Effective Supervision: Ability and Willingness to Act

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The global financial crisis taught us many lessons.

No other financial crisis since the Great Depression has led to such widespread dislocation in financial markets, with such abrupt consequences for growth and unemployment, and such a rapid and sizable internationally coordinated public sector response. Behind this response was the acknowledgement that these costs have been imposed partly as a result of systemic weaknesses in the regulatory architecture and on the failure of supervisors to rein in the excessive private sector risk taking.

A key lesson is that supervision is incredibly important. Countries with the same set of rules had very different experiences during the crisis. Why? There are clearly many reasons but a key one is “better supervision.” After all, rules are only as good as their implementation.

The role of the financial supervisor is unique. They are there during the birth, life, and death of the institutions they supervise. They license them, monitor them, lay out the rules, guide them, penalize them, and step in when they fail.

These are hefty responsibilities. And unfortunately, supervision often comes up short.

Today, I will talk about

- lessons from the Fund’s work on effective supervision,
- lessons from the recent crisis,
- the key attributes of a good supervisor,
- the importance of ability and willingness to act and
- conclude with some implications for Iceland.

Lessons from the Fund's work on effective supervision

Following the Asian crisis, in 2000, the Fund started assessing the effectiveness of the policy response framework in the context of Financial Sector Assessment Programs (FSAPs). The assessment of effectiveness of banking supervision became a critical component of the FSAP.

These assessments identified important gaps in supervision.

- **Risk supervision—**the deficiencies include inadequate tools to evaluate banks' risk management approaches and the absence of authority to require banks to hold capital against such risks.
- **Consolidated supervision—**weaknesses identified include the lack of reliable consolidated information; ability and skills to examine and supervise some financial activities; and the lack of direct access to holding companies.
- **Enforcement—**while most countries had a range of legal powers to take action, powers were not applied consistently and regulatory forbearance was used often.

  Looking at assessments based on the revised principles (we have some 20 so far), it is striking that no country has been assessed as fully compliant on **supervisory independence and resources**.

Lessons from the crisis: what caused supervision to take its eyes off the ball?

The regulatory framework certainly was part of the reason. Regulations did not capture adequately the risks that banks were exposed. And this is why the BCPs were revised in 2012.

Also, the regulatory perimeter was not expansive enough and did not take into account the buildup of risks in the shadow banking system.

And, we have to acknowledge that in some cases, supervision failed to recognize and address some growing risks, and thus contributed to the financial crisis. To give some specific examples:

- **Not intruding sufficiently into the affairs of regulated institutions**. In some cases, supervisors were too deferential to bank management. Reliance on market discipline turned out to be misplaced in some cases. [Market discipline seems to work only in bad times!] Institutional investors relied excessively on rating agencies. Rating agencies, in turn ignored the conflicts of interest in their business models.

- **Not being proactive in dealing with emerging risks**. Supervisors did not in all cases have a capacity to identify risks, or when identified, to act on them. They did not dig deeply enough into the implications of some complex products, nor address the increased dependence of many institutions on short-term wholesale funding.

- **Not being comprehensive in their scope.** Supervisors focused on risks within the regulated system. We know now that there is a need to reconsider the regulatory perimeter—which must be wide enough to facilitate risk identification.

- **Not taking matters to their conclusion**. In some cases, supervisors were aware of the risks that were building up but did not take remedial action. The lack of coordination and information sharing among supervisors contributed to creating opportunities for regulatory arbitrage.

Examining these failures, we identified key attributes of good supervision to ensure that supervisors have the will and ability to act in all situations.

So what makes a good supervisor?

Supervision is not only about the task of implementation, monitoring, and enforcement of the regulations—but also assessing whether an institution's risk management controls are adequate, and whether the institution's culture and its appetite for risk significantly increase the likelihood of solvency and liquidity problems.

That is, the need to deliver "supervisory discipline" in an industry where market discipline is distorted by implicit and explicit government support. This requires "prevention" in normal times and "resolution" in times of stress.

Thus, a good supervisor should be intrusive, proactive, comprehensive, adaptive, and conclusive.

Intrusive. In-depth knowledge of the supervised entity

Proactive. Not worrying about taking the punch bowl away and restricting reckless banks during a boom—this is of course seldom appreciated but may be the single most useful step a supervisor can take in reducing failures.

Comprehensive and Adaptive. Keeping abreast of new products, new markets, new services, and new risks.

Conclusive—Following-up on identified deficiencies and gaps. This is really critical. We said it publically in the case of Spain where the supervisory agency (in this case the central bank) has highly experienced and respected professional staff, and are supported by good information systems. However, a gradual approach in taking corrective action has allowed weak banks to continue to operate to the detriment of financial stability.

How do we ensure ability and will to act? How do we learn to say “no”?

The ability to act depends on

- proper legal authority
- adequate resources
- a clear and well-defined strategy,
- a robust internal organization, and
- an effective working relationship with other agencies.

Even with all this in place, we still need to ensure the **willingness to fulfill the role of supervisor**.

This is often the hard part, and involves standing up to the vested interests.

For this to happen, the policy and institutional environment must support both the supervisory will and ability to act.

The assessments of the Nordic countries in the last years suggest a robust regulatory framework with adequate emphasis given to risk-based supervision. And gaps include issues with operational independence, staffing shortages, incomplete or weakly defined discretionary powers. These are all aspects that can undermine the effectiveness and timeliness of supervisory action.

What creates the will to act?

- **A clear and unambiguous mandate**. The supervisory agency must have clear objectives, ideally in relation to financial stability and systemic soundness, as well as the safety and soundness of particular institutions.

- **Operational independence**. Supervisory agencies should be able to resist inappropriate political interference or inappropriate influence from the financial sector itself. This needs to be reflected in the processes for appointment and dismissal of senior staff, stable sources of agency funding, and adequate legal protection for staff.

- **Accountability**. To balance independence, supervisory agencies should have to report to the public on their use of resources, key decisions, and as far as possible, the effectiveness of their supervision in relation to their supervisory objectives. It is important to ensure that agency performance can be assessed.

- **Skilled staff**. This is an issue that straddles both dimensions—the will and the ability to act. Staff must be able to respond to changes in industry practices with confidence. Rigorous hiring processes are required, as well as scope to offer competitive remuneration packages to attract and, as importantly, retain expert supervisory staff.

- **A healthy relationship with industry**. Supervisors should be able to dialogue with industry but maintain an arm's-length relationship. Agencies should have policies on the turnover of staff devoted to the supervision of individual institutions and on the movement of their staff into employment with regulated institutions. Strict ethics codes are necessary to protect and preserve the will to act.

- **An effective partnership with boards**. Supervisors should hold boards responsible for the performance of the institutions they oversee. They should ensure that boards and individual directors are sufficiently empowered and informed both to understand emerging risks within an institution and to respond appropriately to those risks.

What does this mean for Iceland and what are the challenges ahead?

It was clear that prior to the crisis, supervision in Iceland was hindered by lack of qualified persons, information systems, and a consistent risk-based framework.

Since the crisis, much has been done.

Authorities took steps to improve banking regulation and supervision.

- Several pieces of legislation have been proposed to keep it up to date with the evolving regulatory landscape at the regional (EU) and international level;
- new powers have been granted to the Financial Supervisory Authority (FME);
- a national credit registry has been established;
- tougher provisions on large exposures, connected lending, and fit and proper requirements for owners have been introduced.

The FME has engaged in a multi-year supervisory reform program and started implementing a risk-based supervisory approach. This will reinforce its ability to adequately diagnose the health of the banks and of the financial system.

The FME is also working on incorporating business model analysis in risk-based supervision.

And we are here to provide support – the Fund is engaged into a comprehensive technical collaboration program aimed at building a robust framework for risk-based supervision, drawing also from the experience of other regulators.

What would be our wish list for the FME:

- authority to issue prudential regulations and legally binding guidelines;
- stronger early action capacity, including ability to suspend distribution of dividends, bar individuals from the banking sector, and make board accountable;
- adequate funding to facilitate stronger operational independence and attracting and retaining skilled staff;
- improved internal frameworks and infrastructure, to build up necessary tools and processes and IT infrastructure to support the supervisory processes;
- full access to the banks' documentation when on-site; and to regularly receive prudential reports for their off-site controls;
- stronger collaboration with the central bank.

With respect to staffing, let me point out that risk-based supervision can only be effective if it relies on informed, qualitative judgments made by qualified and experienced staff. It is essential that guidance and training are provided to staff for performing supervisory reviews of the banks' risks.

The challenges of lifting capital controls

The liberalization of the capital account should boost confidence and private investment and raise long-term growth.

But the transition will no doubt be a challenge in many respects, not least for the financial sector and the FME in particular.

In the banking system, there are still unresolved legacies (i.e. ownership and funding links with the old banks).

The gradual return to “normality” presents both opportunities and challenges for the Icelandic financial sector.

And this is when the supervision will be put to test once again.

On the one hand, the financial market players will have better risk and income diversification opportunities, but on the other hand may be tempted to take on new risks, which may not be fully understood or well managed.

The FME will have to be there, always one step ahead, anticipating what new risks may be emerging and threatening the safety and soundness of banks or the financial stability.

To conclude….

Improving bank supervision should not be viewed as an isolated task: good bank supervision is a public good – it contributes towards lasting financial and macroeconomic stability.

Strong supervision need to be complemented with strong financial safety nets—that is an effective bank resolution regime, a good deposit insurance guarantee framework, and a clear and transparent emergency liquidity framework.

Restoring the trust in the financial sector and financial supervision is not an easy task. The crisis has taken a hard toll on Iceland and the healing is taking time.

Many good and important steps have been taken to strengthen the financial sector supervision and the authorities are very committed and engaged in their reform program.

Such efforts are laudable and have to be sustained.

But there is no room for complacency. Iceland has a window of opportunity to reinforce its financial sector infrastructure ahead of the capital controls liberalization.

This is the time to ensure that a proactive, intrusive, and conclusive approach to supervision is emerging a strong pillar of financial and economic stability.

As always, the Fund stands ready to provide support this important objective.