs;
- Understand the effectiveness of risk management and other internal control functions;
- Test for weakness in the implementation of important policies and procedures;
- Permit a comprehensive risk assessment of the institution and the development of an “evergreen” supervisory plan that is responsive to the risk assessment and the supervisor’s objectives;
- Provide a basis for recommendations and other supervisory actions to improve weak risk management and control functions and address excessively risky business practices.

To accomplish the above objectives, robust, intense, risk-based on-site inspections are needed.

The authors would urge the standard-setting bodies to review and strengthen the language of the existing standards around the subject of on-site supervision, including eliminating any suggestion that it is a supplement to off-site monitoring and removing the possibility of outsourcing the activity to outside experts.

c) Ensure that supervisors have the power to exercise discretion in their judgments and in the actions that they take

Efforts to significantly improve the quality of supervision may rise or fall on the issue of supervisory discretion. This is undeniably a difficult issue.

In some Roman-law jurisdictions, authorities cannot exercise discretion and all actions must be supported by legislation or regulation. In such jurisdictions, capital adequacy requirements, for example, are set out in legislation and can only be modified by amending the legislation. The kind of supervisory discretion contemplated in Pillar II of new Basel Capital Accord is not permitted. Thus efforts have been made in some countries to formalize the criteria for requiring supplementary capital under Pillar II. These are often jurisdictions in which supervisory decisions can be challenged in the courts before they take effect and in which supervisors lack legal protection.

In other jurisdictions, with a tradition of external or political interference in the decisions of financial supervisors, efforts by the supervisor to exercise discretion and to use judgment may place the supervisor at greater risk of interference, some of which may take career-limiting, unpleasant, frightening or even terminal forms. In such jurisdictions, formula-driven supervisory responses provide an important security blanket for outcomes that may be unwelcome to regulated institutions.

This view is reflected in the recommendations of the Geneva Report (Box 17):

“The more that the utilisation of such instruments is likely to provoke opposition from major interest groups at the time of their application, the more such application needs to be based on pre-set, pre-announced, (even statutory) rules. ‘Taking away the punch-bowl, just when the party gets going’ is no more popular with respect to asset price booms, than to the macro-economic conjuncture. For this latter reason we would advocate that much of the counter-cyclical armoury that we have suggested becomes couched in presumptive, rule-based terms.”

While one can be sympathetic to the sort of thinking that underlies the above recommendations, the blunt truth is that limiting the supervisor’s ability to react against and excessive build-up of risk in one institution or across the financial system to the application of mathematical formulae will undermine the very objective that the rules are designed to achieve.

This is because any formulae will be based on what is known now, taking into account past experiences and events. Such formulae are unlikely to accommodate the impact of rapid financial innovation and the unpredictable surprises that innovation can bring. They are also certain to encourage unpredictable forms of regulatory arbitrage, once they become known to the financial industry.

Unless, in our responses to the financial crisis, we manage to suppress financial innovation to the extent that major uncertainties and new “black swan events” can be ruled out, which seems rather unlikely, regulators will need the flexibility to react to the unexpected both at the systemic and the institutional levels.

A useful paper written by Augusto de la Torre and Alain Ize of the World Bank, entitled: “Rebuilding: Financial Regulation: The Missing Paradigm”, analyses the financial crisis in terms of three paradigms: moral hazard; externalities; and innovation/uncertainty. The third, or “missing paradigm” is seen as the best, though not a complete framework within which to understand the global financial crisis and needed regulatory responses. The paper describes an appropriate role for a financial regulator under the third paradigm:

“Under this third paradigm, regulation should be geared to prudently navigating under foggy conditions rather than internalizing well-known externalities under clear weather. Observing strict speed limits, even when that might delay the ship, should be the order of the day. This points in favor of rough-and-ready but effective regulations (such as rigid limits on leveraging and liquidity risk exposure) that have no precise risk-based justification but yet do the job of keeping all traffic under reasonable control. However, to avoid slowing traffic down to a crawl (which could throw financial intermediation back to the middle ages or exacerbate cross-country regulatory arbitrage), the regulator also needs to play a more enlightened role that would provide clear value added. He should be the skipper at the top of the mast warning for possible obstacles ahead and working closely with the ship’s captain (the financial market players) to slow the speed when needed and manoeuvre around the obstacles without losing too much overall travel time. Keeping the process of financial innovation under proper control should naturally be the center of focus. In doing so, the supervisor can no longer be only a cop; instead he must also become half scout half moderator, and work in very close contact and cooperation with the institutions and markets

he supervises. This is of course a very tall order that would require strong and independent institutions populated by highly skilled civil servants.”²⁸

To this might be added: “a tall order that would also require those highly skilled civil servants to be armed with flexible and discretionary supervisory powers to navigate around unexpected obstacles whose shape and location cannot be determined.”

What can be done to enhance the ability of supervisors to deal with systemic and institutional uncertainties, given the existence of legal and cultural impediments to the use of supervisory discretion and judgment?

This is an issue that should be addressed in the supervisory standards. Ideally, the standards would make a clear statement in favour of the exercise of supervisory discretion and judgement, but, recognising the difficulty that will be experienced by some jurisdictions in moving quickly in this direction, enhanced standards might have to approach this issue in the manner of the IAIS Core Principles, setting out both Essential Criteria and Advanced Criteria.

G. Implications for Regulation in Developing Countries

The current crisis might be described as a *trans-Atlantic financial crisis*, followed by a *global economic crisis*. The supervisory failures that contributed to the financial crisis occurred in some developed countries on either side of the Atlantic and not in the developing world. So what lessons can there be for supervisors in developing countries?

1. Avoid complacency

Some of the supervisors who have, to date, experienced fewest difficulties in the current crisis had previously strengthened their procedures in response to earlier crises. This includes supervisors in developing countries. However, relative absence of difficulties may also be attributable to more conservative behaviour on the part of financial sector actors and not just effective regulation and supervision. There is likely to be good luck as well as good management in the favourable experiences of some of the “successful” supervisors. It will therefore be important for developing country supervisors to learn from the difficulties of others and strengthen their own practices. All of the above recommendations have some relevance for developing country supervisors, as does the work underway to strengthen capital and liquidity standards and other rules that appear to have contributed to the crisis. Two points may be of particular relevance to developing country supervisors:

²⁸Augusto de la Torre, Alain Ize, Regulatory Reform, Integrating Paradigms, World Bank Policy Research Working Paper 4842, February 2009.

2. Strengthen governance and mandates of supervisory agencies

Insufficient de facto independence combined with inappropriate implicit or explicit mandates may have contributed to supervisory failures in some developed countries. These also tend to be areas of weakness in some developing countries. Efforts should continue to strengthen these areas, including the extraordinarily important issue of legal protection for employees of supervisory authorities.

3. Avoid full implementation of the FSA supervisory model of integrated supervision

The U.K. FSA model of integrated supervision is proving to be popular in developing countries because it makes efficient use of resources in countries where resources are scarce. Some aspects of the FSA model may be quite appropriate, but developing countries should understand the risks of attempting to achieve the degree of integration sought by the FSA and other developed country supervisors like APRA, particularly the partial elimination of industry-focused supervisory groups (retail banking, life insurance, general insurance, securities firms) in favour of classifications based on perceived major risk factors. Care should also be taken not to charge those responsible for prudential supervision with market conduct supervision as well, because different skills are required and public pressure will always tend to emphasise the latter. A more appropriate model, at least in the early stages of integration, might be the MAS model of integrated supervision, in which industry-specific supervisory departments have been retained (Banking, Insurance) and separate groups coordinating closely, are responsible for prudential and market conduct supervision.

H. Conclusion: From light-touch supervision to right-touch supervision

The failure of large institutions in developed countries has revealed gaps in the regulation and supervision. While changes in rules are welcome, they are insufficient. Supervisory culture needs to change as well towards:

- A seamless link between macro-prudential surveillance and micro-prudential supervision;
- Risk based supervision, based on a deep understanding of the business model of the regulated entity;
- Robust on-site supervision carried out by qualified and experienced supervisory staff and not outsourced to external auditors or consultants;
- A results-oriented supervisory style that attempts to ensure that both systemic and institution-specific weaknesses are addressed before they become serious;

Supervisors should be allowed to ask the right questions and take necessary actions. This is particularly challenging in developing countries where legal protection is often insufficient and resources scarce.

**Appendix A: Speech by John Palmer, Superintendent of Financial Institutions of
Canada to the 3rd Annual Forum on the Future of Financial Institutions Toronto,
Ontario, October 5, 1999**

Looking over the agenda for this Forum on the Future of Financial Institutions, you have participated in a wide ranging discussion on changes taking place within the financial sector including such issues as globalization and consolidation, the ability of Canadian institutions to compete internationally, changes taking place within specific industries, and the policy challenges that all of these changes create.

Today, I want to talk about one aspect of the changes that are taking place – the implications for the prudential regulation and supervision of the financial sector. And I want to do this taking both a historical and an international perspective.

The changes you have been hearing about over the last day and half have been taking place in the context of generally buoyant financial markets.

The current US business cycle expansion, which is driving the Canadian economy, was 8 years old last March. It is already the longest peacetime expansion, and second only to the one during the Vietnam period in the 1960s. While Canada and Western Europe may not be experiencing the same measure of economic expansion, their economies are quite healthy.

So prolonged has this expansion been, that we are reading articles in both academic and popular literature asking whether we have entered a new "golden age", suggesting that the traditional business cycle is dead. In such a context, those placing constraints on creative business activity – regulators of financial institutions, for example - are viewed with increasing scepticism, if not downright hostility.

When times are good, however, our collective memory becomes somewhat clouded and the demand for prudential regulation tends to recede. It is viewed as a hindrance to further progress.

The demand for market conduct regulation, on the other hand, often rises in good times. Insolvency is no longer viewed as much of a problem, but competition, prices and the way financial institutions deal with their clients become the focus of attention.

I want to assure you that OSFI's role is not to impede responsible business endeavours – we recognise that the marketplace for financial services today is intensely competitive, innovative and global and we have to respond to this. But it is my responsibility to make sure that the lessons we have learned in the past are not forgotten in the unbounded optimism of an expansionary cycle. And you will gather from that comment that I don't think the traditional business cycle is dead.

In the history of Canada's financial sector, we have had cycles of regulation and deregulation. Our last taste of deregulation occurred in the 1970s and early 1980s. There was a growing belief at that time that Canada's banking legislation was too restrictive, and more deposit-taking institutions were needed. A form of deregulation took place and many new financial institutions entered the Canadian market. A lot of these were trust companies. Some were subsidiaries of foreign banks. And still others were new Canadian banks, including the second Bank of British Columbia, and the Northland and Canadian Commercial Banks in Alberta.

However, that experience with deregulation was not entirely pleasant. The three new regional banks, as well as 18 trust companies disappeared. Very few of the new institutions created during this period of deregulation are with us today.

On the international front, we have had recent banking crises in Latin America and in Asia and the organised rescue of a major hedge fund.

Whenever there are disruptions like these to the financial system questions are immediately raised. What went wrong? What should the regulators have done? What new powers should the regulator have?

These developments have led to calls for stronger and better enforced regulatory and supervisory standards internationally. But because Canada has not experienced problems in the recent past, we seem to be moving into a classic deregulation phase in this country. Policymakers have decided that it makes sense to accept a higher level of risk in the system in exchange for the ensuing benefits, such as enhanced competition. To assess the tradeoffs involved, we first need to consider the rationale for prudential regulation.

Prudential regulation is ultimately about maintaining a stable financial system, a very important basis for a healthy economy.

Regulated financial institutions readily acknowledge this, but have a "love-hate" relationship with the regulator. On the one hand, they want to operate under a regulatory and supervisory system that is considered to be strong because it facilitates their access to capital and their status as counterparties. Rating agencies and potential counterparties view financial institutions operating in strong, well-regulated, well-supervised financial systems as better risks than those operating in weaker, poorly regulated and poorly supervised systems (other things equal). A strong system opens doors globally. In the jargon of the economist, a strong regulatory system is a public good. The benefits are enjoyed by all in the system.

At the same time there is a price for this public good because regulation clearly imposes a cost on financial institutions. There is a direct cash cost, because in Canada federal institutions pay the regulator's costs. And there is an indirect cost – the internal cost of compliance with regulations. And not surprisingly, the institutions constantly strive to keep these costs to a minimum. So the challenge to policymakers is to find the right balance between the important benefits of regulation, and the very real costs. And the policymakers must do this in a highly dynamic environment.

There is a constant interplay between the regulator and the regulated financial institutions. Regulators attempt to design regulatory and supervisory frameworks that will achieve the goals established by legislators – systemic stability, protection of depositors and policyholders, encouragement to competition – while regulated financial institutions work to minimise the impact of these frameworks on their operations. The system is one of never-ending action and reaction. Innovation by one prompts innovation by the other.

A good example of this action and reaction can be seen in the evolution of the Basle Capital Accord first released in 1988. The original 1988 Basle capital standards were the result of extensive study by, and protracted negotiation among, major bank supervisors to reverse a long-term decline in bank capital cushions and were an attempt to relate capital requirements to risk.

As most of you know, assets were divided into four risk classes. This was an important achievement because it established the principle of risk-based capital. But the risk classes were crude and didn't link closely to probability of insolvency or loss.

Faced with these standards, the banks then had an incentive to engage in regulatory arbitrage, that is, to structure their risk positions in such a way that lower capital requirements were applicable. Banks have learned to design products to minimize their "unproductive" capital. And we have seen the creative redesign of existing products and the development of new products to accomplish this. Securitization and the use of derivatives have received significant impetus from this drive to reduce regulatory capital.

Regulatory arbitrage has generated serious difficulties for the 1988 Capital Accord. Consequently, the Basle Committee on Banking Supervision released a consultative document earlier this year, suggesting some major revisions to the existing capital accord. The underpinnings to the new accord would be: (1) a more risk-sensitive regulatory capital standard; (2) a more active supervisory program to better assess the risk profile of an institution; and (3) improved bank disclosures to facilitate market evaluation and discipline of a financial institution. OSFI has been involved in the development of the consultative document and will remain active in the ongoing consultation process.

The benefits and costs of regulation as well as the dynamic regulatory environment are issues that were carefully considered by the Task Force on the Future of Canada's Financial Services Sector and by the government in issuing its Financial Sector Policy Paper last June. One conclusion, as you know, was that in Canada we may have done a better job of fostering safety and soundness in our financial system than we have in terms of competitiveness and openness to the entry of new players. Thus the decision to shift the balance somewhat away from safety and soundness and protection of savings toward competitiveness and openness.

And so, as you also know, the government will be making a number of changes intended to enhance the competitiveness of the Canadian financial sector and to encourage the entry of new players. These include:

- Making it easier to incorporate new financial institutions.
- Allowing commercial entities to own smaller banks.
- Making it possible for credit unions to operate beyond their provincial borders.
- Permitting financial institutions to gain additional flexibility through the use of holding company structures and other means.

While attempting to open up the Canadian financial system in this way, the government has also attempted to learn from the experiences of the last wave of deregulation in Canada by recommending that OSFI be given certain additional powers to help it cope with the additional risk in the system which could be introduced by new and potentially riskier financial institutions, and more complex and riskier corporate structures.

In my view, taking into account the state of Canada's financial system and notwithstanding the changes that are taking place globally, it makes sense to accept a slightly higher level of risk in our financial system in order to gain the advantages of increased flexibility and enhanced competition. And OSFI is committed to working with other arms of government and with financial institutions themselves to make sure the government's intentions are translated into workable, practical legislation.

One of the biggest challenges in this regard is to develop legislation to give Canadian banks and life insurance companies greater flexibility to undertake new ventures and to structure their operations in ways that make economic sense while at the same time adhering to international standards of best practice in terms of regulation and supervision.

There are two ways in which the objective of greater flexibility can be accomplished. The first is to amend the rules governing downstream investments of regulated financial institutions to permit a broader range of investments and to lift some of the limits on size of investments. The second is to permit regulated financial institutions to operate within holding company structures.

For a holding company regime to meet international standards of best practice in regulation and supervision a number of tests will have to be met:

- regulation of the holding company;
- adequate capital at the holding company level to support all activities within the corporate group;
- a prohibition within the corporate group against purely commercial activities as distinct from those that have some relationship to financial services; (and we recognize that a broader view of this issue needs to be taken, particularly in the area of technology);
- access to information by the regulator about what is taking place in the unregulated affiliates, and the ability to intervene if necessary to prevent contagion from the subsidiary or affiliate to the regulated financial institutions;
- more stringent rules on self-dealing.
- As was discussed yesterday, work is underway to develop a holding company regime and more flexible downstream investment rules. That work is involving industry representatives as well as officials from the Department of Finance and OSFI, and I agree with Jim Bailey's comments that the work is going well, although there is still much to do.

In my view, the goal of any reform, including the one we are now embarked on, should be to permit financial institutions to decide what the best corporate structure is for their activities on the basis of commercial considerations. It should be a response to market incentives, such as the cost of raising and allocating funds within a complex institution. We should not be creating artificial biases toward any particular structure as a result of regulatory, or dare I say it, tax considerations.

I talked earlier about the additional supervisory tools described in the government's Policy Paper to help OSFI cope with the increased risk in the system that other changes would tend to create.

It is important to realize that, even with an enhanced set of tools, external regulation and supervision can only go so far. Internal management must bear the primary responsibility for risk control. Well-designed internal controls and sound internal governance should be in place. This implies that incentives must be designed to ensure that adequate internal monitoring of risk is undertaken. This is one of the objectives of OSFI's new Supervisory Framework, which was released publicly a few weeks ago. That framework links the extent of supervision to OSFI's assessment of a financial institution's net risk. Lower risk, well managed institutions will receive less attention from OSFI than institutions which don't meet these tests. And we will be using this framework to help us make judgements about resource allocation in supervising the more complex corporate groups that are likely to result from the new downstream investment and holding company rules.

Looking forward, one of the most important issues in prudential regulation is the extent to which the regulator should rely on the market to discipline financial institutions, in order to reduce the costs and the distortions caused by many regulatory requirements. A strong case can be made that regulators should expand their reliance on market discipline over financial institutions in order to cope with the complex system they oversee. And the case is gaining growing acceptance. In the 1996 changes to Canada's financial sector legislation, provisions were included requiring enhanced public disclosure by institutions of financial information, and by OSFI of information filed by institutions. I have also mentioned the proposed changes to the Basle Capital Accord, one of which would require enhanced disclosure of financial information.

But there are important limitations to the greater use of disclosure and market discipline, particularly in an international context.

Institutions are becoming global, and quality of financial information and standards of disclosure vary from country to country. In my view, while we must work to improve accounting, auditing and disclosure standards around the world, strong supervisory regimes will be needed for the foreseeable future. At the international level, the challenge is to design a supervisory system that will minimise the "cracks" through which financial institutions can fall.

One of the most important supervisory issues today is effective consolidated supervision of a financial institution by its home country regulator. It is critically important that the home country regulators have the powers to deal with the international activities of these financial institutions based in their countries, relying on other regulators where this is possible and extending their own procedures internationally where this is not.

Achieving effective consolidated supervision is one of the building blocks of a new global financial architecture, an issue to which numerous international organizations are now directing their attention. These include the G-7, the G-10, the G-22, a newly created G-20 group, which Mr. Martin, our Minister of Finance, will be chairing, the IMF, the World Bank, the Basle Committee on Banking Supervision and many more.

The G-7 finance ministers, notably Mr. Martin, have been particularly active in calling for change in this area. Last April, they created a new international body called the Financial Stability Forum to help avert the sort of crises recently experienced in Asia and other regions. One of its early initiatives is likely to be to enhance regulatory and supervisory standards around the world.

These calls have gained impetus from the growing volatility and interdependence within the global financial system.

The trend is clear. Oversight of the international financial system by the various international organizations and supervisory bodies is going to increase.

Another potential source of potential global instability capturing the attention of regulators and many others has been the Year 2000 issue, or Y2K problem as it is more commonly called. The threat has been recognized for some time, and major resources have been committed to addressing it.

OSFI, for its part, has been working with Canadian financial institutions for more than three years to encourage Y2K readiness.

Although the potential has been worrisome, I believe that the news on this front is good. Based on the detailed reporting that we have been requiring from Canada's financial institutions over the last two years, we believe that Canada's financial sector will be able to operate in a normal fashion before, during and after January 1, 2000.

This is just one of many issues that involve active dialogue between regulator and regulated in the fast moving and dynamic environment which I have been describing.

Let me bring these prepared remarks to a close by saying that, in all the changes taking place in this fast moving and volatile financial world, OSFI's biggest concern is dealing with expectations of what the regulator can reasonably accomplish in the future. We understand that changes are required in our financial system to meet the needs of Canadians and to permit institutions to compete successfully in a rapidly changing environment. And we have been working, quite effectively I think, with both the Task Force on the Future of Canada's Financial Sector and the government in the development of proposals that can accommodate these needs, while still allowing us to maintain a stable financial system and protect the savings of Canadians. We have also been making some pretty fundamental changes to the way we do things at OSFI, including the development of our new supervisory framework, in order to adapt to the demands of a more complex, more fluid financial environment. But even with the changes that we are making internally and some enhancements to our supervisory powers, we are still facing a considerable challenge.

As I said earlier, OSFI accepts that there is a strong case for shifting the balance between safety and soundness on one hand and competitiveness and openness on the other. At the same time, Canadians will have to be understanding about what we can accomplish as we work to carry out our responsibilities in this more challenging environment.

Appendix B: Address by John Palmer, Superintendent of Financial Institutions of Canada to the Empire Club of Canada Royal York Hotel, Toronto, June 8, 2000

For those of you who haven't previously dealt with the Office of the Superintendent of Financial Institutions or OSFI as it is affectionately known, let me take a minute to explain what we do.

We are the primary regulator and supervisor for all federal financial institutions and pension funds. That includes all banks operating in Canada, whether Canadian or foreign owned, as well as federal trust companies, life insurance companies and property and casualty insurance companies. We are responsible for about 500 institutions in total, and about 1100 federal pension plans.

We are what is called a "prudential" supervisor. That means that we focus on the financial health of institutions and pension plans and the protection of your savings.

In 1995, when I last spoke at the Empire Club, I had been Superintendent of Financial Institutions for less than one year. The Canadian economy was just coming out of a difficult period and between 1989 and 1994, a total of 139 federal financial institutions went out of business, including:

- 15 small banks
- 17 trust and loan companies
- 33 life insurance companies and;
- 74 property and casualty insurance companies

And those numbers did not include companies like Royal Trust that retained their identity but which were taken over by other institutions.

The financial institution failures and near failures of the early 1990s led to a reappraisal of the changes which Canada had made to its financial sector legislation at the beginning of the decade, and a decision to further strengthen the regulation and supervision of federal financial institutions.

OSFI was given a legislative mandate, which made it clear that it had a responsibility to protect the savings of depositors and policyholders of federal financial institutions. Importantly, the mandate also made it clear that OSFI's responsibilities did not extend to preventing the failure of financial institutions. Instead, OSFI was expected to become more interventionist in its supervisory approach, detecting potential problems earlier, and moving faster to ensure a resolutions of the problems, either by requiring the institutions to fix them or by closing the institutions before further erosion took place in the savings of depositors and policyholders.

This mandate, which was passed into law in 1996, has been driving OSFI's activities since that time. At the risk of lapsing into immodesty, I can tell you that we have fundamentally transformed OSFI, as a result.

We have developed a new approach to supervising financial institutions which includes closer attention to the key risks which institutions are taking on and the quality of the institutions' own

risk management systems. Our new approach also requires us to intervene more quickly and decisively when problems become evident.

As part of our new approach, we have been encouraging institutions to increase capital levels and strengthen their reserves for losses.

We have also played a more active role in shaping legislation than was the case before I became Superintendent. While we do not shape financial sector policy, we do develop recommendations for amendments of a more technical nature which will permit the legislation to achieve its objectives and ensure that OSFI can accomplish its prudential mandate.

During this period, OSFI has undergone organizational changes to eliminate overlap and duplication and ensure that our activities are better focused on our objectives. We have created a conglomerates group to supervise our larger, more complex institutions and are building an internal consulting division staffed with specialists in such areas as value at risk models, securitization, as well as experts in accounting and actuarial matters. This has been essential to help us keep up with the rapid changes taking place in the financial sector.

Well-qualified, well-trained and highly motivated people are the key to the success of any organization, and some profound changes have occurred in OSFI's human resources over this period. We have experienced a staff turnover of about 50%. Some of this was initiated by us, and some was unsought, as employees left for better paying jobs in the private sector, a continuing challenge for OSFI. We have also been eliminating lower value positions and adding higher value ones as we sought to enhance our expertise.

Overall, our staff levels are down nearly 10% since I became Superintendent, but at the same time, our salary expenditures have gone up by nearly 30%, reflecting the upgrading in talent that has been taking place.

We have been working hard, too, to give our people the training they need to enhance their knowledge and skills. Training expenditures have quadrupled since I became Superintendent. Overall, our expenditures, which we charge out to the institutions we supervise, have increased by 25% since I last appeared before this audience. While we are clearly out of step with other government organizations which have been attempting to reduce costs, I make no apologies for this. The industry we supervise has become more complex and our work has become much more difficult. During the same period in which our costs went up 25%, the non-interest costs of the Big 6 Banks increased by 68%, and their total assets under administration increased by 70%, even after deducting the impact of the massive securitizations which have taken place over the last couple of years.

We have been also attempting to develop information to track our own performance, information that we will soon make public. We are trying to track the impact of our more interventionist supervisory approach, monitoring the number of institutions on our watch list and how long they stay there. We are also tracking losses from financial institution failures to assess just how well we are protecting depositors and policyholders. And we are conducting surveys to find out how well our employees and our institutions think we are doing.

While we have been working hard to become a more effective and, in a quiet Canadian way, a more aggressive supervisor, as required by our legislation, what has been happening around us?

The recession of the early 1990s is well behind us and we are enjoying one of the longest expansionary economic cycles in history. In the United States the expansion has lasted for 110 months, the longest of any cycle since data was first compiled in the 1850s. The number of institutions on our watch lists has dropped, and there have been few failures. Indeed, many of the financial institutions we supervise are enjoying record profits despite the dire predictions we have been hearing since the bank merger proposals were turned down. In fact, many financial institutions, both in Canada and abroad are targeting rates of return in excess of 20% and achieving them, at a time when inflation is holding in the 2% to 3% range.

And as the last recession recedes from memory, the public debate concerning the financial sector has shifted away from prudential themes such as the protection of the savings of depositors and policyholders toward the challenge posed by technology and globalization. Policymakers are now wrestling with questions of how to permit our institutions to compete with much larger foreign competitors and unregulated institutions while at the same time ensuring that the rights and needs of consumers are not overlooked.

In this environment, some might argue that OSFI is still fighting the last war - working busily to build and strengthen a prudential "Maginot Line" around our institutions, while bigger, stronger, more technologically advanced, and often foreign competitors sweep past our defences and mount their electronic blitzkrieg against our institutions, well beyond OSFI's reach.

We have certainly heard this from some commentators.

Let me acknowledge that there may be an element of truth to this observation. We still see building prudential protection as the heart of OSFI's job. The government has given no indication of weakening OSFI's mandate to protect your savings, and we have not suggested this. OSFI has not forgotten about the last recession and those that preceded it. And while there are some who may believe that we have entered a new economic paradigm in which recessions are a thing of the past, we at OSFI are not convinced of this.

History tells us that all economic growth cycles eventually end. And sometimes they end with a bang, not a whimper.

When the boom in the 1980s came to an end, that bang was a big one. Banks in many countries incurred heavy losses, and lots of them failed. Repairing the damage was hugely expensive. Public outlays to repair their deposit taking institutions amounted to nearly 3% of one year's GDP in the United States and 5% to 7% GDP in some of the Scandinavian countries. In Japan, the economic cost has been many times greater, and the resolution of the banking problems in that country is still taking place.

And so, knowing what has happened in the past, in Canada and other countries, we have to be scanning the horizon in search of any distant storms that might be brewing, even when the economic weather seems most sunny and promising.

And if we can't yet see storms, there are at least a few clouds that we have to be concerned about.

Those 20% rates of return that I talked about a few minutes ago, are being achieved at a time when risk premiums are at very low levels. Thus, almost by definition institutions have to be taking more risk to achieve these sorts of returns. And while market participants are taking on more risks, some cracks are beginning to appear. Standard and Poors reported that default rates

were up last year to the highest level seen since the recession. There are reports of more fraud and creative accounting by borrowers, often symptoms of the end of an economic cycle. Some US banks are beginning to tighten their lending conditions. Stock markets are increasingly volatile. The U.S. Federal Reserve is performing a remarkable highwire act, carefully tightening credit to discourage latent inflation in the system, without bringing this era of growth to an unpleasant end. In the past, similar initiatives have often brought about a recession.

And we shouldn't forget about the near miss that we in developed countries experienced two years ago during the financial crises which occurred in Asia, Latin America and other regions. These crises were successfully contained and the collateral damage, at least in the developed world, was slight, even if the impact on countries like Indonesia was and continues to be quite terrible. The important point is that, if it were not for some good management and a dose of good luck, the damage to developed economies could have been quite serious.

So, at this advanced stage of an unprecedented economic cycle, having just dodged one bullet and with some danger signs ahead, would it not be reasonable for policymakers to be putting up more prudential barriers?

Yet despite what OSFI has been doing over the last five years, the actual tendency is now just the opposite. What happens is that, at this point in the economic cycle, we all tend to see the world through rose-coloured glasses. Consumer spending is up. Business investment is up. Governments are spending again and even cutting taxes or promising to do so. And the focus of regulatory policy tends to shift toward reducing regulatory burdens - giving market participants more flexibility to innovate, grow and compete.

But of course there is more to the pressure to reduce regulatory barriers than typical late-cycle thinking; in addition to the frothy economy, there appears to be a sea change occurring in the international financial sector. Geographic barriers are dropping. Global institutions are emerging. And technology is fundamentally transforming products, delivery systems and customer relationships.

There is a clear need to respond to these changes, even if we are doing so at what may be a late and therefore riskier point in the economic cycle.

The financial sector bill that Mr. Martin will introduce next week will form the government's primary response to these changes in the financial landscape. While some may fear that the bill will not go far enough - it is nevertheless a significant response. As you know from the government's policy paper issued a year ago, the bill is expected to bring:

- changes in ownership rules,
- more structural flexibility for Canadian financial institutions,
- reduced barriers to entry for new banks and other financial institutions, and;
- enhanced consumer protection.

Despite our strenuous efforts to strengthen regulation and supervision over the last five years, and despite our still vivid memories of past crises, OSFI is also playing a role to ensure that Canada's financial institutions are able to adapt quickly to the big changes now underway around the planet.

We have played a significant supporting role in the development of the new legislative package, particularly those directed at giving financial institutions more structural and operating flexibility. These include the new holding company provisions and expanded downstream investment rules. Contrary to recent media reports, many downstream investments made by financial institutions will not require Ministerial approval but can be approved by the Superintendent, increasing flexibility and faster turnaround.

To add further flexibility, OSFI is also developing a streamlined approval process in which many approvals will be obtainable through a simple notice procedure.

At the same time, OSFI has been overhauling our Supervisory practices - moving away from a standardized approach to a more flexible supervisory framework adaptable to the risk profile of each institution and placing heavy reliance on an institution's own internal controls and risk management systems.

What adds impetus to our efforts here in Canada is that similar initiatives are occurring in other countries. And some of the efforts are multilateral. One of the most important is the revision now underway to the Basel Capital Accord - the formula used to set regulatory capital of deposit taking institutions in most developed countries. An effort is underway to tailor regulatory capital more closely to an institution's own risk profile and allow it to use its own risk rating systems to determine the capital it holds. This should allow some well-managed institutions to release capital (though I confess I hope that it will not be too much). OSFI is playing a major role in this international undertaking.

But we are trying not to throw caution to the winds in the name of flexibility and competitiveness.

The new legislative package should contain some additional regulatory powers that OSFI has been asking for, including the power to remove officers and directors under certain circumstances, the power to levy administrative money penalties, and some enhancement of self-dealing rules to help us oversee the more complex corporate structures likely to emerge from the legislative package.

Because so much of the pressure to relax our own rules is motivated to permit our institutions to compete with foreign players who may be subject to weaker rules, OSFI has been in the vanguard of the movement to set international standards of best practice for financial regulators and supervisors, including promoting a system of peer review to assess national supervisors' compliance with these standards.

OSFI itself was subject to a peer review against international standards last fall, carried out by the IMF as part of its new Financial Sector Stability Assessment Process. I am happy to tell you that OSFI and indeed the Canadian financial system generally passed with flying colours, although we did receive a number of helpful suggestions.

OSFI will continue its efforts to enhance its capacity to regulate and supervise. As soon as we gain more experience with our new supervisory framework, we will be introducing a new rating system for financial institutions. Like all other prudential supervisors, we won't make these ratings public because of systemic stability concerns, but we will be disclosing them to our institutions and using them as levers to encourage improvement. We will continue to strengthen our Human Resources with the help of a more competitive compensation system, ongoing recruiting from the private sector and a continuing emphasis on specialization.

And most important, perhaps, we intend to become increasingly accountable, as we develop and test an array of performance measures and standards, and publish our successes and failures. To help us to strengthen accountability, we are forming an external Advisory Board, made up of former financial community executives. These advisors will review our performance against the objectives the government has set for us, and will also help us find the right balance in our supervisory policies between safety and soundness on the one hand and competitiveness and flexibility on the other.

While we are proceeding in a balanced and careful way, it is important for you to understand that, as a result of all the changes that are taking place, more prudential risk is being introduced into the financial system at a late stage in the economic cycle.

But despite the end-of-cycle rose-coloured glasses that we are all wearing to some extent, I think this is being done intelligently, with a reasonable understanding of the costs and benefits that are in play. I also believe that Canadians have matured to the point where a strategic shift of our system a few notches up the risk curve to obtain some important benefits is something many can understand and support.

The financial sector is key to our current and future economic success. We need a financial sector that offers a competitive array of products and services to Canadians and we need to ensure there is room for competitive, successful Canadian-based financial institutions as well as foreign institutions in our open economy. To achieve this, we can't ignore changes that are occurring beyond our borders, even if those changes are also influenced by the same end-of-cycle thinking that is driving our changes. While we need to maintain prudential walls around our institutions, those walls can't be higher than those which we see in our major trading partners. We have to seek a level playing field for our institutions. So OSFI's mandate continues to be the protection of your deposits and insurance policies in federal institutions, but we're trying to do this in a balanced way that recognizes international developments and facilitates a competitive financial system.

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