TORONTOCENTRE
Leadership in Financial Supervision

Is there a need to rethink the supervisory process?

John Palmer, June 2009

Outline

1. Why did financial regulation and supervision fail?
2. Where is regulatory reform headed?
3. Why regulation and supervision fared better in some countries
4. Rethinking the supervisory process
5. Implications for regulation in developing countries

Why did financial regulation and supervision fail?

- Different approaches to balancing innovation and soundness
- The “madness of crowds”
- 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

Why did financial regulation and supervision fail?

- Weak supervisory cultures and inappropriate incentives within supervisors
- Inadequate understanding of financial institutions and what drives their behaviours
- Inadequate “tripartite arrangements”
- Suboptimal cooperation among supervisory bodies
- Absence of real on-site supervision

Where is regulatory reform headed?

- Broader role for FSB and IMF in surveillance and promoting international cooperation
- Enhance cross-border crisis preparation and management
- Enlarge the scope of regulation and supervision (systemic institutions, hedge funds)
- Strengthen prudential regulation/supervision: counter-cyclical capital buffers and provisions, include off-balance sheet exposures in capital requirements, liquidity buffers

Why regulation and supervision fared better in some countries (Can, Aus, Sing, Others)

- Past crises lead to strengthened supervision
- Political acceptance of robust supervision w/o developmental objectives
- Leaning against the cycle
- Contingency planning and crisis simulations
- Effective cooperation central bank-supervisor
- Skeptical approach to financial innovation

Why regulation and supervision fared better in some countries (Can, Aus, Sing, Others)

- Robust capital rules
- Conservative approach to provisioning
- Regulation and supervision of liquidity
- Commitment to on-site supervision
- Risk-based approach to supervision and discretionary powers
- Result-oriented supervision, emphasis on early intervention/prompt correction of weaknesses

Rethinking the supervisory process

Wanted: new concept of supervision

- Macro and micro-prudential
- Intense, risk based, results oriented
- Understanding of financial system and business models
- Focus on major risks & risk management
- Requires pre-emptive remedial action by supervisor to curb risks/improve risk management

Rethinking the supervisory process

1. Leaning against the cycle
2. Enhancing the context in which supervision takes place
3. Strengthening macro-prudential surveillance and mitigating pro-cyclicality
4. Supervising complex, cross-border financial groups on a consolidated basis
5. More effective supervision

Rethinking the supervisory process: Leaning against the cycle

- Enhanced surveillance role for FSB-IMF requires resources & mechanisms for effective cooperation
- Close linkage needed between surveillance and prudential findings (counter-cyclical initiatives)
- Update supervisory standards to include macro-prudential and counter-cyclical supervision
- Greater FSAP emphasis on outcomes
- In the short-term, IMF-article IV program to improve macro-prudential surveillance

Rethinking the supervisory process: enhancing context for supervision

- Self-assessment process on compliance with standards and codes
- Strengthen the Basle, IAIS, IOSCO standards in several areas to change cultures and practices
- Enhance de jure and de facto supervisory independence (legal protection)
- Include guidance on qualifications of supervisory heads (contrarian thinking)
- Remove or subordinate financial sector development mandate to financial stability

Rethinking the supervisory process: macro-prudential surveillance and pro-cyclicality

- Both issues should be addressed jointly
- Quantitative tools not enough: they can undermine exercise of discretion by supervisors when needed, and institutions can “game” the system
- The role of the home supervisor should not be weakened by counter-cyclical regulation
- Respective roles of central bank and financial supervisor should be balanced and linked (e.g. supervisor leads on capital adequacy, central bank on surveillance)

Re. the supervisory process: supervising cross-border groups on a consolidated basis

- Supervisory colleges: a promising approach provided they have resources and a leader
- Lead supervisor: old concept, recent recognition. Should be in a position to recommend overall supervisory strategy for group and expect cooperation from others
- Consolidated supervision should be (better) acknowledged in the IAIS and IOSCO standards

Rethinking the supervisory process: more effective supervision

- What is effective supervision:

- risk-based supervision, supported by a deep understanding of business model of the financial institution

- robust on-site supervision not outsourced to external auditors

- results-oriented supervisory style addressing weaknesses before they become serious

Rethinking the supervisory process: more effective supervision

- Risk-based supervision: sufficient experienced staff and time allocated to key risk areas
- Robust on-site: amend standards to prohibit outsourcing of on-site supervision; make on-site work the core and not mere supplement to off-site monitoring
- Supervisory discretion: supervisors need flexibility to provide early responses to problems before they are "provable"

Rethinking the supervisory process: more effective supervision

- Consider graduated approach (Can/Aus) to the exercise of supervisory discretion
- Supervisory discretion is already a difficult issue in Roman law jurisdictions or places with history of political interference
- New rules and formulae-based tools could further undermine supervisory powers

Rethinking the supervisory process: more effective supervision

- Would this approach weaken financial innovation?
- Experience in several countries suggests that healthy financial innovation still possible in a stability-centred regulatory/supervisory system

Implications for regulation in developing countries

- Avoid complacency
- Strengthen governance and mandate of financial supervisors
- Avoid full implementation of integrated and thematic model (e.g. FSA); keep industry groups, avoid focus on market conduct that could weaken prudential supervision

Conclusion

- Markets cannot be left alone to assess and manage risks; active supervision is needed
- Supervisory cultures need to change
- Formulae-based regulation may curb supervisory power
- Update in standards as a start to change cultures
- Enhanced FSAP and international surveillance to check implementation
- Supervisory discretion is a key element of effective supervision, but safeguards needed

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Thank You