CAN WE ENHANCE FINANCIAL STABILITY ON A FOUNDATION OF WEAK FINANCIAL SUPERVISION?

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The global financial crisis has spurred vigorous responses from governments of many countries and also from supra-national bodies and international groupings such as the G8 and the G20. The responses reflect a determination to prevent another such crisis from occurring. They include various measures to enhance financial stability such as a strengthened and reconstituted Financial Stability Forum (now the Financial Stability Board), more responsibilities for the IMF, efforts to strengthen macro-prudential surveillance at the international and national levels, and new financial sector regulations to enhance capital adequacy and limit elements of compensation packages that encourage excessive risk-taking.

These measures are well-intended and are likely to improve matters, at least until the collective amnesia that contributed to the current crisis sets in again. However, in the view of the author, an experienced financial sector supervisor, they do not go far enough. Virtually none of the measures calls for improved supervision of financial institutions at the micro-prudential level.

In the view of the author, our ability to prevent future financial crises will be greatly enhanced if we can strengthen the art and science of financial supervision. This goes well beyond strengthening capital rules. It includes strengthened supervisory mandates, greater independence for supervisory agencies, as well as the expertise, methodologies and authority to develop a good understanding of the business models of supervised institutions, their risk appetites and risk management practices, and to take action to encourage/require institutions to curb excessively risky practices. Such factors have been notably absent in a number of the supervisory authorities whose financial sectors were most affected by the financial crisis.

This article is based on a discussion paper entitled *Is there a need to rethink the supervisory process?,* prepared by the author and Caroline Cerruti of the World Bank ("the Madrid paper") for a conference to address the topic of *Reforming Financial Regulation and Supervision: Going Back to Basics,* which took place in Madrid on June 15, 2009. The conference was organised by the World Bank (Chief Economist Office for Latin America and the Caribbean) and Banco de España. The sources for many of the statements made in this article will be found in that paper. The paper can be found on the website of the Bank of Spain (www.bde.es).

1 Introduction

The response of national and international authorities to the global financial crisis has been vigorous and proactive. The authorities have showed creativity and determination to keep systemically important banks in business and minimise the impact of the crisis on the real economy. It is too early to fully assess the results of these efforts, but most commentators seem to feel that absent these efforts, the economic impact of the crisis in most countries would have been far more serious.

While addressing the immediate symptoms of the crisis, authorities have paid serious attention to the causes of the crisis and possible steps that could be taken to reduce the chances of such a crisis taking place again. Important initiatives are now underway to enhance financial stability and "crisis-proof" national and global financial systems.

Much of the focus of the many initiatives 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 (regulating executive compensation) and on improving certain supervisory practices, such as consolidated supervision and cooperation between home and host supervisors. Considerable attention is being paid to the emerging art/science of macro-prudential supervision, seen by many as the key to detecting emerging crises and taking timely preventative action.

All these initiatives are worthwhile, but, in the view of the author, they largely ignore the need for better micro-prudential supervision, particularly of systemically important financial institutions. It is the thesis of this article that, without more effective micro-prudential supervision in many countries, our collective hopes of enhancing financial stability will be more difficult to realize. Without effective supervision, the current approach will resemble a disarmament treaty with no provision for verification, or to use another analogy, will be like trying to prevent another outbreak of H1N1 or SARS through high level epidemiological planning, without involving the doctors and health workers on the ground.

2 Why is good micro-prudential supervision important?

Good micro-prudential supervision is able to identify excessive or poorly managed risks in financial institutions and intervene to curb the risks or ensure that they are adequately cushioned through provisions and capital.

To extend the earlier metaphors, good prudential supervisors are like arms inspectors, identifying breaches of commitments and taking action to blow the whistle and ensure that commitments are adhered to. Or they are like doctors and nurses in a pandemic, working to protect their patients and providing valuable information on the spread of the disease.

If prudential supervisors had played such roles or played them more effectively in a number of important countries, it seems unlikely that the financial crisis would have been as serious or damaging. This is not to lay the sole responsibility for the financial crisis at the doorsteps of the financial supervisors. There are many others brilliantly qualified to share this responsibility, including heads of financial institutions, politicians, central bankers and other public officials, but weak prudential supervision played a role.

3 How could good prudential supervision have mitigated the impact of the global financial crisis?

In the lead-up to the financial crisis, good prudential supervision would have identified many instances of excessive risk-taking, including excessive exposures to sub-prime products. It would also have identified weak risk management practices, including inadequate attention to effective risk management at board and senior management levels of financial institutions.

Good prudential supervision would have spotted weak funding models including excessive and growing reliance on wholesale funding and the least reliable forms of retail funding (deposits gathered via brokers or the internet). Good prudential supervision would have encouraged or required remedial measures, including scaling back of risky activities, increasing provisions and/or capital levels and improving funding strategies through additional liquidity or more long-term funding.

Institution by institution, good prudential supervision would have discouraged the build-up of excessive leverage taking into account both on and off balance sheet items, and, in so doing, significantly reducing the vulnerability of financial systems to the shocks that were on the way.

Good prudential supervision in countries with important financial systems probably would not have prevented the financial crisis from occurring, but, in the opinion of the author, could have materially reduced the impact of the crisis in most countries and globally.

Is this pie in the sky? Is it simply 20-20 hindsight? It is neither. This is in fact what occurred in a number of countries which largely avoided the first wave of the financial crisis and which were only affected (in some cases rather seriously) by the global economic slowdown that was triggered by the financial crisis.

4 Why was prudential supervision sometimes ineffective in the lead-up to the financial crisis?

There are many reasons. Some are symptoms. Some are causes. What might be described as symptoms were ably summarized by Federal Reserve Chairman Bernanke in his speech to the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition on May 7, 2009, in which he commented on "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:

– 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;

– 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

– 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.

Many of these weaknesses may in part be addressed by measures now under consideration by the new Financial Stability Board, the IMF, standard-setting bodies such as the newly-expanded Basel Committee and their new de-facto oversight body – the G20. In particular, work is underway on enhanced capital buffers, liquidity standards and compensation guidelines.

However, if these weaknesses are symptoms and not causes, can we be comfortable they will not recur if the causes are not also addressed?

How could such weaknesses have originated? None of issues identified as a weakness, with the exception of the last (compensation practices) is new and each forms part of the supervisory issues listed in the manuals and templates of supervisors in most developed countries.

In the Madrid paper, the authors suggested several possible explanations for these weaknesses or failures, including the following:

- different policy choices in balancing innovation and soundness;
- widely-held beliefs about the benign state of the global economy and financial markets;
- 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.

Unlike the symptoms, it would appear that only two of these causal factors are likely to be addressed by the measures now under consideration by the G20, the new Financial Stability Board and other bodies in the vanguard of efforts to crisis-proof the financial system. These include work to identify emerging risks and to ensure that they are surfaced at senior decision-making levels despite unwelcoming conventional wisdom and efforts to enhance supervisory cooperation through supervisory colleges with expanded mandates. In addition, a few supervisors appear to have recognised the impact of mixed supervisory mandates and pressure to foster financial sector development while supervising financial institutions. But to date, little attention seems to have been paid to the other causal factors.

5 What might happen if micro-prudential supervision is not strengthened?

If major improvements are not made to micro-prudential supervision in a number of countries, it is possible that the measures now in train to strengthen and shock-proof the financial system will not be as successful as their proponents hope. What could happen?

5.1 MACRO-PRUDENTIAL SURVEILLANCE WILL NOT BE EFFECTIVE

Despite the current “buzz” about macro-prudential surveillance, it is not new. It became a priority for central banks and international bodies like the IMF in the wake of the serious regional financial crises of the nineteen nineties. Over the last decade, many central banks and international organizations published regular *financial stability reviews* and similarly-titled research documents, aimed at identifying emerging systemic risks and proposing remedial actions. However, these well-intentioned efforts to prevent or mitigate future financial crises proved to be ineffective. In the view of the author, one reason for this is that the economists responsible for conducting macro-prudential surveillance were not close enough to financial markets to understand what was happening on the ground. They were unaware of the types of products and risks gaining currency in financial markets and did not fully understand the dangers of what was taking place.

Good micro-prudential supervision would have surfaced these issues (and did, in some instances). With more effective cooperation between central banks and supervisory agencies (an issue that is being addressed) such issues could have been brought to the attention of those conducting macro-prudential surveillance.

Little in the current suite of measures now being proposed would address this issue. Therefore, it is hard to be comfortable that those now responsible for macro-prudential surveillance will know any more about new developments in financial markets than did their largely ineffective predecessors.

5.2 BANKS WILL FIND WAYS OF ARBITRAGING NEW OR MODIFIED CAPITAL RULES AND LIQUIDITY REQUIREMENTS AND REGULATORS WILL NOT BECOME AWARE OF THIS ON A TIMELY BASIS

Among the measures under discussion for enhancing financial stability are various proposals to enhance the quality and quantity of capital maintained by financial institutions, particularly those that are systemically important. Proposals include improvements to the Basel Capital Accord, the imposition of a simpler leverage ratio to supplement the more risk-sensitive approaches inherent in the Accord, and a macro-prudential adjustment to strengthen capital in times of potential bubbles. Measures are also being considered for strengthening liquidity. All these have merit and deserve serious study. But their effectiveness will be in doubt unless there are competent supervisors on the ground able to determine whether financial institutions are observing the new rules.

Something that is often difficult for policy-makers to understand is the sheer power and tenacity of the drive to reduce capital and liquidity in financial institutions. Increases in capital reduce returns on equity and earnings per share. Increases in liquidity reduce returns on assets and therefore also impact the profitability measures. Even if politicians and regulators succeed in curbing excessive bank bonuses, the drive to reduce capital and liquidity will remain as long as banks and other financial institutions have bottom lines for which they are accountable.

Financial institutions have always been extraordinarily creative in their efforts to minimize capital levels. Three simple examples from the author’s own experience will illustrate this:

- banks “window-dressing” capital at reporting dates in order to meet capital adequacy requirements;
- banks in two countries with different regulatory reporting dates making use of bilateral hedges to improve capital levels on their respective reporting dates;
- banks moving loans to the trading book to take advantage of more generous capital rules.

The important point is that the regulator only became aware of these and many other examples of regulatory arbitrage and just plain cheating by carrying out robust, on-site supervision. Many regulators do not have the means to detect such activities. Unless regulators develop the capacity to verify the compliance of financial institutions with enhanced capital and liquidity rules, the institutions will always find ways to minimize the impact and therefore the effectiveness of the rules.

5.3 THE ENHANCED SUPERVISORY COLLEGES WILL NOT BE EFFECTIVE BECAUSE SUPERVISORS WILL NOT KNOW ENOUGH ABOUT THEIR FINANCIAL INSTITUTIONS

The proposals to build on the modest success of supervisory colleges in coordinating the implementation of Basel II across international banking groups are promising and efforts in this direction should continue. However, there are several impediments in the way of making supervisory colleges work more effectively. One is accepting the need for one supervisor to lead and coordinate the efforts of the college. Another is persuading supervisors, particularly home supervisors, to share sensitive information on a timely basis when the supervised financial group is experiencing difficulties.

A final problem is reconciling differences in supervisory approaches among members of the college. Although most supervisors now claim to be carrying out risk-based supervision, what they do on the ground differs widely. Some practice high level, largely off-site supervision, and know little about the institutions they supervise. This is what some of us refer to as "supervision at 30,000 feet". Others supervise at the "one foot level", practicing very detailed, compliance-oriented supervision and do not have a good overview of the risks their institutions are taking or how they are managed. It is difficult for supervisors with such divergent approaches to develop a good understanding of risks at the group level or to create a common approach to the supervision of the group. The good news is that the colleges may help to reconcile divergent approaches over time, but until this occurs, the colleges will operate well short of their potential.

5.4 MICRO-PRUDENTIAL SUPERVISION WILL CONTINUE TO BE INEFFECTIVE IN MANY COUNTRIES. SUPERVISORS WILL NOT KNOW ENOUGH ABOUT THEIR INSTITUTIONS TO BE ABLE TO DETECT EXCESSIVE RISK-TAKING AND POOR RISK MANAGEMENT AND TO TAKE TIMELY ACTION

There is clearly soul-searching going on within a number of supervisory agencies, including the analysis of Dr. Bernanke cited above. But few of the remedies proposed are likely to deal with the root causes of weak supervision. Unless this changes, financial institutions, with their extraordinary capacity for innovation and, in the case of systemically-important institutions, underpinned by virtually explicit *too-big/important-to fail* protection, will develop new products and enter into new activities whose risks may be unacceptably high. This is likely to occur without the supervisors becoming aware on a timely basis of what is happening or the full extent of what is happening. So without further action, history may well repeat itself.

6 So what can be done?

There is an urgent need to do more than treat the symptoms of weak supervision. The causes, including those cited above, need to be addressed.

Some suggestions follow:

6.1 CLARIFY AND STRENGTHEN REGULATORY AND SUPERVISORY MANDATES

Some supervisors have mandates that include explicit or implicit developmental objectives, which have demonstrably contributed to weak supervision and regulatory forbearance. Mandates must be clarified to ensure that the prime responsibility of prudential supervisors is the safety and soundness of supervised institutions. Mandates should also make clear that the supervisory body has a responsibility to work with the central bank and other authorities to contribute to financial stability.

6.2 ENHANCE THE INDEPENDENCE OF SUPERVISORY BODIES

Some supervisors report directly to Ministers of Finance and their de-facto overseers are politically-attuned Treasury officials. Others lack the resources and the support to do an effective job. Still others do not have legal protection. It is difficult for supervisors in these circumstances to avoid political and institutional pressures and to make firm supervisory decisions in the long term best interests of the financial system. Supervisory bodies need the same level of independence and protection now enjoyed by many central banks. Heads of supervision should not report to Finance Ministers but, ideally should report to boards of directors with representation from a critical mass of independent directors. Supervisory bodies need the power to set their own budgets and pay levels without approval from other arms of government, and need sources of funding that do not hamper their activities. Supervisory bodies and individual supervisors need protection from legal actions as they carry out their duties in a responsible way.

None of these ideas is new. All are reflected in banking, insurance and securities core principles of supervision. Yet there continues to be reluctance at the political and even bureaucratic levels in a number of countries to make the necessary changes.

6.3 IMPROVE SUPERVISORY INCENTIVES AND CULTURES

Although evidence at this stage is largely informal and anecdotal, it is the experience of the author that supervisory cultures differ significantly from country to country. Some supervisors are aggressive and proactive in indentifying and addressing problems in financial institutions and their financial systems. Some are passive and reactive and, in some instances, prone to allow institutions to hide problems through regulatory forbearance. There are supervisors who are prepared to make judgments about risky practices and quality of risk management and able to take action without being required to prove the existence of the weakness. Others take a legalistic approach and will only act if a legal breach can be established and, if necessary, proven in court. These differences are driven by many factors, including different legal systems and national cultures. They are also influenced by supervisory mandates, discussed above.

Another important factor is the explicit and implicit incentives that influence supervisory behaviour. Success on the part of prudential supervisors might well include well-managed stable institutions, but this is difficult to measure or to attribute conclusively to supervisory actions. On the other hand, when supervised institutions run into trouble or fail, it is easy to conclude that the supervisors have failed to prevent these conditions from occurring. In any case, supervisors are rarely rewarded for success but can well be punished for perceived failures. Senior officials of supervisory agencies can and do lose their jobs when failures occur, or can be reassigned to the supervisory equivalent of Siberia. This can encourage perverse behaviour, including delaying or discouraging the recognition of losses in financial institutions in order to avoid the consequences of failure.

Addressing the cultural factors will take time and will require changes to legal systems and even national constitutions. More research into cultural differences among supervisors is also needed to give us a better understanding of the differences, those cultures that seem to work best, and how cultures develop and how they can be changed. Incentives may be easier to change. To the extent that clear mandates can be set for supervisory agencies, it will be easier to set objectives and key performance indicators for the agencies themselves and the people who run them. For example, requiring supervisors to take "prompt corrective action" or initiate "early intervention" as occurs in some American and Canadian agencies, can help overcome the built-in incentives to cover up problems and forbear.

6.4 ADOPT ROBUST SUPERVISORY METHODOLOGIES WITH A SIGNIFICANT ON-SITE COMPONENT

Many supervisors rely primarily on off-site monitoring to supervise the institutions for which they are responsible. They review regulatory returns and financial information submitted by their institutions to assess compliance with rules and apply various early-warning tests. In some cases, on-site supervision is restricted to short visits ("supervision by power-point") or is outsourced to external auditors. Even in supervisory agencies that do practice more active on-site supervision, supervisory activities tend to focus on verifying the accuracy of regulatory returns or checking for minor compliance breaches. In the experience of the author, such approaches are not sufficient to permit supervisors to develop a proper understanding of how risky financial products evolve and how institutions actually manage the risks of such new products. The only solution is detailed on-site examinations and inspections, carried out by qualified people, with a focus on businesses, products and the management of risks. Such on site-work must include reviews of policies and procedures and verification by following transactions through the system. This is the only way to give regulators the knowledge of institutions and their practices and risks, as well as the confidence to take action when weaknesses are identified.

This kind of robust approach to on-site supervision is never easy. Even supervisors committed to such approaches struggle to recruit and retain the necessary qualified staff and to make difficult qualitative judgements about when practices are excessively risky and what remedial action is required. But such approaches, even when carried out imperfectly, tend to be more effective than off-site approaches where the supervisors have no chance of getting to know their institutions well enough to supervise them effectively.

7 What will trigger improvements in prudential supervision?

The four recommendations described above do not appear to be on the work agendas of any of the bodies charged with risk-proofing the global financial system, including the Financial Stability Board and the IMF. If significant improvements in prudential supervision are to occur in the countries where they are most needed, the backing of these bodies will be needed. It will also be important for the IMF's Financial Stability Assessment Process (FSAP) to devote time and attention to such issues.

Some of this already takes place. The FSAP focuses on compliance with standards and codes. The standards and codes applicable to financial supervisors (Basel Core Principles, IAIS Core Principles, IOSCO Core Principles) already address such issues as supervisory independence, including the need for adequate resources. The Core Principles are less helpful when it comes to supervisory incentives and on-site supervision. On-site supervision is characterised in the Core Principles as a method of verifying regulatory returns and it is hard to recognise modern risk-focussed techniques of on-site supervision in the standards. The Core Principles are also agnostic on whether on-site supervision should be carried out by the supervisor or outsourced to others. A review of the Core Principles should be carried out to strengthen those standards intended to address quality of supervision.

Changes are also needed to the FSAP process itself to shift some of the focus away from inputs (are the conditions and characteristics in place for the supervisory to supervise effectively?) to outputs (what supervisory results are achieved?). These are matters deserving of serious attention on the part of the IMF, World Bank and other stakeholders in the FSAP process.

8 Conclusion

There has been an impressive and unprecedented international effort to address causes of the global financial crisis and take steps to reduce the chances of future crises as well as minimising their impacts. Some worthwhile and potentially useful initiatives are underway. However, insufficient attention has been paid to the failings of micro-prudential supervision in the run-up to the crisis and to the role better micro-prudential supervision can play in enhancing financial stability. Unless significant improvements are made soon to the way micro prudential supervision is carried out in many countries, efforts to improve global and national financial stability may be frustrated.