Financial Supervision in the 21st Century

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Editors

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Foreword

What distinguishes this book is that it is not just about the last crisis and not very much about the law.

Most of the analyses that have appeared in the wake of the Global Financial Crisis (GFC) explore the nature of regulations which, if only they had been in place, might have averted the disaster or mitigated its effects. But that particular form of learning seems narrow and partial compared with what we need to minimize, i.e. the likelihood and severity of future crises. Spectacular failures in complex systems are nearly all novel. As with the forensic debriefing of commercial airplane crashes, we know how—by prescribing control enhancements based on retrospective investigations—to ensure that any particular accident that happened once can then never happen again.

As the GFC unfolded and was quickly dubbed a regulatory failure, critics questioned whether US regulators had learned anything at all from the Savings and Loans crisis of the 1980s. The answer was clearly yes; they had learned how to prevent another Savings and Loans crisis. But lessons drawn from the 1980s did not much help financial regulators anticipate or head off a sub-prime mortgage crisis, or understand the destabilizing implications of risk exposures based on Credit Default Swaps. Dissecting the last crisis is always necessary but never sufficient.

Nor is it sufficient to focus only on the content of the law, for two reasons. First, important risks often have nothing to do with noncompliance. Many serious road accidents and most plane crashes occur without anyone having violated a law. Causes can include mechanical failure, tiredness, carelessness, distractions, or unpredictable interactions among complex systems. Likewise, instability in financial markets may result from a range of causes—for example, unhealthy correlation in exposures or unforeseen interactions between computerized trading algorithms—which do not involve violations by anyone and which are unlikely to be controlled through any set of standard or static regulatory requirements enforced at the level of specific firms. But such risks to markets, investors, and financial systems nevertheless need to be spotted, studied, understood, and controlled, despite not being amenable to traditional forms of regulation.

Second, focusing solely on the state of the law overlooks the enormous difference that professional regulators (or "supervisors" as the Dutch call them) can make. These professionals stand between the law as written and societal protections as delivered. It matters how regulators organize themselves and what methods they use to prioritize attention and target resources. It matters what skills they develop. It matters what forms of discretion they recognize and exercise and how they explain and defend the choices they must inevitably make. It matters whether they understand the disparate motivations of the regulated community and whether they have mastered the full range of techniques for managing compliance and influencing behavior. It matters what forms of analysis they conduct and intelligence systems they use, as those choices will largely determine which risks they can see and which ones they may miss. It matters what forms of relationship they establish with the industry and whether purpose is sacrificed for comfort. And, perhaps most significantly, it matters a great deal whether they address themselves only to the narrow task of compliance-management or whether they assume the broader challenge of identifying and controlling risks.

By focusing on regulatory *practice* rather than regulatory law, the chapters in this book tackle important contemporary questions for professionals: What is "quality supervision"? What is the relationship between enforcing regulations and managing risks? On what basis might one determine whether to choose rule-based, principle-based, or self-regulatory structures? Can regulators address system-level risks? If so, what is the relationship between that task and the more familiar work of managing firm-specific behavior? How do we measure regulatory performance in the absence of any recent disaster? How should we evaluate it in the wake of a disaster? Do we only know how to describe regulatory failures, looking backward, or can we actually specify best practice, looking forward?

All these questions, of course, have relevance far beyond the field of financial regulation. Similar questions are being asked across the entire regulatory frontier by those concerned with controlling different risks, such as crime, pollution, occupational and transportation hazards, terrorism, corruption, and disease.

Most of the questions this book examines were being considered *anyway*, although at a more leisurely pace, even before the Global Financial Crisis (GFC) erupted. The reason we have this particular book at this particular time, written by a set of leading financial regulators from around the globe, is that the GFC shook financial regulation to its core, making change more urgent, exposing the inadequacy of traditional approaches, intensifying debate, and accelerating the processes of experimentation and innovation. More has happened lately, therefore, in this domain than in most other regulatory domains. Therein lies the value of this collection of chapters for a much broader regulatory audience: the chance to share the benefits of financial supervision's recent ferment and accelerated learning.

The questions about regulatory practice that were being asked anyway, and which have been asked so much more intensively in the wake of the crisis, boil down to this: "What does it actually mean to be an effective risk-based regulator?" Many regulators adopt the rhetoric of a risk-based approach, but struggle to define the implications for operations.

We have learned from a spate of recent catastrophes (terrorist attacks, mining disasters, Hurricane Katrina, the Japanese earthquake and tsunami, as well as the financial crisis) what the public expects of their governments with respect to risk control. Citizens do not expect that governments will be able to avoid all disasters or contain all harms. But they do expect government agencies to provide the best protection possible, and at a reasonable price, by being:

(a) *Vigilant*, so they can spot emerging threats early, pick up on precursors and warning signs, use their imaginations to work out what *could* happen, use their intelligence systems to discover what others are planning, and to do all this even before much harm is done
(b) *Nimble*, flexible enough to organize themselves quickly and appropriately around each emerging risk rather than being locked into routines and processes constructed around the risks of a preceding decade, and being more problem-centric than program-centric
(c) *Skillful*, masters of the entire intervention toolkit, experienced (as craftsmen) in picking the best tools for each task, and adept at inventing new approaches when existing methods turn out to be irrelevant or insufficient to suppress a risk[1]

These notions are fundamental to effective risk control. The chapters in this book put flesh on these bones with a lot of practical experience and novel ideas. To give a few examples: In terms of *vigilance*, the contribution of Kellermann and Mosch describes the importance of thematic analysis and research as a supplement to more traditional forms of firm-specific monitoring, particularly given the significance of macro-prudential risks. As risks come in many different shapes and sizes, it helps to slice and dice the world from a variety of perspectives. Some risks result from specific forms of noncompliance by one firm. But others have to do with specific types of financial products, or investment instruments, or marketing methods, or categories of vulnerable investors, or market instabilities of one kind or another caused by regrettable correlations or collective behaviors. Using a broader range of analytic lenses and perspectives increases a supervisory agency's chances of spotting anomalies and understanding emerging threats early.

In terms of organizational *nimbleness*, the contribution of Houben explores the practical implications of the complex relationship between macro-prudential (i.e., system issues) and micro-prudential (i.e., firm-specific) considerations and describes the search for organizational designs that support effective collaboration between differently focused units. Addressing the merits of alternative regulatory *structures,* de Vries provides a thoughtful and practical discussion of the paradoxes of principle-based supervision, which leads to useful and nuanced guidance for supervisors as they contemplate whether and where to use rule-based, principle-based, or self-regulatory structures for different classes of risk. And as many European countries shift variously among *sectoral*, "*twin peaks*," and *single supervisor* oversight structures, the contribution of van Hengel, Hilbers, and Schoenmaker provides a

[1] This summary framework was originally presented in Sparrow (2012).

risk-focused analysis, specifying which classes or risks might be better managed under which structure and how best to handle the conflicts of interest that can arise between prudential and market-conduct supervision. Their chapter also addresses the design of multi-tiered regulatory structures, promoting a rational approach to determining which regulatory tasks ought properly to belong at the European level rather than national level and how best to structure the European controls.

In terms of *skillfulness*, the contribution of Richards explores the considerable range of tools available to regulators for influencing behavior and shows how to pick the right tools for the job by matching different methods to differing motivations and attitudes. Kellermann and Mosch emphasize the importance of skills-based education for supervisors, with a view to enhancing personal effectiveness, assertiveness, and confidence when dealing with powerful industry players. The contribution of Adams discusses the particular set of communication skills essential to risk-based regulation: how to shape public expectations, how to communicate risks in the absence of catastrophe, and how to procure a suitable and sustainable level of attention and appropriate tolerance for regulatory impositions.

The contribution of Nuijts and de Haan examines the prospects for “culture and conduct regulation,” recognizing that some risks stem from incentive schemes that induce unwise or illegal behaviors in order to meet short-term performance-based goals. These authors describe the Dutch Central Bank’s pioneering efforts to improve firms’ underlying decision-making frameworks, orienting them more closely to long-term stability. To do this, DNB has exploited the existing research literature on what characterizes “high-performance” organizations, and deployed organizational psychologists and change experts (alongside auditors, economists, and lawyers) to examine Board and executive-level decision-making processes. The attempt to diagnose “culture and conduct” in order to get at the roots of excessively risky behaviors is certainly ambitious. Many regulators might suspect this is not possible or question whether it pushes regulatory intrusiveness too far. But Nuijts and de Haan describe how DNB defends this approach and has actually implemented it using as diagnostic tools a combination of desk-research, interviews, organization-wide surveys, and observation of Board or executive-level meetings, and how DNB supervisors have been able to provide feedback and guidance to firms where defects in culture and weaknesses in decision-making became apparent.

In my view, the chapters collected in this book provide a rich set of landmarks in a terrain that a great many regulatory practitioners—financial and otherwise—are already exploring. This book helps clarify the aspirations of modern regulatory professionals as they confront increasingly complex and rapidly evolving risks. It highlights the strategic and organizational challenges a supervisory agency faces when it shifts its overarching framework from compliance-management to risk control. And it provides an illuminating collection of innovative ideas, many of which could readily and usefully be translated into other regulatory settings.

I heartily commend it to you.

Malcolm K. Sparrow

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Sparrow MK (2012) The sabotage of harms: an emerging art form for public managers, ESADE Institute of Public Governance & Management, E-newsletter, March 2012 (published in English, Spanish & Catalan)

Preface

After the recent financial crisis, regulations applying to the financial sector have rapidly become stricter along many dimensions. Financial institutions that were not supervised are now brought within the scope of supervision, while those that were already subject to supervision now must comply with stricter rules. For example, new regulations require financial institutions to hold higher capital buffers so they can better withstand possible crises in the future and require them to have crisis and resolution plans in place.

However, the financial crisis has not only triggered developments in legislation and regulation focusing on banks and financial institutions. The performance of those responsible for supervising the financial sector was called into question as well. Did supervisors have appropriate powers and were they making adequate and effective use of these powers? Was the way supervisors operated still appropriate, in view of the rapid changes that the financial sector had undergone? Had supervisors, in a rapidly changing society, been over-reliant on the moral suasion that had traditionally proved so effective in prompting financial institutions to comply with standards? And were supervisors actually able and willing to say "no" to a sector that contributed so much to society's prosperity in good times? These questions were asked by the general public and by parliaments to which the supervisors are accountable.

The financial crisis also prompted financial supervisors themselves to take a critical look at their own performance. In the UK, the Turner Review made recommendations for the supervisory approach to be adopted (FSA 2009). De Nederlandsche Bank, the prudential supervisor in the Netherlands, published a new Supervision Strategy for 2010–2014 that translated the lessons learned from the crisis into a new method of supervision and new areas of attention for supervisors (DNB 2010).

Over the past years, supervision itself and the methods that supervisors apply have undergone fundamental changes. The "toolkit" available to supervisors is considerably more varied than it was a few years ago. Traditionally, supervisors

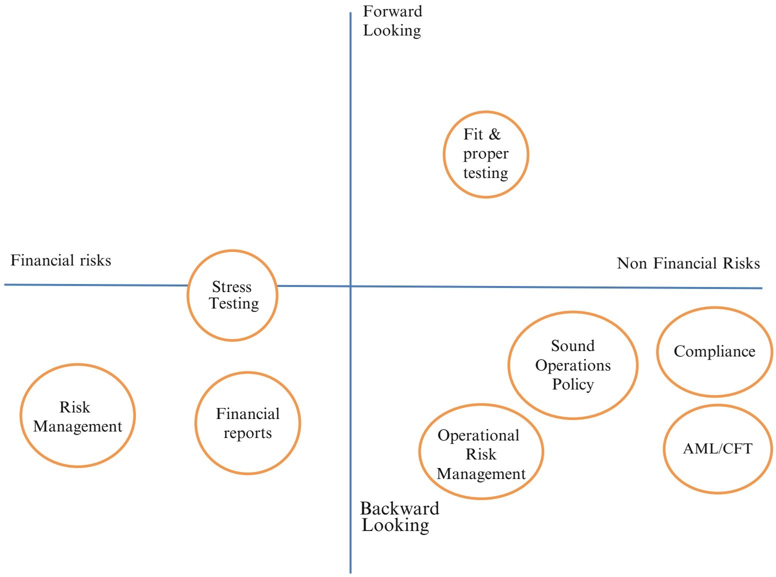

Fig. P.1 Supervision before the crisis

concentrated on financial risk indicators, such as solvency and liquidity ratios. Their focus was mainly backward looking, their assessment of risks based on reports of "past" financial performance and the existence of organizational procedures (see Fig. P.1). During the financial crisis, supervisors have encountered the limitations of this approach. One of the main lessons supervisors learned was that they were often powerless by the time a financial institution's problems were reflected in its financial performance figures. Therefore, supervision had to become more forward looking, taking into account also soft controls, such as "conduct and culture" and business models of financial institutions.

The crisis also made it clear that financial institutions are far more interconnected with each other and with the real economy than had previously been thought. Supervision should hence adopt a stronger macro-perspective and should look beyond individual institutions. As a result, the areas of attention of the financial supervisors were complemented with a number of new risk areas. In addition, benchmarking and thematic research complemented the traditional focus on individual institutions. As Fig. P.2 shows, this resulted in a more forward-looking and comprehensive or holistic way of supervising.

In their search for a more comprehensive view on the financial sector, supervisors have also turned to other parties, such as accountants, actuaries, and other external and internal supervisory bodies that play a role in the system of checks and balances of financial institutions. In addition, supervisors have actively sought to expand their toolkit beyond the traditional formal sanctions such as fines and instructions, since these instruments often proved to have limited preventive power. Instead, they focus more on influencing the behavior of the actors in the

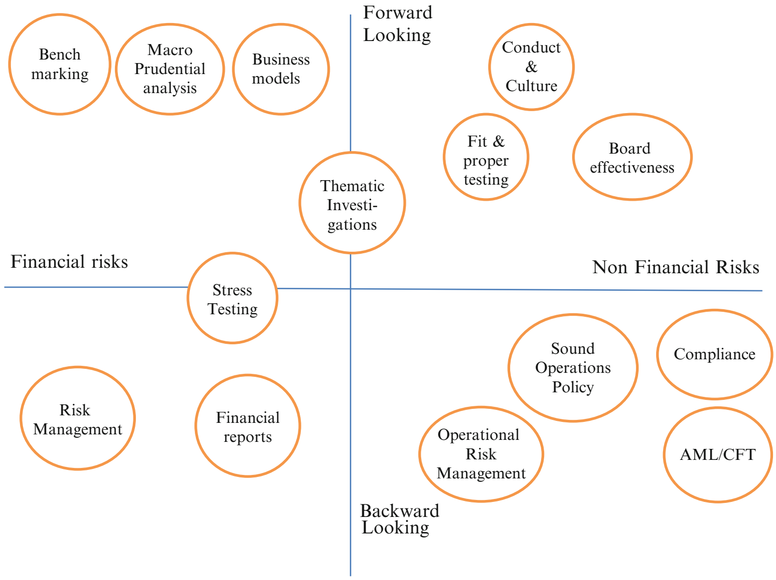

Fig. P.2 Supervision after the crisis

financial sector and have started to use communication as a tool in reaching their supervisory objectives.

Supervisors have also looked at how best to arrange their activities internally so as to ensure effective supervision, while there have also been substantial changes in the past few years in supervisors' internal quality management and in how they assess their impact.

Despite these rapid and interesting developments in the "art of supervision," hardly any attention has been paid to these developments in the academic literature. Publications, apart from a small number of supervisors' policy documents and reports of (parliamentary) inquiries, focus on the content of new regulations for financial institutions and their consequences, while developments in supervision itself have remained under the radar screen. While it is difficult to capture what we mean precisely when we speak about supervision, which is often referred to as an art or a craft (Sparrow 2000), it is clear that without a vibrant, innovative, and flexible supervisory culture, no regulation, old or new, will be successful.

The crisis has taught us that financial supervisors must evaluate and develop their working methods permanently to keep up with the rapid development within the financial sector. There are many experiences that warrant exchanging knowledge across borders, and we have tried to bring together a number of supervisors to foster this exchange, in search of best practices from around the world. This collection of chapters discusses several significant changes in supervision methods and supervisory organizations and examines what methods contribute to "good supervision" and what can reasonably be expected of supervisors.

The question of whether these changes are sufficient to prevent or control a new crisis can only be answered many years from now. Supervision is a craft, not a science, and we can only aim at continuously improving our skills. We hope that this book will stimulate the debate and will contribute to the development of good supervision of the financial sector.

Amsterdam, The Netherlands

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List of Abbreviations

ABCP	Asset Backed Commercial Paper
ACP	Autorité de Contrôle Prudentiel
ADIs	Authorised Deposit-taking Institutions
AFM	Authority for the Financial Markets
AML	Anti-Money Laundering
APRA	Australian Prudential Regulation Authority
Bafin	Bundesanstalt für Finanzdienstleistungsaufsicht
BCBS	Basel Committee on Banking Supervision
BCPs	BCBS core principles on banking supervision
CEBS	Committee of European Banking Supervisor
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CCB	Countercyclical Capital Buffer
CCPs	Central Counterparty Clearing Houses
CDOs	Collateralized debt obligations
CDS	Credit Default Swap
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CGFS	Committee on the Global Financial System
CRAs	Credit Rating Agencies
COI	Expert Centre on Culture, Organisation and Integrity
CRD IV	Capital Requirement Directive
CRR	Capital Requirement Regulation
DIF	Deposit Insurance Fund
DNB	De Nederlandsche Bank
EBA	European Banking Authority
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervisors
ESCB	European System of Central Banks

ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FATF	Financial Task Force on Money Laundering
FDIC	Federal Deposit Insurance Corporation
FI	Finansinspektionen
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
GDP	Gross Domestic Product
HIH	Heath International Holdings (Australian insurance company)
HQLA	High Quality Liquid Assets
IAD	Internal Audit Department
IAIS	International Association of Insurance Supervisors
IIF	Institute of International Finance
IOPS	International Organisation of Pension Supervisors
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
LDD	Livret de Développement Durable
LEP	Livret d'Épargne Populaire
LIBOR	London Interbank Offered Rate
LTRO	Long-term Refinancing Operations
LVR	Loan to Value Ratio
MAS	Monetary Authority of Singapore
MB	Management Board
MD	Managing Director
MPR	Money Protection Ratio
NSFR	Net Stable Funding Ratio
OSFI	Office of the Superintendent of Financial Institutions
ORSA	Own Risk and Solvency Assessment
PER	Performance Entity Ratio
RBS	Royal Bank of Scotland
SB	Supervisory Board
SIE	Supervisory Intensity and Effectiveness Group
SIFIs	Systemically Important Financial Institutions
SMEs	Small and Medium-sized Enterprises
SMP	Securities Market Program
TARP	Troubled Assets Relief Program
Wft	Dutch Financial Supervision Act

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