Judgment Day

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Changing the rules alone cannot make the financial system safe. The judgment of banking supervisors is crucial

IN the wake of the global financial crisis, there have been numerous proposals to reform the oversight of the global financial system—from the Group of 20 advanced and emerging economies (G-20) and international standards setters. Nearly all of the proposed reforms focus on strengthening bank-centered regulations, such as capital, liquidity, loan loss provisioning, or compensation arrangements. These enhancements, particularly higher capital and liquidity buffers, should make the global financial system better able to absorb and provide more tangible backstops to curb excessive risk-taking at banks.

Still, changing rules alone is insufficient to foster financial stability *if* the quality of their application—that is, supervision—is not effective. The business of banking supervision—and the risk management practices of banks—remains inherently subjective, regardless of the imposition of new, or tightening of existing, rules. For this reason, the proposed regulatory reforms are akin to "trying to prevent another outbreak of H1N1 through high level epidemiological planning, without involving the doctors and health workers on the ground" (Palmer, 2009).

Strengthening micro-prudential supervision should be at the forefront of the global reform agenda and is the linchpin in fostering financial system stability. Enhancements to macro-prudential supervision (which focuses on an assessment of common shocks affecting the broader financial system), although necessary, are beyond the scope of this article.

Two sides of a coin

Regulation and *supervision* are often used interchangeably when describing the official sector's role in the oversight of the banking system. In practice, regulation and supervision serve two distinct but related functions:

- Laws and regulations are the collective set of rules that provide the banking authority with powers to license banks, set minimum operating and risk management standards for banks, and take necessary corrective measures—including revocation of banking licenses—in problem bank situations. The main intent is to require bank management to behave prudently because banks are the guardians of depositor funds.
- Supervision is the authorities' means of implementing these rules through ongoing off-site surveillance and periodic on-site examinations of individual banks. Supervisors carry out these tasks by evaluating banks' corporate governance, internal controls, and risk management practices;

their financial capacity; and their compliance with various laws and regulations. Based on their risk assessments, supervisors are also responsible for taking timely actions against problem banks or problems in banks.

Supervision traditionally has taken a back seat to regulation within the international reform agenda for two main reasons. First, its application is local and context driven. Second, it is a far more complex "fix" than strengthening regulations. Regardless, the lack of international focus on the practice of supervision has unintended consequences.

An example is the formulation and implementation of the Basel II capital accord, whose stated objective is to strengthen financial stability through enhanced capital requirements, better supervision, and robust market discipline. In practice, the overwhelming focus of Basel II was on the technical construct of regulatory capital, with limited emphasis placed on strong supervision until very late in the process.

Because the architect of Basel II (the Basel Committee on Banking Supervision) is also the international standards-setting body for bank regulatory and supervisory standards, the relative importance *it* places on supervision often influences—or in many cases reinforces—the preexisting biases within some national regulatory bodies that regulatory policy development is a more important function than the activities of front-line supervisors. This perspective, if widely held, has significant implications for both resource allocation and the prioritization of internal reforms within each jurisdiction. Thus, the starting point in the reform agenda begins with changing *our collective mindsets* on the importance of strong supervision in fostering financial system stability.

Judgment is essential

Strong supervision is premised on the *ability* and *willingness* of supervisors to take timely actions (Viñals and Fiechter, 2010), according to an IMF staff position note. To have the ability to act, supervisors must possess sufficient legal authority and resources, a clear strategy, and strong working relationships with other regulators. To have the willingness to act, supervisors must have a clear mandate, operational independence, accountability, skilled staff, and a healthy relationship with the banking industry that still is distant enough to avoid regulatory capture (in which the regulator identifies more strongly with the regulated than the public interest).

Beyond these critical elements, perhaps a more fundamental reason why good supervision remains elusive is because it relies heavily on the ability of supervisors to exercise *sound judgment*, often on complex issues that are neither black nor white. This innate characteristic of supervision has been amplified by deregulation across major financial centers, where banking laws or regulations no longer prohibit or prescribe explicit constraints on the scope or size of a bank's risk-taking activities, as long as banks and their management are judged—by supervisors—to have robust risk management systems and sufficient capital to support the underlying risks.

Herein lies the hidden risk in the prevailing construct of banking system oversight: there is no benchmark as to what constitutes *sound risk management* or *adequate capital*—arguably the two most critical factors to constrain the excessive risk-taking activities of banks. This, in turn, highlights the critical role of informed supervisory judgment in fostering a safe and sound banking system. Any time the effectiveness of a profession hinges on its ability and willingness to exercise sound judgment, the likelihood grows that vested interests—the industry, politicians, and the regulatory authority itself (interference from the top)—can influence the decision-making process.

Not a mechanical exercise

Little known outside of the arcane world of banking regulation is that nearly all banking rules—whether they relate to risk management, capital adequacy, or the design of corrective action programs against banks—are subject to and heavily reliant upon informed judgment by supervisors. In this regard, there are two formidable challenges:

- Regulations are almost always minimum requirements and rarely depict what is appropriate for each bank. Thus, a fundamental prerequisite to the proper application of rules is a supervisory mindset that views banking rules as floors rather than ceilings. If supervisors adopt the philosophy that requirements are ceilings, they will never seek to go beyond prescribed regulations during the examination and surveillance process.
- Supervisors must be able and willing to implement rules based on a regulatory concept known as "proportionality," which requires them to tailor the application of rules to each bank—based on its size, complexity, or risk characteristics—rather than to apply a "one-size-fits-all" approach.

For these reasons, *how* supervisors implement rules is critical because it sets the context for the *discovery* process—through which supervisors unearth the specific facts used to form conclusions about an institution's overall risk profile, which drives the nature and severity of any subsequent supervisory actions. Thus, the effectiveness of the entire supervisory review process hinges on the supervisors' ability and willingness to interpret rules as "floors" and to appropriately apply those rules specifically for each bank, consistent with a safety and soundness mindset.

To illustrate the subjective nature of rules, consider risk management, capital adequacy, and supervisory actions.

Risk management: The first line of defense against financial instability at individual banks, or in the banking system as a whole, relies on the quality and effectiveness of the risk management practices at each bank. For this reason, many of the key regulatory standards or supervisory expectations focus on the ability of the bank's board and senior management to properly identify, monitor, measure, and control its material risk exposures. Supervisors are expected to take actions against banks in which significant risk management shortcomings are identified, even if reported capital remains strong.

Exactly what constitutes sound risk management is not clear cut and is influenced by many factors, including the bank's size and complexity; the nature of its material risk exposures; the perceived sophistication of the bank's risk models, particularly at large and complex banks; the supervisor's competence and personal experience with other banks' risk management systems; and risk management norms that prevail in the country at that point in time. Adherence to prevailing norms can lull supervisors into a false sense of security or delay their taking actions, if the entire industry is engaging in weak risk management practices—for example, by degrading loan origination standards.

Capital adequacy: The application of judgment is also relevant in evaluating capital adequacy, which appears to be a quantitative question but in fact is largely a qualitative assessment. Although most jurisdictions have adopted global capital rules—which require a minimum 8 percent ratio of capital to risk-weighted assets—the accuracy of the ratio is premised on, among other things, the reliability of asset valuations of bank balance sheets. Those valuations are difficult, especially when they involve problem loans and other hard-to-value assets for which there are no observable market prices and whose assigned values depend on many assumptions. Because banks are highly leveraged, a small miscalculation in asset valuations can lead to a large impact in reported capital ratios. For example, a 4 percent decline in asset values equates to a 50 percent drop in the minimum 8 percent capital ratio, using a simple capital to assets measurement methodology.

A more complex challenge is determining how much capital is adequate—regardless of regulatory minimums—to ensure that capital levels are aligned with an institution's overall risk profile. This assessment is particularly critical during an expansionary cycle, when a combination of relaxed loan origination standards and easy credit allows marginal borrowers to *refinance*—rather than to repay—their debt obligations, which leaves the impression of low default risk. Because of the procyclical bias of capital measurement techniques, this low level of "observed" default risk is fed into bank risk models, which results in an underestimation of required capital for both regulatory requirements and the bank's own internal benchmarks.

It is during this time that a robust *supervisory* assessment of capital adequacy—one which challenges the prevailing consensus—becomes critical to constrain excessive risk-taking. Key decision-making inputs, all of which are judgmental, include the nature, size, direction, and stressed results of an institution's material risk exposures; the quality of its risk origination and management practices; economic forecasts; asset growth projections; and the reliability and size of internal sources of capital from retained earnings.

Supervisory actions: In most countries, the menu of supervisory actions is discretionary, which allows authorities to fit the punishment to the crime. Therefore, the design and effectiveness of supervisory actions depend first on the supervisor's *ability* to identify the key problems and second on its *willingness* to follow through with the appropriate actions. Both ability and willingness depend on many preconditions, including adequate legal protection of the supervisor and institutional will of the supervisory authority.

To minimize the propensity of supervisors to delay taking timely actions, some countries have adopted prompt corrective action (PCA) provisions. PCAs, which were introduced in the United States in the early 1990s, include both mandatory and discretionary actions that are triggered once a bank's capital ratio falls below the minimum 8 percent threshold, with the mandatory actions becoming more severe the farther capital declines below the benchmark.

However, PCAs are not a panacea in restricting supervisory judgment. First, the term "prompt corrective action" is misleading. It is a *lagging* indicator that is triggered only after capital falls below regulatory thresholds. In other words, PCA provisions do not require any actions if bank capital remains above regulatory minimums, even if there might be other significant problems unrelated to capital. A more fundamental and forward-looking challenge is to determine *whether*, *when*, and *what* actions should be taken against banks that report higher than the minimum regulatory capital, but have identified weaknesses in risk management or other safety and soundness concerns. This remains necessarily a discretionary process, because the perceived type and severity of the identified shortcomings and the supervisor's view on whether management has both the ability and willingness to address the weaknesses on their own could vary.

Second, even when PCA becomes relevant, the timeliness of mandatory PCAs is based on the accuracy of reported capital ratios, which are premised on the reliability of a bank's asset and loan valuation practices. That, as outlined above, is itself an inherently assumption-dependent process. And when banks are close to breaching the minimum capital rules, they have incentives to apply overly optimistic valuations to their problem loans and other hard-to-value assets to keep reported capital from falling below the threshold. Thus, supervisory judgment—backed by critical analysis—remains essential to ensure that bank's reported capital ratios are accurate, so that the established PCA triggers *can* be activated in a timely manner.

The supervisory reform agenda

Given the importance of informed judgment to the implementation of all banking rules, it is imperative that policymakers focus as much time on strengthening supervision as on changing the rules themselves. Strengthening supervision may be the more important and far more difficult task. Although there are calls to curtail supervisory discretion, this is not a feasible option unless policymakers are willing to raise minimum capital and liquidity requirements to an extent that would have dire consequences for credit intermediation and job growth. Therefore, policymakers must begin to focus efforts on the *countercyclical promise* of supervision by strengthening supervisory practices. A difficult question is how to enhance the quality of supervision. Here are some possibilities:

Establish a robust supervisory culture within each regulatory authority. Although the concept of a supervisory culture is abstract, it is simply the collective set of values, beliefs, and behaviors that are rewarded within each regulatory body. This begins with the appropriate tone set by, and the actions of, the leaders of the regulatory authority, which set the broader context within which day-to-day supervision operates. A strong supervisory culture requires operational independence (from the government and industry) and encourages the independence of individual supervisors. It places an overriding focus on safety and soundness, and promotes the use of intrusive supervision, if needed, to enforce its views. This troika of independence, safety and soundness, and intrusive supervision at both the institutional and individual supervisor levels is the cornerstone of a robust system of micro-prudential supervision.

Beyond this, the political dimension of banking supervision cannot be ignored, given that the banking system is at the core of the power play in all countries. As such, a strong culture of supervision requires an enabling political system that recognizes (through legislation) and respects (through minimal political interference) the sanctity of independent prudential regulators who can call the plays as they see them regardless of the players— or politics—involved.

Strengthen the ability and willingness of supervisors to exercise sound judgment. The demands placed on supervisors are enormous. They are required to master many roles, including risk manager, financial analyst, accountant, lawyer, investigator, forecaster, and financial economist. In addition, they are expected to make conclusions that form the basis of early supervisory actions, based on evidence that often involves micro-level technical minutiae. Above all, they must be able and willing to lean against prevailing headwinds and to say "no" even when society is saying "yes." And they must recognize that bad times also come to an end. This requires an ability to look beyond the present and necessitates a formidable set of conceptual, analytical, decision-making, and communication skills, not to mention a "sixth sense" and intestinal fortitude that can take years to develop. That is a tall order, particularly in societies and organizations—like some central banks and supervisory authorities—that traditionally reward conformity and preservation of the status quo.

As a starting point, each regulatory authority must ensure that its culture, compensation, and promotion practices are sufficiently attractive to recruit and retain high-caliber individuals with the skills needed to thrive in supervision. In addition, a robust, ongoing, and well funded in-house training program that keeps pace with market developments is an absolute must to build and to sustain supervisory capacity.

Develop a constrained, discretionary approach to supervision. Consideration should be given to developing a system of tripwires that would require certain actions against banks that report good financials, but have identified weaknesses in risk management, to promote early supervisory intervention. In this regard, the tools, methodologies, and handbooks used for day-to-day supervision must strike the right balance between encouraging sound judgment while ensuring structure and consistency to the risk assessment process. That dual approach should result in a system of constrained discretion.

Require systemically important banks to downsize if supervisory resources are insufficient in relation to the size and complexity of the regulated entity. The links between a bank's size and the ability of authorities to supervise it cannot be ignored. If a bank is too big to supervise, it suggests that supervisors do not have sufficient means to independently test and properly validate the integrity of a bank's risk management systems, and are limited to conducting high-level "process" reviews of the bank's policies, procedures, and limits. In such circumstances, the supervisor *must* rely on the bank's own assessment of risk—a situation now viewed as a key shortcoming in the run-up to the financial crisis that began in 2007. Unless regulatory authorities are willing to bet that bank management will exert greater self-discipline during the next expansionary cycle, a robust approach to reducing risk-taking is warranted in the oversight of banks that are too big to supervise.

Design a sustained set of longer-term programs to enhance both the pool and quality of professionals in financial supervision. Supervision is too important for society to outsource training to each regulatory authority. There have been calls to make financial supervision a recognized university academic discipline. As such, international standards setters and leading supervisory authorities could collaborate with academic institutions to establish graduate degree programs in financial supervision. Additionally, there should be a globally recognized certification program for financial supervisors. The certification process would be based on a combination of practical experience and multilevel rigorous testing of technical competency and critical thinking skills that replicate the daily challenges of supervisors. Over time, the certification could become a "gold standard" and facilitate career mobility across jurisdictions.

A chance to reshape

The financial crisis has provided policymakers with a once-in-a-lifetime chance to reshape the regulatory and supervisory architecture that governs the global banking system. So far, reform efforts have focused overwhelmingly on the regulatory landscape, with limited consideration given to the *art* of supervision and its critical role in fostering financial stability. It is time to lift supervision out of its black box and place it in the center of the global reform agenda. Perhaps one of the most important lessons of the recent financial crisis is that there is no substitute for strong supervision. It is in the collective interests of policymakers, politicians, and the broader public to support the efforts of supervisors, especially when they swim against the tide of conventional wisdom and take on powerful vested interests, including government policy itself, to safeguard financial stability. ■

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