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Editors

Financial Supervision in the 21st Century

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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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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

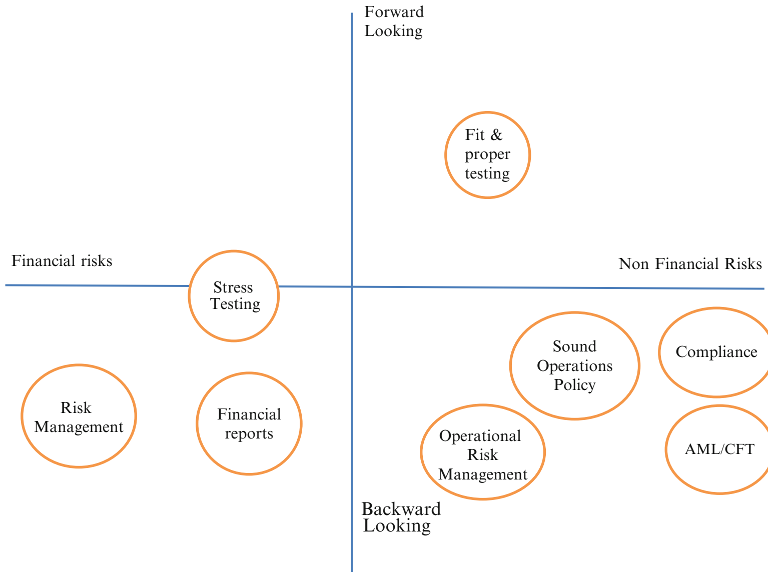

Fig. P.1 Supervision before the crisis

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

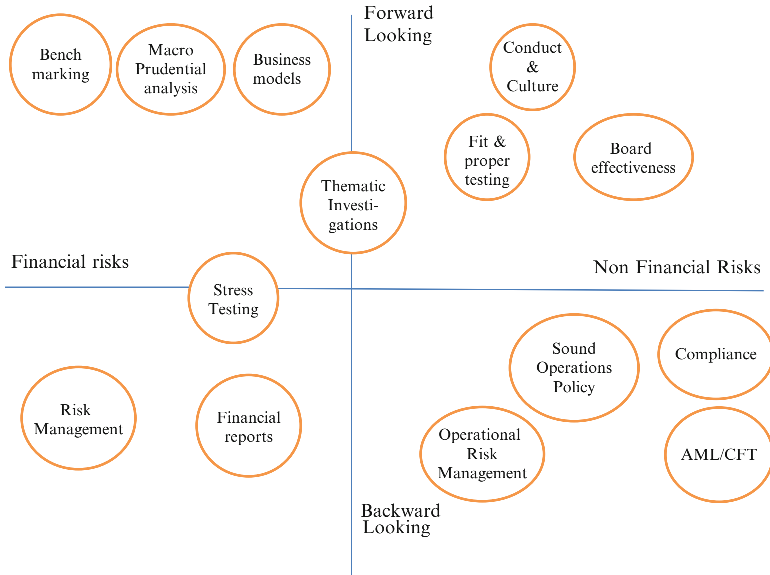

Fig. P.2 Supervision after the crisis

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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Chapter 1
Good Supervision and Its Limits in the Post-Lehman Era

A. Joanne Kellermann and Robert H.J. Mosch

1.1 Introduction

The financial crisis of 2008 took the community of regulators in the West largely by surprise. We all faced unprecedented events and were rocked by the waves of immense volatility that shook financial markets worldwide. It was a hard awakening from a prolonged period of relative calm in financial markets. The overriding shock, felt first in financial markets and subsequently in the real economies of the western world, was coupled with an intellectual shock, as many of the notions and beliefs we had about the workings of financial markets and how to regulate them turned out to be considerably less valid than expected. As a consequence, the common idea of what constituted good supervision was in disarray too.

On the policy front, the international regulatory community reacted quite rapidly[1] and soon many new regulatory policy initiatives for restoring and protecting financial stability began to take shape. Supervisors had daily contact with the financial institutions badly affected by the crisis. They soon realized that their work would never be the same again. However, to date, there are hardly any international initiatives[2] that focus on the methods and tools supervisors use in their day-to-day operations. So when supervisory authorities, such as De Nederlandsche Bank (DNB), felt the need to rethink their supervisory strategy and started to overhaul their supervisory culture, there were few precedents to build on.

At DNB, we were pleased to find some markers in the form of the five elements of good supervision as identified in the IMF staff position note 'The Making of

[1] G20 leaders issued a declaration on strengthening the financial system in April 2009, followed by an action plan on improving financial regulation by the FSB in May 2009 (G20 2009; FSB 2009).

[2] The 'principles for supervision' issued by international organizations of supervisors like BCBS, IAIS and IOPS are sources of inspiration in this field, but their rather high level of abstractness limits their practical use; the recently set-up review panels of EBA and EIOPA may be more promising.

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Good Supervision: Learning to Say No' (Viñals and Fiechter 2010). These elements guided and inspired us in designing our own version of good supervision. In this chapter we describe some of the major choices we made, why we made them and how we tried to implement them in our organizational structures, work processes and culture.

1.2 The Need for Better Supervision

What is good financial supervision? The academic answer is that good supervision is supervision (including regulation) that allows financial markets to operate more smoothly and that reduces the risk of market disturbance by countering the inherent market failures, notably external effects and information asymmetries (Barth et al. 2006; Brunnermeier et al. 2009). Given that trust is the foundation on which financial markets operate, fostering trust is central to supervision. Good supervision holds a close watch on the soundness of financial enterprises, hence protecting the financial interests of financial services customers, while at the same time contributing to the stability and integrity of the financial system. Most of the times, this comes down, de facto, to preventing accidents and defaults in the financial sector.

Although this definition does not give many concrete clues about how to implement good supervision, or how to determine your ranking on a scale of good supervision, we think it is fair to say that many supervisory authorities around the world were pretty confident that they were doing a good job in the years before the crisis. In most western countries, bank defaults had been very rare for at least the last two decades, almost all financial sector companies were highly profitable (due to rising stock market and other asset prices and a stable macroeconomic environment with low inflation), and public trust in financial institutions (measured by surveys) was at record heights. The financial sector's ability to weather the dotcom stock market crash in 2001 was seen as another sign of its resilience.

Furthermore, several supervisors had been restructured in the decade leading up to the crisis, establishing clearer mandates (and sometimes mergers) between central banks and supervisory authorities. Many central banks created financial stability units that focused on macroeconomic financial risks and prepared colorful financial stability overviews. Supervisory authorities increased their attention for market conduct, integrity and mis-selling issues in the financial sector. On top of this, external evaluations of national financial supervisory frameworks, such as those provided under the IMF Financial Sector Assessment Program (FSAP), were quite positive across the board. The typical reaction of governments worldwide was to assume that regulation and supervision should not stand in the way of ever-accelerating business and profits in the financial sector. Supervisory authorities were forced to take cuts in their capacity. Legislators were wary of the administrative costs they were imposing on the financial sector, culminating in the idea of 'light touch regulation'.

Also in the Netherlands, the institutional set-up of financial supervision was modernized and a twin peaks model, similar to the Australian model (see the contribution of Richards in Chap. 5), was implemented. In 2004, the Netherlands central bank merged with the insurance and pension funds supervisor to become the sole prudential 'integrated' supervisor for all financial institutions in the Netherlands. Around the same time, the Netherlands Authority for the Financial Markets (AFM), a new agency for market conduct supervision, was established (see the contribution of Hengel et al. in Chap. 12). As part of the restructuring, a financial stability division was created within the new DNB, the risk assessment framework was updated, and a new integral supervisory strategy was formulated (DNB 2006). This general feeling of doing good was shared by the government, which consequently decided to lower the budget for DNB's supervisory activities and appeared to be wary of new regulation.

And then the global financial crisis hit. Substantial parts of the global financial system were shaking on their foundations. Some very large financial institutions collapsed, as did many smaller ones. Governments, supervisory authorities and central banks had to intervene on an unprecedented scale. Billions of taxpayers' money was used to stem the crisis and prevent a meltdown of the financial system. Public trust in financial institutions (and supervisory authorities) fell sharply. And driven by the huge amounts of taxpayers' money suddenly at risk, parliaments initiated investigations into the causes of the financial crisis and the role and responsibilities of the supervisors. In many countries, the supervisory authorities' license to operate was at stake and the Netherlands was no exception. Supervisory authorities had to redefine their supervisory approach in search of a new workable basis for good supervision.

Two phases of responses and changes can be discerned in this search for more effective supervision. Initially, the emphasis was on monitoring what was happening inside financial institutions. Although this was useful, it did not prove sufficient, thus creating room for a new phase in which the conduct of the supervisors themselves became the topic of discussion. Although it is clear that these trends occurred internationally, in the next sections we will focus on the experience in the Netherlands in order to offer concrete examples.

1.3 Phase 1: Improving the Analysis (2008–2009)

The changes in Phase 1 were primarily technical. The underlying idea was that since the global financial crisis had taken us more or less by surprise, the monitoring and analysis of potential risks to the financial sector deserved strengthening to make supervision more effective. Two aspects are singled out. First, the call for deeper analyses, especially with respect to supra-institutional dynamics. Second, the need to foster changes towards a more forward-looking financial supervision (DNB 2010a).

1.3.1 Looking Beyond Individual Institutions

Although many supervisors had identified most of the vulnerabilities in the financial sector in time, they failed to foresee the fall-out of the crisis in terms of its scale, scope and speed, in particular with respect to the impact of relevant macroeconomic developments and the interdependence between the institutions. It became clear during the credit crisis that financial institutions are more interconnected globally and with the real economy than had been previously thought. Moreover, the most critical risks often occurred simultaneously at many comparable financial institutions. Correlation took on a whole new meaning. This called for a supervisory method which, alongside the institution-oriented approach, would have a stronger macro-orientation and a sharper focus on risk areas and supervisory themes.

At DNB, we worked on two components to make this happen. The first component is the reinforcement of macro-prudential supervision (see the contribution of Houben in Chap. 17). This was mainly done by enhancing consistency between micro and macro-supervision and by planning the introduction of instruments for reducing macro-prudential problems. Insights from the entire macro and micro spectrum (developments in individual institutions, sectors, payment systems, supervisory frameworks, financial markets and the monetary and real economy) are now included in the analysis and are used for prioritization and reduction of risks. National and international macro-prudential risk identification (including recommendations from the European Systemic Risk Board) is converted into micro-prudential action. To achieve good coordination between macro and micro levels, it is vital that the information channels within the organization are wide open. We made the structural application of analyses per (sub)sector a primary part of this supra-institutional approach. To make this possible, we enhanced the capacity of the management information system to provide aggregated information about peer groups of financial institutions and sector trends, as well as relevant themes and risks relating to these trends. Our initiative to systematically compare individual institutions with similar institutions (benchmarking) proved to be most useful. Identified outliers are often a marker for underlying problems. At the same time, management of financial institutions appears to be rather more susceptible to supervisors' remarks when supervisors can illustrate that the institution is on a deviant track.

The second element is that we urged our supervisors to think and work more in terms of risk areas – such as strategy and governance risk; financial risk; operational and ICT risk; and legal, integrity and compliance risk – instead of focusing on individual financial institutions. In order to do justice to the complexity of these risk areas, a substantial number of the supervisors have specialized in one of them. Their knowledge is used to produce more frequent in-depth analyses of specific themes. This deeper view entails a shift in supervision: from an assessment of the set-up of business processes to an assessment of their actual operation. Both the performance of these analyses and the conversion from analysis into targeted action rest on supra-institutional information. Supervisors who operate as general examining officers of a group of institutions fulfill a coordinating role. They are the first

point of contact for the institutions in question and actively enlist specialists where necessary. Specialists have been given greater responsibility for maintaining an up-to-date picture of the specific risks in a sector (or several sectors) and for mitigating these risks where necessary. To this end, they have received an extended mandate to prepare targeted risk analyses and propose interventions in their areas of expertise.

1.3.2 Forward-Looking Supervision: Business Models and Strategy, Conduct and Culture

To pursue the aim of safeguarding a stable financial system with sound institutions, so that consumers' financial interests are safe, supervision was traditionally mainly concentrated on checking whether the institutions were meeting the statutory requirements in terms of solvency, liquidity and controlled business operations. Although this angle remains key, a lesson from the crisis is that it takes more to realize the said goal. Supervision must probe to a deeper level. It must track down and tackle the possible root causes of later problems before they even translate into deteriorating solvency and liquidity ratios. This is all the more necessary given the increased speed at which developments in the financial sector arise and can escalate into a crisis.

A primary source of potential problems is the financial institutions' business model and strategy. In order to make supervision more effective, supervisors must better understand what these business models and strategies involve, consider whether they will be sustainable in the longer term, and feel compelled to intervene in these areas when needed. This does not imply that supervisors must decide how a financial institution is going to make its money, but rather that the management of financial institutions should give convincing answers when the sustainability of their business model appears questionable. Relevant questions are: How does the institution create competitive advantages? How and where are its profits earned? How does it retain its customers' trust? How efficient are its operations? To what extent is the institution's strategy endorsed by its stakeholders and capable of withstanding external dynamics? Is the business model sustainable in the longer term?

Another source of potential problems is the conduct and culture within financial institutions (see the contribution of Nuijts and de Haan in Chap. 10). The crisis has reaffirmed that soundness not only has a business component but also a 'conduct and culture' component that may have consequences for the way institutions deal with, for example, risk management and integrity issues. One major factor in influencing institutional conduct and culture is whether senior management of the institutions has the expertise and integrity that is expected. The practices of mis-selling, huge bonuses for traders and management, the LIBOR scandal, pyramid investment funds etc. have prompted enhanced worldwide supervisory attention. This ties in with the growing awareness that in our current dynamic times, problems that start as conduct-of-business violations (e.g. related to miss-selling) can rapidly develop into a prudential problem. Supervisors now also look more closely at

whether institutions sufficiently control the risks arising from the incentives attached to variable remuneration, particularly in cases where these incentives induce risk-taking behavior. In addition, more attention is being devoted to the integrity risks at institutions that arise from involvement in money-laundering and terrorist financing, and violation of international sanctions.

1.4 Phase 2: Improving the Supervisory Culture (2010 – Present)

It may have taken the supervisory community a while to recognize the fact that the technical Phase 1 improvements were typically a traditional response to problems that would not suffice in this case. The intensity of parliamentary investigations and the scrutiny of the media in many countries had resulted in a growing awareness and uneasiness about proceeding with supervision in the accustomed manner. This uneasiness, combined with the growing attention for aspects, such as conduct and culture within supervised institutions, eventually led to a reconsideration of the conduct and culture within supervisory authorities themselves. In addition, more forward-looking supervision places more demands on supervisors, given that it is much harder to form an objective picture of the vulnerability of an institution's strategy and its conduct and culture than to establish its compliance with financial rules. It is also more difficult to raise these types of issues with senior management, because it gets much closer to the core of their institutions and encroaches on their comfort zone. In other words, identifying and solving problems of this nature would demand more alertness, assertiveness and persistence on the part of the supervisors. For that reason, the desired changes could not be reached by making technical amendments only to the supervisory approach. They should be complemented with changes in the corporate culture, decision-making and day-to-day work practices of supervisory authorities.

It is not surprising that, at least at DNB, initially not everyone was convinced that we should move in this direction. The existing culture of thorough analysis and cautious interventions had evolved over almost two centuries and had served our institution well. At this crucial moment, the Dutch Parliament de facto helped us out by calling for a 'cultural transformation' of the prudential supervisor to deal with the dramatic changes in the financial environment. But where to start?

1.5 Five Elements of Good Supervision

In the midst of the crisis, the IMF published a staff position note entitled 'The Making of Good Supervision: Learning to Say "No"' (Viñals and Fiechter 2010) that provided valuable inspiration for supervisory authorities looking for new ways of organizing good supervision. We made our own adaptation.

1. Good supervision is intrusive

   IMF: Supervisors should have intimate knowledge of the supervised institutions, conduct on-site inspections and ask difficult questions. The supervisor's presence should be continuously felt by the institutions.
   DNB adaptation: Supervisors have an intimate knowledge of the supervised institutions, drawn from on-site inspections and off-site analysis. However, the institutions will be more forcefully challenged. This means asking searching questions, setting clear limits and, if necessary, escalating and taking measures; not only in relation to traditional components of supervision, such as solvency and liquidity, but especially to the less quantifiable elements, such as business models, governance and the quality and performance of Executive and Supervisory Board members – factors which ultimately have a major impact on institutions' financial health (see the contribution of Groothuis et al. in Chap. 8).

2. Good supervision is skeptical but proactive

   IMF: Supervisors should adopt a permanently critical attitude, especially in good times. The seeds of a crisis are generally sown in times of exuberant growth, when risk awareness in financial markets slips.
   DNB adaptation: The complexity of the financial world cannot be captured in a checklist of rules. Besides regulation, there has been a worldwide shift towards principle-based supervision (see the contribution of de Vries in Chap. 11), which requires supervisors to adopt a more critical attitude and give institutions the burden of proof. This will result in more frequent discussions with institutions on the interpretation of laws and regulations and may raise the number of disputes brought to court. Adequate legal protection for the supervisor is crucial. Moreover, a critical and proactive attitude implies an independent perspective on risks and a willingness to question what is generally assumed to be true, particularly during a boom. Supervisors are also critical towards colleagues.

3. Good supervision is comprehensive

   IMF: Supervisors must be constantly on the lookout for developments and risks on the horizon, not only for the supervised institutions individually, but also for the system as a whole.
   DNB adaptation: Supervisors continually scan the horizon for new developments and risks, both for financial institutions and for the system as a whole.

4. Good supervision is adaptive

   IMF: The financial sector is a constantly evolving and innovating industry. Supervisors must be in a permanent learning mode so that they can quickly identify the risks inherent in new products, markets, and services and respond with adequate risk-mitigating measures, or call a halt to certain developments.
   DNB adaptation: Supervisors are able to quickly identify the risks attached to new developments in the sector. Supervisors intervene rapidly and effectively where risks become too great by taking risk-mitigating or cessation measures

5. Good supervision is conclusive

   IMF: Supervisors must follow up on their analysis by taking action. This means that supervisors must not only demand risk-mitigating measures, but also ensure that these measures are actually implemented and, if necessary, commit to tough intervention to achieve the desired objective.
   DNB adaptation: Analysis is followed by action. Supervisors strictly monitor compliance with stipulated measures, and, if necessary, resort to tougher instruments to achieve the desired result. The organization's structure and work practices underpin this enforcement approach. Escalating occurs in accordance with the intervention ladder. Where necessary, control is handed to the newly established intervention unit.

In the case of DNB, we felt that that our supervision would especially benefit from becoming more 'intrusive' and 'conclusive'. Traditionally, and not uncommon for central banks, we scored relatively high on content ('analysis') but had room for improvement in giving it more bite ('action'). It takes some courage and persistence to follow-up on analyses that give rise to red flags. Especially since a red flag is, in practice, seldom a clear red flag. It is often a shade of amber that may seem to warrant further data gathering and analysis before moving into confrontational interventions. Our action plan for a change in the conduct of supervision was hence entitled 'From analysis to action' (DNB 2010b).

Of course, we were not an exception. Our analysis was in line with the *Zeitgeist* and international trends, the recurring theme being the readiness to impose limits on supervised institutions and act decisively towards them, which was quite a change from the generally endorsed culture of 'light touch regulation' before the crisis. A more general observation is that supervision does not take place in isolation but is part of wider social processes, which not only push for the improvement of supervision, but may also hold back change. Cultural change in supervision cannot be seen separately from cultural change in the environment in which supervision operates.

1.6 From Analysis to Action

The literature on culture changes in corporations is clear: any change of culture is an enormous challenge, it often fails completely, and if it is to be successful, the process takes at least a few years to have an enduring effect. We took up the challenge with these humbling thoughts in mind, set up a project team and then just started. Our actions were in part directly aimed at conduct and culture, but we also initiated changes in human resource management, the organizational structure and risk analysis method to embed the desired way of thinking and behaving in all aspects of our organization (DNB 2012). DNB's Supervisory Board and an external

advisory committee (consisting of former CEOs of large organizations and academic experts in corporate culture change) acted as coaches.

Attempts to Change Conduct and Culture Directly. Early on in the project we realized that we needed to avoid lengthy and esoteric discussions about what defines the culture in an organization. Instead, we focused on the way in which organizational culture is expressed, i.e. the conduct of the employees. When trying to change an organization it is essential to involve everyone in the organization, making them part of the movement. It helps to create a bottom-up process with full participation, and without compromises on transparency about where the organization is heading. Our take on this was to organize sessions on the attitude and conduct required for good supervision. Some of these sessions were with all employees; some were with smaller groups in a more intimate atmosphere. All were aimed at maximum interaction between employees themselves and with (higher) management, often with brainstorming elements, and always with a summing-up of clear results in the form of good ideas and action points at the end. Concrete issues for discussion during these meetings were, for example, which of the five elements of good supervision was most in need of promotion within the organization, how this could be done, and how employees would themselves make these changes happen. We made sure to follow up on these ideas and action points in a transparent manner shortly after these sessions. Higher management (including Executive Directors) 'walked the talk', by attending all meetings, conveying the message that they fully supported this important change for the organization and were making no exceptions for themselves.

Supportive Changes in Human Resource Management. A more indirect way to influence conduct is through changes in human resource management. The underlying idea is that the elements of good supervision – especially intrusiveness and conclusiveness – must be reflected in the competencies, attitude and conduct required of staff and management and that these must take precedence over technical expertise. In other words, staff and management must not only be capable of rapidly understanding new and complex financial issues and identifying risks, but also be able to evaluate how such issues interact with one another and have the acumen to cut to the quick. They should be able to engage in dialogue with financial institutions as evenly matched and critical discussion partners, and be willing and able to ask difficult questions and not be too easily satisfied. While they must be familiar with the problems facing the institutions under their supervision, they also need to keep their distance and be able to switch from dialogue to forceful intervention. We reviewed the whole spectrum of management, performance management and staffing policies, including recruitment and selection, assessment, training and rotation.

Job Profiles and Assessments. Job profiles for staff and management reflect the desired requirements, in terms of competencies, technical expertise, attitude and soft skills. Staff and management undergo semi-annual assessments based on these profiles. The functioning of the senior management, including members of the

Executive Board, is also subject to assessment: there are periodical board effectiveness reviews with external support, supplementing the annually held internal reviews. This enables the Supervisory Board to effectively assess management of the institution by the Executive Board.

Permanent Education. An intensive training program on both technical expertise and soft skills was set up for staff and management. Permanent education is a mandatory element of the job, so as to further develop substantive knowledge and the required competencies. Besides attending training courses run by external providers, staff may participate in internal education and training programs, to cover job-specific themes that cannot be easily outsourced. Like many other supervisory institutions, we opted to establish our own ‘Supervisory Academy’ to conduct in-house training. The DNB Supervisory Academy provides an extended training program for all new hires in the supervisory divisions. Ideally, new employees follow this 20-day program in the first 4 months of their employment, thereby gaining a kick-start in their new jobs. The Academy also offers specialized training programs in craftsmanship, mastery and leadership for more experienced supervisors. The emphasis in these programs is on personal effectiveness rather than technical expertise.

Rotation. A strict rotation policy is in place that ensures that supervisors continue supervising a particular institution for no more than 4–5 years. The aim is to ensure that supervisors counter regulatory capture by keeping enough distance from the institution under their supervision, while at the same time preventing the loss of knowledge. In addition, rotation promotes knowledge sharing and co-operation, and helps employees to take a broader view.[3] In this light, the organization actively stimulates mobility initiatives by facilitating internships in other parts of the organization, other supervisory institutions, government agencies and international organizations.

Organizational Structures That Help Embed the Desired Conduct and Culture. Well-designed organizational structures can be very helpful in embedding the desired conduct. The traditional way of structuring a supervisory organization is to cluster supervisors around the objects under supervision. Every team, section and division of supervisors is responsible for its own set of supervised institutions that share certain common characteristics (e.g. type of activities, size, international orientation). Large financial companies are assigned a team of supervisors that focuses on just one particular institution. In addition, in the last decade most supervisory organizations have set up organizational units that specialize in a particular kind of expertise or activity. These expert centers create horizontal layers in previously mainly vertically structured organizations, leading to matrix organizations. Expert centers have the advantages of fostering knowledge of, and experience with, specific issues, enhancing harmonized treatment of these issues

[3] At the time of writing this contribution, DNB’s research department examines regulatory capture both within DNB and the AFM.

and supporting a supra-institutional view. The major disadvantage is that the experts are less familiar with the specificities of particular financial corporations. Given the experiences of the financial crises and the lessons drawn, it makes sense to give expert centers higher prevalence in the organization structure. At DNB, we created several new expert centers, which we clustered in a line organization. The percentage of supervisors working in an expert center (as opposed to teams clustered around a type of institution) is now about 30 %. The expert centers focus on a particular kind of technical expertise (such as financial risk, ICT risks, actuarial risks, market access, integrity risk and conduct and culture). In order to make supervision more intrusive and to give the operational supervisors the opportunity to sharpen their focus, the involvement of these expert centers has become mandatory. The expert centers have been empowered to start inspections at their own initiative, and the deployment of the expert centers has become an integral component of supervision.

Besides the technical expert centers, we also created an intervention and enforcement department as well as a risk management of supervisory processes department. The intervention department supports supervisors when non-compliance by a financial institution has reached a certain escalation level. This department helps us to reach the level of intrusiveness and conclusiveness needed when co-operative behavior by a financial institution is no longer a given. It also gives a clear signal to the financial institution involved that a stage beyond normal supervision has been reached.

The risk management department's goal is to enhance internal quality control (see the contribution of Sijbrand and Rijsbergen in Chap. 2). The department verifies whether the supervision process is being conducted in accordance with the defined supervisory approach and whether it produces the desired results. Its work is supported by the manual on supervision quality that describes for all supervisors, in some detail, the desired supervisory approach. Furthermore, the department devotes attention to the application, development and maintenance of the supervisory methodology, and plays a special role in the process of constantly focusing on and further improving supervision by monitoring, and if necessary initiating changes in, the supervisory methodology. It is also responsible for the Supervisory Academy.

1.7 Preliminary Experiences

All in all, the aim of all these changes was to become a more effective supervisor and to be better able to cope with the challenges of the present day (see Fig. 1.1). Have we achieved this aim? The formal answer is that we don't know (yet). Given the exceptional circumstances of enduring stress in the financial sector, a more or less objective answer would require a time-series of results on quantitative performance indicators; we are still in the process of formulating and testing these.

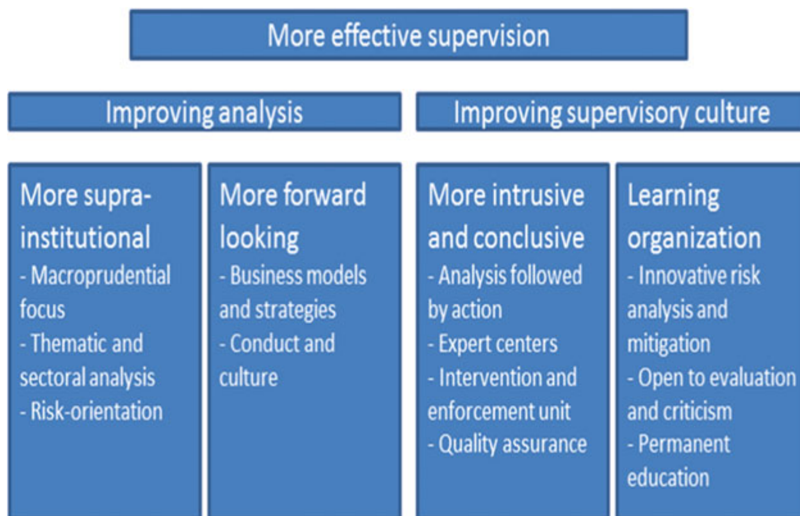

Fig. 1.1 Steps towards more effective supervision

However, from a more subjective viewpoint, we have been noticing changes in our supervisory conduct (and effectiveness) that tend to point into the right direction. First, our general feeling is that we are more in control. In the new institutional set-up, we obtain a much broader picture of where individual financial institutions stand: not only with regard to their own particular opportunities and risks, but in the broader perspective of macro issues, in comparison to their peers, and on specific thematic issues. We are looking at the same institutions, but with insights from different angles. Our impression is that this has reduced the chance that we fail to identify something that is going substantially wrong. Furthermore, under the new set-up any relevant issue is confronted with an action plan that sets out concrete actions for risk mitigation, measurable results, and a strict timeline. This has shortened the period in which corrective actions are taken and issues are solved. Besides, the more forward-looking attitude seems also to have resulted, more or less automatically, in a willingness to extend the supervisory mandate to a certain extent. Supervisors feel freer to touch on topics which may not be illegal per se, but might be harmful nonetheless from a supervisory perspective (Sparrow 2000). In this respect, anecdotal evidence in the form of financial institutions' feedback on our supervisory conduct seems to confirm the perception that we are taking a stricter approach, probing deeper, and raising the bar. Supervised institutions occasionally concede that they have benefitted from our intrusive approach, especially regarding business models and business culture.

Second, we have experienced – without regret – that a more assertive attitude does not necessarily mean that we issue more fines, binding recommendations, or other formal measures. We have clearly moved beyond 'moral suasion' and 'light touch regulation' as points of departure, and formal measures have become more

mainstream in our supervisory approach. Nonetheless, we have learnt that a result-oriented and forward-looking approach can promote more creative ways of influencing the behavior of supervised institutions than installing formal measures. Supervision has become more than monitoring, analyzing and, if necessary, correcting. It has become a continuous process of influencing behavior, by all available means, depending on what proves most effective. This may include publishing a sector-wide thematic report on a specific issue, holding an intensive discussion with the Supervisory Board of a financial institution, confronting a financial institution with a peer group analysis, starting an online public awareness campaign and repeating the same message in every speech.

Third, the organization as a whole has become more aware that good supervision is a continuously moving target, and that each supervisor is personally responsible for making it happen. This has created a new dynamism in the organization. Supervisors now feel a greater need to cooperate, to ask for specific expertise, to explore new ways of supervising, to keep up with new developments, and to update their skills and expertise.

1.8 The Limits of Good Supervision

Many supervisory authorities around the world have been criticized for their performance in the run-up to and during the global financial crisis. As a result, they have made drastic changes to their supervisory methods, their organization and their attitude. We may hope that these changes have been for the better, resulting in a supervisory system that has come closer to the ideal of good supervision. Nonetheless, the question arises as to what we can expect of good supervision. Do the newly attained levels of good supervision allow supervisors to prevent, once and for all, new bank failures and financial crises? We do not think so, alas. An important lesson from the financial crisis is that the supervisory community should be vigilant, but humble, and continuously recognize the limits of supervision.

It is important to remind ourselves of what supervision can be expected to deliver. Supervision aims to promote financial stability, but it was never intended to eliminate all risk, and would never be able to do so. The objective of eliminating all risk would be incompatible with our free market economy where scope for private initiative is seen as a *conditio sine qua non*. Risk-taking is part and parcel of this economic model. Banks and other financial institutions live by taking risks. Their business model is based on the idea that they are better equipped for taking risks (credit risk, maturity risk, longevity risk, interest risk) than other organizations or individuals. Supervisors cannot and should not eliminate this risk taking. Indeed, they should strive to make sure that financial institutions understand the risks they are taking and to mitigate them, especially when these risks could have external or systemic effects. In other words, financial institutions can fail. Referring to the issue of moral hazard, Greenspan once quipped that he didn't know what the optimal level of bankruptcies in the financial sector was, but that it would be more than zero.

In theory, the goal of the supervisory authorities should thus not be to protect financial institutions, their shareholders or their bondholders per se. Their objective should be to have assurances in place that problems at individual institutions will not lead to a collapse of the wider system and harm the taxpayer, nor harm the interests of deposit holders and policyholders. In practice, however, the most straightforward way to do so is to prevent any new defaults, especially in times in which trust in financial institutions is fragile.

Furthermore, capacity constraints obviously play a role. Supervisors simply don't have the capacity to look over the shoulder of each and every manager, sales person and trader in the financial sector. Formal constraints apply too, often for good reasons. In certain areas the supervisor's powers to intervene depend on the cooperation or approval of other authorities, foreign supervisors or the courts. Moreover, supervisors are, by definition, always slightly behind the curve of new developments in the financial sector. The sector innovates constantly, as it should, and supervisors can only try not to lag too far behind. At the same time, the expectations of financial supervision held by the public and the political arena are not stable either.

From a broader perspective, it is not a given that more supervision will always lead to better results. After a certain point, the extra costs of additional supervisory activities (administrative costs, supervision fees, etc.) would outweigh the extra benefits ensuring from a lower risk of problems in the financial sector. Furthermore, supervision has a tendency to create perverse incentives and results (see the contribution of Nouy in Chap. 4). And enhanced international co-ordination among supervisors and increasing harmonization of regulatory standards is generating a new risk: financial institutions may adapt their business models in similar ways, which could lead to a less diversified system of financial institutions that is more prone to systemic risk.

This issue is also relevant within supervisory organizations. On the one hand, it is desirable to ensure a certain level of quality and harmonization in all supervisory activities. We stimulate this by training people in a certain way, designing a common supervisory methodology, defining procedures, etc. We set standards and draw up rules and manuals so that everybody knows what to do and how to do it. On the other hand, it would be counterproductive to suppress the professional judgment of supervisors. Instead, we look for ways to trigger their out-of-the-box thinking. This requires space instead of strict procedures and is essential to keep people motivated (thus lowering turnover of more experienced supervisors) and help them spot new, previously unknown risks in the financial sector.

Finally, supervision is only one of the factors that determine the solidity of institutions and the stability of the system. That not only makes it difficult to demonstrate the effect of preventive supervisory activity in terms of impact measurement and evaluation – how can we demonstrate that problems did not occur because of supervision? – but should also remind us that supervision provides just one of the numerous inputs for managerial decisions at financial institutions.

There seem to be two main lessons that can be distilled from these limits to financial supervision. The first is that supervisory authorities should even more

actively communicate the limits of supervision to the larger public, especially in times when these have become overshadowed by a booming financial sector. The timing of this is always difficult. Risks may build up in the financial sector when the economy is on the rise, (over)confidence is gaining the upper hand, and attention for risk mitigation is subdued in favor of potential lucrative opportunities. In such circumstances, the public is less receptive to supervisory warnings, especially when these come with new restrictive powers for the supervisor. Besides public awareness, there is the issue of the supervisor's accountability to the public and to political authorities. For both reasons, it would be helpful if the supervisor could regularly report on concrete cases in which the supervisor had intervened and brought problems to a solution. It would keep the public aware of risks, thus reducing the risk of public moral hazard. It would also show that the supervisor is still making an effective contribution to the functioning of financial markets and protecting deposit holders, policyholders and taxpayers. However, the possibilities for opening up on specific cases are limited. Restrictions stem from confidentiality as well as financial stability considerations. Financial institutions' cooperation with the supervisor should not be impeded by the fear that information about their particular challenges will be published later. Neither would it be helpful if openness about supervisory issues were to lead to an aggravation of problems, i.e. if market parties turned their back on affected financial institutions in a disorderly run to the exit.

The second is that good supervision is a moving target. The financial sector and the environment in which it operates are constantly evolving. Supervisors cannot and should not hold back change, but rather adapt quickly to the world around them. In this light, it is good to see that more and more supervisory authorities, both inside and outside the financial sector, put time and effort in assessing what it means to execute 'good supervision' in practice. There is ample room for supervisory authorities to learn from each others' good practices, challenges and experiences. Many of the dilemmas, problems and trade-offs individual supervisors face, have common elements that are widely shared by the supervisory community at large. An interesting outcome of such cooperation between supervisors from different fields is the recent report on criteria for good supervision by a group of seven supervisory authorities in the Netherlands (Market Supervisors Council 2012). Despite their many differences in supervisory tasks, powers and objects, they could agree, maybe surprisingly quickly, on the elements that constitute good supervision in their opinion.

1.9 Concluding Remarks

Triggered by the financial crisis, supervisory authorities have, over the past years, accelerated adjustments to their organizational structure, methodology and culture in their search for better supervision. As good supervision is far from an absolute given, there may be several ways to achieve it. We think that the following three

focus points have served our institution well in taking steps in the right direction. The first is to aim for intrusive and conclusive supervision – this requires result-oriented, innovative and efficient supervision, thorough knowledge of supervised institutions, and analysis followed by action to achieve the desired result. The second is to ensure forward-looking and in-depth supervision – this implies more attention for supra-institutional and macro-prudential supervision, and for financial enterprises' financial risks, conduct and culture, and business model and strategy. The third is to create a learning organization – this calls for innovative ways of risk analysis and mitigation, permanent education of employees, and quality assurance. But more importantly, it requires the organization to be open to internal and external evaluations and criticism. This will not prevent future mishaps, but will ensure that lessons will be quickly taken on board by the organization and are translated into more effective supervision. And that, we feel, is our ultimate goal, because supervision is only good if it is effective.

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Chapter 2
Managing the Quality of Financial Supervision

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2.1 Introduction

Following the financial crisis, the quality of financial regulation and supervision has emerged as a material concern. The crisis revealed important vulnerabilities in the regulation and supervision of the financial sector and underlined the need for regulatory reform.[1] In recent years, the international community has been working vigorously to overcome these flaws. The goal of these efforts is to strengthen the quality of financial sector regulation and supervision, as well as to enhance the resilience of the financial sector so that it is better able to absorb shocks while contributing to economic activity and growth.

The focus of the international response to the crisis has primarily been on the need for more and better regulation. The subsequent reforms have improved the quality and availability of capital and liquidity (Turner Review 2009) and resulted, among other things, in the new Basel III framework for banking supervision.[2] Although these new approaches to capital, liquidity and leverage will significantly reduce the probability of failures, they will not reduce this probability to zero. The

This chapter represents the personal views of the authors, who would like to thank the editors as well as Paul Hilbers (DNB), Ivo Bruijn (DNB) and Dirk Broeders (DNB) for their helpful comments.

[1] The terms 'regulation' and 'supervision' are generally used interchangeably in financial literature, but have different meanings. Palmer and Cerruti (2009), amongst others, argue that 'regulation' consists of setting the framework of laws, regulations and rules within which financial actors must operate, while 'supervision' consists of monitoring the behavior of the financial actors and intervening when needed to ensure they are acting in ways that are consistent with the letter and spirit of the regulatory framework.

[2] Basel III includes many changes based on lessons from the crisis, such as a limit on the amount of leverage in the banking system, an additional capital charge for systemically important financial institutions (SIFIs) as well as a countercyclical buffer.

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system of financial regulation and supervision is therefore being supplemented with arrangements for crisis intervention such as bank resolution plans. These plans ensure an orderly wind up and avoid shock effects to the rest of the financial sector. Supervision and resolution, in that sense, are both sequential and complementary.

The financial crisis has also emphasized the need for more intense and effective supervision. Not all types of risks can be mitigated with better or more regulation. Some problems may be considered harmful by a supervisor, even though they are not illegal (Sparrow 2000). In these instances, supervisors cannot solely rely on their regulatory tools. Supervisors thus need a comprehensive and intrusive approach to either mitigate the harmful problem or strengthen regulation to effectively make the problem illegal. Moreover, as the regulatory rule book is becoming more detailed and robust after the crisis, the supervisory approaches and skills required to implement these rules are also becoming more challenging. In response, many supervisors around the globe are currently evaluating or redesigning their supervisory approach based on lessons from the crisis.

This chapter contributes to that effort by examining ways in which financial supervisors improve, safeguard and measure the quality of their supervision. For that, the remainder of this chapter is structured as follows. Section 2.2 concentrates on improving the quality of financial supervision. In this section we distinguish seven global trends that aim to further improve the quality of financial supervision by making it more forward-looking, more supra-institutional and more comprehensive in its approach. Next, Sect. 2.3 focuses on how to safeguard the quality of financial supervision by analyzing the quality management adopted by De Nederlandsche Bank (DNB). In Sect. 2.4 we examine how supervisors can adequately measure their effectiveness and which key performance indicators DNB developed for that. The chapter finishes with the most important conclusions.

2.2 Improving the Quality of Financial Supervision: Seven Global Trends

Following the financial crisis many supervisors find themselves in the spotlights of public attention. In many instances, this includes Parliamentary inquiries into the causes of the crisis as well as external reviews regarding the supervisory practices. At the same time, many supervisors performed critical self-evaluations of their own work practices, organization and internal culture. Examples include the supervisory strategy 2010–2014 of DNB and the Turner Review which was published by the English FSA. In general, these studies and reviews have produced many valuable insights and suggestions for improvement.

The starting point for improvement is situated in the goal of financial supervision. The primary objective of prudential supervision is to safeguard a stable

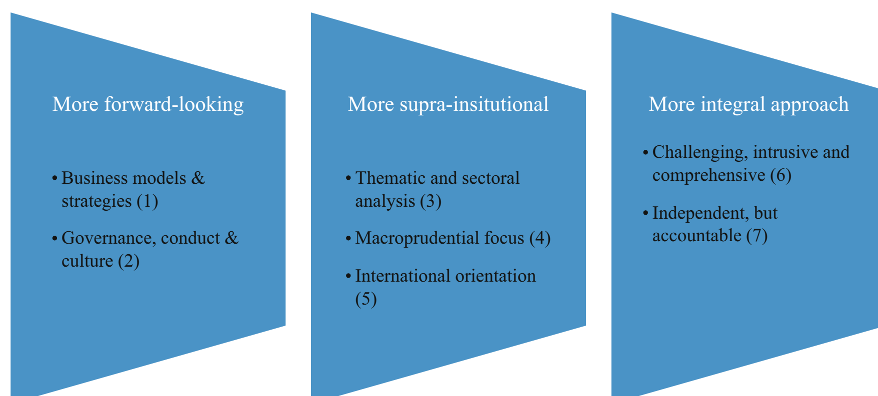


Fig. 2.1 Seven global trends in financial supervision

financial system with sound institutions.[3] In meeting their objectives, supervisors traditionally mainly concentrated on checking whether institutions met the supervisory requirements in terms of solvency and liquidity (see also the contribution of Andersson et al. in Chap. 3). However, the financial crisis underlined that it takes more to realize the prudential goal of ensuring financial stability. An institution, for instance, cannot safeguard its long-term soundness by simply holding enough capital or liquidity when there are serious flaws in its risk management practices or its governance structure. Good supervision therefore requires a probe at a deeper level (DNB 2010b).

In general, we distinguish seven global trends in the current supervisory redesign which will further improve the quality of financial supervision. These trends aim to supplement the regulatory reform efforts that, among other things, have improved the quality and availability of capital and liquidity. In general, the trends are already (being) implemented in many countries and relate to lessons from international studies, external reviews and self-evaluations of financial supervisors. Figure 2.1 presents the seven trends that we will discuss in more detail in the remainder of this section.

Business Models and Strategies. The crisis has highlighted the need for supervision to be more forward-looking. This implies paying more attention to strategic and qualitative elements in supervision. More than in the past, financial supervision will

[3] Some financial supervisors state their objective more explictly. The Australian APRA, for instance, mentions in its annual report that prudential regulation should not pursue a 'zero failure' objective, but should maintain a low incidence of failure of supervised institutions (APRA 2011). Also note that market conduct supervisors naturally have a different primary goal such as ensuring market transparency.

therefore seek to detect and address possible sources of future problems at an early stage, before they translate into a deteriorating financial position (Hilbers 2011).

In this context, supervision needs to focus on the sustainability of business models and strategies. These elements are often related. A strategy focused on aggressive expansion in foreign markets today, for instance, will have substantial implications for that firm's future business model. Supervisors therefore require a deep understanding of the strategy and business models of financial institutions. DNB has started analyzing these strategic elements by asking questions such as: 'how does an institution hold on to its customers?', 'how does it position itself amid its competitors?', and 'how sustainable is its income model?' Answers to these types of questions provide additional insight into structural strategic vulnerabilities and will help to make supervision more forward-looking.

Governance, Conduct and Culture. The crisis also underlined the importance of governance and culture within a financial institution as these aspects may seriously affect prudential and ethical requirements. Corporate culture may signal various types of risks within financial institutions. By focusing on behavioral and cultural aspects, supervisors can identify and mitigate such risks before they detract from an institution's financial soundness or integrity. In doing so, supervisors can make an institution aware of its behavioral weaknesses and underscore how behavior may contribute to the origination and continuation of prudential and integrity risks (FSA 2009). Based on lessons from the crisis, DNB strengthened its supervisory approach by incorporating behavioral and cultural aspects such as the management structures at institutions, the composition, quality, leadership style and effectiveness of their Executive and Supervisory boards as well as remuneration policies. Although these soft factors are often 'below the surface' and thus less easily observable, they are crucial for sound corporate functioning (DNB 2010a).

Thematic and Sectoral Analysis. The crisis underlined the interdependence of financial institutions and the fact that many financial risks are cross-institutional and cross-sectoral. This requires a supervisory method which, alongside the institution-oriented approach, has a sharper focus on risk areas and supervisory themes and a stronger macro orientation. A structural application of sector or thematic analyses is an essential part of such a supra-institutional approach. These analyses provide a clear viewpoint of sector-wide vulnerabilities by offering an overview of the regular economic conditions, the trends occurring in the sector as well as relevant themes (FSB 2010). Moreover, benchmarking individual institutions with their peers provides supervisors with an effective instrument for identifying outliers and best practices.

Nowadays, many supervisors apply a thematic approach in supervision. For instance, DNB adopts a thematic approach to better identify firms which are outliers in terms of risks or business strategies and to identify emerging sector-wide trends which may lead to systemic risk (DNB 2010b). The Federal Reserve employs 'horizontal reviews' to examine particular risks or activities across a group of banking institutions. An example of such a horizontal review is the Supervisory Capital Assessment Program that the Federal Reserve conducted in 2009. This

program involved a broad simultaneous review of several types of risk exposures at a wide selection of banking institutions (Bernanke 2009).

Macroprudential Focus. Another lesson of the financial crisis is that supervision should be more focused on the soundness of the financial system as a whole. This requires adequate reflection of financial stability aspects in the supervision of individual institutions. Connecting macroprudential analysis with microprudential supervision strengthens the surveillance of risk factors that can pose a threat to the entire sector (Brunnermeier et al. 2009).

Macroprudential supervision differs from its microprudential counterpart in the way that macro-economic and market conditions are taken into account. In microprudential supervision, the macro-economic conditions are typically considered given, since a single bank or insurance company is hardly able to influence the global stock or bond market. Good microprudential supervision is of crucial importance because a stable financial system requires robust financial institutions. However, this does not guarantee financial stability. For that, adequate macroprudential supervision aimed at monitoring the financial system as a whole and allowing for the dynamics of the building up of imbalances is also necessary (DNB 2010c). Macroprudential policy is increasingly being shaped by the development of specific instruments, such as the countercyclical capital requirements for banks, additional buffer requirements based on macro stress tests, capital increases for systemically important institutions and loan-to-value and loan-to-income ratios in mortgage markets. Internationally, major regulatory efforts are being devoted to the further development of this toolkit. This is promoted by the establishment of the European Systemic Risk Board (ESRB) which is responsible for identifying systemic risks to financial stability. The ESRB can issue warnings and, where appropriate, related recommendations.

International Orientation. As financial institutions are becoming more and more internationally active, the need for well-functioning international arrangements for the supervision of cross-border institutions continues to increase. The then Governor of the Bank of England, Mervyn King illustrated the essence of the pre-crisis problem when he argued that “global banking institutions are global in life, but national in death” (FSA 2009). Experiences during the crisis highlighted the necessity of a more internationally oriented supervision for cross-border institutions (The Larosiere Group 2009).

Such concerns have been quickly processed in proposals by the international community. This resulted in the creation of a new European supervisory structure at the beginning of 2011. The European System of Financial Supervision (ESFS) consists of three European Supervisory Authorities in the field of banking supervision (European Banking Authority, EBA), insurance supervision (European Insurance and Occupational Pensions Authority, EIOPA) and in the field of securities market supervision (European Securities and Markets Authority, ESMA). The objective of these independent supervisory authorities is to ensure greater harmonization and consistent application of supervisory rules within the European Union. In addition, the ESRB is responsible for macro prudential supervision by

mapping risks for European financial stability. Even more promising is the creation of a European Banking Supervisor. The European community is currently working on the design of this new supervisor, together with a European resolution and funding mechanism and a European deposit guarantee scheme.

Challenging, Intrusive and Comprehensive. One of the lessons of the crisis is that supervision needs to be more challenging, intrusive and comprehensive in its approach. Instead of relying on subtle strategies of soft enforcement and gentle persuasion, supervisors will also have to be alert and react firmly when necessary (DNB 2010b). In the past, moral suasion proved to be an effective method for problem-solving without the need for intervention or confrontation. However, behavioral science suggests that persuasive techniques such as moral suasion are generally ineffective if supervised institutions or individuals are simply unable or unwilling to adhere to a norm or rule. In that context, experiences during the crisis illustrated that moral suasion has lost some of its effectiveness in the modern financial world and that supervisors, as a result, tended to stay on the sidelines too long (Viñals and Fiechter 2010).

This also relates to the pre-crisis assumption of many supervisors that market forces and market discipline would keep both the economy as well as regulated institutions broadly on track.[4] Experiences during the financial crisis have somewhat undermined this assumption, as market forces failed to prevent inadequacies in risk management at many financial institutions (Briault 2009). Common sense risk management practices such as "invest only in products you understand" were sometimes abandoned, while the complexity of the models used to measure and manage risk made it increasingly difficult for top management to judge the relevant risks. The crisis also highlighted the importance of interaction between different types of risk, and the danger of risks falling in the crack between the vertical disciplines of market and credit risk management. The interaction of risks sometimes resulted in compounding effects that were not properly captured by the risk management tools available before the crisis. Therefore, one of the key lessons from the crisis is that a comprehensive risk management framework should not only be firm-wide, but also encompass and aggregate the different types of market and credit risks to which a specific institution is exposed (UBS 2010).

Independent, But Accountable. A challenging supervisory approach requires the ability and willingness to act from the part of the supervisor, which are both strongly related to its operational independence. Masciandaro et al. (2008) argue that solid independence and accountability arrangements are essential foundations of supervisory governance, which in turn, have a positive impact on the soundness of the banking system. Palmer and Cerruti (2009) emphasize the need to be

[4] Note that these assumptions have long been challenged. Shiller (2000), for instance, illustrates that market efficiency does not imply market rationality. The fact that asset prices move as random walks and cannot be predicted from prior movements does not imply absence of herd effects and prices overshooting rational equilibrium levels.

independent from political influence and the financial sector. This preserves the supervisor's willingness to act, especially in circumstances where such action may be highly unpopular. Not surprisingly, the criterion of 'operational independence' is included in many international codes and standards, while the FSB recommended reinforcing the criteria for assessing operational independence (FSB 2010). Operational independence, however, requires supervisory agencies to be accountable and transparent. Quintyn and Taylor (2002) find that accountability and independence are somewhat complementary to each other, indicating that supervisors can actually increase their independence by being transparent.

2.3 Safeguarding the Quality of Financial Supervision: Process and Outcome

International efforts since the financial crisis have resulted in a stronger regulatory framework and a fundamental redesign of financial supervision. As described in the previous section, these improvements will make supervision more forward-looking, more supra-national and more comprehensive in its approach. But will these measures result in good supervision? That is a difficult question to answer. The view on what constitutes good supervision changes over time, reflecting shifting attitudes in society and developments within the financial sector itself. Much of what was regarded as appropriate and adequate 10 years ago no longer fits that description nowadays. The challenge is to operate a supervisory approach that is sensitive to changes in the supervisory environment and can adapt accordingly (Baldwin and Black 2007). As a result, the optimal set of supervisory tools and strategies will require continuous updates and improvements. In this context, Viñals and Fiechter (2010) emphasize the need for supervisors to work on criteria that do justice to recent developments in the financial sector. They determine five criteria for good supervision. Good supervision in their view is intrusive, skeptical but proactive, comprehensive, adaptive and conclusive. Viñals and Fiechter (2010) conclude that although these criteria are embedded in existing supervisory standards, they still need to be institutionalized in many national supervisory approaches.

Like many supervisors, DNB has taken the international findings and lessons to heart and is incorporating them in existing and new policy. DNB outlined the lessons of the crisis in its "Supervisory strategy 2010–2014" and subsequently translated these lessons into concrete measures with the publication of the "Action plan: from analysis to action" (DNB 2010b). This resulted in the development and implementation of a new supervisory approach ('FOCUS!') which aims to improve the supervisory process (output) as well as increase the effectiveness of our supervision (outcome). To this end, changes have been made in the working practices, organizational structure and culture of prudential supervision (see Fig. 2.2). In the work processes, more emphasis is placed on effective risk analysis

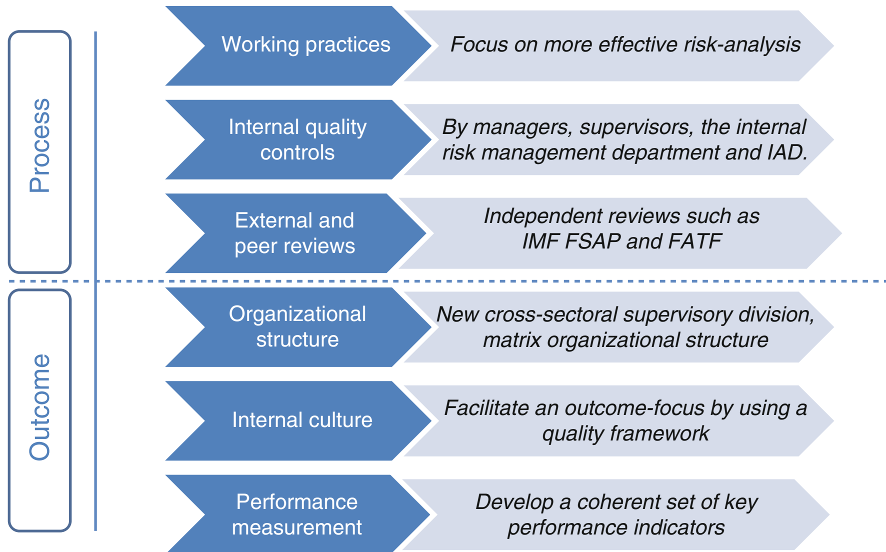


Fig. 2.2 Managing the quality of the supervisory process and outcome (DNB)

by sector-wide and thematic investigations, as well as alignment with macroeconomic developments. The analysis also has a strong forward-looking character by incorporating a review of the business model, strategy, governance and culture of supervised institution. The main objective is to achieve a more risk-focused approach to supervision which will make it more effective and vigorous (DNB 2012).

DNB employs several measures to control the quality of its supervisory process. The first and foremost responsibility lies with the managers and supervisors within the organization. They manage the process from risk analysis to mitigation and are well positioned to signal possible improvements in the supervisory process. A second layer is represented by the newly formed internal risk management department. This department performs a quality assurance role by addressing problems that pose a risk to the effectiveness of the supervisory approach as well as by providing continuous suggestions for improvement. The internal risk department can either take action by request or at its own initiative. Finally, the third internal level of quality management is performed by the Internal Audit Department (IAD). By conducting independent and objective audits, this department helps to evaluate and monitor the effectiveness of the supervisory approach.

In addition to these internal measures, DNB is also extensively using external and independent reviews to assure the quality of its supervisory processes. Last year, the Netherlands Court of Audit investigated DNB's banking supervision, while the IMF compared Dutch supervision against international standards as part of its Financial Sector Assessment Program (IMF 2011). The Financial Task Force on Money Laundering (FATF) has performed a somewhat similar analysis in 2011

by evaluating the Dutch approach against money laundering and the financing of terrorism. These reviews have produced many important insights, including the need to expand the supervisory instruments and scope for intervention, as well as increase the focus on performance measurement. DNB also participated in peer reviews of its supervision. In 2011, the European supervisors EIOPA and EBA separately examined DNB's supervisory practices regarding cross-border activities and supervisory colleges. In both instances, the outcome of the review was positive.

Adequately managing the supervisory process, however, is no guarantee for the quality of the desired supervisory outcome in terms of financial stability. Some supervisory problems can simply not be addressed by making the supervisory processes more efficient. A supervisor must not only do things right, but must also ensure that he is doing the right things. The importance of this is underlined by the innovative and rapidly changing economic environment in which financial supervision takes place. Different types of risks tend to interact and evolve through time, making them difficult to adequately capture or manage within a single process. As a result, no amount of process improvement can effectively bring them under control. In this context, supervisors need to adopt a problem-solving strategy which applies tailor made solutions that address specific, clearly defined problems or risks (Sparrow 2000).

To that end, DNB has focused on strengthening the organizational structure. For one, DNB has added a cross-sectoral division to its organization whose responsibilities include the continuous improvement of the supervision methodologies, early intervention when problems arise and the development of more effective means of influence. This division, for instance, facilitates the organization of expert sessions or 'time-outs' where supervisors with different areas of expertise jointly examine a supervisory case. Examining the problem from a broad range of perspectives can help supervisors identify 'new' risks in an early stage as well as help them find a suitable solution for the problem. Moreover, the creation of the new cross-sectoral division has resulted in an organizational matrix structure for our supervision. This not only facilitates a more rapid response to changes in our environment, but also strengthens the quality of our supervision as more highly specialized employees and departments are involved in more parts of the supervisory process.

In addition, DNB has made efforts to effect an internal cultural change aimed at speeding up the transition from risk analysis to supervisory action. The aim of these changes is to quickly identify any unwanted developments in the financial sector – something that can never be ruled out completely – and ensure a rapid switch from preventive to corrective supervision. To facilitate the internal cultural change, the newly formed internal risk department has constructed an internal quality framework. The central aim of this framework is to help supervisors to use the new supervisory approach ('FOCUS!') effectively. For that, managers and supervisors need more than to simply adhere to the supervisory process. They also need to constantly monitor whether their efforts have the intended results. In that context, the internal quality framework provides an overview of relevant questions and dilemmas that help supervisors focus on the desired outcome. For one, these dilemmas relate to the supervisory context by raising questions such as: 'how

does the problem relate to our overall mission?', 'do we focus on an illegal or harmful problem?' and 'what do our stakeholders expect from supervision?' The questions also relate to the steps in DNB's new supervisory approach, ranging from risk identification to risk mitigation. Box 2.1 provides an illustration of the quality framework by showing how it can help supervisors in the process of risk identification.

2.4 Measuring the Quality of Financial Supervision

Another way for supervisors to examine whether their actions contribute to the desired result is by establishing an adequate routine for performance measurement. By measuring their performance periodically, supervisors are not only able to measure the level of compliance with their processes (output), but also monitor their effectiveness (outcome) and change their approach accordingly. Moreover, it also provides supervisors with the means to measure their progress in meeting their objectives and consequently report this progress to the public. As such, performance measurement can strengthen the accountability and transparency of a supervisor and should be an integral part of the supervisory process (Baldwin and Black 2007).

In general, effects can be measured at three different levels: strategic, tactical and operational. At the strategic level, supervisors typically strive to present the strategic outcome of their actions to the government or general public. This, for instance, may refer to the extent to which supervisory efforts contributed to the overarching goal of financial stability. Due to the experiences of the financial crisis, stakeholders are increasingly expecting supervisors to be able to show the effects that their activities have on their mission by measuring the effects at a strategic level (Hilbers et al. 2012). Performance measurement at the tactical and operational level, on the other hand, is more focused on improving the quality and efficiency of the supervisory processes.

In practice, however, measuring the effectiveness of supervisory actions is not straightforward. We distinguish three challenges that financial supervisors typically face. The first is methodological and relates to the question of whether it is possible to prove causality. Sparrow (2008) argues that an increase or decrease of risk over time might have little or nothing to do with any interventions from the supervisor. It could simply be the result of a change in economic conditions or some other exogenous factor. In order to prove causality, supervisors therefore should to be able to isolate their own impact on the problems they address. Ideally, this would require the formation of a control sample or an advanced research design such as a randomised controlled experiment.[5] Opportunities for such controls, however, are

[5] A randomised controlled experiment consists of multiple measurements (pre-event as well as post-event), a randomised intervention as well as a randomly selected control group.

rare in financial supervision.[6] The second challenge refers to the legal question of whether supervisors are allowed to report the outcome of all their interventions. In practice, most prudential supervisors face a statutory duty of confidentiality and are thus not allowed to report or publish all their actions. Finally, the third challenge relates to the preventive nature of supervision and the difficulty to measure the impact of preventive interventions (so-called 'near misses'). For example, consider a situation in which intervention by the supervisor averts a financial institution's impending insolvency. By intervening, the supervisor will reinforce the financial solidity of the institution, as well as boost public confidence in the specific institution and probably also in the financial sector as a whole. Communicating the 'near miss' and the effectiveness of this intervention to the general public, however, could have an adverse impact on public confidence in the specific institution and the overall financial sector, thereby countering the very objective of the intervention.

Box 2.1. How the Internal Quality Framework Can Help Supervisors Identify Risks.

Adequately identifying risks is essential for effective supervision. In practice, however, this is not always easy. Supervisors generally receive huge amounts of information from various sources, while risks are not always clearly visible before they materialize. The internal quality framework aims to support supervisors by providing possible 'red flags', asking relevant questions and explicitly stating relevant dilemmas.

Tips and tricks:

- Search for symptoms of inflammation. Signals of risks in a financial institution show resemblance to the four characteristics of inflammation in the human body. In medical terms these reactions serve both to warn the human body that injury has taken place and to set in motion responses that save the body from further injury.
  - Dolor (pain): Company faces an unexpected loss (of profit) at a business unit.
  - Calor (heat): Company is active in 'hot' market with rapid increase of competitors.
  - Tumor (swelling): Company is rapidly increasing employees in a certain business unit.
  - Rubor (redness): Development of company's business unit is deviating from competitors.

(continued)

[6] Forming a control group is difficult as it presents the supervisor with a reputational risk as institutions are in the control group without prior consent. Moreover, it will typically be hard to effectively separate the institutions in the control group from exogenous influences that influence the rest of the population.

- Safeguard a random process of risk identification. Only focusing on the identification of risks in specific 'high risk regimes' may cause selection or recency biases and facilitate blind spots in the risk identification process.
- Be aware of your perspective. Problems can be approached from different perspectives (such as an economic, legal or psychological) and at different levels (e.g. micro, macro). Each perspective has its strengths and weaknesses. Addressing a problem from different perspectives or frequently switching viewpoint can enhance the scope for identifying risks and reduce the chance of blind spots.

As a result of these challenges, the development of performance measurement in financial supervision has long been in its early stages. This changed with the crisis and the subsequent focus on the effectiveness of financial supervisors. At the same time, financial supervisors have increasingly realized that while performance measurement is challenging, it is certainly not impossible. For one, it is important to define an objective for the performance measurement and consequently select an appropriate and useful indicator (or portfolio of indicators) for measuring the effect (Hilbers et al. 2012). The choice of indicators is strongly related to the objective, as the objective will determine whether effects are to be measured at a strategic, tactical or operational level. If effects are to be measured strategically, the indicators chosen will need to show effects at a more aggregated level, while a lower level of abstraction will apply if effects are to be measured at a tactical or operational level. Making the objective explicit will help supervisors in selecting suitable indicators.

Moreover, Sparrow (2008) argues that supervisors can increase the plausibility of a causal relationship by reducing the level of abstraction at which effects are measured. He states that translating supervisory missions, such as 'financial stability' or 'financial soundness', into concrete and relevant problems or risks at a micro or project level will increase the plausibility of a causal relationship. For instance, it is easier for financial supervisors to demonstrate that additional on-site visits have strengthened the risk management framework at a specific institution than to show that those visits improved financial stability. In the end, supervisors can demonstrate their effectiveness through a series of successful results at a micro or project level, or as Sparrow (2008) names it through a "compelling account of harms controlled".

In recent years, DNB has worked on developing a coherent set of key performance indicators in order to promote external accountability and improve our supervisory effectiveness. Through these indicators DNB is better able to measure whether interventions contribute to our overall mission. For that, we construct a coherent set of performance indicators at both a strategic, tactical and operational level. Monitoring a portfolio of indicators instead of a single parameter allows DNB to better evaluate its effectiveness, as a single key performance indicator is more sensitive to outliers. In this respect, one might think of the similarity with a pilot

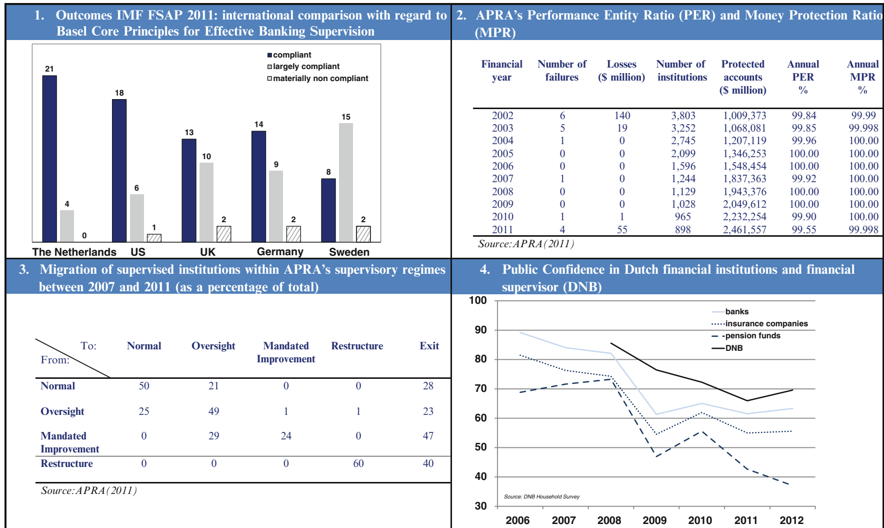
who also observes a wide spectrum of indicators in its cockpit to safely control an aircraft. Hence, it is important to monitor performance indicators through time and within their supervisory context (i.e. by asking whether there are valid exogenous reasons why an indicator is not at its target level). In this section we describe examples of key performance indicators that DNB has developed as well as parameters used by other financial supervisors.

In general, more and more financial supervisors are developing objective and useful indicators of supervisory effectiveness. In practice, the observed key performance indicators can be either classified as 'hard' or 'soft'. Hard indicators are based on quantitative data. Examples include indicators based on market data that reflect the risk profile of a financial institution, such as credit default swap (CDS) spreads (FSA 2011). Key performance indicators may also be based on ratios that reflect the solvency or liquidity position of a financial institution, such as the BIS-ratio and the Tier-1 capital ratio.[7] Another type of 'hard' performance indicator is related to the number of bankruptcies and the amount of losses accompanied by these defaults. The Australian prudential supervisor APRA, for instance, uses two quantitative indicators linked to financial failures (APRA 2011). The first is the Performance Entity Ratio (PER) which reflects the number of supervised institutions that meet their commitments to beneficiaries in a given year, divided by the total number of supervised institutions. The second indicator is the Money Protection Ratio (MPR) and represents the dollar value of liabilities to beneficiaries that remained safe in a given year, divided by the total amount. In this context, the Federal Reserve employs a somewhat similar indicator by measuring the losses from state member banks to the Deposit Insurance Fund (DIF). The Federal Reserve aims to prevent losses from becoming greater than premiums paid into the DIF by state member banks and annually reports the outcome (Federal Reserve System 2011).

Hard performance indicators are also used at the operational level. The Canadian Office of the Superintendent of Financial Institutions, for instance, measures whether its processing applications for regulatory approval are conducted within the established time frames (OSFI 2011). Another example is the Federal Reserve that annually monitors the number of reports of its supervisory examinations that are finished within established deadlines. These types of indicators give a perspective on the efficiency of the supervisory processes. The advantage of 'hard' performance indicators is their high level of objectivity. In addition, many of these indicators are relatively easy to interpret and monitor through time. For example, as Fig. 2.3 illustrates, the annual PER and MPR reported by APRA averaged 99.90 % and 99.99 %, respectively, during the recent decade.

Soft indicators, on the other hand, are typically based on qualitative information. They have the advantage of being able to measure qualitative aspects of

[7] The BIS-ratio represents the ratio between a bank's risk-bearing capital and its total risk-weighted assets. The tier-1 capital ratio depicts the ratio of a bank's core equity capital to its total risk-weighted assets.



Financial year	Number of failures	Losses ($ million)	Number of institutions	Protected accounts ($ million)	Annual PER %	Annual MPR %
2002	6	140	3,803	1,009,373	99.84	99.99
2003	5	19	3,252	1,068,081	99.85	99.998
2004	1	0	2,745	1,207,119	99.96	100.00
2005	0	0	2,099	1,346,253	100.00	100.00
2006	0	0	1,596	1,548,454	100.00	100.00
2007	1	0	1,244	1,837,363	99.92	100.00
2008	0	0	1,129	1,943,376	100.00	100.00
2009	0	0	1,028	2,049,612	100.00	100.00
2010	1	1	965	2,232,254	99.90	100.00
2011	4	55	898	2,461,557	99.55	99.998

Source: APRA (2011)

From: \ To:	Normal	Oversight	Mandated Improvement	Restructure	Exit
Normal	50	21	0	0	28
Oversight	25	49	1	1	23
Mandated Improvement	0	29	24	0	47
Restructure	0	0	0	60	40

Source: APRA (2011)

Fig. 2.3 Four possible performance indicators of financial supervision

supervision, but tend to be somewhat less objective than hard indicators. Figure 2.3 presents an example of a soft indicator that reflects the migration of financial institutions within pre-defined supervisory regimes or risk scores. This type of migration parameter is not only part of DNB key performance indicators, but is also reported by several financial supervisors, such as the Canadian OSFI and the Australian APRA. In addition, the German Bundesanstalt für Finanzdienstleistungsaufsicht also reports the number of supervisory actions within each risk score to strengthen the evidence of any causal relation (Bafin 2011). The public confidence in financial institutions and the financial supervisor is another example of a soft performance indicator. DNB, for instance, annually measures public confidence by means of a representative household survey (see Fig. 2.3).

Furthermore, performance indicators can also be based on the outcome of external or peer reviews that measure the level of compliance towards (inter) national supervisory standards. The FSAP analysis conducted by the IMF, for instance, reports the level of compliance with international supervisory principles such as the Basel Core Principles for Effective Supervision and the IAIS Core Principles for Insurance Supervision (IMF 2011). An international comparison of outcomes between peers (or time) can be an effective way of measuring the performance of financial supervision (see Fig. 2.3) and is part of DNB's set of key performance indicators. An example of such a study is performed by Cihák and Tieman (2008), who analyze the quality of financial sector regulation and supervision by using data from the IMF and World Bank assessments of compliance with international standards and codes. They find significant differences in the quality of supervisory frameworks across countries, with per capita income being a major factor.

2.5 Conclusions

The financial crisis marked the start of vigorous efforts to improve the effectiveness of financial sector regulation and supervision. In this chapter, we distinguished seven global trends that mark the current supervisory redesign. These trends will make financial supervision more forward-looking, more supra-institutional and more integral in its approach. The crisis also underlined the complexity, interconnectedness and rapid development of financial markets. As a result, financial supervisors need to continuously monitor and sharpen the effectiveness of their approach in order to adhere to the latest trends in the financial sector. This requires an adequate system of internal risk management and quality control within the supervisory approach.

In this chapter we described the 'checks and balances' in place within the new supervisory approach of DNB. This includes an organizational structure aimed at continuous improvement of our supervision methodologies as well as a culture that stimulates a rapid transition from risk analysis to supervisory action. These measures not only aim to improve the supervisory process, but also focus on improving the desired outcome of our supervision, namely a stable financial system.

Performance measurement, in addition, is another important instrument of quality control as this enables supervisors to monitor their effectiveness and sharpen their approach accordingly. Although measuring the outcome of supervisory actions is not straightforward, it is also not impossible. In this chapter we described the set of key performance indicators developed by DNB and provided a wide range of indicators that financial supervisors may apply, ranging from 'hard' indicators, such as the number of bankruptcies or the amount of losses accompanied by these defaults, to 'soft' indicators, such as public confidence in financial institutions. These examples can help supervisors in selecting a suitable and 'fit for purpose' portfolio of indicators to measure their effects with.

Although continuous improvement and adjustment will strengthen the supervisory framework, the subsequent transitions may also pose new challenges and risks of their own. However, supervisors may take some consolation from John F. Kennedy, who once said: "there are risks and costs to a program of action, but they are far less than the long-range risks and costs of comfortable inaction."

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Chapter 3
The Case for Analytical Supervision: A Swedish Perspective

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3.1 Introduction

In the years before the financial crisis rocked not only the global financial system but also the entire global economy, there was a strong drive to modernise financial supervision. This drive was characterised by a belief that risk could be precisely quantified through models or market prices while many deemed existing supervision as slow, bureaucratic and unlikely to add much value. A key underlying assumption behind this approach was that senior management judgment and market discipline should not be 'second guessed' by supervisors (Bank of England 2011, p. 5).

This was part of a broader trend in the EU, following the creation of the single currency, where the EU was making big strides towards the creation of a single market in financial services. The financial sector was generally perceived by politicians as an attractive industry – knowledge based, high growth and extremely profitable – that should be promoted. London was the envy of many European politicians who expressed an ambition of hosting an international financial centre in their jurisdiction, or at least creating a regional financial hub. Swedish politicians were not an exemption – over the past decade numerous presentations were delivered on the theme of Stockholm as a financial centre (for instance, Odell 2008). This ambition made politicians vulnerable to the arguments of the financial industry lobby. Whenever a country considered a new or slightly stricter rule, it was quickly reminded by its domestic financial industry of the need for a level playing field and the risk of seeing the financial industry choosing to expand in another capital instead. This competition between existing and wannabe financial centres was one important factor behind supervisory strategies which included elements such as being 'liberal' when implementing internationally agreed regulations, applying a 'light touch' in supervision and being very mindful of the regulatory burden of firms. At the same time, prudential supervision was often downplayed compared to issues that at the time were considered to be more important, such as market conduct, global and regional harmonisation and consumer protection.

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Needless to say, these policies allowed financial firms to operate under great strategic freedom and with very small financial buffers. In the post-crisis debate there is an almost universal consensus that the capital levels required under the Basel II regime were grossly inadequate and that the financial sector had “lived life to excess” (Byres 2012, p. 2). The banks got accustomed to low levels of capital requirements and an abundance of cheap liquidity. In the meantime, unprecedented risk levels built up in the financial system, and unfortunately we – central banks and supervisors – did not see it coming this time either.

3.1.1 The Swedish case in the last crisis

These mistakes were made in Sweden as well, perhaps to a lesser extent than in some other countries, as evidenced by the fact that the country has avoided a credit crunch and all capital increases by major banks during the recent crisis were financed by private sources.[1] However, prior to the crisis, Sweden also prioritised implementing formal regulations such as Basel II and the development of quantitative, model based measures of risks. This focus reduced the available resources necessary for supervision. The Swedish capital adequacy regulation, issued in 2006, was printed on 205 pages, and the new rules resulted in Finansinspektionen (FI) – the Swedish FSA – recruiting a number of credit risk model experts. Meanwhile, on-site supervision of credit risk was understaffed.

Unfortunately, this coincided with the period when three systemically important Swedish banks were building up significant exposures to the rapidly growing Baltic economies, to a large extent funded by short-term borrowing in international capital markets. In the autumn of 2008, when the Baltic boom was coming to an abrupt halt and the first credit losses materialised, FI had more people working on the assessment of credit risk models than actually carrying out credit risk assessments. At the same time, global market confidence in banks disappeared and suddenly also Swedish banks with Baltic exposures were being questioned in the funding markets. To address the risk of Swedish banks not being able to roll over debt, the Swedish state introduced a guarantee program for funding which at its peak in June 2009 amounted to SEK 354 billion,[2] equal to 11 per cent of Swedish GDP.[3]

It cannot be taken for granted that more on-site supervision and generally better staffed supervisory authorities would have prevented banks from taking on big credit and liquidity risks, and in particular not the kind of supervision that prevailed

[1] However, in the case of Nordea, the Swedish government was already (and is still) a minority owner and participated in the rights issue to maintain the Swedish government’s ownership share, currently at 13.5 per cent.

[2] Swedish National Debt Office (2012).

[3] Only one of the major Swedish banks, Swedbank, used this program to issue government guaranteed debt. But it is probably safe to say that the program’s existence had a considerable impact in calming down investor concerns about continuing to fund Swedish banks.

in most countries in the years leading up to the crisis. This audit-style supervision, also referred to as "compliance based approach", was characterised by a focus on controlling processes, firms' own control functions, documentation, and regulatory returns.[4] Only more analytical and holistic supervision would have had a chance to identify the risks building up and challenge the strategies associated with the Baltic expansion. For example, to realise the potential interaction between credit problems in the Baltic subsidiaries and liquidity risks in the Swedish parent bank requires an assessment across risk types and legal entities while also taking into account future stressed conditions.

In fairness, this interaction of credit and liquidity risks across legal entities was in principle well understood by both FI and the Riksbank – Sweden's central bank. Both authorities were involved in crisis simulation exercises on this theme in the years before the crisis. However, the high level understanding of this risk in principle did not have any meaningful impact on supervisory priorities in practice, for example leading to a strong focus on credit risk investigations in the Baltic subsidiaries or liquidity risk investigations in the Swedish parents. This lack of forceful pre-emptive action earned both FI and the Riksbank substantial criticism by the Swedish National Audit Office in a public report in 2011.[5] The price for mismanaging the risk of the Baltic expansion paid by the three banks was arguably higher. Measured by the volume of issuance of common equity and convertible preference shares in the period of 2008–2010, it amounted to SEK 57 billion.

3.1.2 Need for better supervision, not only more regulation

As a result of the financial crisis, over the past five years European supervisors have devoted much effort to strengthen regulation. In banking these efforts have mainly been about raising the quantitative requirements for capital and liquidity. This applies also to insurance regulation where in Europe the past decade has seen enormous resources being spent on developing the Solvency 2 framework. Improving regulation is important but unfortunately, with some exceptions, relatively little has been done to improve actual supervision. The failure of supervision in the past crisis has been well documented. But so far, the preferred remedy has been more regulation. We would instead argue that an equally important remedy should be better supervision.

In the next section the weaknesses of the currently prevailing supervisory paradigm – which we refer to as "audit supervision" – will be examined. This will be followed by the case for another model that we call "analytical supervision" characterised by the use of supervisory judgment, forward-looking assessments and proactive supervisory responses. We will then illustrate these different supervisory

[4] For more discussion on this, see e.g. Viñals and Fiechter (2010).

[5] Swedish National Audit Office (2011)

approaches by discussing some actual Swedish supervisory experiences. Finally, we will conclude by proposing what we believe should be the supervisory model of the future.

3.2 Audit Supervision

We would describe the vast majority of financial supervision done today as audit supervision. Audit supervision – other possible names are compliance or tick-box supervision – is an approach very similar to the auditor's and is mainly concerned with making sure that the processes underlying financial reporting and risk measurement are robust and formally adequate and that internal governance systems are well designed and documented. Accurate financial reporting and adequate quantitative models supporting risk-sensitive capital requirements are all pre-requisites for a sound financial system, effective risk management and regular follow-up by the supervisory authority. Thus, audit supervision is and must be the basis for supervision. But it is not sufficient to ensure good supervision and can only be a starting point. The problem with audit supervision is its scope and mind-set. Audits tend to be detail-oriented and formalistic. The purpose of audits is to verify that processes are in place and well-documented, that policies are actually followed, that numbers are correct, that the model's input data is the right one, etc. Audits may also look at internal governance and risk control, but will do so mainly from a formal point of view, making sure that it is well organised and documented. These are all important aspects for supervisors to look at, in particular with respect to smaller firms where shortcomings in formal controls are more common. But the approach is clearly insufficient for supervision to be effective in reducing the risk for failures of larger firms, and the events leading to the crisis in 2008 are proof of that.

3.2.1 Not seeing the forest for the trees

What audits will never do is to question strategy, discuss the risk culture, criticise the actual decisions made regarding risk or be forward looking. Most people who have read an audit report know that in general, it will tell you everything about the lack of documentation, processes and formal controls, but little about the real risks that a firm is facing. An audit report of a bank would probably look more or less the same in 2006 when the bank was flying high, as in 2009 when it was about to go under. It would most probably be the same long list of action points to deal with more or less mundane weaknesses and glitches in processes, reporting and data management. The audit report would probably not have pointed out that the bank had amassed an

enormous subprime exposure. But it would have told you that the investment policy had not been updated to reflect the most recent organisational change.

In a formal compliance sense major global banks probably had their house in order when the crisis struck – at least they largely complied with the letter of "formal rules". In hindsight, it is apparent that this formal adherence to rules was by far not enough to survive. Neither can the mass failures of major banks in the crisis be explained only by the insufficiency of minimum international capital and liquidity requirements, even if that played a role. What supervisors had missed is that many of those banks had radically changed their business models and risk profiles over the decade leading up to the crisis. But these changes were certainly difficult to measure and capture by quantitative indicators and impossible to identify in a standardised audit, and thus received relatively little attention prior to the crisis.

A large number of banks that were perceived to be at the cutting edge of risk management and modelling survived the crisis only due to massive support from central banks and governments. This was also the case in jurisdictions whose supervisory authorities were seen as being at the forefront of understanding and supervising risk.

We think this failure was mainly due to a lack of effective supervision and only to a lesser degree had to do with weak formal regulation. We think that supervisors generally spent too little time on thinking about what really matters. It is generally well understood that risk models are just that – models; that individual risk measures seldom reveal the big picture; that accounting often only illustrates one of many possible points of view, and that the risk and compliance functions in financial firms almost never have the last word when it comes to really important decisions. Paradoxically, most supervision is still heavily focused on these aspects – risk models, financial reporting and control functions.

3.2.2 Lots of reporting but little analysis

Audit supervision is very much concerned with the firms' quantitative reporting – income statement and balance sheet, measures and ratios for capital and liquidity and output of risk models. However, quantitative risk measurement does not replace or even diminish the need for qualitative assessment. This may sound obvious, but probably is not, judging by how supervisors in many countries allocate their resources in practice. During the past two decades, enormous resources were devoted to quantitative, risk-sensitive and very detailed regulation such as Basel II, as well as accounting standards which relied heavily on internal models (e.g. IAS 39). Intentions were good, but somewhere along the road authorities lost sight of the big picture and neglected the fundamental limitations of models in general and financial ones in particular. This development was characterised by a desire, despite

empirical evidence, to quantify all risks and come up with "objective" risk measures.[6] The result of this is that much of the dialogue that is occurring between the supervisor and the regulated firm is focusing on technical details, such as the outputs of those quantitative models. Supervisors devote much time to approve models and review processes; reflect over proposed methods to apply IFRS when it comes to valuation of complex and illiquid securities, and contemplate on the design of hybrid capital instruments with often-questionable risk-absorption capacity. All these issues are important and require the attention of the supervisor. The problem is that this "baseline supervision" "steals" resources from more risk based and forward looking supervision. The danger is that the actual business activities and day-to-day risk taking of firms go on relatively unattended by supervisors.

Audit supervision is by its very nature reactive since it relies on the firms' reporting. We have seen numerous examples during the crisis how models and ratios have been satisfactory until the crash is a fact. Behind the simple and inconspicuous figures often lies a reality which is radically different. For instance, one reason why the common equity ratio for the three major Icelandic banks looked so impressive was that it neglected a less known fact that the share issuance was funded by leveraged loans, where the same banks provided the financing.[7] In other words, the Icelandic banks' "common equity" had very little in common with the "common equity" as defined by the Basel Committee. Besides, the other figures reported by the Icelandic banks did not capture excessive risk concentrations, and certainly missed financial fraud whose extent in retrospect turned out to be considerable. The limitations of supervision focused on reported figures in such an environment are obvious. That being said, Iceland is unfortunately not an outlier in terms of supervisory approach or overreliance on reported figures. But it is an extreme example in terms of the consequences and the extent to which this supervisory approach was misled.

In the next section we will try to present an outline of an alternative, more analytical approach to supervision.

3.3 Analytical Supervision

The very essence of good supervision is about making judgments regarding issues such as risk appetite, governance and the culture of the supervised entities. In the words of Viñals and Fiechter (2010, p.5) supervision is about "figuring out whether an institution's culture and risk appetite significantly increase the likelihood of solvency and liquidity problems". Good supervision is analytical, holistic and forward-looking. This enables supervision to be proactive, with the aim of tackling problems before they materialise and become serious. The making of good

[6] For more discussion on the limitations of models see Taleb (2007), Haldane (2012).

[7] Special Investigation Commission (2010), Chap. 21 p.16.

supervision is to a much lesser extent about formal compliance or detailed technical reporting. As mentioned above, these obviously serve an important purpose, but only as a basis and starting point for a qualitative assessment.

3.3.1 Qualitative, judgement-based and sceptical

Let us be clear that analytical supervision requires technical and quantitative experts. We need the experts to be able to discover the flaws and limitations of financial and risk measurement and to see through complex accounting. But also the technical experts need to use judgement and should be required to make qualitative assessments. Analytical supervision is characterised by a sceptical mind-set that aims to identify the weaknesses in and the reasons for the firm's chosen approach. It is about trying to understand the underlying drivers of the firms' behaviour and actions. Why is the firm proposing this model change? What will be the overall impact of choosing this approach? Why is the parent company conducting this transaction with its subsidiary? Although legally compliant, is this transaction sound from a risk perspective? When evaluating a model, the supervisor should focus on the fundamental weaknesses of the model rather than just verifying whether it is theoretically underpinned, statistically robust or technically correct.

Understanding the risk and business culture of a firm should be an integral part of all good supervision. This is based on the premise that risk is inherently difficult to measure and its true size will only become known when it materialises, that is to say too late. Supervisors must therefore understand that real risk is created by "soft" factors such as strategic decisions, human psychology, organisational culture and the structure of incentives (see also the contribution of Nuijts and De Haan in Chap. 10).

3.3.2 Principles based and proactive

The supervisory dilemma is that the rule of law requires "objective grounds" for any supervisory intervention, but supervisors are expected to intervene proactively, before the risks materialise, which means that they will often not have the whole palette of facts available. There is naturally nothing wrong to require that supervisors base their decisions on legal grounds, as they should be defendable, if challenged, in a court of law. At the same time, the search for objective and clear "evidence" is not a recipe for good analysis. On the contrary, it directs supervisory attention towards formal transgressions of compliance, where "facts" are easiest to find. It is much more difficult for the supervisor to challenge strategic decisions and risk culture – both analytically and from an enforcement perspective.

One way of addressing this dilemma is by training supervisors to be more analytical in their daily work, in other words, making judgment-based supervision a rule rather than an exception. A key feature of such supervision is the ability to be

forward-looking and to be able to focus on the worst possible scenarios – both of which require judgment.[8] Such an approach requires more profound analysis and courage to question firms' strategic direction and business model rather than to only point out deficiencies in outdated procedures, or criticising the excessive failure rate in a VaR-model validation report. A judgmental approach also requires the ability of the supervisor to refer not only to the letter but also to the spirit of the law and base the reasoning on more general requirements of sound and sustainable business operations and prudent risk management. Principles-based supervision got a bad name after the crisis. We think this is unfortunate and is due to the misunderstanding that principles-based equals "light touch" (see also the contribution of de Vries in Chap. 11). In our experience, qualitative and judgment-based supervision is very much dependent on the ability to effectively apply high-level principles to practical cases. In all major interventions by FI in recent years high-level principles have formed the core of the legal case against the firm.

3.3.3 The sceptical market analyst as a role model

Let us illustrate this point by comparing the approach of the private sector market analyst to the quantitative supervisor. In our experience, the best analysis of "soft" factors and real risks is conducted by market analysts. Of course, market analysts are often wrong and misjudge risk as much as supervisors and central bankers. But there are a sufficient number of contrarians among the analysts who have a "bearish", sceptical view of developments and are the first to formulate warnings, often way ahead of the supervisors. We believe that this kind of sceptical and bearish market analyst is a good role model for the qualitative supervisor. These market analysts are usually good at understanding the firms' business models and strategies: what is the basis for the underlying earnings; how is the firm reaching its profit targets; where is the growth coming from; how can margins be defended; what is the vision of the CEO, and so on. But market analysts do not have access to the firm's internal organisation; they cannot request internal documents and instructions or detailed audit reports. However, this is a great advantage rather than a flaw! It forces analysts to think by themselves and to reflect on firms' strategy, relative strengths and weaknesses, markets and competitors.

The knee-jerk reaction of many supervisors and central banks when faced with the request to analyse a company or phenomenon is to launch a comprehensive data collection exercise. That is particularly visible when it comes to international central bank and supervisory cooperation. The analysis comes in stage two, almost as an afterthought, and is often superficial and produced under time pressure. It is very unusual that such reports ever conclude something different from what was

[8] For other proponents of judgments-based supervision, see Huertas (2011), Haldane (2012) and Viñals and Fiechter (2010).

already a consensus among market analysts prior to the undertaking of the exercise. The authority and the capacity to collect massive amounts of data is a potential enemy of analytical supervision. One way of addressing this problem could be to actually recruit more analysts from the market – something that FI has tried and succeeded in. Another way to deal with it would of course be for supervisory executives to insist on a better balance between the scale of data needs and the quality of resulting analysis. The access to detailed data and internal information is of great importance to the supervisor but its use should be directed by judgment-based and qualitative assessment.

3.4 Some Swedish Experiences

Above we have described the key contrasting features of audit supervision and analytical supervision. We will now try to illustrate these two approaches by a few concrete examples of measures that have been taken by FI over the past few years. In some cases we seem to have been "guilty" of audit supervision, while in some cases we think the measures were at least in part guided by the features of analytical supervision.

3.4.1 Case Study 1: The Failures of Two Local Investment Banks

In the autumn of 2008 FI revoked the license of Carnegie, a local brokerage and investment bank, and in the summer of 2010 FI revoked the license of HQ Bank, another local brokerage and investment bank. Apart from the two banks being very well known players in the Swedish, and in the case of Carnegie, Nordic market for corporate finance and brokerage, these two cases have many aspects in common. Somewhat simplified, both banks had relatively profitable businesses in private banking and wealth management, decent brokerages but struggling trading operations. Both banks were also characterised by big risk appetites, a successful past, and relatively weak risk control functions. The difficult markets that started in the summer of 2007 put severe pressure on the valuations of the kind of long-dated and relatively illiquid options in which both banks specialised.

Carnegie was the first one to fall. In the autumn of 2007 it was revealed that some of Carnegie's traders had manipulated valuations to hide losses. FI responded by fining Carnegie the maximum amount and by forcing it to replace the CEO. However, as the financial crisis intensified during 2008, more problems came to the surface. In the autumn of 2008, Carnegie had an urgent liquidity problem at the same time as FI found out that it had knowingly breached the large exposures limits with regard to a big client. FI decided that enough was enough and revoked the licence. The bank was subsequently nationalised – wiping out the shareholders – and has since been privatised again.

The fall of HQ started in the late spring of 2010, when the bank contacted FI and admitted it had a big unrealised loss in its trading book, that had until then been mis-valued. About the same time, FI found out in its capital assessment of the bank, that the bank's internal capital assessment which had been signed off by the board stated a considerably lower market risk exposure than what the same board had authorised its trading department to take on. In combination with a number of other deficiencies in the governance and control of the bank, this resulted in the revocation of the license in the late summer of 2010.

Naturally, it is easy to be wise when everything is known. Still, we think that a more qualitative and proactive approach would have stood a reasonable chance of addressing the underlying problems earlier on. FI was aware of the aggressive risk cultures and weak governance and control structures prevailing at both firms. Both firms were viewed as "high risk" operations by the supervisors on the ground. However, FI did not formulate a comprehensive supervisory response to address these broader concerns. Instead, in both cases FI ended up reacting to "black and white" breaches of formal rules once they became evident. Perhaps these two failures could have been avoided if FI at an early stage would have forcefully questioned boards and senior management about the risk culture and weak governance and control.

3.4.2 Case Study 2: Addressing Capital Concerns Through Public Stress Testing

The Baltic economic crisis which started in late 2008 did not come as a complete surprise, but its severity and impact on the two most exposed Swedish banks[9] was much greater than expected. Even if the exposure of these two banks was relatively contained – in relation to their overall balance sheet it varied from 12 to 15 per cent at its peak – both banks relied heavily on market funding. A large share of market funding came from unsecured borrowing, often short term. In its analysis of the banks in 2007, FI concluded that the banks' capital situation was adequate to deal with the Baltic crisis. However, this conclusion turned out to be correct only when capital needs were assessed against the formal minimum Basel II requirements, and when the link between credit and funding risks was neglected. The problem with this kind of reasoning was that the solvency of the banks – while being well above the legal minimum – was in the autumn of 2008 still assessed by the providers of funding to be too weak to absorb a Baltic "Armageddon". The two banks therefore experienced intense funding pressures and needed to make extensive use of the Riksbank's liquidity support operations.[10] Three of the major banks - Nordea, SEB

[9] SEB and Swedbank.

[10] All four major Swedish banks used the Riksbank's liquidity support operations at some point and to a varying degree.

and Swedbank - raised new capital in the six months following the Lehman crash. However, this was not enough to completely allay the market's fears. The funding problem was particularly severe for Swedbank which had to use the explicit government guarantee program to be able to issue senior debt. The only path of return to market funding was to strengthen the capital position of Swedbank and to make a powerful case to the markets that the other banks really had sufficient capital buffers, irrespectively of how deep the crisis in the Baltics would become. This meant that FI had to both apply a meaningful stress to the banks' balance sheets and require the banks to have a very high capitalisation – common equity tier-1 ratio of 10 per cent – post stress, which would reassure the markets. FI's tool for that was the use of stress tests in its supervisory dialogue with the banks. Bank-specific supervisory stress tests were normally disclosed once a year, in conjunction with FI's annual Risk Report, but due to the extraordinary circumstances the stress test results were published already in June 2009. The stress test parameters were arguably very conservative, and were publically disclosed. For instance, FI assumed that banks would lose 15–25 per cent of their credit portfolio in the Baltics. The publication of the stress test was preceded by an intense supervisory dialogue, with the view to reaching a common understanding of the need to issue new shares and build extra buffers of common equity. In addition to stress tests, the banks were requested to draft concise recovery plans which were reviewed by FI. In essence, the publication of the stress tests served as a powerful tool of moral suasion, providing an additional incentive for Swedbank to raise more capital, as no institution wanted to be singled out as being undercapitalised compared to its peers.

The approach that FI chose in 2009 to deal with the situation of the Baltics was based on four basic principles. First, transparency, as the outcome of supervisory judgments was available to the public at large in the form of the published stress test results. Second, supervisory judgments were based on the "worst-case", assuming that the banks should be able to deal with a Baltic devaluation, should it materialise (it did not). Third, the required benchmark capital levels were derived from the then prevailing requirements of the funding markets, in order to enable the banks to fund themselves in private markets without the need to fundamentally change their business model. The fourth and final principle was that FI acted pro-actively, requiring banks to take measures at a relatively early stage of the Baltic crisis, when the bulk of expected losses had not yet materialised and before capital ratios had dropped to critical levels.

3.4.3 Case Study 3: Limiting Household Credit Growth Through Loan-to-Value Ceiling

The Swedish housing market has seen an almost uninterrupted growth in the past two decades, with house prices doubling since 1993. In the first decade of the century annual lending growth averaged close to 10 per cent. As a result, household

indebtedness has reached very high levels by international comparison, with the debt-to-income ratio amounting to 170 per cent. At the same time, the average loan-to-value ratio for new loans has increased from 60 to 70 per cent in the past decade and about 70 per cent of mortgage loans are now amortisation free. Most of the newly originated mortgages are variable-rate. Also, certain borrower groups are more vulnerable than the average figures reveal. For instance, for newly originated mortgage loans, one third of borrowers have debt levels that are over five times their annual disposable income.

At the same time, there are important factors limiting the risks for a housing bubble or large losses on mortgages in Sweden. Swedish legislation ensures a strong protection of creditors which in practice makes it very difficult to write off debts or enter into personal bankruptcy. The buy-to-let model has never reached any meaningful proportions, mostly due to extensive rent regulation. Real estate development is also characterised by structural rigidities significantly limiting new housing development. Finally, as in many countries there is a strong demographic trend in Sweden whereby in particular young people move from the countryside and smaller towns to a few bigger cities.

Despite the build-up of household indebtedness, the losses from mortgage lending has remained low or non-existent. In its analysis in 2010, FI argued that mortgage lending did not constitute a prudential concern, as banks had sufficient capital buffers to deal with a multi-fold increase of credit losses. However, there was a concern that many consumers were particularly vulnerable to falling prices in the housing market, especially if such a price drop were accompanied by a weak development of their incomes due to a deteriorating economic situation. In particular, first time buyers living in major urban centres were seen as most sensitive to those shocks, as the absolute price level in major cities was very high. First time buyers typically had lower incomes and thus both their loan-to-value and loan-to-income ratios were high in comparison to other borrowers.

To address the situation of the most vulnerable consumer groups, FI in February 2010 announced that it contemplated to propose a guideline with respect to a maximum loan-to-value ratio for new mortgage loans. In October 2010, a guideline that set the maximum loan-to-value ratio at 85 per cent of the real estate collateral value came into force.[11] The legal basis for FI's measure was a very broad provision in the Swedish banking law that requires banks' business conduct to be "fundamentally sound". The regulation does not prevent consumers from taking more expensive uncollateralised loans if their savings are not sufficient for the required down payment. FI believed that there would anyway be sufficiently strong incentives to amortise such loans over a relatively short period of time.

In the context of qualitative supervision we think that it is worth noting that the regulation was proactive in the sense that it was adopted prior to any materialisation of the risks – there had been no house price crash, there were no signs of asset

[11] In practice, the rule prevents any creditor that is supervised by FI to register as collateral more than 85 per cent of the value of the underlying real estate.

quality deteriorating and interest rates were very low. Indeed, many consumer groups challenged the proposed regulation on the grounds that the risks were much smaller than feared. In retrospect, it seems as if the regulation had positive externalities as far as financial stability was concerned. It remains to be seen whether more regulation will be required to reduce the rise of household indebtedness. However, the evidence seems to support that the loan-to-value ceiling has contributed to a slowdown of lending growth and a reduction in loan-to-value ratios. Indeed, when the effects of the regulation were assessed a year later, mortgage lending growth had dropped almost by half; and only 9 per cent of new borrowers had chosen to have a loan that exceeded the loan-to-value ceiling of 85 per cent, half the level compared to a year earlier.

3.5 Conclusions

The existing paradigm of audit supervision – with its focus on formal compliance and detailed financial and risk reporting – is not sufficient to prevent serious financial crises. It needs to be complemented by a new paradigm of analytical supervision featuring proactive intervention based on holistic, forward-looking judgment of firms' business models, governance and risk profiles. This approach is based on the assumption that a firm must hold capital for the "worst case" and it means that supervisors may have to act on the basis of their "best estimate of a worst case". Such an approach requires supervisors to have both the ability and – equally important – the courage to act. It also means that supervisory actions will more often be scrutinised and questioned by the industry, the media and the public at large. It requires much better communication skills to credibly explain and defend judgment-based interventions than to just refer to a list of formal inadequacies.

The supervisory dilemma of being required to motivate action by "hard evidence" – something that only becomes available once the risks have materialised – can be addressed by raising the level of acceptance for pro-active, judgment-based intervention. The public's acceptance of supervisory judgment goes hand in hand with the perception of the supervisor as being competent, independent and neutral. As early intervention is stretching the limits of supervisory powers, it is very important to ensure supervisory accountability not only through the traditional channels of reporting to Government and Parliament, but also through transparency of supervisory assessments and actions for the market and for the public. Avoiding political capture is as important as not being captured by regulated firms, as the effects could be equally detrimental. Political capture may take different forms, but supervisors should have enough degree of freedom to "take the punch bowl away" even if the party risks abruptly ending just ahead of the election.

In conclusion we think there are four important elements to enable an analytical supervisory approach.

1. Promote judgment: make judgment and assessment central to the supervisory process, increase supervisory knowledge about business models, strategic risks and risk psychology, and recruit more sceptical market analysts.
2. Promote principles-based supervision: apply the regulation's general soundness and stability principles in accordance with solid legal provisions to address risks related to strategy, governance and culture, thereby enabling proactive intervention.
3. Improve transparency: be transparent about the reasoning behind an intervention or a decision. It is necessary for the supervisor's credibility and accountability and in the long run it will raise the skills and competence of the supervisor. Transparency can also be used to influence and direct firms in the "right" direction, before it is too late.
4. Apply worst case thinking: always try to figure out the relevant worst case, and use that as the starting point when considering a firm's situation, future supervisory actions or priorities.

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Chapter 4
Unintended Consequences of Supervision

Danièle Nouy

4.1 Introduction

The crisis has amply demonstrated the limitations of self-regulation and market discipline. Besides the strengthening of the resilience of financial institutions, the new regulations also call for an intensification of supervision. Supervisors are to be entrusted with new powers, as was the *Autorité de Contrôle Prudentiel* at its birth. This comes with stronger responsibilities. Yet, after the irrational exuberance that intoxicated economic agents before the financial crisis, has the pendulum not swung too far in the opposite direction leading to excessive reliance on supervisors?

The new regulations address major weaknesses that the crisis has revealed through stronger solvency ratios, capital of a better quality, and risks better accounted for. The French supervisor strongly supports these invaluable improvements that will result in much more robust financial institutions and a more resilient financial system, although some technical aspects, such as the liquidity coverage ratio and the leverage ratio, require caution and some further improvements.

The French supervisory authority is used to relying on intrusive off-site and on-site supervision to get an in-depth as well as updated understanding of risks incurred by banks and to monitor any undesired evolution before they spiral out of control. The crisis confirmed that this supervisory approach was well-founded. But it has also dramatically increased the issues at stake and has been extremely demanding on supervisors, in terms of speed of reaction, resources and ability to deal with increased complexity.

In the remainder of the chapter, Sect. 4.2 provides, as a background, a brief review of the constraints and risks generally faced by supervision. Section 4.3 then

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considers various examples on how these risks may be exacerbated under the new regulatory framework introduced with the financial crisis. Section 4.4 discusses the possible unintended consequences of the broadening and the deepening of supervisory actions and suggests ways to address them. Section 4.5 concludes.

4.2 Challenges, Constraints and Risks Faced by Supervisors

Before addressing more precisely the current challenges from new regulations and new supervision practices, we provide here some background on (i) the general challenges and constraints faced by supervision, as well as (ii) the institutional response provided in France through the creation of the *Autorité de Contrôle Prudentiel* (ACP).

4.2.1 Constraints and Risks Faced by Supervisors

As shown in the economic and finance literature, supervisory action is inherently subject to several constraints that prevent supervisors to reach their objectives. Therefore, supervisors have to devise an efficient organisations to limit the unintended consequences of their actions.

The constraints that supervisors face are numerous. Although this list is not exhaustive, the following can be mentioned: informational constraints, operational costs, timing constraints, unpredictability of reactions, and the quality of signals on banks' health.

As regards informational constraints, there is a classic asymmetry of information between bank managers and the supervisor. It is natural to assume that banks have better information regarding their own risks and return. However, supervisors have access to comparative/cross-sectional data from different banks and can therefore identify emerging risks that individual banks would not necessarily be able to detect.

Another constraint owes to the fact that banking regulation and supervision is costly, both directly, through the wage bill of regulators and supervisors and administrative costs for banks, and indirectly, through the distortions it generates. Also, it may generate rents for banks (see Freixas and Rochet (2008) for details).

Supervisory action is also subject to timing constraints: even if banks' decisions were perfectly observable, there would be a time lag between these decisions and the subsequent reaction by the supervisor.

Lastly, supervisory action is constrained by the unpredictability of reactions. Banks react strategically to regulation and supervision. Some reactions are intended while others are not. Predicting the exact outcome of this system with multiple players and complex interactions may seem out of reasonable reach.

The supervisor is dependent on the quality of the signals on banks' financial health. As far as micro-supervision is concerned, there are fundamentally two main risks, although their impact differs in terms of severity:

– False negative: classifying a bank as low risk while it is actually and requires strong supervisory action;
– False positive: classifying a bank as high risk and requiring strong remedial actions while it is actually healthy.

It is therefore of paramount importance for supervisors to develop and implement an efficient organisation and processes to prevent these risks, detect weak institutions early on and take preventive actions consequently. In accordance with article 124 of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, the ACP (see Sect. 4.2.2 for details on the ACP's organisation) has developed a Supervisory Review and Evaluation Process.[1]

In particular, the supervisor is subject to a conflict of objectives. Its role is to promote a sound banking sector in order to ensure the long-term financing of the economy. However, putting too many constraints on the banking sector may compromise this ultimate goal. The regulators intend to preserve a level playing field for institutions. The intensity of international competition among banking systems contributes to the reluctance from national regulators and supervisors to take unilateral action. The supervisor is also exposed to several internal risks: regulatory and supervisory loopholes, limited supervision powers, misallocation of supervisory resources, supervisory capture and biased objectives, excessive involvement in operational management decisions or supervisory forbearance. Several factors aim at mitigating these risks: legal and institutional framework, expertise, adequate resources, good governance and efficient internal organisations.[2]

The unintended consequences of supervision encompass many of these dimensions, including market disruptions (fire-sales, herd behaviour, liquidity hoarding, etc.) and regulatory arbitrage, from which market failures could derive. This overall framework is described in Fig. 4.1 that builds upon Freixas and Rochet (2008) in the supervisory domain.

4.2.2 The Statutory Framework of the French Supervisory Authority

This section provides some details on the institutional responses to the challenges described in the previous sub-section, and in particular the responsibilities of

[1] See Commission Bancaire (2007).

[2] See also Viñals and Fiechter (2010).

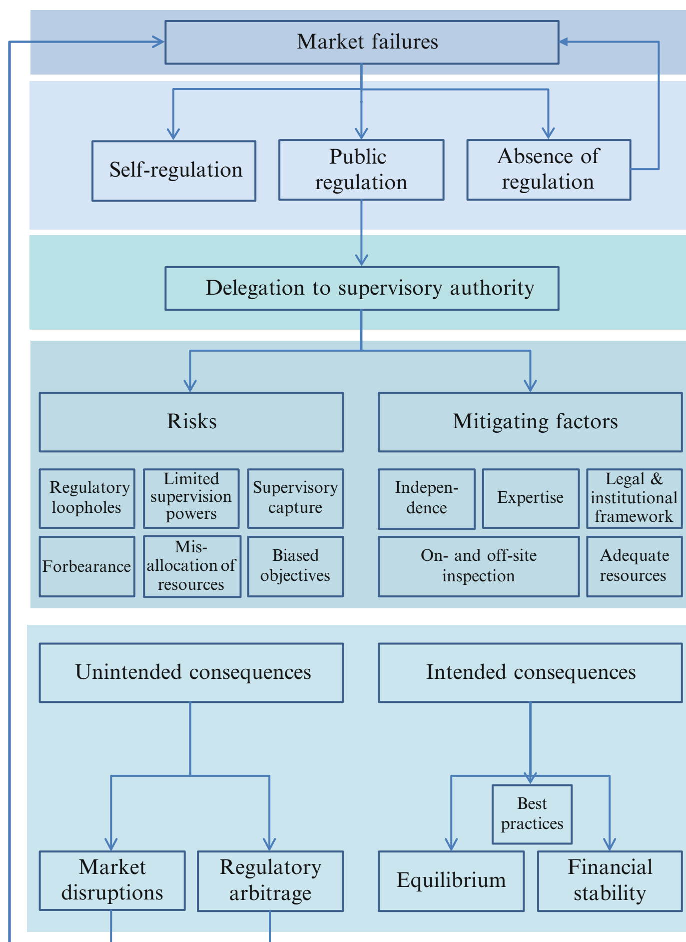

Fig. 4.1 Banking supervision in perspective (Source: Author's own analysis, building upon Freixas and Rochet (2008))

the ACP, the French supervisory authority.[3] Created by ordinance issued on 21 January 2010, and building on the experience of the international financial crisis, the ACP is an independent authority with supervisory responsibility over banks and insurance companies. This new agency was created by the merger of the former French licensing and supervisory authorities in the banking and insurance sectors. The purpose was to provide a more complete view of all of the risks assumed by financial groups. Synergies are systematically sought in the treatment of cross-sectoral and macro-prudential matters.

[3] A detailed description of the activity of the ACP is provided in its annual report (http://www.acp.banque-france.fr/uploads/media/2012-ACP-annual-report.pdf). For a description of the evolution in Europe, see ECB (2010).

The ACP is administratively hosted by the *Banque de France*. The experience of the financial turmoil has highlighted the crucial advantages in times of crisis of a very close link between prudential supervision and the core functions of the central bank,[4] which allows taking timely appropriate actions. Along with an expanded scope of supervision, the ACP has been tasked to preserving financial stability and protecting consumers. The ACP manages the process of on-site and off-site supervision. In fulfilling these responsibilities, the Authority works in close interaction with the network of supervisors in France, in Europe within the European System of Financial Supervisors (ESFS), and abroad.

While further increasing the protection of the legal rights of the supervised entities, the ACP was also entrusted with expanded powers. The ACP has been intensively assessing the lessons of the crisis, with respect to its consequences on the entities that it supervises and also to its own policies and procedures. Building on the principles that proved their soundness during the crisis, its supervision is evolving to address the requirements of the environment. The ACP is accountable to Parliament. Aside from its own management control and audit procedures, it is subject to external assessments of its activities. The Chairman – the Governor of the *Banque de France* – and the Secretary General testify regularly to committees of the Senate and of the National Assembly. The *Cour des Comptes* (court of auditors) can also initiate inspections at any time under its own powers.

The supervision of the ACP is defined in accordance with the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS 2006), which defines a framework of minimum standards for sound supervisory practices that are considered universally applicable. The effectiveness of countries' banking supervisory systems and practices is assessed by the International Monetary Fund (IMF) in the context of Financial Sector Assessment Program (FSAP) that it regularly carries out. As a matter of fact, the IMF has analysed France's financial sector in 2012. In addition to the frequent contacts that the supervisor maintains with credit institutions, this overall framework prevents most risks of unintended consequences of supervision.

However, as indicated in the following sections, additional risks may materialised in the new regulatory environment and therefore need to be addressed.

4.3 Supervision Needs to Prevent the Unintended Consequences of New Regulations

Basel III was introduced under the assumption that the ambitious but necessary changes could be phased in during an adequate transition period. However, the financial crisis and market expectations have been exerting an extreme pressure on

[4] Eichengreen and Dincer (2011) analyse a cross-section of countries relating the structure of bank supervision to financial markets outcomes.

banks to comply with the new regulations in a much shorter timeframe. The contraction of the transition period could notably have several unintended and adverse consequences. We will consider possible unintended consequences of regulations regarding deleveraging (Sect. 4.3.1), banks' funding and liquidity (Sect. 4.3.2), banks' risk-taking (Sect. 4.3.3) and the development of the shadow banking sector (Sect. 4.3.4).

4.3.1 The Unintended Risk of Deleveraging

One of the main reasons why the economic and financial crisis became so severe was that the banking sectors in many countries had built up excessive on and off-balance sheet leverage. This was accompanied by a loss of confidence by market participants in the level and quality of the capital base. To address these failures, the BCBS introduced a number of fundamental reforms to the international regulatory framework,[5] including raising the quality, consistency and transparency of capital, while enhancing the coverage of risks.

Deleveraging is part of a necessary adjustment in response to the crisis to restructure banks' balance sheets and restore the conditions of a sound banking sector. In the wake of the crisis, market participants have been exerting a strong pressure on banks to deleverage and to target higher capital ratios.

While supervisory authorities have to ensure that this deleveraging process is effectively implemented, an obvious unintended consequence that they have to prevent relates to the possible procyclicality of the process from a system-wide perspective. Excessive deleveraging that would disrupt lending to the real economy and further amplify the crisis must be avoided.

The French authorities have been closely monitoring this risk. Attention has been mainly focusing on two types of borrowers:

- Small and medium-sized enterprises (SMEs), which, contrary to large companies, cannot rely on alternative funding sources in case of a banking credit squeeze;
- Local public authorities that face growing financing needs in a context of increased decentralisation in France and seem to experience funding strains as a consequence of the restructuring of the banking market.

In the French domestic markets, despite the tighter standards used by banks when granting credit, since 2008, French SMEs do not appear to have been strongly affected by credit rationing.[6] Indeed, French banks have been focusing their business models on core activities, i.e. retail and corporate banking. They have reduced their market operations and are disposing of legacy assets. This is an

[5] See BCBS (2010).

[6] See Kremp and Sevestre (2011).

intended consequence of the new framework, unless the disposal of assets leads to a downward spiral of fire sales, which is subject to supervisory monitoring.

Similarly, the evolution of cross-border exposures has been an area of concern for supervisory authorities. Chief among them has been the risk of a decrease in lending from foreign banks to Southern Europe and emerging market economies.[7]

Lending cuts by European banks also focused on dollar-denominated loans. European banks, especially French groups, reduced their exposures to US dollar activities in project finance or the financing of trade, aircraft and ships. This did not appear to weigh too heavily on these types of credit, because other lenders abroad took over. However, this may call for supervisory attention because of potential unintended consequences. As a matter of fact, according to article 481 of the CRR under consideration, the European Banking Authority (EBA) will report to the European Commission whether the specifications of the new regulations are likely to have a material detrimental impact on the business and risk profile of credit institutions or on lending to the real economy, with a particular focus on lending to SMEs and on trade financing.

In a market environment surrounded by fears that pressures on banks to deleverage could lead to forced sales, contraction of credit and weaker economic activity, the 2011 EU capital exercise demanded especially careful and tactful handling. Recommendations[8] for major European banks to raise their Core Tier 1 capital ratios to 9 % by mid-2012 had the potential to increase these fears and had to be closely supervised *ex ante* to prevent unintended behavioural responses by individual banks. The EBA stated that these buffers were explicitly not designed to cover losses in sovereigns but to provide a reassurance to markets about the banks' ability to withstand a range of shocks and still maintain adequate capital. The amount of any capital shortfall identified was based on September 2011 figures. However, it was decided that the amount of the sovereign capital buffer would not be revised so that sales of sovereign bonds would not alleviate the buffer requirement to be achieved by June 2012; the sales of selected assets could be accepted provided that it did not lead to a reduced flow of lending to the real economy, in particular in the EU. It was clearly stated that banks should first use private sources of funding to strengthen their capital position to meet the required target, including retained earnings, reduced bonus payments, new issuances of common equity and suitably strong contingent capital as well as other liability management measures.

In spite of these precautions, the supervisory recommendation requiring banks to build up a capital buffer against sovereign debts may have contributed, in conjunction with other factors, to the decision of some banks to reduce their sovereign

[7] See BIS (2012a, b).

[8] On December 8th 2011, the European Banking Authority (EBA) published a recommendation stating that national supervisory authorities should require the banks in the sample to strengthen their capital positions by building up an exceptional and temporary capital buffer against sovereign debt exposures to reflect market prices as of end of September. In addition, banks were required to establish an exceptional and temporary buffer such that the Core Tier 1 capital ratio reaches a level of 9% by the end of June 2012.

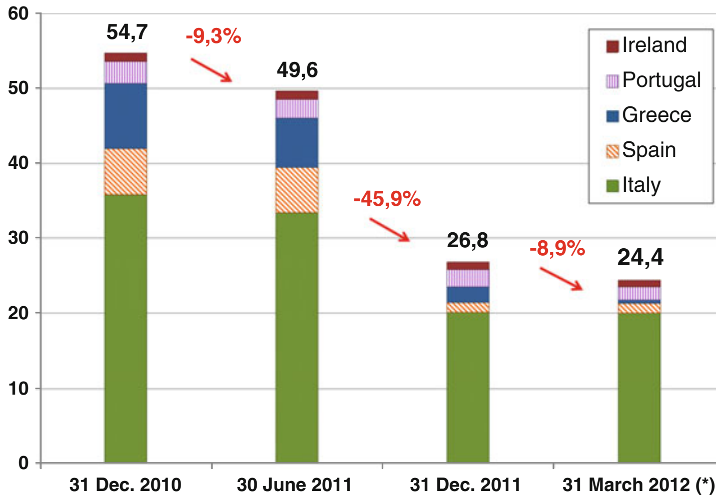

Fig. 4.2 Sovereign exposures on GIIPS of the major French banking groups in the banking book (BNPP,SG,GCA,GBPCE, in € billions) (*Data as of 30 April 2012 for BNPP; Source: public financial information)

exposures.[9] This was the case in France (see Fig. 4.2). This illustrates that any supervisory decision comes at a cost. It is probably inescapable, leaving supervisors with the choice of the lesser of evils.

4.3.2 Unintended Consequences of Regulation on Long-Term Funding and Liquidity

In December 2010, the BCBS published the Basel III international framework for liquidity risk measurement, standards and monitoring. It came as reaction to the major vulnerabilities that were revealed during the financial crisis that began in 2007, when many banks experienced difficulties because they had not managed their liquidity in a prudent manner. The BCBS developed two minimum standards for funding liquidity:

– The Liquidity Coverage Ratio (LCR) which aims to ensure that banks maintain an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet their liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario specified by supervisors;
– The Net Stable Funding Ratio (NSFR), with a one-year time horizon, which was developed to provide a sustainable maturity structure of assets and liabilities.

[9] It is reasonable to think that banks reduced their sovereign exposures also in response to market pressures.

An internationally harmonised liquidity ratio will be a major improvement. However, this new regulation has system-wide implications that are difficult to fully identify and anticipate. Assessing the impacts of the LCR calibration and monitoring the adjustments of financial institutions during the transition period are key areas for attention for regulatory and supervisory authorities. Implications of the standard for financial markets, credit extension and economic growth have to be closely monitored so as to address unintended consequences as necessary.

According to the results of the Basel III monitoring exercise of the BCBS as of 30 June 2011 (BCBS, 2012a), the aggregate LCR shortfall was € 1.76 trillion in the sample of 202 banks in the liquidity monitoring exercise. For the European banks in the sample, the shortfall was € 1.15 trillion (EBA 2012). This is a source of supervisory concern, since many banks simultaneously have to change in depth their funding structure which could, if unchecked, increase systemic risk. Competition among banks to secure long-term funding may come on top of the competition from other economic agents (sovereigns, public administrations and private corporations) experiencing strong refinancing needs and who might also find it more difficult to borrow long-term funds from banks. The ability of the long-term debt market to increase correspondingly remains an open issue, especially in the market conditions that have been prevailing since the beginning of the financial crisis. The rise in sovereign risk in Europe has adversely affected banks' funding conditions delaying their adaptation to the future regulatory framework (CGFS 2011). Regulatory proposals in relation to the bail-in of unsecured debt have also been weighing on the unsecured funding markets.

Supervisors have an important role to play to prevent unintended consequences stemming from the calibration of new regulations. In this regard, it would be hard to disentangle the responsibility of the supervisor from that of the regulator. An example can illustrate some of the concerns of supervisors in the development process of the LCR regulation. Regarding the Definition of High Quality Liquid Assets (HQLA), too narrow a definition of HQLA would have several drawbacks, mainly cliff effects and concentration risk. Any event that would cause previously eligible assets to become ineligible would have market-wide consequences for both debt issuers and banks, particularly those which had relied on the excluded assets and would have to adjust their balance sheet to comply with the LCR. For these reasons, the strong demand for HQLA assets would drive up their prices leading to market distortions. A definition of HQLA, if it were excessively narrowed to sovereign bonds, would give banks a strong incentive to increase their sovereign risk exposures despite the experience of the negative consequences of market concerns about the sovereign risk exposures of banks, and despite the fact that it is not obvious that government bonds are always more liquid than other securities. An unfavourable treatment of certain types of privately issued collateral would weaken incentives for the financial industry to improve the market liquidity of these assets. Furthermore, for those central banks which rely on a larger set of eligible collateral for their refinancing operations, too narrow a definition of HQLA would raise the incentives for banks to pledge their less liquid assets at the central bank, thereby inducing a detrimental regulatory arbitrage.

The LCR aims at being applied internationally and has to encompass very different banking activities, legal and structural frameworks. The impacts of this new regulation on the national banking systems differ. In its supervisory work, the ACP has to deal with intended and unintended consequences of the future regulation on French banks. Although a regulatory liquidity ratio – sharing many traits with the LCR – has been in force in France since 1988,[10] French banking groups are strongly impacted by the new regulation and lag behind some of their peers. There are several reasons for that.

First, the major French banking groups have historically developed according to the model of universal banking,[11] with significant business lines in asset management and insurance. This model showed its resilience during the crisis. Diversification of sources of income and risks proved to be a strength. But, this model has also some drawbacks, one of them being that a significant portion of savings was not intermediated through the balance sheets of French banks,[12] but was directed towards off-balance-sheet products: mutual funds and life insurance. In turn, these vehicles were investing part of their funds in bank debts. An intended consequence of the LCR is to reduce the reliance of banks on short-term wholesale markets; an unintended consequence is that most of the banks have to adapt their funding profile within the same short timeframe. French banks are reacting by actively seeking retail deposits, which is obviously a long-term effort but could possibly trigger a deposit war. The ACP and the Banque de France have been closely monitoring the market and have issued preventive warnings in order for deposits gathering to be achieved at a reasonable cost. This has been the case so far.

Second, regulated tax-exempt savings accounts (*Livret A*, *Livret de Développement Durable* and *Livret d'Epargne Populaire*) are another feature of the French financial system. For households, they combine several advantages: notably, they are highly liquid and represent an important asset class, therefore influencing the market of short-term as well as long-term savings products. The funds are collected by banking networks but a major part is then centralised at the *Caisse des Dépôts*. At the end of 2011, outstanding regulated savings totaled € 337 billions[13] (of which tax-exempt *Livrets A* amounted to € 215 billions). Under a mandate assigned by the State, the *Caisse des Dépôts* manages the funds and uses them to finance a substantial portion of the construction and renovation of social housing through long-term loans granted at attractive rates. More structural shifts in the allocation of household savings are therefore dependent on tax incentives

[10] The French regulation relating to liquidity was reviewed in 2009, introducing a standard and an advanced approach for liquidity risk.

[11] The second banking coordination directive of 1999 made universal banking the norm in the European Union by introducing a single banking license valid throughout the European Union, and limiting product-mix restrictions to those imposed by home regulators (Morrison 2010).

[12] French banks were previously banned from paying interests on sight deposits.

[13] See Rapport annuel de l'observatoire de l'épargne réglementée (2011).

benefiting regulated savings products and long-term savings instruments, notably life insurance.

Third, unlike their US peers, French banks cannot rely on government-sponsored entities (GSEs) and keep large amounts of originated housing loans[14] on their balance sheet. This is a good illustration of the impact of international structural differences on the funding structure of banks.

It is imperative that the LCR be implemented rigorously and consistently across jurisdictions to achieve a level playing field.[15] The BCBS proposed that the LCR be introduced on 1 January 2015. The European Union intends to include liquidity requirements in the regulation implementing Basel III. However, there are major uncertainties regarding whether this regulation will be effectively implemented on the same scope and in a similar timeframe in other areas, possibly leading to an uneven playing field. The level of application of the European capital requirement regulation and capital requirement directive (CRR-CRD IV) is very stringent because it covers credit institutions and investment firms, while Basel III applies, as a minimum, to internationally active banks.

4.3.3 Unintended Consequences of Regulation on Risk Taking: The Example of the Leverage Ratio

Another important concern about new regulations is the possibility for banks to evade them by shifting their business to less regulated markets. Shortcomings in the solvency regulation have been pointed out, among several other important factors,[16] as playing a major role in allowing banks to take advantage of regulatory arbitrage opportunities on a large scale. It has been generally claimed that banks had developed securitisation activities without increasing their regulatory capital accordingly. This was all the more worrisome, given the poor quality of the assets involved in securitisation and the substantial degree of risks that turned out to remain in banks' balance sheets through credit lines either explicitly or implicitly due to reputational factors.

Regulatory arbitrage has always been a major concern for regulatory authorities. For example, in a theoretical setting, if a bank exhibits low risk aversion, its reaction to the introduction of a minimum capital to asset ratio might be a larger shift towards riskier assets to offset the decrease of its return (Kim and Santomero 1980). To avoid this unintended effect, regulators have to set a capital requirement

[14] French housing loans are a low-risk asset class. See Enquête annuelle sur le financement de l'habitat en 2011, ACP, *Analyses et synthèse* – July 2012.

[15] For a progress report, see BCBS (2012b).

[16] The conjunction of several factors has contributed to the emergence of the financial crisis: overreliance on external ratings, flawed rating models, insufficient investors diligence, moral hazard, and inadequate accounting methods.

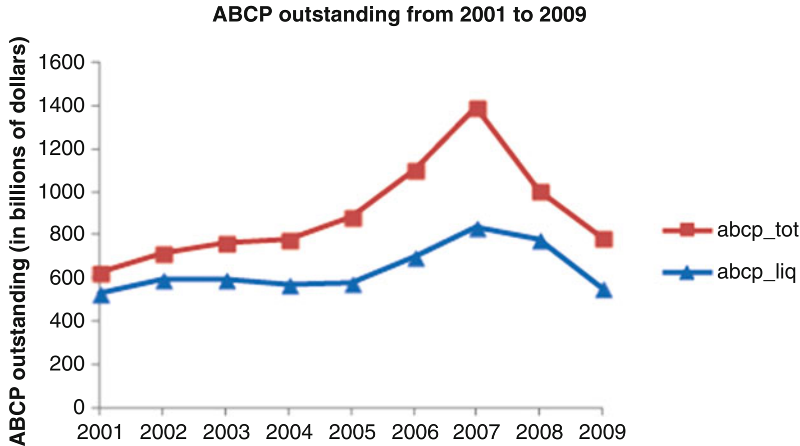

Fig. 4.3 Evolution of bank sponsors' ABCP exposures from 2001 to 2009 (Data are from Moody's and used in Acharya and Schnabl (2012). abcp_tot and abcp_liq represent the total amount of sponsor's exposures to ABCP and the amount of ABCP for which sponsors provided a liquidity guarantee, respectively; Source: Acharya and Schnabl (2012))

taking account of the quality of bank assets and the off-balance sheet risk exposures. This risk-based capital ratio requires to optimally weight bank assets and off-balance-sheet exposures to avoid possibilities of regulatory arbitrage. However, in the recent past, the low weighting assigned to some bank activities under Basel II, such as securitisation, introduced regulatory arbitrage opportunities. The banking sector of many countries built up excessive on- and off-balance sheet leverage contributing to the worsening of the financial and economic crisis which started in 2007.

There is a broad agreement that among securitisation activities, asset-backed commercial paper (ABCP) significantly contributed to the outbreak of the financial crisis, especially in the US. Banks engaging in ABCP transactions sold securitisation assets to conduits which financed their investment by issuing commercial paper. Banks also played the role of sponsor by providing guarantees to outside investors. By selling part of their assets to conduits and providing liquidity guarantees, commercial banks reduced their capital requirement without transferring risk to outside investors (Acharya and Schnabl 2012). Figure 4.3 shows that ABCP outstanding highly increased between 2001 and 2007. During this period, bank sponsors' total exposures to ABCP rose by 121 %. After 2007, sponsors significantly decreased their ABCP exposures.

An answer to the insufficiencies of Basel II risk-based capital requirement has been the proposal to introduce a leverage requirement at the international level. This raises the question of whether there is a trade-off between the simplicity of the regulation and the comprehensiveness of risk assessment. A minimum leverage ratio is aimed at acting as a backstop to risk-based capital requirements. If risk-sensitive capital requirements rely on banks' voluntary disclosure of their risk

profiles, it can be useful to introduce a leverage ratio requirement to avoid that some banks understate their risk (Blum 2008). Moreover, the leverage ratio is a simple tool which may also be used as a countercyclical instrument for macro-prudential regulation.

However, the introduction of a leverage ratio requirement may, in turn, have unintended effects on banks' soundness. There are strong reservations *vis-à-vis* such a ratio which failed to prevent the emergence of the crisis in countries where it was implemented. A leverage ratio requirement may introduce wrong incentives in terms of bank risk-taking behaviour. In fact, because it does not distinguish assets according to their riskiness, it may encourage banks to hold the riskier assets on their balance sheet and to develop their off-balance-sheet activities. A leverage ratio could also negatively impact some business models, such as banks principally exercising retail activity, or at least the segments facing the higher risk weights, hence adversely affecting credit supply. A leverage ratio requirement could also discourage banks from developing robust internal models and managing their assets in a prudent manner. Prudent banks holding in their portfolios a greater part of liquid and high-quality assets may be penalised by the introduction of such a requirement. Furthermore, the dynamic effect of the leverage ratio among the package of reforms is difficult to anticipate. The Basel Committee has been assessing these unintended effects through quantitative impact studies. The results of the Basel III implementation monitoring exercise as of 30 June 2011 notably show that 63 out of 212 banks failed to meet the 3 % Basel III Tier 1 minimum leverage ratio. Great care is absolutely necessary when introducing new requirements or tightening existing ones since they may generate regulatory arbitrage. The leverage ratio should complement other prudential tools, such as risk-based capital and liquidity requirements. It should be used as a supplemental tool for supervisors in order to implement an efficient micro and macro-prudential regulation.

4.3.4 Unintended Consequences of Regulation on the Development of the Shadow Banking Sector

Stronger regulation in a given country could not only lead to massive transfers of assets to less regulated ones via regulatory arbitrage, but also trigger a shift in favour of the shadow banking system, which may represent a systemic threat that the regulators and the supervisors need to address properly. At the November 2010 Seoul Summit, in view of the completion of the new capital standards for banks (Basel III), the G20 leaders highlighted the need for strengthening regulation and supervision of the shadow banking sector as one of the remaining issues of financial sector regulation that warranted attention.[17] The Financial Stability Board issued

[17] See The G20 Seoul Summit Leaders' Declaration, 11–12 November 2010.

recommendations as to the measures regulators should take and the way they could reincorporate the shadow business into the regulated one (FSB 2012). Risks associated with shadow banking have been intensely scrutinised in the United States (Pozsar et al. 2012) and in the European Union, which has shown global leadership in implementing its G20 commitments (European Commission 2012). Shadow banking activity is the largest in the United States, where its size, measured by total assets, was comparable to the one of the regulated banking system in the second quarter of 2011. In the euro area, overall shadow banking activity accounts for roughly one-half of banks' total assets (Bakk-Simon et al. 2012). The risk is that this proportion may increase as regulatory constraints pile up. In that respect, the ACP strongly supports initiatives aiming at addressing areas for possible further regulatory recommendations.

One major concern relates to credit operations which could be increasingly undertaken by non-banks, be it unregulated entities, such as hedge funds, or entities subject to different regulatory requirements, such as insurance companies. Those entities could take advantage of their non-bank status in order to enter in credit-like operations, having the same features as bank credit – liquidity or maturity transformation – but without being regulated as such, and falling outside the scope of banking supervision. Adrian and Shin (2009) showed that in the US a sharp increase in "market based" credit (i.e. from non-regulated institutions) occurred during the pre-crisis period and that it exhibited the most dramatic contraction in the current financial crisis, hence propagating the subprime crisis.

More generally, the transfer of risks out of the banking sector requires special attention. For instance, the development of liquidity swaps, whereby insurance companies lend liquid and high-graded securities to banks in exchange for assets with lesser liquidity or quality, has been a cause for concern for several supervisory authorities in Europe lately. It demonstrated that the supervisor must be reactive to emerging trends, and keep in touch with financial innovation induced by regulatory changes and which is often designed to circumvent regulation. The role of the supervisory authority on this issue is pivotal, in particular when these new categories of transactions are apt to increase interconnectedness between institutions and to foster the transfer of systemic risks outside the regulated sectors. The ACP shares the view that these operations have to be closely monitored and that strict limits have to be applied when appropriate.

In addition, the increasing interconnectedness between various institutions within the financial system, with potential consequences on regulatory imbalances, reinforces the relevance of ACP's extensive approach of supervision, which encompasses banks and insurance companies under the same authority. It is our belief that all institutions which play the same economic role should be ruled by the same regulations and supervised in a coordinated manner.

As a result, the supervisor must be careful about the side effects of any new regulation on credit institutions and foresee the implications of a regulatory regime shift. Discussions relating to the European legislative package CRR-CRD IV – which transposes the recommendations of the BCBS into European law – show policymakers' willingness and determination to set stringent rules that will apply

equally to all European countries. This unified approach across the whole banking sector, covering all credit institutions and also investment firms, contrasts with the choice made elsewhere to adopt a differentiated treatment according to the entities' size. The idea prevailing in Europe was to apply identical rules to all credit institutions, irrespective of their country of establishment, with little leeway for national regulators to set different standards, in order to preserve comparability and avoid regulatory arbitrage within the European Union. With such an approach, however, it appears that the narrow definition of credit institutions[18] in CRR-CRD IV, which would exclude all the institutions that do not collect deposits, reshapes the regulatory environment. For instance, institutions specialised in mortgages or consumer loans could fall outside the banking sector.

This might be a source for concern as notably mortgages regularly experience credit bubbles and affect conditions in the real estate market. What is more, mortgages entail clear transformation risks. Therefore, unless all institutions granting mortgages are captured under the same rules, there is a potential risk that more lending of mortgages will be done through non-credit institutions. A possible solution could be to broaden the scope of the CRR-CRD IV package to those entities providing credit to the economy. Alternatively, the definition of an *ad hoc* status would be appropriate for those institutions no longer covered by the new regulation. This issue is also of importance for these institutions which would otherwise no longer have access to central bank funding.

In France, such companies are currently standing at a crossroads: should they change their business model and start collecting deposits so as to be considered credit institutions and have access to the central bank – at the cost of implementing Basel III requirements – or not? This also applies to other categories of institutions labeled as "financial companies" (*sociétés financières*), 277 in total as of 2011, which operate in such segments as leasing, factoring, consumer credit, or equipment finance (see Fig. 4.4). In order to avoid loopholes and preserve financial stability, the French regulator is considering designing a regulatory framework that would converge towards the CRR-CRD IV requirements, so as to promote a level playing field and encourage best practices.

All in all, Basel III is essential in supporting financial stability but some undesired effects can already be perceived, e.g. between banking and insurance companies: new types of transactions arising from regulation, increased competition between banks and life insurers for households' savings, higher cost of financing to the economy, etc. This shows that, facing globalised markets and interconnected financial institutions, supervisors must more than ever pay attention to the consequences of new regulation on financial stability and actively seek the suppression of any regulatory arbitrage opportunity.

[18] Article 4 of CRR under consideration states that 'credit institution' means an undertaking the business of which is to receive deposits or other repayable funds from the public *and* to grant credits for its own account.

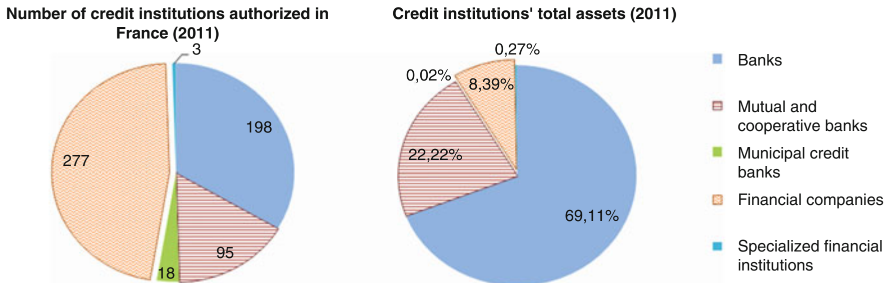

Fig. 4.4 Population of credit institutions in France (Source: ACP)

4.4 The Unintended Consequences of the Broadening and Deepening of Supervision

Supervisors are developing new methods and practices, thereby raising expectations from banks and the general public. Communication by supervisors needs therefore to adapt, overcome the effects of asymmetric information and remedy the increase in risk aversion. Indeed, badly managed communication may, in certain circumstances, precisely precipitate the financial distress that supervisors try to prevent. This is particularly the case for stress tests that have significantly developed in the recent past (Sect. 4.4.1). Supervisors also need to carefully monitor the consequences on banks' behaviours, hence on financial stability, from implementing a more intrusive supervision approach (Sect. 4.4.2), and from adopting a macroprudential perspective (Sect. 4.4.3). This implies addressing possible tradeoffs regarding the current increase in banks' reporting burden, which has dramatically developed since the crisis.

4.4.1 Challenges Associated with the Growing Importance of Stress Tests

Stress tests can be used as a tool for micro- as well as macro-prudential concerns. In the micro-prudential approach, it provides information on the ability of individual banks to face potential losses. From the macro-prudential point of view, stress tests give information on the resilience of the whole banking system. However, the micro- and macro-prudential objectives of stress tests may sometimes conflict, leading to potential unintended effects of the disclosure of stress test results. In particular, the disclosure of the stress test results may sometimes adversely affect incentives and create inefficiencies at the individual bank level. There is a risk of self-fulfilling prophecies at the individual level that the supervisors have to prevent. Furthermore, a bank can make *ex ante* sub-optimal portfolios choices (e.g. large

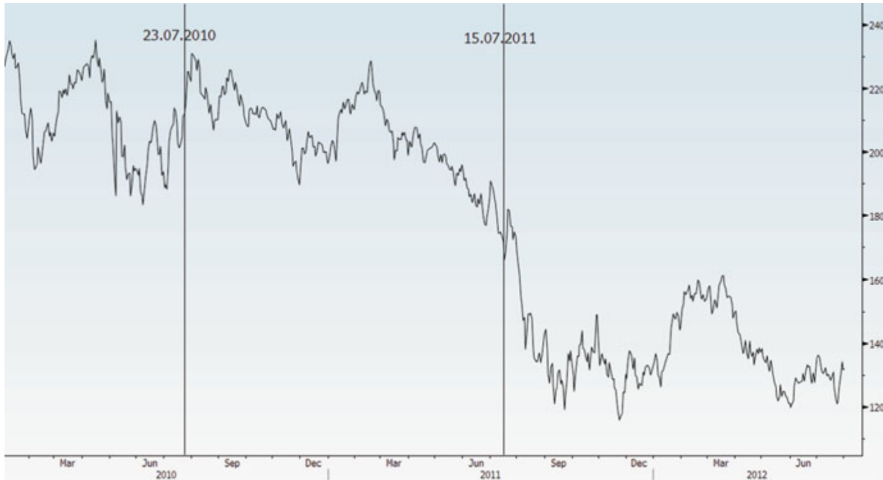

Fig. 4.5 Evolution of the European banks' stock prices around the European stress test disclosures (Source: Bloomberg)

scale sovereign asset sales) to avoid a possible market overreaction. Supervisors have therefore to determine which information on individual banks is relevant to disclose in order to limit markets' overreaction.

Stress test exercises have been one response to the financial crisis. Arguably, national supervisory authorities have been carrying out stress tests for quite some time, but they were generally not published. The situation changed in 2010. Indeed, since 2009, European authorities have conducted three coordinated stress test exercises on European banks. The Committee of European Banking Supervisor (CEBS) conducted the first exercise in 2009 without any disclosure of participant banks' results. The individual simulation results of the second European stress test were published on 23 July 2010. In 2011, the EBA and the national supervisors carried out the third stress test exercise and the simulation results were disclosed on 15 July 2011. 20 banks fell below the 5 % Core Tier 1 threshold under the adverse scenario for 2012. In 2011, more comprehensive public disclosure of credit risk exposures was made mandatory. The aim was to provide relevant information to market participants to enable them to conduct their own stress test. However, disclosing stress tests results can have unintended effect on bank as well as market participants behaviour since new information can be misinterpreted: Figs. 4.5 and 4.6 show a fall in the European banks' stock market prices and an increase in the price of their credit default swap around the 15 July 2011 disclosure. Nonetheless, it is important to mention that the evolution of banks' stock and CDS prices around the publication of stress test results is widely explained by the worsening of the European sovereign debt crisis.

The main argument in favour of public disclosure of stress test results is that it enhances market discipline by allowing investors and counterparties to better understand the risk profiles of each institution. Market discipline based on timely and

Fig. 4.6 Evolution of CDS prices around the European stress test disclosures (Source: Bloomberg)

accurate information should contribute to the optimal allocation of capital and provide incentives for banks to operate efficiently and to manage and control their risk exposures prudently (Flannery and Sorescu 1996). The disclosure of the results of stress tests is intended to restore investors' confidence in the banking system and ultimately sustain activity in the real economy. During the crisis it has become a piece of information strongly awaited from the supervisors, subject to great scrutiny.

However, such disclosures may have unintended consequences. They may involve inefficiencies at the individual bank level in an environment characterised by market and informational frictions. In such cases, more disclosure may reduce welfare. Indeed, if investors and other counterparties do not correctly understand a bank's operations due to previous opacity and complexity, market discipline may force this bank to make sub-optimal portfolios choices or to decide inefficient asset sales. To avoid market overreactions and their destabilising effects, the bank may be willing to take sub-optimal decisions in order to pass the stress tests. A supervisor, disclosing detailed information on the results of the stress test, gives market participants a larger set of information on the underlying risk exposures of the banks, but this information reflects the change in bank's *ex ante* behaviour consisting to a sub-optimal portfolios choice and a window dressing behaviour (inefficient asset sales), in order to pass the test. The bank is considered healthy by the market although its actions were not efficient. As a consequence, in a second best environment with market and informational frictions, it is important to take account of possible ex ante inefficiencies. Furthermore, it is highly desirable that remedial measures be published at the same time as bad news (Himino 2012).

A compromise to this inefficient *ex ante* reaction of banks may be to disclose aggregate results of which may be useful for financial stability as a whole. However, this supervisory choice in terms of disclosure may in turn not be sufficient to

discipline individual banks' behaviour. Supervisors may then complement these aggregated results with a detailed description of the exposures of the individual banks.

An additional and important concern about the disclosure of the results of stress tests is that the *ex post* reaction of market participants may be inefficient. The decisions of market participants are made in an incomplete informational environment. The decision of each market participant takes the expectation of others' actions into account. This may lead to overreactions. The extent of these overreactions may depend on banks' specificities. Market overreactions may particularly be severe for banks that are relatively less liquid, that exhibit significant maturity mismatches, and whose creditors are of small size, as they are less likely to take externalities into account. Moreover, greater supervisor information disclosure may reduce the incentives of market participants to find and exploit their own information (Goldstein and Sapra 2012). Market prices may therefore become less informative. This can lead to a situation in which supervisory information disclosure involves less market discipline. Supervisors have to pay attention to externalities between market participants when disclosing stress test results.

Another dimension is the credibility of the supervisor when implementing stress tests. This requires expert knowledge of banks operations, designing the most relevant scenarios, processing optimally the information from banks using state-of-the art techniques. Credibility can only be achieved in the medium run, but appears to be crucial in crisis periods.

Overall, one may conclude that stress testing is helpful for financial stability. It can help the supervisor to identify weak institutions and to require them to take corrective actions such as raising additional capital. Solving these individual problems properly prevents contagion within the banking system and market's deficiency. An international harmonisation of stress test practices can be useful since a possible loss of credibility of one supervisor may affect the others. Methodological improvements for correctly capturing non-linearities and feed-back effects, both within the financial system and between the financial system and the macro economy, should enhance the effectiveness of stress tests.

4.4.2 Preserving Effectiveness of Supervision by Internalizing the Reaction of Banks to a More Intrusive Approach to Supervision

Before the financial crisis, there was a clear distinction between supervisors favouring off-site analysis and those favouring a more intrusive approach. The French approach has always been intrusive with the supplemental feature that on-site inspections are allowed to be carried out over an extended period of time when it is required by the size or the complexity of the mission. Some other supervisors have been changing their so-called 'light touch' supervisory approach to a more

intrusive approach. The supervisory model of some countries was characterised by a large amount of data reporting. Others may rely on less intrusive controls but impose very severe sanctions when a regulated institution does not comply with regulatory requirements. Nowadays, a consensus seems emerging on the necessity to adopt a more intrusive approach in banking supervision. More frequent and more stringent audits should discipline banks in their risk-taking behaviour since they have more incentives for truthfully reporting their risks. On-site audits can also contribute to the production of more accurate financial reports by banks. However, the advantages of increasing on-site audits are not unlimited. The question of the efficient intensity of supervisor internal audits is of major interest.

Up to a certain threshold, increasing the number of supervisory audits contributes to strengthening the solidity of banks. However, beyond this efficient level, more on-site audits may become counterproductive. The reason is that banks may interpret this intensification of scrutiny as a signal of a higher probability of supervisory enforcement action. As a consequence, they may be inclined to postpone certain projects and wait for the supervisor to give her/his views. The second explanation is that the higher frequency of audits may render the market more suspicious, if it happens to notice this higher frequency. Market reactions may then exercise a negative impact on bank stock price and financing conditions. This can destabilise the institution even if it does not present major weaknesses. Delis and Staikouras (2009) provide evidence of an inverted U-shaped relationship between the frequency of on-site audits and bank soundness.

Adopting a more intrusive approach in banking supervision also raises the problem of how supervisors should allocate their limited resources when examining banks. Obviously, it must not be detrimental to the efficiency of off-site supervision.

4.4.3 Resolving Divergence Between the Micro and Macro Level in Supervisory Action

The financial crisis has highlighted the limits of relying only on micro-prudential regulation. There is now a large consensus on the need for increasing the role of macro-prudential regulation in order to manage systemic risk, which does not focus on individual failures but rather on contagion effects and correlated shocks/exposures (see the contribution of Houben in Chap. 13). However, discrepancies may emerge between the objectives of micro- and macro-prudential regulation. In particular, some micro-prudential measures can lead to a reduction of lending activity and thus to a deterioration of economic conditions.

Some micro-prudential regulation measures may amplify problems in the banking system. For example, if a bank experiences solvency problems, the micro-prudential supervisor will require this entity to restore its capital ratio. A weak bank maximising the shareholder value may choose to shrink its assets, leaving its capital

unchanged. A supervisor with a narrow micro-prudential mandate would not necessarily have the ability to enforce a capital increase instead of an asset reduction (Hanson et al. 2011). However, this choice is not neutral from a macro-prudential standpoint. Indeed, if the main banks are in trouble and decide simultaneously to shrink their assets by reducing their lending activity, this behaviour may badly affect economic activity.

Conversely, macro-prudential concerns may introduce regulatory forbearance *vis-à-vis* important banking institutions. In fact, it may be difficult for weak institutions to increase equity. So, in order to avoid a credit crunch and fire sales, a macro-prudential supervisor could be reluctant to take prompt corrective actions against the institutions in difficulty. In the extreme case, if macro-prudential concerns may lead public authorities to bail out insolvent institutions, this can be perceived as a signal that too-big-to-fail institutions will always be supported. This situation may encourage excessive risk taking by important institutions and reduce the efficiency of market discipline. Setting clearly the conditions of public authorities' intervention may help to solve this moral hazard problem.

On top of capital surcharges on systemically important financial institutions (SIFIs) that were introduced by the Financial Stability Board in response to requests by the G20 leaders, Basel III tries to set up a macro-prudential regulation framework through the countercyclical capital buffer (CCB) that would apply to all banks covered by Basel III (or the CRD4/CRR in Europe). The implementation of a countercyclical capital buffer may introduce a substitution in loan supply between regulated institutions and local intermediaries that are not subject to domestic capital regulation. Aiyar et al. (2012) recently highlighted the existence of this substitution effect for the UK banking system. This situation may influence the effectiveness of this macro-prudential measure. International coordination of macro-prudential regulation is needed to prevent regulatory arbitrage by banks not subject to domestic bank regulation. Besides these measures, the European CRR-CRD IV allows national authorities in Europe to temporarily strengthen its regulatory requirements in order to address systemic risk.

Considering this new framework, another major concern is to set up an institutional arrangement to solve the discrepancies between the objectives of micro- and macro-prudential regulation. Indeed, except for the CCB and the SIFIs capital surcharge, the same tools (e.g. capital and liquidity requirements, risk weighted assets) will be used at the macro and the micro level. Therefore, in most cases the same instrument could be used to solve a common issue at the micro and macro level. But there is a risk that a tool is used differently at both levels for different and inconsistent purposes. Thus either a single institution should be responsible for the whole supervision, or there has to be a very close coordination between the different bodies. In France, the macroprudential framework still depends on the final issue of CRR-CRD IV. Presently, the French Systemic Risk Board (the CoReFRiS, which stands for *Conseil de régulation financière et du risque systémique*) is a council chaired by the Ministry of finance that gathers the Heads of Supervision and the Central Bank. It is not a macroprudential authority in itself, but its role is to ensure the coordination of the policies in the field of financial stability. One recent example

is the implementation of a specific reporting on mortgage loans to better assess risks on the real estate market.

Efforts must be pursued to adequately define and measure systemic risk. More research is needed to improve and find efficient tools which can be used at micro- and macro-prudential levels, without introducing unintended negative effects. This also includes the use of system-wide stress tests taking into account the spillover effects through bilateral financial exposures (Gourieroux et al. 2012). These instruments must provide the right incentives so that financial institutions internalise the externalities associated with their use. More theoretical work could be useful to efficiently use strict macro-prudential tools as complement to micro-economic instruments for macro-prudential supervision. Furthermore, macro-prudential regulation has to be coordinated at the international level to avoid regulatory arbitrage.

4.4.4 Managing Banks' Reporting Burden for More Effective Supervision

Never before have financial institutions been under so close scrutiny and have they been required to disclose so much information to the market and to the supervisory authorities. On the one hand, new reporting is indispensable when new risks emerge; on the other hand, the accumulation of requirements from different parts could provide diminishing returns in terms of true information and effectiveness of the supervisor's action. Therefore regulators and supervisors have to carefully assess the costs and benefits of new reporting and data collections, which may otherwise turn out to be counterproductive.

Disclosure is a way to reduce moral hazard. However, there is a paradox since reporting to the supervisor may theoretically become redundant when the supervised institution has fully internalised the purpose of the regulation and complies with its requirements. Nowadays, regulatory reporting is one of the primary sources of information of the supervisor. These data are essential and a great deal of the supervisor's work relies on their availability and quality. Nevertheless, they can prove insufficient and the supervisor sometimes needs to collect additional information when focusing on a specific issue. These requests are processed through surveys, which are designed to be temporary, and are answered on a voluntary basis and usually in a timely manner. For instance, the ACP carries out a weekly survey on net inflows of life insurance companies, as well as a detailed monthly survey relating to their invested assets. By doing this, the supervisor can track, almost in real-time, the evolution of net inflows or any significant shift in assets allocations. In addition to those surveys, the ACP conducts stress tests, quantitative impact studies, and various surveys under the aegis of the EBA, the European Insurance and Occupational Pensions Authority (EIOPA), the European Systemic Risk Board (ESRB) or the BCBS.

As supervisors, we are conscious that replying to surveys (and more broadly, reporting any type of regulatory data) with a high level of accuracy requires a lot of effort from financial institutions and involves costs. This is all the more true when it comes to altering the regulatory framework and principles, as it is currently the case for insurance companies which are planning to migrate to Solvency II soon. Modifying the architecture of internal information systems requires a large amount of resources and a cost analysis has to be performed by the regulator and the supervisor so that any additional information request does not have disproportionate costs. An associated risk would be that companies under-staff their teams in charge of financial reporting so as to demonstrate that supervisory requests have reached a saturation point. They could also merely report erroneous information due to lack of resources to process the request and produce the correct data.

Furthermore there is also a risk that the templates for the collection of data be ill-conceived and do not allow to assess and monitor the risks properly. It is therefore crucial to consult the different stakeholders, including professional unions, about the kind of information that can be collected, and to be sure that such data requests are relevant, meaningful and feasible. In this regard, the College of the ACP has set up a Consultative Committee on Prudential Affairs, comprising members representing the insurance and banking sectors and professional associations, who are in a position to give an opinion prior to adoption of instructions governing reporting institutions' periodic prudential filings. More generally, supervisory procedures increasingly include consultation processes and impact studies, before implementing new guidelines, in order to get insights from stakeholders. This is essential for the supervisor to make sure that the collection of new information will be useful and efficient.

The supervisor has to provide firms with feedback on their situation, on how it analyses their riskiness, and eventually, to allow them to benchmark and compare with the rest of the market. This latter element has to be treated with utmost care and prudence since it involves confidential and strategic data for firms, but it provides a strong incentive for them to invest resources in regulatory reporting and to fully cooperate with the supervisor.

Complex interactions have developed between supervised entities and supervisors. For instance, Picavet (2010), taking the example of CEIOPS consultation paper 37,[19] points to a learning and experimentation process whereby companies that have started preparatory work for Solvency II prior to its implementation are likely to be more prepared for actual implementation and, conversely,

[19] Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II on the procedure to be followed for the approval of an internal model: General provisions and some specificities related to partial internal model (26 March 2009). Article 3.3 states that many companies suggested during the preparation of the stock-taking exercise that they would welcome a period of engagement with supervisory authorities prior to the submission of their formal application, to enable them to develop and refine their internal model practices in preparation for meeting Solvency II requirements.

supervisory authorities are being given the opportunity to become familiar with the companies' internal models, making the assessment stage more straightforward with a direct positive effect on the quality of future applications. More generally, regulation, while allowing internal models, has increasingly brought supervised entities to internalise supervisory constraints through the development of self-assessments (Pillar II in Basel II, Own Risk and Solvency Assessment in Solvency II) and the growing importance of risk-management, compliance and internal audit functions. An unintended consequence has been a certain suspicion regarding the calibration of the parameters of internal models and uncertainties regarding a possible uneven playing field between institutions (Le Leslé and Avramova 2012). Supervisors are resolutely addressing this issue. The BCBS and the EBA have begun investigations into the consistency of risk-weighted assets. There might be legitimate reasons for the discrepancies. All in all, a stronger consistency in standards implementation and monitoring will emerge.

4.5 Conclusions

New regulations aim at changing behaviours from market participants. Some reactions are intended, while others are not, as supervised institutions react strategically and opportunistically. Innovation, in turn, requires new regulatory adaptations. Although this feedback process entails new risks when institutions try to circumvent regulation by developing risky and convoluted alternatives, this dialectical process of regulatory response remains the best answer to the dynamic nature of risk.

In this chapter we have touched upon the important topic of the unintended consequences of supervision. The attention was first drawn to the undesirable effects that may emerge from new regulation and that have to be managed by the supervisor. The deleveraging process implemented by banks has particularly been closely followed by European supervisors, notably the ACP, to avoid its negative impact on credit supply, in particular for SMEs which cannot rely on alternative sources of funding. The implementation of the liquidity requirements also requires particular attention in order to achieve a level playing field and to prevent excess competition for long-term funding. Regulatory arbitrage which can emerge from a leverage ratio and the development of shadow banking are also major concerns.

There is a growing demand for more supervisory action and communication. In this framework, stress tests can be helpful for financial stability. However, disclosing their results requires special care to avoid banks' *ex ante* inefficient behaviour and market's overreaction. Furthermore, reconciling the objectives of micro and macroeconomic supervision has been growing in importance and will certainly remain a flourishing field for further academic studies. Finally, the coordination of stress test practices as well as macro-prudential supervision under the stimulating influence of peer supervisory pressure will improve supervisory practices.

Providing the right incentives to institutions in order to preserve financial stability is the core objective of supervision. The new regulatory landscape after the financial crisis has changed the perspectives and may introduce further unintended consequences of supervision. They create new challenges for supervision that I identified in this chapter. I am confident that we will collectively be able to address them properly, in order to offer still more effective supervision.

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Chapter 5
Influence and Incentives in Financial Institution Supervision

Heidi Richards

5.1 Introduction

According to the Palmer Report into the collapse of insurer HIH,

> it is important to recognise that financial institutions today face many pressures, of which pressure from the Regulator is but one. Most important by far are pressures from shareholders and financial markets for performance, including historically high returns on equity and growth in those returns. These pressures are overwhelmingly strong, augmented by the compensation systems of financial institutions, which are increasingly performance based, and tied to earnings and share price performance. These pressures have led to highly complex financial engineering to boost income, reduce capital levels, enhance the tax-efficiency of capital and reduce the risk-weighting of the balance sheet for regulatory capital purposes.
>
> In such an environment, even the most diligent CEOs and CFOs can find the wishes of a Regulator to be a nuisance, to be given little more than lip-service. This is particularly so because what the Regulator usually wants to see will depress short term profitability: more capital, strengthened reserves, more conservative asset valuations, stronger risk management procedures, smaller individual exposures.
>
> The Regulator needs ways of making its voice heard, listened to and acted upon. This makes it important that, whenever the Regulator is ignored or not responded to in a timely manner, there be consequences for the institution involved.[1]

As this prescient report into the failure of a major Australian financial institution so lucidly illustrated a decade ago, the supervisors' job to a large extent is to intervene in the business of regulated financial institutions. Almost always, such intervention is intended to result in the regulated institution doing (or not doing) something other than what it would do by choice. But supervisors do not themselves improve bank

The views expressed are those of the author and do not necessarily reflect those of the Australian Prudential Regulation Authority. The author thanks David Lewis for helpful suggestions on an earlier draft.

[1] Extract (abridged) from Palmer (2002), p. 140.

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systems, raise capital or implement risk frameworks. Large, internationally active banks are complex amalgams of people and infrastructure, with activities and locations beyond the direct reach of most supervisors. To be effective in their mission, supervisors must exert influence on banks to achieve these outcomes.

Supervisors have many tools at their disposal to exert influence. These range from industry-wide guidance and public speeches, through to formal regulatory directives placed on individual banks which attach criminal penalties for non-compliance. They can use financial levers – notably capital requirements – to both provide financial strength and incentives to manage risks. The tools used may depend on the bank, the issue to be addressed and the outcomes sought, as well as the culture and methods of the regulatory agency.

Despite the extensive armoury of supervisory tools available to supervisors in most countries, it is far from clear-cut when and how to use them. The response of regulated institutions is also often difficult to observe and may be impossible to predict. What is judged to be prudent business practices in one setting may later be considered reckless in another. Outside of regulatory handbooks and manuals, there appear to be few publications that provide much insight into the day-to-day practice of financial institution supervision. This makes it difficult to generalise about means of improving these practices.

This chapter explores the avenues that supervisors use to achieve outcomes with regulated institutions, in particular banking organisations, based on experience at the Australian Prudential Regulation Authority (APRA). APRA is the prudential regulator of banks, smaller deposit-taking institutions, insurance companies and pension funds in Australia.[2]

This contribution abstracts from the question of whether the policy framework, rules and regulations are appropriate or whether supervisors always identify the most important risks that could threaten an institution's viability, although these are, of course, important questions. Nor does it explore the particular legal mechanisms that can be used to impose enforcement actions, penalties or directives aimed at institutions or their directors or officers. These are generally the last resort once all else has failed, and are more the realm of lawyers than supervisors. Instead, this article attempts to summarise and synthesize some ideas on the operation of the 'carrot and stick' approach familiar that makes up the day-in, day-out business of prudential supervision.

5.2 Historical Perspective

Leading up to the global financial crisis, it is evident that many supervisors did not exert effective influence over regulated institutions to promote effective and prudent risk management. While some latent risks simply were not identified by

[2] APRA was created in 1998, after a Government enquiry into the banking system recommended that an independent agency take over bank supervision functions historically held by the central bank and other sectoral regulators.

supervisors, there are also examples where supervisors had evidence of excessive risk taking or other concerns about risk management but did not intervene effectively to ensure these issues were addressed by the institution.

For many regulatory agencies, the manner in which they exert influence has shifted as a result of this experience. Before the crisis, there was a general sense in many countries that large, sophisticated banking organisations operated with strong internal controls; they had ongoing access to capital markets should this be needed, and so were unlikely to experience any losses that could not be readily absorbed. Issues raised by supervisors were generally aimed at advancing industry practice, refining control mechanisms, and while often raised diligently, they were at times not pursued with great urgency. It was left to institutions to determine resourcing and timeframes for implementing recommended improvements, and supervisors relied on assurances from the institution as to effective implementation. Supervisors felt that it was not their mandate to intervene in the outcome of business judgements or, for example, portfolio composition.

Many reports published since 2007 have dissected the failings of banks and supervisors and provided recommendations for improvements to risk management and culture at banks. This 'lessons learned' process is important and continues to this day.

The current round of regulatory reforms, known as Basel III, is aimed at strengthening the supervisory framework. This set of rules provides the basis and rationale for many types of supervisory intervention – for example, requiring banks to hold additional capital to absorb potential losses, and raising the expectations for the management of liquidity risk. These reforms have been developed and promulgated through the traditional approach for global regulatory bodies and many individual regulatory agencies – a set of technical minimum standards.

There has been less focus on the practice of supervision. Aside from a push for greater direct engagement with boards of directors, there has been relatively little exploration of how supervisors engage with banks to achieve prudential outcomes. In fact, in much of the recent literature on supervision and the global financial crisis, it is simply assumed that supervisors can mandate change within financial institutions once the necessary outcome is identified (e.g. better data reporting capabilities, more effective collateral management).

Yet even since the crisis, the effectiveness of supervisory influence continues to come into question. For example, a group of regulators published a report in 2008 recommending a range of quite specific improvements to risk management. However, a follow-on report in 2009 by that group concluded that:

> Despite the passage of many months since we published our first survey in March 2008, we found that a large number of firms had not fully addressed the issues raised at that time.[3]

[3] Senior Supervisors Group, 'Risk Management Lessons from the Global Banking Crisis of 2008', October 2009.

The regulators attributed this failure to address issues to the substantial resources, both human and financial, required to make a number of the changes needed. The issues were clear, but effective action had not yet been taken by banks and supervisors. This result reflects the reality that, in practice, supervisors have no choice but to balance the changes that are considered necessary with the capabilities and resources of banks to implement them.

The experience in Australia provides some context for exploring how supervision can be made more effective. While always relatively conservative in its regulatory stance, historically, APRA (and until 1998 the previous bank regulator, the Reserve Bank of Australia) took what is considered to be a fairly collaborative approach to bank supervision. The Banking Act 1959 gave the Reserve Bank the power to impose regulations on banks, but the policy approach was to promulgate more informal 'prudential statements' that set out high-level risk management guidance as well as capital requirements and liquidity guidelines.

APRA supervisors conducted occasional on-site reviews focused on the standard banking risk types (credit, market risk). These reviews, which for a particular risk area could be spaced out at intervals of several years, consisted of discussions with bank management and staff and review of the bank's internal documentation and reporting. The outcome was generally a report that included narrative of areas for the bank to consider for improvement; there were generally no formal findings. There was at times limited probing of the picture portrayed by management.

In 2001, the HIH Insurance Group failed, insolvent and with a policy holder shortfall of more than AUD$5 billion (APRA 2004a, p. 45). While there were many factors contributing to the failure, one of the outcomes was that the Government's report into the HIH failure recommended that:

> The Australian Prudential Regulation Authority [should] develop a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision of general insurers. Consultation, inquiry and constructive dialogue should be balanced by firmness in its requirements and a preparedness to enforce compliance with applicable standards.[4]

Other countries that have cast a similarly critical eye against themselves have arrived at strikingly similar conclusions. For example, the UK FSA's report into the failure of RBS (Financial Services Authority 2011) noted that the pre-crisis supervision approach:

> . . .was too reactive in the absence of indicators of heightened risk. As a result, the approach encouraged a culture where supervisors placed undue reliance on:
> — assurances from firms' senior management and boards about governance, strategy, business model and key business decisions; and
> — the firm's control functions (Internal Audit, Compliance and Risk Management) to identify and address issues.

[4] Report of the HIH Royal Commission, recommendation 26.

The supervision team had identified concerns, and had taken a non-confrontational approach to influence the bank rather than use clear and powerful tools such as capital requirements to push change. The FSA (2011, p. 285) noted that:

> Supervision correctly identified within the 2005 ARROW letter that a key risk for RBS was the amount and concentration of its corporate lending, and its commercial real estate portfolio in particular... Supervision chose not to intervene directly to limit RBS's commercial property exposure nor to increase its capital requirements, but tried instead to ensure that the RBS Board adequately considered its risk appetite and developed a stress-testing approach that considered the impact of a sustained economic slowdown.

These recurring themes raise the question of whether supervisors are simply destined to repeat these experiences whenever times are good and the banking system is stable. Indeed this is a genuine concern and worth keeping on the agenda.

It did not take long for APRA to put the HIH report's recommendations into practice. In 2004, a high profile unauthorised trading incident emerged at a major bank. Just a year earlier, the supervisor had raised significant concerns with the bank about its market risk management practices. Unlike some previous incidents, the response to the latter incident was swift, severe and importantly, public. The bank's capital requirement was raised, it lost approval for internal model use and trading activities were curtailed. APRA's report into the incident was made public (APRA 2004b).

Part of this response related to an overhaul of APRA's supervisory methodologies, including implementing a formalised institution risk assessment and rating system together with a more structured set of risk analysis procedures. Prudential rules also became more prescriptive in areas of risk management. By one account, the additional procedural rigour was to force supervisors from adopting a 'cooperative approach where they might otherwise be reluctant to be more intrusive'. The observed result was that for APRA supervisors, 'intervention in larger firms is more aggressive, occurs earlier, and is more graduated' (Black 2006, p. 19). While this may perhaps overstate the impact of the methodological supervision changes alone, the overall result was a more consistent culture from supervisors up to senior management that was more comfortable with intervention, supported by additional resourcing and more formalised prudential rules. This cultural acceptance of the need for intervention survived even through a brief period of rising anti-regulatory sentiment in Australia leading up to the Global Financial Crisis.

5.3 Theories of Regulatory Interaction

It should not be surprising that cycles of alternatively accommodative and intrusive regulatory practice are a recognised feature in regulatory analysis. There is an extensive body of academic literature on the economic theory of and rationale for regulation (cf. Posner 1974).

The nature of the literature seems to reflect the global cycles in industry and political thinking on regulation, particularly the heightened regulatory era of the

Table 5.1 Game-theoretic framework of regulatory interaction

	Regulator's action	
Entity's action	Cooperate	Enforce
Comply	Voluntary compliance; regulatory discretion; principles-based outcomes	Investigative and enforcement costs; rules-based outcomes
Evade	Regulatory objectives not achieved	Costly investigations and legal actions; additional compliance obligations and sanctions

1960s and 1970s, and the deregulation push of the 1980s and 1990s, which sought to wind back regulatory power and discretion. Early consideration of the practice of regulation was often based on economic theories of 'regulatory capture', the perceived tendency of regulators to be influenced by or adopt the objectives of their regulated entities, rather than the public interest.[5] In fact, the concept is often referred to today to describe the apparently accommodative behaviour of some banking regulators prior to the global financial crisis (Pagilari 2012).

While the debate on the rationale for regulation continues, a more recent practice-based literature has examined approaches to increase the effectiveness of regulatory implementation.[6] Although it could be argued that prudential supervision has some fundamental differences to other types of government regulation that is the focus of much of the academic literature, many of the concepts and issues will be very familiar to bank supervisors.

A key point is that regulators in all industries operate within legislation and rules but also have substantial discretion in how they engage with regulated entities and interpret and enforce rules. How they exercise this discretion, which is based on a range of factors, including culture, expertise, and resources, will influence regulatory outcomes.

> Regulatory agencies can take perfectly reasonable law and produce oppressive regimes, and similarly apply an unmanageable set of laws, many of which might be obsolete, and deliver perfectly reasonable regulatory protection (Sparrow 2000, p. 5).

Black (2001) notes that 'enforcement is not just about gaining compliance with the law, it is about determining what compliance is.'

Purely theoretical models can also provide some insights into modes of regulatory interaction. Scholz (1984) introduced the notion of regulatory interaction in a traditional game-theoretic framework. In the typical set-up with a regulator and a regulated entity, the regulated entity chooses between two strategies: compliance or evasion (see Table 5.1 below). Evasion might include compliance with the letter but not the spirit of the law, or outright failure to implement particular requirements. Firms want to avoid compliance costs as well as regulatory sanctions, and

[5] Regulatory capture theory was originally established in Stigler (1971).

[6] See, in particular, Ayres and Braithwaite (1992), Sparrow (2000), and Black (2001; 2007).

regulators want to minimise enforcement costs as well as achieve regulatory compliance objectives. Regulators then respond by choosing between a 'cooperative' or 'enforcement' response. The cooperative response can be taken to mean that the regulator takes a flexible and collaborative approach based on achieving the spirit of the regulation, including negotiation on actions and timelines. This approach allows for more regulatory discretion, and makes the assumption that firms do have incentives to comply and compliance is most effective when it is based on internalised incentives rather than externally imposed compliance requirements; however, this strategy might also be indicative of regulatory capture.

The enforcement response, also called 'deterrence', is a zero-tolerance, rules-based approach where compliance is verified and non-compliance punished with penalties or other negative consequences against the regulated entity.

The economic theory behind these models demonstrates that the outcome of these games is similar to the classic 'prisoner's dilemma' outcome – if both regulator and regulated entity choose the 'compliance/cooperative' outcomes, both are better off than if both choose 'evasion/enforcement'. However, absent any other incentives the latter outcome is the most likely.

Unless the 'game' extends over repeated rounds, there is little incentive for either to choose the more constructive approaches. Information asymmetries compound the problem as do heterogeneity within the regulated population, and other factors. Individual firms may have different propensities to comply or evade, depending on factors such as their perceived payoffs to evasion, the discount rate applied to future payoffs or sanctions, or the probability of detection.

This problem can be overcome in a game with repeated rounds, where the regulator demonstrates its willingness to 'enforce' in the face of non-compliance, prompting the regulated entity to comply in subsequent rounds. Thus, the regulated entity's knowledge of how the regulator typically reacts in response to evasion provides strong incentives for whether it chooses 'evade' or 'comply' on an ongoing basis.

A widely cited paradigm that attempts to resolve this conflict is the 'responsive regulation' paradigm. Regulation is most effective, according to this theory, when it utilises a mix of compliance-based and cooperative approaches (Ayers and Braithwaite 1992). Enforcement activity should reflect a 'pyramid' framework of progressively stringent enforcement. The most frequent interactions involve efforts at persuasion and voluntary compliance (the base of the pyramid), while further up the pyramid are the more interventionist and presumably less frequently used enforcement options such as penalties, other sanctions and de-licensing. The repeated interactions between regulator and regulated entity ensure that both have a reasonable idea of the 'height' of the pyramid (that is, the scope for further escalation) and what will cause the regulator to reach the top. Although it has been criticised as being overly simplistic in a number of respects, this model has been very influential (Fig. 5.1).[7]

[7] For a useful summary, see Parker (2000). For a summary of criticisms of the model, see Baldwin and Black (2008).

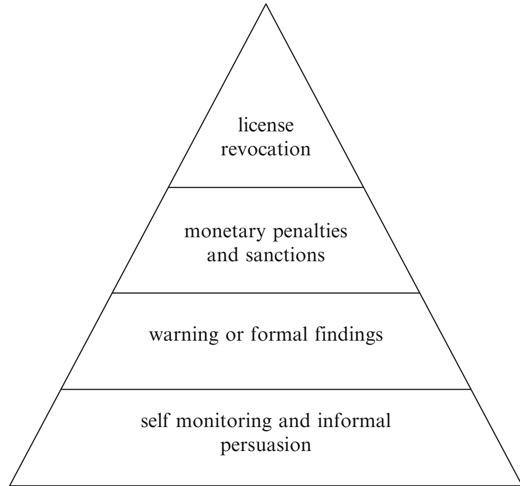

Fig. 5.1 Example of enforcement pyramid

Both the enforcement and cooperative approach can have benefits:

> The enforcement approach can be very useful when getting a program started as it maximises immediate compliance. A stringent, rule-based system also provides an agency a strong defence against litigation, a strong base from which to pull back, external support (initially), a strong sense of mission, internal cohesion, and an effective mechanism for producing consistency…It also lessens the competitive advantage gained through non-compliance, by imposing financial penalties and requiring corrective actions (Sparrow 2000, p. 37).

The severity and prescriptiveness of actions can be escalated as the regulator assesses the regulated entity's progress or sincerity in its compliance efforts. Importantly, the more cooperative and flexible regulatory approaches require more *discretion* for the regulator to adopt alternative requirements that meet the regulatory objectives, rather than a strictly rules-based approach. At the same time, a regulator that does not have a history of occasionally using its 'big sticks' – such as formal enforcement actions, capital penalties or limits on business activities – in the face of major breaches of prudential expectations will have a harder time achieving progress on relatively small issues as well.

In the real world, these regulatory interactions are of course much more complex. Interactions between institutions and regulators do extend over lengthy time periods with repeated engagements on a given issue, where the regulated entity gains a measure of confidence about how the regulator will react to non-compliance.

Institutions are aware that supervisors are constrained by an implicit public duty not to cause institutions to become unprofitable or close their business by imposing unduly costly requirements on them or constraining their business to the extent that it is not viable. Supervisors are also aware that these types of threatened outcomes may also often provoke a political response, in light of the importance of banking to economic growth. Supervisors do not have perfect information on the extent or

costs of compliance, or even on the most effective means of achieving a particular regulatory outcome. All of these factors can lead supervisors to be cautious in adopting an enforcement approach. However, supervisors may have more information than individual institutions on others' compliance efforts, which can lead to less scope for negotiation on a bilateral basis.

This suggests that, in summary, where the regulator's objectives can more readily be internalised by actors within the firm – that is, the regulated firm's objectives are aligned with those of the regulator – a more accommodative stance may be less costly and more effective in the long run. In addition, where prudential expectations that are more judgemental and the costs and outcomes are less certain, a flexible approach is often required simply to arrive at a practical outcome. In contrast, where incentives are unlikely to be internalised, for new rules where costs and desired outcomes are more certain, a more enforcement-oriented approach may be preferred.

5.4 Rationale for Supervisory Intervention

In considering how supervisors can have most effective influence, it is useful to start with the question: why do supervisors intervene?

It is commonly asserted that supervisors mainly enforce 'compliance' with prudential requirements. The prominence of compliance is evident throughout many pronouncements by the Basel Committee on Banking Supervision and similar authorities. Of course, prudential requirements – in APRA's case Prudential Standards – are primarily statements of minimum risk management and control standards as well as minimum capital and liquidity requirements. The objective is not, therefore, compliance per se but sound operation of financial institutions.

The objective of these requirements is aimed at two key objectives which make up the bulk of day-to-day supervision work – first, ensuring financial institutions have sufficient financial capacity (primarily capital) to absorb the risks in inherent in their business, and second, ensuring that their risk controls meet minimum regulatory expectations and are effective in maintaining a risk profile commensurate with the institution's risk capacity. These can be called *risk capacity* and *risk control*. A third and increasingly important area of focus, discussed below, is *risk appetite*. Despite an increasing level of discussion about business models and strategy, the actual prudential levers that supervisors can effectively pull sit in one or all of these three areas. Table 5.2 provides examples of deficiencies in these areas that are often the focus of supervisory activity.

5.4.1 Risk Controls

Risk controls in this context includes the governance, policies, training, limit structures, data and monitoring that help to mitigate the credit, market, liquidity,

Table 5.2 Examples of deficiencies or failures

Risk capacity	Operational risk capital not responsive to changes in risk profile
	Bank insolvency under moderate stress test
	Credit models manipulated to minimise risk estimates
Risk control	Unauthorised trading gives rise to losses (rogue trader)
	Excessive amount of loans mis-graded or approved outside policy guidelines
	Collateral valuations not current or independent
Risk appetite	Commercial property exposures grow to larger share of book than intended under bank strategy
	Increase maximum loan-to-value ratio (LTV) on home loans to increase market share without understanding of impact on risk profile
	Targets for share of short-term wholesale funding not manageable in a prolonged market closure

operational and other risks that are inherent in banking. In addition to being necessary to run the business on a day-to-day basis, effective risk controls prevent unexpected losses and negative reputational events that are not considered part of normal banking, such as rogue traders, a significant amount of loans being made outside approved lending policy, or significant operational outages.

Supervisory expectations for appropriate risk controls are set out at a high level in prudential requirements. Risk controls are assessed during on-site assessments, as well as through evaluations of the quality of management information reporting and discussions with the bank's internal and external auditors. Assessing the effectiveness of banks' controls against prudential requirements involves a high degree of judgement for supervisors, particularly as risk control practices evolve over time and are not always directly observable.

Supervisors frequently find areas where risk control could be improved, such as in systems and data used for risk management, controls over bankers' ability to override modelled credit assessments, segregation of duties in the markets areas, and improvements in the quality of regulatory statistics. Supervisors review files and may find instances where the bank's lending practices do not appear to comport with its own policies, or where counterparty credit grades or valuations are not updated sufficiently often. Effectively, risk control findings are aimed at ensuring that the overall risk profile of the bank is consistent with regulatory expectations and with the bank's own policies.

5.4.2 Risk Capacity

Capital provides the financial capacity for absorbing losses that arise from taking credit, market, operational and other business risks. No discussion of regulatory practice would be complete without a consideration of how supervisors approach capital. APRA, like most countries adopts the Basel Committee's capital rules. Of APRA's suite of 22 prudential standards that apply to banks generally, nearly half

deal predominantly with capital requirements. Inadequate or potentially inadequate capital is a serious matter and intervention will be directive and occur at senior levels with the bank and regulatory agency.

Despite the detailed and prescriptive nature of capital rules, there are areas of interpretation and application in assessing compliance with capital requirements. Reflecting this, the Basel Committee has initiated a project that will (among other things) assess the significance of differences in supervisory practice in implementing capital requirements, and in particular inconsistencies in the calculation of risk-weighted assets, the denominator of the Basel capital ratio.[8]

As any supervisor is aware, a significant component of day-to-day supervisory activity involves verifying the bank's implementation of these requirements, including reviewing models and verifying the treatment of specific exposures against APRA expectations. In fact, at APRA, all banks that are accredited to use internal models are subject to annual formal validation reviews of their operational risk, credit risk and market risk models and more frequent less formal updates on any changes.

Relatively frequently, supervisors require changes to models or parameters used if they are not sufficiently risk sensitive. Supervisors also assess the quality of capital instruments; at APRA most capital instruments are centrally reviewed and approved through a well-established process. While capital rules are relatively complex, the management of capital is generally the responsibility of one centralised area within the bank, and therefore changes can be effected relatively directly.

5.4.3 Risk Appetite

Risk appetite has moved to the forefront of supervision in the last several years and is now implicitly or explicitly the subject of nearly all discussions between banks and supervisors. Risk appetite is a clear statement of the amount of risk a bank is willing to take on in its business activities, which is translated into specific settings for writing new business and managing the existing book. Increasingly, supervisors expect financial institution boards to articulate risk appetite and ensure it is set within the bank's risk capacity as well as prudent industry practice.

A failure of risk appetite occurs when the board or senior management of the bank knowingly allows the bank to take on a certain level of risk exposures, either not fully understanding the downside risk of this decision, or targeting a higher overall level of risk of significant loss than can be absorbed within its financial resources. This might be because macroeconomic conditions worsened more than was thought possible, downside losses were underestimated due to short risk

[8] Basel Committee on Banking Supervision, *Report to G20 Leaders on Basel III Implementation*, Bank for International Settlements, June 2012 (available at www.bis.org).

horizons or long-tail risks that were ignored, or because the strategy was not well aligned with the skills or competencies of the bank. Many of the investment strategies of the financial crisis, such as holding AAA-rated subprime CDOs, or overweight lending to commercial property, fall into this category.

Prudential regulators have generally avoided specifically prescribing risk appetite, although this may be changing. The exceptions are areas where the regulator imposes risk limits, such as on large exposures to individual counterparties, limits on high-LTV lending or commercial property lending as a share of capital, or prohibitions on certain types of trading. A requirement to have a certain level of operational resilience (for example, minimum recovery times for payment systems or diversification of back-up centres) is another example of risk appetite direction by the regulator.

5.5 Institutional Incentives

Ensuring that institutions implement appropriate risk controls, capital levels and risk appetite requires engagement at all levels of regulated institutions. Banks are not monolithic entities but complex organisations comprised of boards, management, staff, policies and practices, and systems and other infrastructure. They are motivated by many different incentives. Only one of those incentives is the expectation of meeting regulatory requirements. Although the long-run objective of supervisors – to safeguard the financial health of the institution – is closely aligned with the objectives of bank boards and management, there is also at times a fundamental misalignment between the regulator and bank on the level of risk that is prudent and the amount of resources that need to be spent on risk control and risk mitigation.

Table 5.3 presents a very high-level stylised overview of the types of incentives that might motivate the tiers of actors within financial institutions to meet regulatory expectations, and the constraints that they operate within. Directors of the regulated institution, particularly the independent directors, in many ways have incentives that are aligned with those of regulators. Personal remuneration may not be a primary goal, when compared with the overall success and reputation or the organisation during the director's tenure, as well as genuine desire to meeting corporate governance responsibilities. Independent directors may not always have particularly clear visibility into risk issues that occur at an operational level, and they often recognise that the third-party regulatory lens is often beneficial to them in carrying out their role in overseeing how bank management is implementing the agreed strategy and risk appetite. Nevertheless, boards come under constant pressure to maximise shareholder value, which often means short-term returns, return on equity and share price appreciation. To a large extent, regulatory requirements, particularly on leverage, are restrictions on the business and on the achievability of financial targets expected by the market.

Management may also be attuned to shareholder expectations and the need to safeguard the bank's reputation, but they also operate with their own objectives for

Table 5.3 Motivations to comply

	Objectives	Constraints
Boards	Demonstrate good corporate governance	Shareholder ROE expectations
	Avoid large unexpected losses during tenure	Visibility of risk information from management
	Avoid reputational damage	Limited operational decision-making
	Not be perceived as a negative outlier within industry	Limited understanding of risks
	Avoid regulatory directions and constraints	Limited ability to influence management
Executives (CEO, CFO, business heads)	Demonstrate good risk management	Financial performance targets
	Avoid criticism from regulator	Industry operating norms
	Avoid constraints on decision-making	Industry competition
	Not be perceived as a negative outlier within industry	Remuneration structure
	Avoid large unexpected losses during tenure	
Risk and regulatory affairs staff	Avoid criticism from regulator	Remuneration structure
	Improve risk management	Budgets and resourcing
	Maintain status of role	Business pressure to achieve least cost regulatory outcome

business growth, executing a successful strategy, and personal remuneration. Responding to supervisors' concerns can in many cases lead to reduced operating performance in particular business areas (for example, higher expenditures on systems development) or in loss of market share if lending standards are required to be tightened.

At a staff level, behaviour is more constrained by the bank's policies and practices. Staff may not have authority to implement regulatory recommendations. Frontline banking staff must operate within risk limits, and breaches of those limits can have significant repercussions. As a result, the manner in which these operating limits are set and enforced has an important influence on staff incentives. Ironically, while bank executives often seek more flexible responses from regulators (sometimes described as 'principles-based'), operational staff often prefer 'black and white' rules with clear boundaries.

Incentives for better risk controls can be internalised within both business and centralised risk functions with banks through appropriate policies, training and remuneration arrangements.[9] Culture and values becomes important in the extent to which staff are genuinely motivated to demonstrate and internalise risk

[9] In fact, Ayers and Braithwaite (1992) note that lower-level staff may occasionally 'tip off' regulators to areas of potential concern.

management objectives and see value in meeting regulatory requirements aside from the need to minimise regulatory criticism or constraints.

The primary constraint tends to be the resources and management attention required to demonstrate effective improvements to risk controls. Most supervisors have probably experienced indirect appreciation or acknowledgement from line staff for promoting particular risk management improvements (such as improved focus on IT security) that may have been sought for some time within the business but was frustrated from lack of resources.

Other staff may be motivated by remuneration arrangements that reward volume-based sales and non-risk based financial performance targets. Remuneration is a relatively new topic of interest for supervisors that has come about since the Financial Stability Board published its recommendations for strengthening financial institution compensation arrangements in 2010.[10] Supervisors may be only just beginning to fully recognise the pervasive impact of remuneration incentives on risk-taking behaviour. While senior executive salary and performance incentive plans are typically public information, it is the remuneration of lower-level bankers, traders and third-parties (such as mortgage brokers) and the performance targets on which their compensation is based that potentially have more scope to have unforeseen risk consequences. Compensation based on predominantly volume-based sales incentives, in particular, invariably lead to incentives to circumvent risk controls, and only the strongest of enforcement frameworks can ensure that these controls are not bypassed or gamed.

Increasingly, supervisors are reviewing the details of remuneration arrangements when they conduct a routine risk visit. Supervisors may request banker remuneration scorecards for particular lending businesses where rapid growth has been experienced. Remuneration scorecards for bank treasurers and treasury staff may also be useful in understanding the incentives for prudent management of the balance sheet.

Incentives relating to capital requirements are also pervasive, particularly in large banking organisations. There is little evidence that regulatory capital requirements are internalised to the extent consistent with regulatory objectives. In fact, despite the global financial crisis, it appears that banks still have strong incentives to minimise regulatory capital. Any increase in a bank's Pillar 1 capital requirement (that is, its risk-weighted assets) has a direct negative impact on reported capital ratios. This affects the bank's relative financial standing, potentially its credit rating and buffer over levels required for compliance. Despite years of work on internal economic capital models, it still seems that banks' frameworks for determining whether the bank has 'enough' capital are highly simplistic and do not take sufficient account of indicators such as stress tests and market expectations. If a bank's staff are readily convinced that the bank has adequate capital, internal directives to reduce (or even evade) capital requirements may seem justified.

[10] Financial Stability Forum (now Financial Stability Board), FSF Principles for Sound Compensation Practices, 2 April 2009, available at http://www.financialstabilityboard.org/publications/r_0904b.pdf.

Risk appetite incentives are perhaps the most difficult for a supervisor to influence through more voluntary or persuasive methods of supervision, because these incentives are generally directly related to the institution's market positioning. That is, a more aggressive risk appetite is generally a feature of attempts to gain market share over competitors by taking on business that other institutions would not. Where the bank is a clear outlier in its product risk settings, the regulator may be able to convince or require the bank to change its business settings; however, where the industry as a whole has a risk appetite that the regulator considered imprudent, generally this cannot be dealt with solely at the level of the individual supervisor and bank.

5.6 Modes of Engagement

While supervisors can require banks to take certain actions, whether or not those actions achieve the desired outcomes (more prudent risk taking, better risk management) is often harder to discern. Shifting the underlying risk-taking and risk management behaviour of a large, complex banking organisation cannot be achieved by fiat.

As articulated cogently in the Palmer Report, supervisors must make their voice heard, and there must be consequences for inaction. This starts with the day-to-day interaction between bank and supervisor. Much of this interaction does not involve any explicit enforcement activity. This is consistent with a view that often the more powerful forms of influence involve non-coercive activity. The Palmer Report recommended that:

> In carrying out its mission, APRA should seek to benefit from its powers of intervention, both new and old, by using them vigorously but informally through the voluntary compliance of authorised entities with APRA's requirements without having to resort to the formal use of its powers (Palmer 2002, p. 15).

While the Royal Commission Report emphasized the need for more intrusive approach, a separate report commissioned by APRA recognised the benefits of more subtle forms of influence:

> Supervisors have found that their powers are used most effectively as a threat or last resort. Similar results can often be obtained by helping the institution understand the powers that are available to the Regulator, the Regulator's willingness to resort to those powers if necessary and what voluntary action can be undertaken by the institution to avoid any formal action on the part of the Regulator (Palmer 2002, p. 153).

For a large banking organisation, supervisors at APRA would interact on a daily basis with the bank's regulatory liaison area.[11] There might be weekly interaction with other bank staff in the risk and treasury area, which handles capital and

[11] APRA does not use resident supervisors, that is, supervisors stationed at the regulated institution on an ongoing basis.

Table 5.4 Type of regulatory engagement

Boards	At least annual discussions with senior regulatory executives
	Formal correspondence regarding significant prudential concerns or new policy
	Speeches
	Guidance documents
Executives (CEO, CFO, business heads)	Discussions with senior regulatory executives
	Formal findings from on-site visits
	Other regulatory approvals or limits
Risk and line staff (CRO, Regulatory liaison)	Liaison meetings
	On-site visits
	Informal communications (email, routine approvals and interpretations)

funding. Liaison meetings to update the supervisory team on new developments and to follow up on outstanding regulatory requirements or new prudential requirements generally occur quarterly with the bank's management of the credit risk, markets, treasury and IT and operations areas. Supervisors and their own management would have regular interactions between business executives and senior bank management, at least several times each year and often in the context of on-site reviews and major acquisitions. APRA senior executives generally meet with the full board at least annually and often more, including with specific subcommittees such as the risk and remuneration committees.

Key forms of interaction between regulators and regulated financial institutions are discussed below, and summarised in Table 5.4.

5.6.1 Informal Guidance

Like most other regulators, APRA published non-mandatory guidance on emerging regulatory issues, and senior APRA executives routinely give speeches on issues of current or emerging prudential concern. Speeches are designed to alert senior levels within institutions and their boards to issues on APRA's radar in a non-enforcement oriented manner. A typical example is a discourse on 'Life in the Slow Lane', where APRA's chairman overviewed the risks to which APRA is particularly alert in the new slow growth, post-crisis environment (Laker 2012). In another instance, an APRA executive provided an outline of the type of informal 'checklist' of 16 points that supervisors would start using to assess the emerging statements of risk appetite (Laughlin 2011). These types of speeches are often used as a starting point for bilateral dialogue between supervisors and bank boards.

Speeches can be particularly useful in highlighting concerns about risk appetite at an industry level. For example, in 2003 APRA executives gave speeches

highlighting the growing perception that the housing market was overheated (Laker 2003). The key point made was that:

> Where necessary, APRA would raise minimum capital ratios for ADIs (Authorised Deposit-taking Institutions) whose housing lending practices are not up to the mark.

This message put bank boards and management on notice that a more forceful regulatory response could be expected if there was evidence of risk appetite outstretching risk capacity.

APRA also issues guidance in the form of discussion papers and prudential practice guides, which are intended in part to assist in compliance with specific prudential requirements, but also to provide useful information to banks on emerging risks industry practices. Recent guidance on cloud computing is an example. While not constituting formal prudential expectations, this letter provides an outline of the types of questions that supervisors ask in practice when analysing actual proposals to use cloud computing for sensitive data.[12] This type of document can also be used as a guide in discussion risk controls during on-site assessments; while it would most likely not lead to formal findings, institutions have been asked to justify how they have considered these risks in their operational decisions.

5.6.2 Peer Comparison

One of the most effective means of persuasive supervision is for supervisors to provide the institution's board and management with observations as to the institution's risk profile relative to peers. Supervisors can benchmark key risk profile indicators and provide feedback to the bank on how it compares to peers. In practice, this approach can be particularly effective in influencing individual banks' risk appetite.

Indeed, in a concentrated market comprised of similarly sized banks, institutions are very sensitive to be regarded as an outlier among their peers. Disclosures of exposures has increased through Basel Pillar 3 requirements, and banks and industry analysts scrutinise these disclosures for the appearance of any areas in which particular banks are not 'in the pack'. This may be particularly the case in Australia, where the four large banks are relatively homogenous in size and business composition.

Peer comparisons can be effective even where no minimum regulatory requirement or benchmark exists. For example, as liquidity pressures came to the forefront in 2007 and 2008, comparisons of banks' funding risk profile relative to peers provided a more useful risk indicator than regulatory compliance tests.

Other peer indicators, such as the share of commercial property lending, growth in high loan-to-value residential mortgages or interest-only or investment lending,

[12] APRA Letter to all ADIs, 'Outsourcing and offshoring: specific considerations when using cloud computing services', 15 November 2010 (available at www.apra.gov.au).

can be useful as indicators of relative risk appetite. Supervisors typically do not suggest particular limits, but where a bank is emerging as an outlier this can be a result of inappropriate risk appetite and is highlighted with the institution.

Peer comparisons may arise out of horizontal or thematic reviews, which are methods to provide the regulator and the industry with deep insights into industry practice in a particular area. Institutions find these extremely valuable; however, they can be very resource intensive for the regulator to conduct.

The downside of benchmarking as an ongoing supervisory tool is that there is no clear line at which enforcement activity will commence, constant monitoring of peer groups is required and institutions may feel that the bar is constantly moving. This is why the formal prudential requirements eventually need to reflect results of benchmarking as well.

5.6.3 Engagement with Boards

Supervisory requirements place expectations on boards to attest to risk management frameworks, approve key policies and capital management plans. Boards are expected to play a back-stop risk oversight role. However, supervisors typically have much less face-to-face engagement with boards than with other bank staff. APRA executives meet with the board of all large banks at least once each year. There may be additional meetings with the board risk committee or with the chair or independent directors. The board is expected to be provided with all supervisory visit reports and other formal correspondence. A meeting with the board or board members to express specific concerns is usually a last resort before more formal action is taken, although it can also be done relatively informally.

Senior-level engagement with boards can also be more formal even where not strictly tied to regulatory compliance matters. For example, APRA's chairman wrote to the boards of larger banks in 2011 to remind them of the need to be alert to any deterioration in credit standards in housing lending. Boards were requested to provide assurances that they are actively monitoring housing loan portfolios and are comfortable with risk appetite settings and risk control measures. The communication also cautioned boards to be alert to over-ambitious lending growth or market share targets that did not reflect the current subdued pace of mortgage lending (APRA 2011, p. 19). This mode of engagement required boards to explicitly understand, articulate and stand behind their current risk appetite settings.

5.6.4 On-site and Off-site Reviews

On-site assessments (which APRA terms reviews or visits with similar activities in other countries called examinations or inspections) and off-site analysis make up a substantial component of supervisory activity. These reviews are designed to reach

conclusions about whether the bank is meeting the supervisory expectations as set out in prudential standards and based on good industry practice. As such, on-site reviews are primarily focused on risk controls. In some instances they are quite formal processes with required actions transmitted to institution boards. In other cases, they can be more informal assessments of practice and may involve the type of benchmarking activity discussed above.

Following the failure of HIH in 2001, APRA's approach to on-site visits became noticeably more forceful. Visit reports began to include a list of formal findings categorised into 'Requirements', 'Recommendations' and 'Suggestions'. 'Requirements' are measures that APRA expects the bank to adopt within a specified time frame. 'Recommendations' are improvements to risk controls that the bank must rigorously consider, but others may also be feasible to satisfy the particular concern.

The distinction between on-site and off-site or other ongoing modes of assessment has changed somewhat in recent years. APRA supervisors now conduct more targeted reviews and regular updates on specific risk areas, particularly where internal models are approved for use in determining capital requirements. For example, supervisors would meet regularly, often quarterly, to discuss developments in key risk areas, including credit quality, market risk developments and model changes, other risk models and IT projects for the largest banks. As preparation for these meetings, supervisors may request copies of papers prepared for the board risk committee, updates by the chief credit officers, model validation reports and the like. The benefit of these less formal interactions is that they allow more detailed follow-up on progress on issues identified during on-site visits, as well as monitoring of any changes to strategy or models that may arise in the interim.

A common issue confronting supervisors is the pressure from institutions to close or remove open issues from the regulatory findings list. There are natural incentives for banks to propose actions to address particular visit findings, but if the action is more a short-term 'fix' rather than a solution that addresses the underlying root cause, the result may be repeated findings in on-site visits in subsequent years. The supervisor's difficult job is to try to discern the quick fixes from the root cause solutions and to influence the institution to seek and implement the latter.

5.6.5 Approvals and Limits

Transactional approvals and notifications provide a regulatory touch-point for influence and an opportunity for the supervisor to demonstrate the extent to which it is prepared to intervene in business decisions in order to ensure regulatory expectations are met, both spirit and letter. To do this effectively, regulators have to be prepared to reject requests at least occasionally.

For example, APRA individually reviews the transaction documentation for all regulatory capital instruments prior to issuance. Most securitisation structures are

also reviewed for compliance with relevant prudential rules, and banks are also expected to seek approval for all material model changes and any instances of novel or unclear capital treatment. These approval hurdles often result in rejections with changes required to be made before implementation. In the case of capital instruments, for example, it is the exception rather than the rule that an institution receives approval on its first attempt at submitting transaction documentation.

As in most countries, APRA requires approval of all acquisitions of other regulated entities. Acquisitions are considered a core part of business strategy, and intervening in an acquisition is a decision that most regulators have historically avoided. Supervisors can, however, be proactive in providing oversight of the due diligence process and highlighting risk issues. In a few instances, the supervisor's pressure may have led institutions' boards to recognise more risks in an acquisition than were originally evident.

APRA, like other regulators, includes as part of its prudential framework the ability to set limits on activities or exposures. Supervisors tend not to use this authority extensively. Imposition of regulatory limits as a substitute for a bank's own limits often precludes the institution from setting its own risk appetite and internalising the risk, such that it solely monitors against the regulatory limit.

5.6.6 Capital and Liquidity Requirements

While capital requirements are a baseline regulatory requirement for financial institutions, capital is also a powerful supervisory tool that ranks relatively high on the enforcement pyramid for those regulators that are prepared to use it. The impact of capital and capital requirements on banks remains pervasive, particularly for the larger banks that listed on exchanges and operate in international markets. There are few discussions between supervisors and banks that do not have a capital implication to them.

One of the features of the Australian approach, compared with some others, is the supervisor's willingness to use capital as a tool to exert influence, rather than to enforce capital requirements purely as a compliance measure. To begin with, APRA often imposes capital requirements beyond the minimum Basel framework in setting the individual prudential capital ratios that reflect the Pillar 2 approach in Australia. Pillar 2 additions to capital requirements are not made lightly or in response to transient events or risks. However, they have been used to provide incentives for banks to make changes to comply more fully with particular requirements.

Regulatory agencies can also use capital requirements to address industry-wide concerns about risk appetite that are not tractable on an individual-bank basis. For example, in 2004 as a result of concerns about an overheated housing market demonstrated through supervisory stress tests, APRA raised the relative capital requirements on higher-risk residential mortgage loans (APRA 2004a, p. 36). Raising capital requirements on 'low-doc' loans immediately reduces the

profitability of writing this type of loan. This may have helped minimise the share of higher-risk loans leading up to the Global Financial Crisis, despite a strong housing market in Australia over the same period.

Supervisors also may apply a higher capital requirement to a novel product or transaction, where the capital rules may be inappropriate or unclear, either through a specified risk-weighting or through the addition of an overall Pillar 2 addition to the capital requirement. These types of decisions are often critical in addressing potential emerging risks. Supervisors can be confident in making these discretionary decisions if they have sufficient expertise and resources to assess the relevant risks, and are supported by the policy and management framework.

5.7 Why Do Supervisors Fail to Assert Their Influence?

Even the supervisory agencies that have been most successful in avoiding banking crises have experienced occasions where concerns are raised but the institution does not effectively address the concern. Why do supervisors fail to influence institutions to achieve outcomes, and what strategies can help overcome these factors?

5.7.1 Institutional Push-Back

One of the most common reason why supervisors fail to achieve desired outcomes is because they come under pressure from the regulated institution to weaken the particular prudential requirement. This pressure can be relentless for the line supervisors; the institution's staff may even suggest that the supervisor is uninformed or even incompetent and seek to escalate to more senior management within the supervisory agency. There are repeated requests for meetings where the bank takes supervisors through logically argued and carefully rehearsed presentations on why the particular decision or action the regulatory proposes should not be taken.

Arguments typically put forward by banks include the following:

1. The proposed treatment unclear is incorrect, or it does not address underlying policy concern. Banks often exploit the inevitable grey areas and loopholes in existing rules-based prudential requirements. Arguments include 'the requirement is not explicitly ruled out' or 'the requirement isn't clear'.

For supervisors to rebut these arguments requires that the principles that the prudential requirement is trying to achieve are clear even if the wording of the rules is not. It also requires that supervisors fully understand the policy rationale, and preferably were involved in the actual policy development process so that they understand why requirements were articulated in the way they were. It also requires that supervisors are trained to look beyond the letter of the rules to the principle and to be able to debate the rationale and how the decision is consistent with it.

In addition, the supervisor needs to get internal support for the particular treatment, including from internal specialist areas, as well as from senior management. This requires a reasonable nimble internal process for arriving at decisions on unclear areas of supervisory practice.

2. The bank is being treated unfairly as other banks have been allowed a more favourable treatment. If the bank can demonstrate that different decisions have been taken with other banks in the past, supervisors need to explain that a change in policy is being applied industry-wide. Supervisors find themselves in a very awkward position in defending a particular action if indeed other banks were not held to the same standard by other supervisors within the same authority. The competitive implications of this situation against selective enforcement are compelling.

To address this problem, it is very critical that the regulator have a formal mechanism for internally ensuring consistency of treatment. This often involves either very close coordination between supervisors of different peer banks, or a central function that advises on consistency of application of prudential requirements. APRA houses all large bank supervisors in physical proximity, and also has a central technical and interpretive unit which serves as the repository for decisions involving interpretation of prudential requirements. Centralised risk teams also serve a consistency function.

3. The proposed decision is too costly and the bank will be uncompetitive or will consider exiting the particular business. Supervisors need to be reasonably pragmatic. A stable prudential regime is based on avoiding sudden large changes in regulatory costs to the business. Supervisors often do not have particularly accurate information on the cost and effort required to improve risk controls, or their impact on the business. Institutions will at times attempt to exaggerate these costs.

Cost arguments are reasons for transitional relief that may allow a bank to absorb costs over time, particularly if the particular bank has historical reasons why it faces higher costs than competitors. Supervisors need to have discretion to provide transitional arrangements, but this discretion cannot be so broad that banks know it will always be made available.

5.7.2 Failure to State Clear, Achievable and Measurable Outcomes

In some cases, supervisors may have a concern about risk controls or appetite, but may not always have sufficient insights into the business operations to be able to recommend an action that will address the underlying risk concern. For example, if business continuity appears weak, supervisors cannot mandate achieving a particular disaster recovery outcome because the risk events occur only rarely and are observable only ex post.

The finding from an on-site review, may state that underwriting standards appear to have loosened. The experience of recent years suggests that without a specific requirement as to changes to loan settings or enhanced oversight of bankers, the institution may simply respond that it will remain vigilant, without actually making any effective changes.

5.7.3 Failure to Follow Up

With stretched resources at supervisory authorities, failure to follow up effectively on identified risk concerns is a common potential problem. On-site reviews tend to generate a large number of findings and issues to be remediated by the institution. Often the institution's response is that it will make changes to policies or implement alternative practices. However, without reviewing detailed documentation or conducting a follow-up review, supervisors are unable to have confidence that the proposed actions have been effective in addressing the particular risk issue. Both supervisors and banks have often failed to follow up and ensure seemingly small issue were rectified, usually due simply to resource and time constraints. In some cases, these seemingly minor issues later turned out to be symptomatic of more significant underlying risk appetite or governance issues.

Failure to follow up is largely a resourcing issue as well as one of prioritisation within supervisory teams. Not all minor issues can receive explicit follow up analysis. Bank management also has limited time and resources. As a recent report noted:

> . . .Feedback from firms reveals that in some cases most of the discussion between firms and supervisors happened on immaterial issues while the more material thematic discussions didn't take place (FSB 2010, p. 15).

The supervisor needs to be alert to when an individual finding in itself is typically not of very significant concern, but an accumulation of individual findings can be symptomatic of broader governance or cultural issues.

5.7.4 Evasion and Arbitrage of Rules

Institutions are adept at finding ways to exploit grey areas within regulatory rules to achieve a favourable outcome. Uncovering these cases requires a significant amount of effort by supervisors.

For example, institutions must notify APRA supervisors of outsourcing of 'material' business activities and 'material' changes to internal models used for credit, market and operational risk. Some banks may interpret or apply this rule as permitting a number of small changes with no notification. Overcoming this type of behaviour requires greater informal oversight, such as through regular liaison

meetings, so that supervisors can assess which changes are material and which are not. Of course, this oversight process requires additional supervisory resources.

Particularly with the strengthening of global capital requirements under Basel III, many banks now have set explicit targets for risk-weighted assets minimisation. This is of concern if it occurs without commensurate reductions in risk. Some even include explicit incentives to reduce capital usage as part of staff's key performance indicators. If not closely monitored by supervisors, this can result over time in a plethora of small model changes, reporting definitional changes and other tweaks to reported capital requirements that, when seen individually may not be significant, but overall lead to a weakening of the effectiveness of capital requirements.

Another example illustrating the need for strong follow up is engagement between supervisors and banks has been the capital treatment of commercial real estate exposures (also called specialised lending) under APRA's implementation of Basel II.[13] APRA has adopted the more prescriptive (and typically higher) Basel II prescribed 'slotting' approach to determining capital requirements for these exposures rather than rely on internally modelled default and loss estimates. Some banks have resisted fully applying the capital treatment across all relevant portfolios, or have implemented it initially but then gradually over time have narrowed the definition of covered exposures. The remuneration and return on equity incentives to reduce risk-weighted assets means that individual bankers and credit officers may tend to avoid classifying a particular loan in a manner that will result in a higher capital requirement.

APRA's approach was to proceed along a measured process with an industry working group establishing common definitions. APRA has reviewed their application through repeated on-site visits and detailed reporting of data, which in some cases resulted in requirements to change the reporting treatment.

In summary, preventing arbitrage where rules are complex requires supervisors to be very proactive and detailed in reviewing banks' reporting and activities, or to adopt very punitive penalties for banks that are considered to have pushed the rules too far. The latter approach is difficult for supervisors because, by definition, there are grey areas with regulatory rules, and taking strict enforcement action in an area where rules are complex and may not always be entirely clear is a challenge.

5.8 How Can Supervisors Be More Influential?

5.8.1 Matching Intervention to the Objective

One conclusion from the foregoing discussion is that different objectives for regulatory intervention may suggest which method may be most effective. In

[13] Capital requirements for specialised lending are found in APRA prudential standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk, January 2008 p. 50 and Attachment F.

Table 5.5 Methods of influence

Area of concern	Public	Private
Risk control	Prudential requirements	Peer benchmarking
		On-site visits and follow up actions
	Guidance documents	External auditor review
		Capital penalties/incentives
Risk capacity	Detailed prudential requirements	Verification of capital calculations
		Validation of models
	Published interpretations	Approval of individual capital instruments
		Capital penalties
Risk appetite	Speeches	Peer comparisons
	Disclosure requirements	Board discussions
	Exposure limits	Requirement for board to articulate and confirm risk appetite settings

particular, decisions about risk appetite are usually made by the board and senior management. Decisions most relevant to risk capacity are typically handled by the capital management unit, which is generally centralised. Risk controls, however, are much more dispersed and require engagement at a variety of levels, including appropriate follow up to ensure appropriate resourcing on the institution's side. The process of achieving certain outcomes (for example, a reduction in operational failures) requires ongoing engagement across a range of actors within the bank and the supervisory agency (Table 5.5).

The ideal outcome is for bank staff, from line staff up to directors, to internalise the particular regulatory concern. In other words, they see it is in their interests to comply because it aligns with their business objectives. For this to be achieved, boards and management need to be reasonably convinced that the supervisor has identified a valid issue. This requires supervisory focus (that is, not distracting the institution with too many issues potentially competing for resources) and direct engagement across a number of levels within the bank. It also may occasionally require the supervisor to back off on issues that are less material in a risk sense.

Supervisors should focus on a few key issues each year. These should be the topic of dialogue with CEOs, boards, risk officers and on-site visits. A common pitfall among supervisory teams is in communicating a very long list of discrete issues over the course of numerous regulatory engagements, all of which need to be addressed within particular timeframes. One of the biggest challenges is simply the need for appropriate people in a labour-constrained market who can manage and understand complex projects required to improve risk controls.

5.8.2 Leverage Institutional Incentives

In influencing banks, supervisors need to understand the role of external competitive forces and internal incentives. Influencing an institution to take position away

from current market norms or that will affect its competitive position will always meet with push-back and requires more than one level of engagement. For an institution to internalise long-term or tail risks is much more difficult because these are beyond the time horizon or plausible scenarios of many bank directors and staff. Where it comes to risk appetite issues, the institutions mainly want to know they are being subject to the same expectations as others so that no competitive advantage is gained. As discussed earlier, reflecting internal incentives may involve assessing compensation arrangements for specific staff or groups of staff, and also internal budgetary decisions.

5.8.3 Follow Up and Escalate

Enforcement authority is the 'big stick' that supervisors carry which, in the vast majority of supervisory interactions, is never used. At the extreme, supervisors can revoke a bank's license or place it into liquidation or statutory management. Like most regulators, APRA has broad authority to formally direct banks, to raise capital, remediate a failed risk control or even limit or cease particular businesses. Supervisors can use this power whenever there is a serious breach of a regulatory requirement, or that an institution is operating unsoundly.

The existence of this authority (not necessarily its use) is the most powerful incentive for banks not to find themselves in a situation of being substantially at odds with the regulator. A supportive legal regime, which allows clear legal enforceability of these powers should they be challenged through the legal process, is therefore an important precondition for allowing a supervisor to operate even on the more mundane aspects of day-to-day supervision.

It also requires senior management of the regulatory authority to have regular rapport with supervisors and to have a mechanism for risk issues to be discussed openly within senior levels of the organisation. One of the most problematic situations is to enforce a particular remediation requirement when other institutions with similar risk or compliance issues have not been required to do so. As a result, the processes for ensuring consistency and communication with the supervisory agency, particularly for peer institutions, must be a pervasive aspect of the supervisory organisation.

An effective strategy for escalation needs to be established at the outset. This requires considerable experience, fortitude and judgement on the part of individual supervisors. In particular, if supervisors are quick to escalate relatively minor issues, they will be seen as unreasonable and the bank is more likely to evade or take a compliance-based approach to risk control. On a personal level, supervisors need to be well trained in dealing with conflict and negotiation skills.

Table 5.6 illustrates the typical progression of interventions that could be used in escalating a particular risk concern with a regulated financial institution. The escalation approach may depend on the rationale for intervention – that is, whether it is targeted at a failure of risk controls, risk capacity or risk appetite. The nature

Table 5.6 Escalation of Interventions

Regulatory action	Description
Questions or advice	Supervisor provides advice to the regulated institution based on a question or directs questions regarding compliance practices to the bank. The institution has the opportunity to demonstrate that it is taking a conservative approach that meets the spirit of the requirement
Notifications and reporting	The supervisor asks that the institution notify it when certain events occur, or inform the supervisor of the size of certain exposures, for example: exposures above a certain limit, new outsourcing contracts, or new products and their size. This allows the regulator to determine whether further action is needed before the risk increases to an unmanageable level
Benchmarking	Industry practices or key risk profile metrics are compared across institutions of similar size and business profile, with each institution provided with its own results compared with the average or summary of its peers. Outlier institutions are encouraged to review their position and take action
Follow-up questions, self-assessment and informal investigations	The regulator probes the responses to informal queries, requests formal data to be provided, requests formal self-assessment of compliance. The supervisor may use this information to benchmark sound practices across the industry
On-site review	A detailed formal assessment of risk control measures in place, with formal findings for follow-up that have timeframes for completion
Engage with executives and board	Senior regulatory staff meet with the chief risk officer, CEO, full board or independent directors to raise issues of concern
Limits	The supervisor applies or tightens applicable regulatory limits, such as on large exposures or particular business volumes
External audit	External audit firm conduct a review that involves compilation of facts and testing of controls at a level of detail beyond the typical on-site review
Capital penalties	Supervisors can increase the minimum capital requirement for a bank, or change the capital treatment (e.g., the risk weight) applied to particular exposures. This can be a permanent or temporary measure, pending the outcome of other remediation efforts
Mandated rectification plan	The institution is required to submit a formal rectification plan which forms part of an informal undertaking to the supervisor
Formal external investigation	The supervisor undertakes a formal independent investigation addressed to the supervisor
Formal enforcement action	Formal enforcement can include enforceable undertakings, directions, statutory management or licence revocation

and speed of escalation may also depend on how clear is the action required, as opposed to identifying the problem, the cost and timeframe for implementing this, and how transparently the effective resolution can be measured.

Finally, it is useful to consider the industry view on the regulator-regulated institution interaction. According to a recent publication, the industry's view is also that supervisors should adopt an approach of graduated action, but the impression is that this should generally be collaborative and based on a common view of the issue and objective. As the key banking industry body puts it:

> In most cases this dialogue, which may need to be carried out at a senior level in both the firm and the supervisory body, should result in agreement as to the extent that the firm's practices may need improvement (IIF 2011, p. 23).

The industry views the situation where the supervisor needs to resort to action stronger than a dialogue as highly unusual.

> In exceptional circumstances, the firm may fail to satisfy the supervisor that the right balance has been achieved between inherent risks undertaken by the firm and the necessary risk measurement, management and governance... This would justify placing supervisory limits on the particular activity....Such decisions should be taken at the highest levels in the supervisory authority and extensively justified on legal grounds. There should be no question of such actions being taken routinely...

The supervisory experience, in contrast, suggests that intervention is more commonly required in order to exert effective influence.

5.9 Summary

Prudential supervisors spend most of their time on the more voluntary modes of persuasive supervision rather than on formal enforcement actions. This suggests more analysis and discussion is needed about how to make these supervision methods more effective in practice.

Since the global financial crisis, in APRA's experience, the emphasis of supervisors has shifted toward:

- Greater focus on risk appetite, not just risk controls and process; and
- Greater inclination to use more forceful enforcement levers, notably capital requirements, to achieve prudential outcomes.

The more persuasive modes of supervision can be very effective in providing greater visibility to institution boards of industry-level issues and in helping align their incentives with those of the supervisor. However, the academic literature on regulatory practice asserts that supervisors need to occasionally demonstrate that they will take harder enforcement action on issues that are considered significant. In particular, supervisors need to be alert to incentives within banks that work against regulatory objectives, and to be prepared to expend more enforcement effort in those areas.

Determining when and how to escalate issues of non-compliance or inadequate risk management requires significant experience, judgement and management support. Experience and regulatory theory suggests that supervisors should target the less cooperative/more enforcement-style responses at areas where incentives are unlikely to be aligned and there is less uncertainty about the cost of compliance. Capital requirements would be an obvious example.

Supervisors also need to pay attention to understanding the underlying incentives, particular in terms of remuneration, that lie behind instances of non-compliance, imprudent risk appetite or weak risk controls.

More effective supervisory influence can be summarised as:

- Striving for alignment of incentives with institutions, and boards in particular. This is particularly effective for risk control oversight, where boards have clear incentives to heed regulatory concerns.
- Recognising that – at least for large, market-listed banks – objectives for sufficient capital to absorb remote risks will rarely be aligned between supervisor and bank.
- Moving up the enforcement 'pyramid' – being prepared to move to formal findings from informal persuasion. Exercise authority day-in, day-out, not just on big issues.
- Directing sufficient supervisory resources to the labour-intensive process of follow-up on identified issues.
- Industry-wide risk appetite issues addressed through benchmarking and industry-level action, such as through public pronouncements and capital incentives.

An understanding of methods that are most effective is clearly an area that could benefit from further research and discussion among the supervisory community and with industry. Regulatory authorities should take the opportunity to consider case studies illustrating where they have been effective in influencing change and where they have not.

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Chapter 6
Developments in Supervisory Enforcement

Aik Yang Lim and Swee Lian Teo

6.1 Prerequisites for Effective Supervision and Enforcement

Regulation forms the foundation upon which supervision and enforcement are built.[1] Rules should be outcome-focused, be clear and consistent, and be risk appropriate. They need to keep pace with industry changes and be relevant over financial cycles. Regulation should be designed with due regard to its market and cost impact and recognise that different stakeholders have specific responsibilities in delivering regulatory outcomes. They should also take into account both local and international contexts.

However, relying solely on regulations is like setting rules for playing a sport but not bothering to have umpires, referees, or linesmen to check on the players during the match. This is where supervision and enforcement come in. The basic craft of supervision has not changed. However, the financial crisis has underscored that sound rules must be followed up by rigorous application.

Trust amongst the financial authorities, the regulated financial institutions, the public and the government, is essential. There has to be mutual respect as well as appropriate levels of empowerment between these parties in order for supervision and enforcement to be effective. Proactive supervision requires close and continuous monitoring of financial institutions in order to identify problems in a timely manner, to curb excesses and to prick bubbles, if necessary. It may also require a certain level of intrusiveness into the day-to-day management of financial institutions. Without trust, intrusive supervision might be criticised for being unnecessarily premature or meddlesome. This is especially so when economic and financial conditions appear benign and supervision can be seen to be an irritant.

[1] Regulation refers to the establishment of specific rules of behaviour. Supervision and enforcement means the more general monitoring of the behaviour of financial institutions and intervening when needed to ensure that they are acting in a manner consistent with the letter and spirit of the regulatory framework.

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Ironically, this is usually the case when complacency sets in and so supervisors must be extra vigilant when the industry lets its guard down.

Another key lesson from the crisis is that supervisors can never hope to be effective if they do not have the requisite resources and tools. This includes having enough appropriately skilled professionals to be able to decompose and understand the different risk strands in complex business models and financial instruments.

There also needs to be a seamless link between macro-prudential surveillance and supervision (see also the contribution of Houben in Chap. 13). Top-down surveillance and intervention are needed for pervasive issues that pose risks to the financial system. Often these risks are first identified through behaviours observed at the institution level. They could also be risks that emanate from other sectors of the economy but which could have a severe impact on the financial system. One example is the real estate sector. Many countries keep a watchful eye on this sector. In the case of Singapore, the Monetary Authority of Singapore (MAS),[2] the fiscal authority, and the agencies responsible for land supply and development have worked closely together to implement coordinated measures to temper excessive optimism in the property market. Bringing together these agencies expands the policy options to deal with systemic risks, which include prudential rules that target banks' lending to the sector, fiscal tools such as transaction taxes, and control of the housing supply.

Closer cooperation between home and host supervisors of internationally active financial institutions is key. There should be two-way flow of timely and relevant information and complementary supervisory oversight. Only then can there be effective consolidated supervision by the home, and jurisdiction-specific supervision by the host supervisors. The global financial crisis has spawned important initiatives internationally for better coordination of recovery and resolution plans for internationally active financial institutions. This good work should permeate into better collaboration among supervisors during non-crisis times too.

6.2 Intensity of Supervision and Timeliness of Intervention

Supervisors' failure to intervene on a timely basis has been cited as one of the causes of the crisis. There were also calls for more tough action by supervisors in crisis-hit jurisdictions. The challenge, however, is ensuring that supervisors can adopt a more counter-cyclical, interventionist, and outcome-oriented approach even during more buoyant times.

The following section examines in more detail two key aspects – intensity of supervision and timeliness of intervention – and how they can be calibrated to facilitate effective supervision and enforcement.

[2] MAS is the central bank and integrated financial supervisor overseeing the banking and insurance industries, and capital markets in Singapore.

6.2.1 Intensity of Supervision

Risk-Based Supervision: Scaling Up from a Firm Base. First, the crisis has shown that problems at financial institutions, big or small, bank or non-bank, can affect confidence in the system as a whole. This is especially the case if a class of similar institutions is affected at the same time. Therefore, it is critical that there be a "base-level" intensity of supervision for all financial institutions.

Second, supervisors need enough knowledge of an institution to diagnose that it is nearing a dangerous risk profile and therefore requires supervisory intervention. Third, intervention will likely be more effective and have the cooperation of the institution when the supervisor-institution relationship is characterised by mutual trust and respect, and regular professional interactions.

Such "baseline" supervision can include a combination of offsite monitoring of key soundness and risk indicators and developments in the institution's business; reviewing regulatory returns and audit reports and following up on concerns, as well as periodic on-site inspections. The key point is that supervisors can intensify their actions from this baseline when necessary.

This basic supervisory intensity must be proportionately stepped up for high-risk institutions, and importantly, high-impact ones. One of the ways MAS has sought to achieve this is by inspecting the high systemic impact institutions more frequently and being more intrusive in its supervisory oversight.[3] During on-site inspections, which can last for months, supervisors assess the effectiveness of corporate governance, internal controls, and risk management processes. Besides reviewing policies and procedures, a considerable amount of work involves following transactions through the system to ensure that both regulatory as well as the institution's internal controls are adhered to. The scoping of this on-site work is guided by the supervisors' understanding of the institution's business plans and strategy, operations, and risk management systems and controls. There are also frequent interactions with both the line managers and senior management, and the board of the institution. Where process and control weaknesses are found, supervisors assess the implications for the institution as a whole, seek to identify common themes, and focus on key recommendations that target the root causes.

The approach yields a robust understanding of the business model of the institution and the effectiveness of its governance and risk management that is backed by a track record of sound inspection outcomes. This provides supervisors

[3] A key part of MAS' supervisory framework is assessing the potential impact of a financial institution on the financial system, economy and Singapore's reputation. The impact assessment covers aspects of the financial institution such as the relative size and importance in terms of share of activity in different markets; relative scale of retail reach in terms of number of customers and representatives, and type of business; and criticality to the stable functioning of and confidence in the financial system. Generally, the larger the institution's intermediary role in critical financial markets or in the economy or the greater its reach to retail customers, the higher would be its assessed impact.

the confidence and credibility to take action when weaknesses are still nascent, before the soundness or viability of the institution is more clearly threatened.

Mergers and Acquisitions: Having the Power to Pull the Plug. A common approach before the crisis was to leave major business decisions, such as major takeovers and acquisitions, to the institutions' senior management and board. However, in the case of Singapore, MAS adopted a more inquisitive approach even before the crisis. At the time, some felt that this could be overly intrusive. Post-crisis, a more interventionist approach is now advocated internationally to supervise major corporate transactions.

Box 6.1. Scrutinising a Cross-Border Acquisition

In a cross-border transaction, Bank A, a bank in Singapore, became interested in purchasing a majority stake in a sizeable bank of a country in the region. The acquisition would have amounted to a 60 % increase in asset size for Bank A at the time. The proposition was that the acquisition would enable Bank A to diversify its operations into a higher return and higher growth market, and was expected to improve Bank A's key financial ratios including net interest margin and return on equity.

Bank A approached MAS to discuss its interest to acquire the stake. It sought MAS' approval because Singapore banking rules require regulatory approval for major transactions involving a stake of more than 10 % of the issued shares in a company. A number of issues were discussed, but most pertinent was whether Bank A had the financial resources to make the purchase:

- **Capital adequacy**. The bank presented only one option to fund the acquisition, and did not plan to raise any equity. Its capital estimate post-acquisition did not include any buffer for additional risk-weighted assets (e.g. loan growth, potential losses) from the acquiree, nor the integration risks that could arise based on its past acquisitions. Indeed, under the proposal additional supervisory capital was likely to be necessary but the bank had not factored this in.
- **Country, regulatory and integration risks**. The home regulator and supervisory regime of the acquisition target were independently assessed to be undergoing a difficult and challenging phase and the banking system had been in crisis only a few years before. Bank A was also less familiar with the commercial practices and market in the foreign country given its small business presence there. Independent reports had warned that the country had strong and militant unions which would oppose any restructurings. The CEO of the acquiree was also very likely to leave after the acquisition. It was not clear that Bank A's management team was sufficiently strong to successfully assimilate the acquiree and manage a foreign operation which was culturally very different.

After careful consideration, MAS rejected Bank A' proposal. It was assessed that the bank was not ready for this transformational deal. The bank met MAS several times to ask that MAS reconsider its position. While MAS re-assessed the subsequent options put forth by the bank, it did not find valid reasons to change its decision.

The target bank was finally sold some years later, but only after several failed attempts which were hampered by legal disputes, regulatory delays, and public backlash.

Hence, supervisors should be able to ask questions about the appropriateness of business models, strategies and earnings, without being seen as disenfranchising senior management and the board of financial institutions. This is now one of the new approaches that have been developed after lessons from the last crisis.

6.2.2 *Timeliness of Intervention*

Early Intervention: Making Difficult Judgements. Financial authorities often hope to prevent future financial crises by taking away the punchbowl when the party heats up. In view of the fact that market discipline is inadequate while at the same time financial markets have become increasingly complex, a prominent question is how supervisors can act more pre-emptively before large problems materialise?

First, supervisors need the ability to make rigorous judgments about risky practices and the inadequacy of risk management sometimes even before losses become evident. Supervisors then have to take action while they are not able to fully prove that the risks will materialise. Timely interventions are ultimately based on subjective judgements. They can, on hindsight, turn out to be wrong or be challenged by institutions. Creating a culture of early intervention therefore requires support at the highest levels so that supervisors making these difficult decisions have steeled backbones. Supervisors must also accept that they will never win popularity contests.

Box 6.2. Strengthening the Context in Which Intervention Takes Place

Characteristics of MAS' supervisory governance model which have supported MAS' approach of being pre-emptive in tackling problems in financial institutions include:

- **Separate legal entity**. As a statutory board, MAS is legally separate from the government. The MAS Act sets out the powers and composition of the board of directors (Board), the powers of the Managing Director (MD), and officers of MAS. The Board members, Chairman, and MD, are

(continued)

appointed by the President of Singapore, who is separately elected and independent of the government. The Board, via the Minister-in-charge of MAS, is accountable to parliament for MAS' performance.

- **Operational Independence**. The independence of the MD in the day-to-day management of MAS is legally protected. The Board and the government are not involved in decisions relating to the supervision of individual financial institutions. MAS is a self-funded statutory board and its budget is approved by the President. It has autonomy on policy and operational issues as well as financial and human resource matters.
- **Clear mandate and responsibility**. The conduct of integrated supervision of financial services is clearly set out in the MAS Act. The forum that has been delegated the power to make all supervisory decisions is made up entirely of management staff responsible for supervision. It has the power to approve or reject license applications, and decide on supervisory actions to be taken against financial institutions. The safety and soundness of financial institutions and financial stability are of paramount importance.
- **Legal protection**. MAS staff are protected by law to ensure that they are not vulnerable to civil or criminal actions for carrying out their work in good faith. It has also been helpful that the Board has a number of people who have had experience working at MAS before and so understand supervisory and financial stability issues very well.

Second, in order to intervene effectively, supervisors also need to understand very well the risks that institutions face so that they have the ability to effectively debate and challenge institutions.

Box 6.3. Correcting Risk Management and Control Weaknesses Promptly

MAS inspected two trading desks of a large, international bank with a significant investment banking business in Singapore. These two desks were selected because of their significant contribution to risk and profitability – one of the desks accounted for the bulk of the increase in risk from new businesses entered into in recent years, while the other was the most profitable emerging markets desk during that year.

The inspection uncovered that different teams, divisions, and departments within the bank appeared to have been operating in silos. The design and execution of internal controls varied across different product types, both within and across the different trading businesses (e.g., profit and loss attribution and decomposition, surveillance of trade cancellations and amendments, and off-premise trading). The bank could not offer good reasons or justifications for these differences. Further, bank managers who

monitored trading activities did not ensure that traders were trading within their authorised mandates or that trading books were properly mapped for profit and loss, and market risk reporting.

Another serious weakness found was that market risk officers were overly focused on analysing the aggregate risk figures reported for the emerging market business as a whole and did not pay sufficient attention to reviewing the risk positions for the individual trading desks for which they were responsible. For example, the risk positions of one of the trading desks covered by MAS were under-reported by more than 80 % and would have remained undetected if MAS had not highlighted the issue to the bank.

Although the inspection covered only two trading desks, both of which were profitable, MAS was sufficiently concerned to require the bank to undertake a pre-emptive review of all the other trading desks of its investment banking business. There was concern that the apparent silo mentality could compromise effective management oversight of the trading business as a whole, and that the lack of attention to risk positions of individual desks, even if they were deemed to be small, could result in the bank being unaware of subsequent build-up of risk positions should any under-reporting remain undetected for an extended period of time. There was opposition from the bank once it learned that this request was based on MAS' work on only the two desks covered in the inspection. MAS' view was that these were symptoms of what could be a larger and more serious problem for the bank if left untreated. The bank has since begun to improve upon its risk oversight.

MAS came to know subsequent to its inspection that its findings were similar in nature to those unearthed in an investigation into an unauthorised trading incident at a seemingly "low-risk" desk in another part of the bank's investment banking business in another jurisdiction. In the incident, the true magnitude of the risk was distorted because early warning signs were not sufficiently investigated nor looked into diligently. The incident led to significant losses for the bank.

Hence, going forward, supervisors should develop this ability to pay early attention to even seemingly minor weaknesses if they could be symptomatic of larger systemic problems in the financial institutions.

6.3 Conclusion

Financial supervision ultimately aims to maintain a stable financial system that enjoys the trust and confidence of all who depend on it. In order to achieve this, supervisors need to be able to identify and manage risks that emanate from individual financial institutions, understand how these risks can affect the financial

system as a whole, and take appropriate and timely remedial actions. Financial supervision is a craft that needs to be continuously honed to keep abreast of industry innovations and changing operating environments. Lessons should be learnt from financial mishaps and crises to help identify and close gaps in practices of both industry, as well as supervisors. Where good practices have helped to contain risks, these should also be promulgated and strengthened further. Supervisors must also be willing to take action pre-emptively if need be.

Chapter 7
Supervising in Good Times and Bad: Public Opinion and Consistency of Supervisory Approach

Julian Adams

7.1 Introduction

The public has rarely been as preoccupied with either the financial sector or its supervision as it is today. By July 2012 some 69 % of British people surveyed felt that there was too little government regulation of financial services.[1] Certainly, the critical function that the financial services regulator provides has never been more apparent to the public than in failure and we are all painfully aware of the costs to society as a whole of a having a regulatory framework which failed to promote financial stability. The UK's experience is, of course, not an isolated one and across the world politicians, regulators and monetary authorities have set themselves the challenging task of re-shaping the regulatory architecture and the supervisory approach at both a national and international level.

This chapter examines the extent to which societal attitudes towards and expectations of the financial regulator within the UK have both changed and shaped the conduct and priorities of regulation and with what consequences.

7.2 The Political Location of the Financial Service Regulator

But let me first provide some context. The current regulatory architecture of the UK was largely created by changes enacted by the Labour Government elected in 1997, which brought together nine regulatory bodies[2] into a new body, the Financial

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[1] YouGov 2012 http://cdn.yougov.com/cumulus_uploads/document/8vud040b3f/YGCambridge-Archives-Economy-160712.pdf. Accessed 19 Sept 2012.

[2] The Securities and Investments Board, the Personal Investment Authority, the Investment Management Regulatory Organisation, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of Trade and Industry, the Friendly Societies Commission, and the Registrar of Friendly Societies.

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Services Authority ('FSA'). The previous institutional structure, it was argued, had been:

> costly, inefficient and confusing for both regulated firms and their customers [and was not] delivering a standard of supervision and investor protection that the public has a right to expect. (HM Treasury (1998), p. 8)

The case for change, as so often, was reinforced by failures. In this case they included widespread mis-selling scandals linked to personal pensions, endowment policies, home income bonds as well as broader scandals associated with Blue Arrow and Robert Maxwell (DTI 2001). There was criticism also of the handling of the failure of BCCI and Barings Bank by the then banking regulator, the Bank of England. The intention was, through the creation of a new regulator, to change the supervisory culture to one that was more inquisitive and intrusive and less trusting of the regulated.

Under the Financial Services Market Act 2000 (FSMA) the FSA was established as a quasi-judicial body, independent of government. Despite various accountability and procedural constraints on action, the FSA was constitutionally separated from elected politicians and institutionally and organisationally disaggregated from the civil service. In this respect, it is similar to other Independent Regulatory Authorities, which regulate many aspects of public life such as environmental protection, food safety, telecommunications, medical drug licensing and energy (Giliardi and Maggetti 2010). FSMA, together with a new detailed rulebook, underpinned by a smaller set of Principles of Business delegated considerable power to the new body.

Ultimately, however, the FSA (and other IRAs) receive their mandate from the public, via elected politicians. The FSA's mandate is far reaching, as set out in its statutory objectives which relate to market confidence; financial stability; consumer protection and the reduction of financial crime. Given the importance of these functions and the powers which the FSA holds, what does the public actually understand about this arrangement? According to the data available, very little. For example, one FSA survey showed that, even after prompting, only 33 % knew the FSA existed as a financial regulator and 43 % had no knowledge supervision existed (FSA 2012). The lack of knowledge extends to what the public expects of financial markets. When asked whether financial firms are ever allowed to go bankrupt, only 30 % said "Yes, all firms". This is a great concern as the FSA has taken repeated steps to try and articulate, in line with the regulatory principle of proportionality that it does not aim to create a 'zero-failure' regime (FSA 2003).

A similar picture emerges in the Netherlands. Here only about 1 in 5 (18.6 %) respondents correctly identified the two independent regulators responsible for banking supervision. Some 49 % believed it was the responsibility of the banking supervisor "never to let a bank fail" (van der Cruijsen et al. 2010). As the authors of that study rightly point out, because of moral hazard problems, capacity constraints and unforeseen events, it would in fact be neither possible nor advisable for supervision to commit to the agenda apparently favoured by a large section of the public.

What both studies underline, however, is the fundamental need for supervisors to agree and communicate clearly the objectives of regulation and, what they can and cannot achieve. Past experience shows the difficulties of doing so, not least because of the very limited knowledge referred to above but also the fact that some members of the public believe the knowledge they have is correct when it is not.

7.3 The FSA Between 2000–2007: Influences on the Supervisory Approach

In practice, before the onset of the financial crisis in 2007, much of the FSA's supervisory agenda related to how financial firms treated their customers. This point was made clearly in a recent review of the FSA's supervision of the Royal Bank of Scotland (RBS) which highlighted the high degree of focus on conduct issues at the expense of critical and increasing prudential risks, particularly liquidity. Importantly, the report found that the approach was generally "in line with the prevailing practices and approach of the time" (FSA 2011, p. 260). The philosophy, not the implementation of that philosophy, was identified as deficient. To a significant extent, that philosophy was influenced by the broader social and political context in which the FSA operated in the run up to the crisis and the inability of the FSA to distance itself in practice from these influences. I want to consider, first, the social and political environment, before examining the extent to which it can be observed that the environment shaped the regulatory philosophy and supervisory approach.

The political attitude to how financial supervision should be carried out in the period before the crisis is neatly summarised in the quotation below from then Chancellor of Exchequer when launching the UK Treasury's 'Better Regulation Action Plan':

> The new model we propose is quite different. In a risk based approach there is no inspection without justification, no form filling without justification, and no information requirements without justification. Not just a light touch but a limited touch (Brown 2004).

Fundamental to this attitude was the view that unnecessarily restrictive and intrusive regulation represented a key threat to the vitality, efficiency and productivity of the financial services sector. As such, it needed to be cut back.

This view was reinforced by the observations of the broader machinery of government including the National Audit Office following its review of the FSA in April 2007. In his observation of the findings of that review, the then Economic Secretary to the Treasury, Ed Balls MP stated that:

> The independent NAO report shows that the FSA is working well, is a world leader in a number of areas – which can only be good for the competitiveness of the UK financial services sector. (HM Treasury 2007)

This quotation highlights another key political concern of the period – the competitiveness of the UK financial services sector. In this context, there is good reason to support the conclusions of the RBS report that a more intensive approach to supervision in the period up to 2007 would have "been met by extensive complaints that the FSA was pursuing a heavy-handed, gold-plating approach which would harm London's competitiveness" (FSA 2011, p. 262).

The environment also encouraged an emphasis on a range of current and legacy conduct of business issues. These included issues arising out of Equitable Life, extensive pensions and mortgage endowment mis-selling, the Retail-Distribution-Review and Treating Customers Fairly (TCF) programmes. This was at a time when a range of novel 'risk transfer' products were being created, which we now know were fundamental to the development of systemic risks and not their reduction. This intellectual failure has been much discussed elsewhere but it bears repeating that there was a broad consensus amongst practitioners, policy makers and regulators across the globe that micro prudential risks were low.

To what extent can we link these social and political influences to the FSA's resulting supervisory philosophy? One answer to this question can be seen in the range of documents which the FSA published in response to government concerns about the regulatory environment and the supervisory approach. In December 2006, for example, the FSA published its own Better Regulation Action Plan, What we have done, what we are doing (FSA 2005). This was substantially a response to the Government's The Better Regulation Plan which concentrated on reducing the obstacles and burdens on regulated companies to ensure UK competitiveness.

The degree to which the FSA took on the then government's agenda of removing impediments to financial service business can be seen clearly in the high profile, public dispute between Prime Minister Tony Blair and the then Chairman of the FSA in May 2005 concerning the FSA's supervisory approach. The dispute came following a speech given by the Prime Minister at the Institute for Public Policy at which he raised concerns that intensive supervision by the FSA was impeding innovation and business expansion. The Chairman of the FSA responded that the supervisory approach was proportionate, noting that the FSA had substantially fewer supervisors than American regulators would have employed for similarly sized banks (FSA 2011).

It is important to note that the FSA itself never promoted the concept of 'light touch' regulation and that it made extensive use of its powers to require firms to make improvements in prudential management and conduct of business. Nevertheless, it is clear in a number of areas that the FSA was influenced by the political desire to have a 'light touch' regime. A prime example of this was the concept of the 'regulatory dividend'. Under this approach, a firm could be rewarded with less intensive supervision simply for levels of co-operation and adequate controls which should have been seen as the non-negotiable minimum acceptable standard.

7.4 The Crises and a New Phase in the Supervisory Cycle

Since the onset of the crisis there has obviously been a significant shift in position. The public, media and politicians have been unanimous and vociferous in demanding changes in the supervisory approach. The FSA has responded to those calls. In March 2009, the FSA published, in response to a demand from the Chancellor of the Exchequer, The Turner Review. This outlined a number of areas where the supervisory approach had been deficient, both within a national and international context, and set out proposals for addressing those deficiencies.

First, there has been a definite shift towards a more intrusive approach to supervision. This has required a significant increase in resources devoted to the supervision of high impact firms and an increase in the frequency of comprehensive risk reviews. It has also required a shift in supervisory emphasis from focusing on systems and processes, towards liquidity and capital rules and the sustainability of business models and strategies. Second, there is great emphasis on macro-prudential analysis, assessing the broader economic environment in which financial services companies operate. Third, there has been greater FSA involvement in accounting issues and engagement with firms' balance sheets. This entails comparative reviews of the judgments made by different banks, and meetings with management and auditors to explore the reasons for outlier positions.

The new approach to micro prudential supervision is not the only fundamental change. Fundamental change has also been proposed to the institutional framework as laid out by HM Treasury in A new approach to financial regulation: building a stronger system (HM Treasury 2011). The proposals reflect the lessons learnt in the financial crisis in three important respects. The first is the establishment of a new Financial Policy Committee within the Bank of England responsible for 'macro-prudential' regulation, that is, regulation of the stability and resilience of the system as a whole. The second is the creation of the Financial Conduct Authority (FCA) with responsibility for conduct supervision and regulation across all financial services.

The third is the creation of the Prudential Regulation Authority (PRA), as an operationally independent subsidiary of the Bank of England, responsible for regulating and supervising banks and insurance companies. The PRA will be free to make its own regulatory judgments reflecting the fact that it has broadly overlapping but different functions and powers, as well as statutory objectives, from the central bank. The intention is also that they work very closely together, for example through making the Governor of the Bank of England the Chairman of the PRA. In practice there could also be benefits from bringing supervisors closer to the formulators of monetary policy, for example, in terms of data coverage as well as market intelligence.

One of the main motivations for this framework of supervision is to create organisations with a much narrower set of functional responsibilities to ensure a through-the-cycle focus on both prudential and conduct of business risks.

The structure is also designed to tackle the issue of underlap between micro prudential supervision and the maintenance of financial stability.

7.5 Supervising in Good Times and in Bad: Through the Cycle Supervisory Approach

A crucial element of the new supervisory approach must be a process of dialogue with the broader public, setting out the supervisory agenda and aspirations which will be grounded in a much more focussed set of statutory responsibilities than those of the FSA. The new approach, and how it will differ from the FSA, is set out in four approach documents in 2011 and 2012.[3] Under the proposed legislation, the PRA will have a general objective of promoting the safety and soundness of the firms it regulates and a second objective, with respect to insurers, of contributing to the securing of an appropriate degree of protection for those who are or may become policyholders. The Act will require the PRA to advance its general objective by seeking to ensure that the business of firms is carried on in a way which avoids any adverse effect on the stability of the financial system and seek to minimise the adverse effect that the failure of such a firm could be expected to have on the system.

For the PRA to succeed, it will be necessary to explain it to the public and politicians and remind them that it will not be a 'zero-failure' regime. To do so would set the scene for further market failures – witness the concern over the 'too-big-to-fail' problem in banking (King 2009). This point was explicitly recognised by the then Governor of the Bank of England:

> If we are to maintain the ability to act independently and take unpopular decisions, it will be crucial to explain what we are doing and why. Setting realistic expectations for what can be achieved is an important objective. And, since these new policy instruments are to be wielded by unelected officials, the accountability arrangements need careful thought. (King 2012)

We have recently made an important step in the direction the Governor was anticipating by publishing two documents which set out clearly how and why the PRA will supervise banks and insurance companies. However, whilst the need to be transparent about the way in which we will go about our objectives is well understood, it is also very difficult to do in practice since one of the points about which we need to be explicit is that firms *will* be allowed to fail. But this is precisely what many of the public think is the role of the regulator to prevent as is evidenced by the responses to the two surveys referred to above. A key part of being able to be

[3] Bank of England, FSA. "Our approach to banking supervision", 2011, "Our approach to insurance supervision", 2011, "The PRA's approach to banking supervision", 2012, and "The PRA's approach to banking supervision", 2012. http://www.fsa.gov.uk/about/what/reg_reform/pra.

successful in this public debate is to ensure that we have an effective resolution in place which ensures the continuity of financial service in the event of a firm failure and also which minimises the disruption of failure to users of the financial system.

> Members of the public will be less familiar with these matters (indeed for the most part they may be unaware of them), but politicians and regulators will be able to give assurance that continuity of payments will be broadly preserved, savings can be accessed within a relatively short time and the costs of failure will fall on investors and other creditors, not depositors or taxpayers. One important element in the recent changes has been to cut the time in which depositors of a failed bank can get their money back to one week (FSA 2009).

Applying this thinking to insurance is not quite so straightforward, partly because of the nature of the contracts involved and partly because of existing run off and insolvency practice which already does some of the job. However, discussion is underway within the UK about whether to refine and develop existing arrangements. Insurance companies will fail in the future. If we are to deal with this as regulators we will need robust resolution arrangements in addition to effective compensation schemes. It is on this basis that we can supervise firms in good times and bad without having to pretend that we can always anticipate and prevent firm failure.

This approach will also require that the narrative of what the public can expect, in terms of their personal protection, needs to be articulated and explained on various levels. In the end we will only know if this works in the next failure if there is no rush to withdraw funds or cash in insurance policies – and if there is no political demands to redraw the institutional boundaries of financial regulation and the legal basis on which it operates.

7.6 Conclusion

Failures in UK prudential regulation and supervision which occurred in the period from 2007 onwards had their basis in the weakness of domestic prudential supervision, amplified by the shortcomings in the international framework of banking supervision, in particular its under-estimation of the amount of capital which was required to be held against market risk. Within the UK, however, domestic supervisory failure was due to both a lack of focus in the application of prudential resources and undoubtedly from pressure from wider societal pressure to reduce the amount and intrusiveness of prudential regulation.

To move beyond this to a robust and effective prudential system that works in good times and bad, we have seen that there will need to be a renewed emphasis on key concerns such as liquidity and capital. In addition, the new framework will need to carry public support, both when things are going well and when firms are in difficulty and failing. The reasons for allowing failure needs to be explained as well as the protection offered to retail customers of both banks and insurers when it does.

In this way public opinion can be used to give stability and legitimacy to the new arrangements, as well as enabling a more robust framework for prudential regulation.

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Chapter 8
Board Evaluations

Margriet Groothuis, Aloys Wijngaards, and Ashraf Khan

8.1 Introduction

The Dutch Central Bank (De Nederlandsche Bank, DNB) supervises Dutch financial institutions (i.e. banks, insurance companies, pension funds). It is the mission of DNB to focus on financial stability by monitoring Dutch financial institutions on solvency and liquidity, on the implementation of legal issues, such as Basel and CRD, and on corporate governance. In this chapter, we look at the role of DNB as supervisory authority in its supervision on board evaluations. Board evaluations are part of corporate governance. Corporate governance is defined by the OECD (1999) as a set of relationships between a company's board, its shareholders and other stakeholders. DNB assesses the governance of financial institutions in order to ensure that they become more resilient against adverse market conditions and, in doing so, seeks to contribute to the stability of the financial sector.

After the financial crisis, the European Banking Authority (EBA 2009) concluded that weak internal governance issues were a crucial underlying factor for the genesis of the financial crisis. It was not a lack of governance rules, but a lack of effective implementation of these rules that caused problems. A well-functioning and trusted banking system, supported by sound corporate governance frameworks in place, is key in any modern economy, according to the EBA. One of the weaknesses identified by the EBA was the weak oversight by boards[1] in their supervisory function. Boards failed to understand the complexity of their business and the risks involved, and consequently were unable to identify and constrain excessive risk-taking.

Trust in the Dutch financial sector has decreased after the national banking crisis in 2008. During the last few years, the media have extensively reported on management failures at major financial institutions. Questions that were asked are: How could this happen? Have people become more corrupt or reckless? Or is there a

[1] The term 'board' refers to one-tier and two-tier systems.

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better explanation? As one of the interviewed London bankers on the *Joris Luyendijk Banking blog* (The Guardian) puts it:

> In the absence of a credible alternative vision about financial reform, we are left with outrage and futile symbolism each time a new scandal breaks. It's always a variation of the following sequence: denials, apologies, hearings, sacrificial sackings or resignations – followed by calls for more sacrificial sackings.

The question is: could reflexivity and feedback have prevented or contained these scandals? Is asking feedback about one's functioning the solution for every scandal? Should more questions have been asked about board members' effectiveness to ensure independence, full participation, open discussion and lack of dominance by any one person or subgroup? And – as such – does this then have any added value for supervisory authorities?

In its Guidelines on Internal Governance, the EBA (2011) states that "Sound internal governance practices and procedures for the management body send important signals internally and externally about the governance policies and objectives of the institution." One of these practices and procedures is the assessment of the functioning of the board. The board should assess its efficiency and effectiveness on a regular basis, according to these EBA Guidelines. At the national level, the Dutch Act on Financial Supervision (Wft) includes rules on controlled and sound business operations and the expertise of the persons determining day-to-day policies of the organization. A board evaluation, when properly conducted, can have a positive effect on the soundness of the organization. Moreover, by reflecting on the expertise of board members, the 'properness' of board members can be assessed. A board constantly needs to fine-tune its performance if it is to be sure of being able to respond quickly and appropriately to changes in its environment. Evaluating the functioning of the board is an exercise that provides valuable feedback on how the board can operate more effectively and add greater value to the organization. Any leadership team, both in financial and non-financial institutions, may find the exercise of holding up a mirror very valuable provided it is willing to take an honest look at its strengths and areas of development. It can be an integral part of developing a learning culture in the boardroom and in the organization as a whole, by setting the tone from the top through its commitment to continuous improvement.

Recent events teach us painful lessons about what can happen when decision-makers are not open to feedback. In our opinion, feedback-seeking behaviour has never been more important. How many corporate scandals could have been avoided if leaders broke their isolation and sought feedback (Ashford et al. 2003, p. 774)? After the crisis, financial institutions as well as supervisors and regulators were challenged to reflect on their actions.[2] Board evaluations can play an important role in seeking feedback and reflecting on necessary changes.

[2] For example, the former Minister of Finance and the President of DNB were called forward by a parliamentary committee to explain their roles in the credit crisis in the Netherlands.

In this contribution, we first summarize the pros and cons of board evaluations,[3] and connect them to prudential supervision. Secondly, we provide suggestions on what constitutes 'good supervision' on this topic and what can reasonably be expected of DNB in order to incorporate it in its supervision.

8.2 Evidence from Academic Research and Its Implications for DNB as Supervisory Authority

Sonnenfeld (2002, p. 113) argues: 'No matter how good a board is, it's bound to get better if it's reviewed intelligently'. This quote marks the increased attention for board evaluations in the academic corporate governance debate. The arguments in favour of board evaluations are summarized in Table 8.1.

Research by behavioural psychologists and organizational learning experts indicates that people and organizations cannot learn without feedback**.** This finding can directly be related to the governance issues noted by the EBA (2011). The functioning of the board of a financial institution can be improved upon by reflecting on its roles, responsibilities and accountability in a board evaluation. It helps the board to work smarter as a team, be innovative in a demanding environment, and it gives an opportunity to reflect upon roles and responsibilities in the board. Moreover, decision-making and communication can be improved, making the board a more coherent team. A board is able to set the 'tone at the top', through which culture can be spread through the rest of the organization. By reflecting upon its functioning, the board can also challenge its own members. In a board evaluation, board members reflect upon their own functioning and are able to question their own approach and expectations.

However, academic research also shows that boards have difficulties reflecting upon their practices. The arguments against board evaluations are summarized in Table 8.2.

Several researchers found that the more important and complex the role of the board member, the less frequent and consistent the feedback on their functioning becomes. The fact that people fear giving honest appraisals of their superiors is called the 'CEO disease' (Ashford et al. 2003). For people in lower levels of an organization, it is difficult to give feedback to the board, which is the reason why it barely happens. Besides this, for board members who are used to work in the highest positions, receiving feedback is not business as usual. The 'CEO disease' can make board members think that they function adequately and that they are

[3] In the literature, the concepts of board evaluations, self-evaluations and self-assessments are used interchangeably.

Table 8.1 Arguments pro board evaluations

Board effectiveness	Important effectiveness tool	Ashford and Tsui (1991), Long (2006)
	Improved leadership, teamwork, role clarity, responsibilities, accountability, decision-making, communication and board operations	Kazanjian (2000)
	Powerful governance tools to enhance board effectiveness and its decision-making culture	Minichilli et al. (2007)
Roles, responsibilities	Improve understanding of governance role and responsibilities	Kiel and Nicholson (2005)
Skills, expertise	Reflect on contributions, skills, expertise, and identify personal strengths and weaknesses	Ingley and Van der Walt (2002)
	Determine if the associated skills of the board and its members are appropriate	Kiel and Nicholson (2005)
Culture/organization	Shared set of board norms can influence a positive board and organization culture	Kiel and Nicholson (2005)
	The actions of board members may create a norm of active feedback seeking in the organization	Ashford and Tsui (1991)
	Board culture is important to attract good directors and its effect on the organization as a whole	Stybel and Peabody (2005)
Introduction new board members	Opportunity for new board members to question approach and expectations	Long (2006)
Cohesion	Useful teambuilding exercise	Kiel and Nicholson (2005)
Innovation	Team reflexivity is positively related to team innovation. To be effective, a team should be innovative	Schippers et al. (2012)
Goal orientation	Moderator between goal orientation diversity and group performance because there is a shared understanding of the task situation at hand	Nederveen-Pieterse et al. (2011)

'doing the right things', while they actually lost track of internal supervision. This is exactly what the EBA found: weak oversight by the board is a central problem in the functioning of the governance framework.

What could be the beneficial effects of board evaluations for DNB in its role as prudential supervisor? The 'CEO disease' can also be a serious problem for financial institutions. The concomitant risk of a 'tunnel vision' at the board level can have a negative effect on internal supervision and hinder the ability to learn and adapt to new circumstances. Therefore, as a board evaluation creates feedback and leads the board to reflect on its decisions and goals, it can strengthen internal supervision.

Table 8.2 Arguments against board evaluations

Time-consuming	Time-consuming and unconvinced of the benefits	Long (2006)
	Additional activity which is not worth the effort	Stybel and Peabody (2005)
	There are issues of greater importance for the board	Kiel et al. (2005)
Too process-oriented	Too process-oriented or, a victory of "form over substance"	Kazanjian (2000)
Not objective	Impossible to establish objective and meaningful measures of performance at the board and individual director level	Kiel et al. (2005)
	It might not reveal the contributions some board members make	
Feedback is not necessary	Board members should not be subject to evaluation; track record speaks for itself	Kazanjian (2000)
	Unaccustomed to be exposed to evaluations	Schmidt and Brauer (2006)
	Board members are hesitant to criticize each other's performance	Cascio (2004)

Having presented an overview of both the arguments in favour and against board evaluations, how should these arguments be evaluated from the perspective of DNB as supervisory authority? In general, the arguments favouring board evaluations focus on the functioning of the board, based on effects demonstrated in research. The arguments against board evaluations mainly are objections that organizations and board members have. For example, board members do not see the benefit of evaluating the board, because they think it is too time-consuming. This is an important difference in the nature of arguments: proven (positive) effects versus objections that appear to be based on the expected inconvenience of implementing board evaluations.

Yet, apparently, there are serious doubts amongst boards against evaluating their own functioning. The question for DNB as supervisory authority is: what does this tell us? Is having a positive attitude towards board evaluations necessary for boards to be able to evaluate their functioning in a beneficial way? If people are not willing to conduct a board evaluation, will the advantages instead become disadvantages? It is clear that there are still several unanswered questions. For DNB, it is important to take hesitance amongst boards seriously. A board evaluation can be useful, but might also be harmful. Board evaluations could harm the cohesion and might in the end even prove detrimental for the effectiveness of the board and, therefore, for the stability of the financial institution.

Although it is a sensitive topic, in several self-regulatory corporate governance codes, board evaluations are part of the comply-or-explain principles. The evaluation of boards is subject to increased attention in the Netherlands, which is most notably reflected in the Dutch Corporate Governance Code. The next section will discuss the various corporate governance codes and international legislation.

8.3 Corporate Governance Codes and International Policy Rules

Several corporate governance codes underline the importance of board evaluations. These codes are not part of the supervision by DNB, but reflect norms that are accepted in general. For this reason, it is interesting to look at how best practices on board evaluations are being implemented by firms in general. The Dutch Corporate Governance Code applies to all listed firms in The Netherlands. Best practice III.1.7, stresses an annual board evaluation of the supervisory board and the functioning of the committees and the individual members. The desired profile, composition and competence of the supervisory board have to be discussed (Corporate Governance Code Monitoring Committee 2008, p. 20). Important in this best practice is that the report of the supervisory board must state how the evaluation has been carried out.

Professionalism of supervision is increasing; especially supervisory boards are taking their responsibility, according to the Monitoring Committee Corporate Governance Code. In 2012 the Committee presented its report on compliance with the Dutch Corporate Governance Code (Corporate Governance Code Monitoring Committee 2012). The report concludes that in the 2011 annual reports of the supervisory directors more attention is paid to the board evaluation compared to previous years. Likewise, they contain more information on the general outcomes of the evaluation. The Monitoring Committee regards this increase in transparency as a positive development.

However, the Monitoring Committee Banking Code stated in its most recent report that among Dutch banks the ability to self-reflect is weak. The Dutch Banking Code, which came into force in 2010, emphasizes the need for an annual board evaluation and a board evaluation with an external facilitator every 3 years. The Monitoring Committee links this need with the diminished trust in the Dutch banking sector. Banks do not yet fully realize the difficulties they caused for Dutch society and are not showing enough remorse and receptiveness, according to the Committee (Monitoring Committee Banking Code 2012).

Less than 50 % of the Dutch Insurance Companies conduct a board evaluation yearly, according to the latest report of the Insurer Governance Principles Monitoring Committee (Insurer Governance Principles Monitoring Committee 2012). The Dutch Insurance Code also stresses an evaluation of the board, every 3 years, with an external facilitator. A large part of Dutch insurance companies did not comply with this principle in 2011. Only a small part (one fifth) indicates that they are planning to conduct a board evaluation with an external facilitator in the future.

Among Dutch pension funds, evaluating the board's functioning takes place yearly. The Principles of Pension Fund Governance require that 'the governing body shall lay down a procedure for the periodic evaluation of the performance of the governing body as a whole and that of its individual members'. These principles

are legally binding.[4] However, as research by Veltrop et al. (2012) indicates, Dutch pension funds show quite some diversity when it comes to board reflexivity.

In 2009, Sir David Walker presented his consultative review on corporate governance in UK banks and other financial institutions. The review was commissioned by the Prime Minister in view of critical losses and failures across the UK banking system. According to the Walker Review (2009), not all UK boards have given the process of board evaluation the attention it deserves. It strongly recommended regular board evaluations and better disclosure to investors. In the UK, boards of listed companies are also expected to regularly review their performance and effectiveness.[5]

Besides Corporate Governance Codes, recently global and European legislation was published. With the Principles For Enhancing Corporate Governance, issued in 2010, the Basel Committee on Banking Supervision stresses the importance of board evaluations or a regular assessment of both the board as a whole and of individual board members.[6] As stated earlier, the EBA issued Guidelines for Internal Governance (EBA 2011): "The management body should assess the individual and collective efficiency and effectiveness of its activities, governance practices and procedures, as well as the functioning of committees, on a regular basis. External facilitators may be used to carry out the assessment." The EBA Guidelines on Internal Governance are implemented in DNB's supervisory practice by the 'Beleidsregel toepassing richtsnoeren EBA Wft' (De Nederlandsche Bank 2012).

At the national level, the Dutch Act on Financial Supervision (Wft) brings together all the rules and conditions that apply to financial markets and their supervision. Section 3:17 refers to policy rules on controlled and sound business operations. These rules concern the control of business processes and risks, integrity (for example, conflicts of interest) and the soundness of the financial institution. Section 3:8 refers to policy rules on the expertise of the persons who determine the day-to-day policy of the organization. A board evaluation, when properly conducted, can enhance the soundness of the institution. Moreover, by reflecting on the expertise of board members, the 'properness' of board members can be assessed.

We now turn to the implications for DNB as supervisory authority in the Netherlands. The central question in this regard is: what is the role of the supervisory authority? Is it limited to 'checking' whether financial institutions have carried out a board evaluation, or are supervisors to look at the content of the evaluation as well?

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[4] Cf. the Order in Council by the Ministry of Social Affairs and Employment of December 18, 2006 on the Pension Law and Law on Mandatory Pension Arrangements, Article 11.

[5] Financial Reporting Council, 2010, p. 10.

[6] Principles For Enhancing Corporate Governance, Basel Committee on Banking Supervision, 2010, p. 11.

8.4 The Changing Role of DNB

In its Supervision Strategy for 2010–2014 (De Nederlandsche Bank 2010), DNB translated some of the lessons from the crisis into new methods of supervision and new areas of attention for supervisors. Alongside traditional supervision, which is mainly aimed at quantitative criteria, such as solvency and liquidity, the scope of supervision has been expanded by strategic and qualitative elements, notably the supervised institutions' business models and strategies as well as their conduct and culture (for the latter: see the contribution of Nuijts and De Haan in Chap. 10). Many of the problems that led to the crisis which were related to the strategy, conduct, and culture of financial institutions, were only identified in retrospect. To avoid that the same pattern occurs again, supervision should take a more forward-looking approach. Signals from a financial institutions' conduct and culture provide information about how its employees deal with all kinds of regulations and processes. Looking at conduct and culture can therefore help to predict future events.

Board evaluations might be a useful instrument in DNB's forward-looking approach. A board evaluation can help identify problems in the functioning of a board, and enables both the board itself and the prudential supervisor to act proactively. A board may find reflecting on its performance valuable as long as it is willing to take an honest look at its strengths and weaknesses. This includes that the board looks back and reflects upon past decisions and looks forward as well. A research project commissioned by DNB on the methods and content of board evaluations, 'Board Evaluations in Practice', indicates some important implications for DNB's working plan for 2013 (Groothuis 2011).

The board evaluation is useful for boards to reflect upon their functioning, but this is an internal board process. Although DNB receives more information about the functioning of boards than in the past, one of the results of the research project is that the evaluation is most effective when it is done by the board itself. One of the respondents was asked what the added value of a board evaluation is. In his response, he argued that:

> The irony is that those boards that object to the time and expense involved in carrying out a 'proper' board evaluation are the very organizations that would benefit from it; either to identify potential risk areas or to uncover underlying tensions that have not yet surfaced.

For this reason, it might not be a good approach for DNB to force financial institutions to conduct board evaluations, because it could disturb the process of the board evaluation. As the academic literature discussed above indicates, there are still board members who are not convinced of the value added of board evaluations. This may lead to undesirable results for DNB in its role as supervisory authority.

The majority of the respondents argued that board members might not be completely open and honest about their functioning when they think the supervisory authority is monitoring. As one of the respondents put it:

> This results in not getting the 'truth' out of the board evaluation. DNB is watching, so we will try to keep up appearances and give socially desirable answers. The board evaluation

> will be minimalistic, tick-the-box exercises and the soft controls won't be discussed. People don't like the feeling of being watched.

Therefore, at least in the present situation, DNB might better not strictly determine how financial institutions are to evaluate their conduct and oblige them to report the results. Boards are complex entities handling multi-faceted challenges, often across the world, which makes it difficult to subject them to simple methods of control.

In this context, the approach of the different governance codes presented above is welcome. Rather than operating a one-size-fits-all regulatory model, self-regulatory codes can act as an enabling device to encourage review since there are no extensive industry standards, codes of conduct, nor governance codes on this topic yet. Sir David Walker (2009) has encouraged consultants offering external board evaluations to set industry standards or a 'Code of Conduct'. At the time of writing, this Code of Conduct has not been published yet. The goal of this Code is to make external facilitators articulate precisely what is to be expected from the evaluation and from the board. In the final section, we sketch an outline of the supervisory approach that DNB is to take in 2013.

8.5 Plan for 2013: A Focus on the Process

We strongly agree with maintaining the current scope of the different corporate governance codes regarding disclosures, notably the focus on the process rather than the outcome of board evaluations. Requiring the latter may provide incentives for boards to be less than candid in their evaluations. A focus on the process shows what the 'tone at the top' is. Therefore, board evaluations must be seen as enhancing board effectiveness rather than merely as an exercise in compliance with a governance code.

Clearly, a board evaluation only represents a snapshot of how well that board is performing at a certain point in time. It will not, in itself, solve all problems. However, boards can benefit from a thorough review and constructive feedback, which can in turn guide them in setting targets for improved performance. Conducting a board evaluation can be very important to set the 'tone at the top' by indicating to the entire organization that the board values feedback and holds itself accountable. But how to combine the elements of honest reflexivity with simultaneously sharing some kind of information on the outcome with the financial supervisor? Can you have your cake and eat it?

In 2013 DNB will, based on its research, check with different financial institutions on how they incorporate board evaluations into their business practices. The key element is not to do this by means of a regular 'supervisory data exercise'. Instead, the aim is to create an atmosphere of mutual trust. Therefore, this inquiry will focus on the process of board evaluations during the first year. The main reason for this approach is that DNB does not want to disturb the process of the board's

reflexivity, as explained above: the key player in a board evaluation is the board itself. After the inquiry in 2013, DNB intends to publish a set of Best Practices regarding the process of board evaluations. The goal is to give financial institutions some guidance on how to set up the process. One of the respondents in the research project on board evaluations argued that:

> Board members have an opinion about each other's functioning, but have to learn how to express this. It takes courage to give each other feedback. In order for board evaluations to become 'business as usual', DNB should facilitate the process. This is a form of 'positive interference' because it enhances the ability to evaluate the board.

Board evaluations are not yet 'business as usual'. Having conversations about how to evaluate a boards' effectiveness hopefully results in boards reflecting upon their practices more often. Board evaluations are a very usefull tool for boards and we think it should be more than an annual compliance-exercise. In the future, DNB will therefore increasingly focus on board evaluations. Besides the inquiry in 2013, board evaluations continue to be an important element in the thematic research of the culture and conduct of financial institutions.

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Chapter 9
External and Internal Supervision: How to Make It Work?

Kees Cools and Jaap Winter

9.1 Introduction

Authorities responsible for prudential supervision and Supervisory Boards (SB) as internal supervisor are both in the business of supervising financial institutions. But the roles, objectives, methods and positions are different. In this chapter, we discuss why and how they are different and how each of them can best fulfil its role. We take the Dutch Central Bank (DNB) as an example, but our findings and conclusions are of a general nature and also apply to most authorities for prudential supervision in other countries.

According to its mission statement DNB's key role is to safeguard financial stability. To this end, the mission statement continues, DNB operates as an independent supervisor to ensure a shock-resilient financial system and a secure, reliable and efficient payment system and to ensure strong and sound financial institutions that meet their obligations. In doing so, DNB aims to protect the financial claims of their customers towards financial institutions, whether on the basis of deposits, insurance policies or pension claims. DNB's traditional approach to the supervision of financial institutions was very much focused on quantitative criteria, such as solvency and liquidity, and to some extent on traditional risk management.

Following the financial crisis the prudential supervision of DNB is broadening its scope, with increased attention to risk management and now also focusing on qualitative aspects, such as the strategy and business model of the institution and its conduct and culture (De Nederlandsche Bank 2010). This brings it much closer to the role of the SB as internal supervisor. The SB's primary duty is to supervise the management of a financial institution in the interest of the institution, by weighing the various interests of all stakeholders concerned. The new focus of DNB creates at least overlap and possibly a conflict with the role of the SB. In this chapter we discuss the questions and dilemmas this raises with respect to the relationship between DNB as external supervisor and the SB as internal supervisor of a financial institution. Our core message is that, for various reasons, DNB as

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external supervisor should focus on safeguarding the proper functioning of the SB in all its facets. Supervision of the Management Board (MB) in the areas of strategy, business model, culture and behaviour should to the largest part be left to the SB itself. DNB should be very cautious in double-checking or second-guessing the SB in these matters.

We first set out the roles, objectives, methods and position of both DNB as external supervisor and the SB as internal supervisor (Sects. 9.2 and 9.3). We limit ourselves to insurers and banks. We proceed in Sect. 9.4 to describe the new approach taken by DNB and how this relates to the role of the SB and what questions and dilemmas are triggered by the new approach of DNB. We then argue in Sect. 9.5 that DNB should restrain itself in its new approach and how it could nevertheless further the functioning of the SB. Section 9.6 concludes.

9.2 DNB's Supervision of Financial Institutions

DNB supervises banks and insurers on the basis of the Act on financial supervision (*Wet financieel toezicht*) and a wide range of secondary regulation based on this latter Act. De Nederlandsche Bank (2010) describes the objectives of its supervision. The central objective is to safeguard financial stability and to protect the financial claims of customers towards financial institutions. To achieve this DNB supervises the solidity of financial institutions, in particular that their assets are sufficient to pay all their debts to customers.

Traditionally the primary focus of the supervision by DNB has been the solvency, liquidity and classic risk management of financial institutions, with extensive regulation and reporting duties on capital requirements and provisions. In addition, DNB supervised the soundness and control of the conduct of business by financial institutions and also guarded systemic risk. Although the regulation of the conduct of business has increased over the last 10 years leading up to the financial crisis, it is fair to say that this part of DNB's supervision did not dive overly deep. The qualifications and trustworthiness of executive directors were reviewed by DNB,[1] the financial institution had to have policies and procedures to ensure the soundness of its conduct of business, among others dealing with conflicts of interests, compliance and the acceptance of clients,[2] the organisational structure, division of duties and responsibilities, the reporting of rights and obligations all needed to be clear and adequate and there should be a policy and procedures for managing various risks.[3] Financial institutions also had to have a SB, consisting of at least three members, but nothing more was provided in this respect.[4]

[1] Art. 3: 8 and 9 Wft and art. 5 and further Decree Prudential Rules Wft.

[2] Art. 3: 10 Wft and art. 10 and further Decree Prudential Rules Wft.

[3] Art. 3: 17 Wft and art. 17 and further Decree Prudential Rules Wft.

[4] Art. 3: 19 Wft.

As an external supervisor DNB's powers to supervise financial institutions is based on regulation. Without an explicit basis in regulation DNB has no authority to supervise. On the other hand, when there is an explicit basis in regulation DNB can give instructions to financial institutions that they need to follow, where necessary enforced by fines and penalties.[5] As a result, there is a strong compliance component in the supervision by DNB, in particular in the area of soundness and control of the conduct of business of financial institutions.

DNB's supervision itself is subject to judicial review by administrative courts. DNB's formal decisions can be challenged by financial institutions on the basis of the General act administrative law (*Algemene wet bestuursrecht*). The risk of losing a court case to some extent forces DNB to take formalistic positions that it can defend in court.

DNB's role by definition is one of outside-in supervision. DNB may have the right to request all information from the financial institution that it needs, but nonetheless remains an outsider. DNB is not part of the decision-making process within the financial institution and carries no responsibility for this decision-making.

9.3 The Supervisory Board

The SB is a body of the financial institution itself, charged with the supervision of and advice to the MB of the institution.[6] In performing its duties the SB should be guided by the interests of the company and its business.[7] This legal duty is understood to mean that the SB should weigh the interests of all stakeholders. Within that stakeholder approach the SB is specifically accountable to shareholders. The SB is appointed and can be dismissed by the General Meeting. The SB, together with the MB, annually reports to the General Meeting and individual members of the SB sign the annual accounts. It is clear that the SB members need to retain the confidence of shareholders in order to continue to play their role.

The Dutch Corporate Governance Code sets out what the supervision of the SB entails. This description also seems a fair description of the supervision by SBs in non-listed companies. Best practice provision III.1.6 of this code provides that the supervision of the SB entails amongst others:

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[5] Art. 1: 75 and further Wft.

[6] In the Netherlands traditionally a two-tier board model is applied. In a one-tier system executive and non-executive directors are member of the same board. In a two-tier system the executive directors are member of the MB and the non-executive directors form a separate legal body, the SB. As of January 1, 2013, a new law is effective, which clarifies certain rules when a one-tier board is applied. Under the Wft banks and insurance companies are required to apply a two-tier structure and cannot apply the one-tier board.

[7] Art. 2: 140 Dutch Civil Code (DCC).

(a) Achievement of the company's objectives;
(b) Corporate strategy and the risks inherent in the business activities;
(c) The design and effectiveness of the internal risk management and control systems;
(d) The financial reporting process;
(e) Compliance with primary and secondary regulation;
(f) The company-shareholder relationship; and
(g) Corporate social responsibility issues that are relevant to the company.

The achievement of the company's objectives and the corporate strategy are the first two elements mentioned. This makes clear that the SB shares responsibility with the MB for the success and failure of the company. This fundamentally distinguishes the internal supervision by the SB from the external supervision by DNB. DNB is not itself responsible for ensuring the financial institution's success beyond compliance with the rules. It is not sufficient for a proper fulfilment of the duties of the SB that all the legal and regulatory requirements have been fulfilled. In the end, the SB shares the same goals as the MB it supervises: the long-term success of the institution.

Other provisions in the Code clarify that the SB also has a primary role as employer of the members of the MB, selecting and sometimes appointing and dismissing them, reviewing their performance and determining their remuneration within a policy designed by the SB and adopted by the General Meeting.[8] This role is not so much a supervisory role but much more a directing role. The SB in this capacity of employer is responsible for the process and the content of the various decisions to be taken and not just agreeing to proposals made by the MB. This also differs fundamentally from the external supervision by DNB in this field, which only has an evaluative role, reviewing candidates nominated for the MB in a fit and proper test.

The SB is part of the internal decision-making process of the financial institution, again different from DNB as external supervisor. Its decisions are required for the institution to be able to move ahead. This is explicitly so when certain decisions of the MB are made subject to the approval of the SB on the basis of the Companies Act (in case of companies subject to the so called structure regime) or the articles of association of the institution.[9] Even without explicit approval rights of the SB it follows from its duty to supervise that it needs to be involved in key affairs of the company.

Another fundamental difference is that the responsibility for internal supervision extends to members of the SB personally. Improper supervision by them can lead to

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[8] See chapter II.2 of the Code on executive remuneration and III.1.7 for the review of the performance of the SB and its members.

[9] The Dutch so-called '*structuur regime*' applies to large companies (net assets in excess of EUR 16 million, 100 employees or more and a works council installed) with a view to providing employees co-determination rights. Companies subject to the structure regime must have a SB. For one third of the members of the SB the works council has a special nomination right.

litigation and personal liability. Litigation may take the form of initiating an inquiry procedure at the Enterprise Chamber of the Court of Appeal in Amsterdam. The Enterprise Chamber can order an inquiry and can rule that there has been improper management and supervision of the company. The Enterprise Chamber can dismiss SB members in that case.[10] Not only such a decision by the court but also the litigation in itself can seriously damage the reputation of SB members. The litigation can also take the course of holding members of the SB personally liable for damages. Creditors and the trustee in bankruptcy under circumstances can sue members of the SB personally if their (lack of) supervision has contributed to the inability of the company to pay its debts.[11] Shareholders can sue SB members if the annual accounts of the company provide a misleading representation of the financial situation of the company.[12] Clearly, the role of member of the SB involves personal risks that can be substantial.

Finally, the SB is part of the financial entity which is subject to the external supervision of DNB. The SB supervises subject to the supervision of DNB. In its role as external supervisor DNB can have opinions about the quality and effectiveness of the internal supervision by the SB and it can apply its supervisory powers also to the SB. The SB and DNB are not equals in their supervisory roles: one is itself subject to the supervision of the other. This matters not only legally but certainly also psychologically.

9.4 DNB's Post-financial Crisis Approach to Supervision

The financial crisis has prompted legislators and regulators across the world to review the supervision of financial institutions and the supervisory toolkit. This is leading to a tightening of solvency and liquidity requirements and new and detailed regulation of risk and risk management, as can be seen in the proposals for the EU Capital Requirements Directive and Regulation IV.[13] De Nederlandsche Bank (2010) takes the view that this in itself is not a sufficient response to the financial crisis. Solidity is not just determined by economic factors but also by issues relating to integrity. DNB therefore also focuses attention on matters of integrity, governance, and conduct and culture of financial institutions (see the contribution of Nuijts and De Haan in Chap. 10). Its supervision should go one layer deeper than just the regulatory requirements of solvency, liquidity, classic risk management and control of business conduct. Supervision should try to detect potential sources of

[10] Art. 2: 344 and further, in particular art. 357 DCC.

[11] Art. 2: 9 and art. 2: 138 (248) DCC are the basis for such claims by the company itself to SB members, which in case of bankruptcy can be exercised by the trustee. Individual creditors may sue SB members on the basis of tort, art. 6: 162 DCC.

[12] Art. 2: 150 (260) DCC.

[13] See http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm.

problems that may later cause deteriorating solvency and liquidity ratios. One such source would be the strategy and business model of the financial institution, how it creates competitive advantage, how it seeks to gain and maintain the trust of customers, how efficient the institution is and to what extent its strategy is supported by its stakeholders and resilient in light of external dynamics. A second source of potential future problems is the conduct and culture of an institution. Questions in this field include to what extent the conduct of the institution can be explained and accounted for, not only following the letter of the law but also the spirit. The expertise and integrity of the leadership of the institution is crucial in all areas mentioned.

As a result of this new focus the supervision by DNB should become more prospective. DNB acknowledges that it will be more difficult to objectively assess the vulnerability of the institution's strategy, business model, conduct and culture than its compliance with financial regulation. This makes it more difficult to get the attention of the management of the institution and therefore DNB must be more alert, assertive and tenacious in signalling and solving (potential) problems in these areas (De Nederlandsche Bank 2010).

DNB correctly points at the difficulty of making objective assessments of a financial institution's strategy, business model, conduct and culture. It then draws only one conclusion: that it needs to be alert, assertive and persistent in its supervision in this field and that stronger involvement of DNB is required. Another conclusion could also be drawn and seems as at least as relevant and justified: DNB needs to be modest and should act with restraint concerning any findings in these categories of supervision it may come across and even more concerning the conclusions it believes should be drawn from these findings. This alternative conclusion is based on the very nature of these areas of supervision and on the view that a SB is better positioned then DNB to supervise the MB in these areas. What justifies that view?

Proper supervision is characterised by independence, expertise, adequate information and adequate authority. DNB is independent, it has some of the relevant authorities to supervise the MB, but compared to a SB it is fundamentally disadvantaged regarding adequate information and relevant expertise in the areas mentioned. A SB is, or at least should be, well informed regarding strategy, business model and also culture and conduct of the MB and the financial institution at large. The SB should have regular and in depth interactions with the MB, they can and should speak to other senior managers and e.g. workers council and can and should be thoroughly informed about strategy, business model and actual performance. This is not to say that all SBs do indeed possess all relevant information, but given their (legal) role, responsibilities and rights, they are in a better position than DNB to possess superior information. Not only regarding the subject matters themselves but also regarding the decision making processes. In fact, from our experience in board reviews and from our consulting experience we have learned that SBs often do *not* gather all the information necessary for properly performing their duties. But they can do so and are then in a better position than DNB to supervise the MB. We will come back to this issue later on. Of course, DNB has the legal right to access all

available information in a financial institution, but information on culture and conduct is rarely put on paper and neither is the actual functioning of a strategy or business model. Surely, in some instances DNB is better informed, in particular when it obtains information through people and systems at lower levels of the organisation, for example regarding risk (management) or certain compliance issues. DNB could and has just started also to conduct thematic studies based on interviews and surveys on e.g. the culture and conduct of financial institutions (see the contribution of Nuijts and De Haan in Chap. 10). There is, however, no replacement for regular formal and informal interaction with MB members as a source of information to judge intentions, behaviour, board dynamics, culture and expertise.

Regarding the issue of expertise, what is the expertise of DNB to make claims about the quality of the strategy, business model, conduct, culture and corporate governance of financial institutions? What specific knowledge or experience has DNB on which it can base a substantiated view on how financial institutions (should) perform in these fields? DNB can indeed conduct thematic studies, as mentioned earlier, which have the advantage of being carried out by an independent party, but the disadvantage of being dependent on the possibly biased views of the actors in the field (board members) since the study is being performed by an interested and powerful party, the external supervisor. DNB has furthermore never designed a strategy for a single financial institution in order to make it successful. It has no expert knowledge in the field of operating a complex financial institution, dealing with the daily dilemmas and pressures that come with it. DNB has never itself had to change the conduct and culture of a financial institution. There is no particular indication or empirical evidence that DNB, itself a NV, the Dutch equivalent of a PLC, subject to the same Companies Act as all other financial institutions, has an excellent corporate governance system, conduct and culture with an optimal interaction at the top between supervisory directors and executive directors.[14] We do not mean to imply that DNB's own corporate governance is sub-optimal, outsiders just don't know. The lack of information about the quality of DNB's own corporate governance however makes it difficult for DNB to speak to other financial institutions with the authority of its own experience. None of this is to say that DNB should not involve itself at all in these areas. But we do believe that DNB should do so with restraint and with modesty. Also for DNB venturing in these areas is, for now, a learning process. In order to gain better insight into conduct and culture of financial institutions and any potential risks involved, a new centre of expertise was set up by DNB, the Expert Centre on Culture, Organisation and Integrity (COI). This indicates the recognition and willingness of DNB to improve in these areas, but it is still a learning process. And a learning

[14] Based on the report of the Scheltema committee, in 2010 the Dutch Minister of Finance commanded DNB to adapt their organization, operating model, governance and culture. Although soon after measures have been announced and implemented, there is no external evidence as to what the current status and level at DNB on these four dimensions actually is.

process involves doubting, testing, making mistakes, tracking back etc. It also involves refraining from imposing measures in a digital way, assuming that certain practices are either good or bad.

Moreover, the expertise DNB is building consists of professional (research) knowledge of mainly organisational psychologists and change experts. As such that is certainly valuable and a laudable initiative to strengthen DNB's prudential supervision. But it cannot be a substitute for the real life boardroom experience of SB members, in previous and current roles as executives or non-executives or as subject matter experts, having lived through various events and circumstances and having made or counselled difficult decisions in uncertainty. Judging and supervising the motives, intentions, actions, decision making process of MB requires at least first hand experience, as (former) executive or as subject matter expert (e.g. financial, legal or banking experience).

Even if DNB should become better equipped in these fields, their nature warrants restraints as in these fields no absolute answers and certainties exist. Inherently these areas are very different from rule based, compliance focused, quantitative (supervision on) topics such as solvency, liquidity and classic risk management. There are no single prospective tests for quality of strategy, business model, conduct and culture with clear outcomes that should have specific consequences. On the business side, the institution's strategy and business model and their potential for future success or failure, are inherently uncertain and therefore some level of unpredictability is in their very nature. Sensible observations can be made about the quality and rigour of the strategy-setting process, the quality of the analyses underlying decisions, etc., but ultimately setting the strategy and developing the business model is a matter of human judgment about risks and opportunities. They are determined to some extent by external developments that are beyond the institution's control and that are difficult to predict and of which the exact impact is difficult to assess with any knowledge and expertise available now.

Somewhat similarly, on the conduct and culture side the problems and concerns are always multifaceted, with elements of personal or group behaviour, in some instances counterbalanced by other behaviour or formal processes and in others not. Many conduct and cultural elements are difficult to discern or in relation to which to draw general conclusions from individual observations. In addition, in both fields, strategy and business model on the one hand and conduct and culture on the other, observations are determined and distorted by problems of human perception. What we see and witness, at least what we recollect of what we have seen and witnessed, is not objectively what has happened but the version of what has happened as created by our brain. We learn more and more about the illusions, heuristics and fallacies created by our brains in generating cognitive or visual representations, our bounded perception and rationality that trouble our decision-making.[15] But apart from this, our perceptions are to a large extent personal, determined by the personal experiences we had, studies we undertook, newspapers

[15] See, for example, Kahneman (2011) and Bazerman and More (2009).

we read, conversations we had etc. In the board reviews we have performed over the last few years, for example, we have witnessed how these individual perceptions of the same boardroom reality sometimes differ widely. All of this makes it difficult, if not impossible, to impose a digital, rule based form of supervision in these areas that were predominant in the past concerning issues of solvency, liquidity and risk (management). DNB needs to further develop new supervisory tools that it can apply in these fields. Tools that leave scope for doubt, for discretion, tools that nudge, that strengthen responsibility rather than weaken it (Thaler and Sunstein 2008). Such tools have in common that they leave the decision of what and how to do it to the persons or bodies that are primarily responsible for taking the decision, rather than imposing a certain decision on them or prohibiting another.

In addition to fundamental issues of information and expertise and the inherently different nature of strategy and culture there are some other considerations to take into account when contemplating the external supervisory role of DNB. Firstly, a field that DNB now explicitly extends its supervision to is corporate governance. A specific new basis for this has been laid down in art. 17 Decree Prudential Supervision. One aspect of this new field of supervision is the extension of the fit and proper test to members of the SB.[16] Although reviewing the fitness and propriety of SB members can be delicate and complex, we believe such fit and proper test is unavoidable if we rely more strongly on the role of the SB in the proper governance of the financial institution. Another part of this new field of supervision is the Guidance DNB has given on the independence of SB members. DNB distinguishes between independence in mind (being able to objectively contribute to balanced decision-making), independence in appearance (avoiding conflicts of interests) and independence in state, referring to a formal position of independence. For this it refers to independence criteria of the Dutch Corporate Governance Code and provides that at least 50 % of the members of the SB should be independent. DNB frames the discussion on the independence of SB members as a concern that the interests of all stakeholders are taken into account, in particular the interests of creditors of the institution and that the interests of the shareholders should not be predominant.[17] This is a reflection of DNB's own bruising experience with its supervision of the failed bank DSB, which had a single shareholder who dominantly imposed policies on the bank to his own benefit and to the detriment of creditors of the bank. A controlling shareholder now in the mind of DNB creates a red light, marking the risk of decisions detrimental to the bank's creditors. We have the impression that DNB is much tougher in enforcing the independence requirement where such a controlling shareholder exists and even more so when the shareholder is a foreign party, than in case of other independence criteria. Paradoxically, at least the majority of the members of the SB of DSB would qualify as independent according to the criteria in the Corporate Governance Code, signalling that insisting on independence of a majority of SB members is not guaranteeing good outcomes.

[16] See article 3: 8 Wft and Beleidsregel geschiktheid 2012.

[17] See http://www.dnb.nl/nieuws/nieuwsoverzicht-en-archief/dnbulletin-2012/dnb278277.jsp.

It is a necessary but not a sufficient condition. The failure in the internal governance at DSB was not caused by a lack of formal independence from the controlling shareholder but by an insufficient understanding and execution of the role of the SB by the independent SB members.

Secondly, a specific risk with the external supervision of corporate governance arrangements is that it easily becomes a compliance, box ticking, digital exercise. By insisting on following specific rules on composition and operation of the boards, the own responsibility of the boards of a financial institution is in fact being reduced. Less and less the real governance, the intrinsic quality of the management and supervision is seen as a factor that contributes to the success of the institution. More and more these are dealt with as mere compliance matters, not requiring thinking, judgment and commitment but only automatically following of DNB rules. Exercising good corporate governance, being sensitive to different executive and non-executive roles, the behaviours that match with these roles and the interplay between the various roles and behaviours, all of this in fact requires constant judgements about what is needed, appropriate, effective, non-acceptable etc. in a complex and constantly changing environment. By framing corporate governance primarily as a compliance matter where rules need to be followed, we suggest that boards no longer need to make those intricate judgements and are only responsible for compliance with the rules. The quality of the corporate governance as a result will be reduced (Winter 2010). The quality of management and supervision cannot be captured solely or even primarily by formalised governance rules.

This view not only reflects our own experience in board reviews but is also found in the academic literature. The evidence that formal governance characteristics such as board size, percentage of financial experts, experience, percentage blockholders, busyness of directors, percentage of independent directors, attendance, etc. would impact firm performance is largely absent or at best mixed. That applies to non-financial firms, but also to banks (see De Haan and Vlahu (2012) for a survey of that literature). In trying to identify the characteristics of companies whose executives have engaged in fraudulent practices, also Cools (2005) finds that the quality of the formal corporate governance of these companies did not differ from those of their peers. Behavioural traits of fraudulent MB members, on the contrary, did significantly stand out relative to their peers, in particular narcissism of their CEOs, belief in unrealistic (growth) targets, and extreme sensitivity to variable pay. It will not be easy to capture such elements in formalistic governance rules.

Thirdly, when DNB ventures in these fields this also raises the question of whether DNB may actually become responsible and liable for interventions, instructions, orders, restrictions or other measures it takes or imposes vis-à-vis a financial institution that may directly affect the success of the institution or the position of third parties related to the institution such as its shareholders. The closer DNB's supervision gets to the core of material decisions affecting the institution or third parties, the more likely direct responsibility or liability of DNB becomes and the more such liability would be justified. In the wake of the financial crisis, however, the liability of DNB, and of its executive and supervisory directors and employees, has been explicitly restricted to situations where damage is caused by

intentional improper exercise of duties or powers or grossly culpable conduct (*opzet of grove schuld*).[18] This restriction has been included to deal with the 'damned if you do, damned if you don't' dilemma of external supervisors, who can easily be criticized by some if they do not interfere or interfere too late and by others if they do interfere or interfere too soon. Limitation of liability also facilitates that the external supervisor publicly accounts for its actions in a self-critical manner, which furthers the quality of external supervision. At the same time the limitation of liability denotes that the primary responsibility for the financial institution's direction and actions lie with its MB and SB. This is a further reason why DNB by entering into these new fields of supervision that overlap strongly with the role of the SB, should exercise restraint and should focus on ensuring that the SB performs its roles properly.

9.5 How to Ensure a Proper Functioning of the Supervisory Board?

Certainly in the aftermath of a crisis, new laws, new strategies or new regulatory approaches are full of good intentions but implementation can be full of pitfalls, dilemmas and paradoxes. Few would dispute that dangerous strategies, business models, conduct and culture of financial institutions have at least partially caused the financial crisis to happen and that mechanisms should be put in place to mitigate such risks in the future. The question is, who is best positioned to prevent or correct hazardous practices in these areas and how should that be done?

We have argued in the previous section that supervision of strategy, business models, conduct and culture is important, but that a SB is fundamentally better positioned then DNB to take on that task. The SB and the MB are part of the same institution and they therefore should share the same objectives; the SB has or can obtain more information than any outside body regarding the decision-making process and real functioning of the MB; the SB can observe and influence the managerial and corporate culture; because of superior information, shared goals and more frequent interactions the SB can more easily build a relationship based on trust with the MB. It is virtually impossible for DNB to double check or second-guess the work of SBs based on significantly less information and armed with less board competencies and first hand experience. This is not to say that SBs of financial institutions have done a stellar job in the years leading up to the financial crisis and since, certainly not. Internal supervision by SBs often has not been taken seriously enough, has been too superficial and remote, insufficiently connected to business practices and their drivers. Our point is that if a SB is functioning well it can do a much better job in the fields of strategy and business models, behaviour and culture than DNB could ever do. DNB should therefore

[18] Art. 1: 25d par 1. Wft.

focus its supervisory role in these areas on the supervisory process of SBs and on their proper functioning. Yes, DNB should be alert, assertive and persistent, but primarily in safeguarding the proper functioning of SBs, much less in solving strategic or behavioural problems themselves.

A second reason for this approach of external supervision is that it matches the recently limited liability of DNB and its executives and supervisory directors and employees to liability following from intentionally improper or grossly culpable supervision. Members of the SB have the primary responsibility for supervision and are personally responsible and liable in case of improper supervision, a much lower threshold of liability.

A third reason why DNB should focus on monitoring and safeguarding the functioning of SBs is because it would address a fundamental weakness in corporate governance. SBs supervise the MB, but who supervises the SB? Nobody, in a way. Indeed, the General Meeting of shareholders can dismiss members of the SB and can also reject proposals of the SB that are subject to approval of the General Meeting according to the Companies Act or to the articles of association. That, however, rarely happens and if it happens it is mostly because of differences of opinion on strategic matters, not so much because of malfunctioning of the SB. Moreover, the lack of inside information of DNB applies even more to the General Meeting and to shareholders, especially of listed companies where share ownership if widely dispersed. Consequently, the General Meeting is often in a very weak position to properly monitor and evaluate the functioning of the SB.

Where effective supervision of the SB's performance by the General Meeting or by DNB is difficult, if not impossible, to achieve, much depends on the ability of the SB to assess its own performance. Responsible SBs, i.e. SBs that feel and take responsibility for their own performance, regularly assess their own performance. In our experience, for quite some SBs that responsibility does not come naturally. Almost all SBs struggle with the fact that it is hard for them to assess their own performance with sufficient objectivity. SBs, like any other team of human beings, have the tendency to overestimate their own performance. In addition, as indicated by Veltrop and Van Manen (2010), resistance towards board evaluations might exist because directors fear their ego might be hurt or reputations might be damaged. Moreover, SBs regularly seem to be reluctant to recognise the fundamental governance issue that they also need to be evaluated, or supervised, in a way. They often have a tendency to believe they are beyond the need of sharp external review and scrutiny; that this basic governance principle does not apply to themselves. SBs find that MBs obviously cannot supervise themselves and need to be supervised by an experienced, independent and well-informed body, being the SB, and that the SB should provide the necessary countervailing power for the 'ultimate power', the MB. That the SB itself also needs critical assessment is something that until recently simply did either not occur to many SBs or SB members were deliberately reluctant. Since the Corporate Governance Code in 2003 recommended that SBs review their own performance, most SBs have done so rather superficially, on the basis of questionnaires that leave ample scope to ignore potentially serious performance issues. A number of boards that have approached us to conduct a board

review mentioned that they were dissatisfied with the results of these self-assessments.

There is another reason why in particular those boards that would need an in depth evaluation most – those with potentially serious performance issues – will be the last to *properly* evaluate themselves. It's like the Groucho Marx joke: I would never accept to become a member of a club that would accept me as a member. The SBs that do not want to assess themselves should be profoundly evaluated. We have seen this on several occasions in our own board review practice, with some of the common excuses being no time, no money (too expensive), and most revealing of all: we do not need a board review because there are no issues. This is also what Groothuis et al. in their contribution in Chap. 8 report. Groothuis et al. then draw the conclusion that "it might not be a good approach for DNB to force financial institutions to conduct board evaluations, because it could disturb the process of the board evaluation". There is indeed a concern that pressure of DNB on a SB to conduct a board evaluation may distort the outcomes of such an evaluation, particularly if DNB would have access to an evaluation report or presentation. But that would leave the conundrum that SBs who most need a critical performance review are the least likely to undertake such a review themselves. The conundrum can be solved if the details of the evaluation are not shared with DNB, but the SB reports to DNB what it believes to be the key findings of the evaluation and how it intends to deal with these – as we argue below this is the proper approach for sharing the evaluation with DNB. The importance of a significant performance improvement of such a SB outweighs the (limited) risk of a somewhat troublesome process.

All in all, there are not only theoretical but also actual needs to have an external party assess the proper functioning of the 'final ultimate power'. Should DNB play that role?

DNB qualifies in some respects, but not all. DNB is independent, but does not have the right experience and expertise. Although assessment experience can be developed, it would partially have to be insourced by DNB since it requires seniority and experienced persons that are familiar with board dynamics in practice and who are accepted in that role by members of SBs and MBs. Moreover, as a regulator and external supervisor DNB is not always trusted in this role since it has specific supervisory objectives and does not have an interest in some of the company objectives. DNB could use the information obtained in a board evaluation for some of its other supervisory duties and consequently SB and MB members will not be fully open when providing their input in an assessment process. Not only have we witnessed this in our board reviews on several occasions, this is also what Groothuis et al. find based on a survey amongst SBs and MBs of financial institutions. They report that the majority of the respondents argued that board members might not be completely open and honest about their functioning when the supervisory authority is part of it. As one of the respondents put it "This results in not getting the 'truth' out of the board evaluation. DNB is watching, so we will try to keep up appearances and give socially desirable answers. The board evaluation will be minimalistic, tick-the-box exercises and the soft controls won't be discussed. People don't like the feeling of being watched." Honesty and openness

are a prerequisite for any effective evaluation. DNB would therefore not qualify as a fully trusted and objective party to assess the performance of the SB.

That would leave an independent, objective, experienced and trusted party as the preferred candidate to perform a periodic assessment of the functioning of the SB. As it happens, the Dutch Banking Code (art. 2.1.10) requires the SB of a bank to have an independent outsider evaluate its functioning at least every 3 years, in addition to a yearly self-evaluation. Could these evaluations, in particular the external one, be used by DNB to safeguard the proper functioning of the SB? That is not an easy question to answer. Before answering the question, let us first try to understand what are the characteristics of a 'proper external evaluation'?

According to the Dutch Banking Code, an evaluation of the SB addresses at least the commitment of each SB member, the culture within the SB and the relationship between SB and MB. In our view, an evaluation starts with assessing the alignment within the SB and between SB and MB on corporate goals, risk-appetite, values and strategy and the division of roles and responsibilities between MB and SB. The latter relate to hygiene factors (e.g. financial reporting, audit and control, risk management, compliance), strategy and performance (the strategy process, monitoring performance in line with strategy, strategy changes), people (composition and evaluation of MB and SB, remuneration, management development process, succession planning) and shareholder/stakeholders (information disclosure, involvement and role concerning important decisions, managing conflicts). Concerning roles and responsibilities both the *Soll* (what they should be) and *Ist* (what they really are) positions should be reviewed. In our board review experience, SB members and MB members often have different perceptions of the various roles that are to be performed and what they entail in terms of behaviours, attitudes and actions. This may cause misunderstanding but also frictions and outright conflict, which are then typically and unconsciously converted into conflicts on the substance of matters under supervision, such as a particular investment decision or performance or strategic discussion.

Subsequently, all other aspects of 'the system' and all behavioural aspects should be evaluated. 'The system' includes compliance to legislation, regulation, rules, governance codes, the articles of association and bylaws, the well-functioning of committees, composition of the SB, proper procedures for nomination, evaluation (very important) and remuneration of MB members and also SB members. Behavioural aspects include individual motives, behaviour and personal traits (e.g. leadership style, CEO conduct, conduct of the chairman, looking good, epistemic versus social motivation) as well as group traits and group dynamics (e.g. informal hierarchy, cohesion, non-discussables, critique as sign of distrust, CEO-chairman interaction, CEO disease). In addition, performance reviews of each individual SB member should be made. As one might expect, sometimes sensitive, delicate and personal issues will be reviewed, whereby the quality of the review is fully determined by the openness and honesty of each interviewee. Such openness and honesty can only be achieved when full personal confidentiality is guaranteed and relied upon.

Can the SB and also DNB credibly guarantee such confidentiality? What are the limits to openness? It is relatively easy for DNB to ascertain whether an external evaluator is given the right assignment, with the right scope and deliverables, and whether he or she is qualified. How to deal with the results of the evaluation is less obvious. Effectiveness has to be balanced against transparency and trust. Full openness of the interviewees (SB and MB members and a few others close to the SB, e.g. controller, secretary of the board, external auditor) is essential to obtain maximum effectiveness of the evaluation. Therefore, all interviews should be personally confidential, meaning that views and opinions will not be attributed to specific interviewees. Consequently, if all goes well, all issues will be put forward and be included in the final evaluation, including serious issues like distrust between MB and SB, insufficient risk management, a dysfunctional culture, one or more dysfunctional SB and/or MB members, a 'sun king' CEO, disorderly SB meetings, poor performance management, lack of disclosure towards external stakeholders, poor or no evaluation processes of MB members, etc.

The results of the evaluation can be twofold: (A) some issues have been identified and require immediate and severe actions by the SB, or (B) the issues identified are so serious that the external supervisor should be informed (e.g. DSB bank case).

In case of A it is not necessary that DNB is informed about the detailed content of the evaluation. However, without destroying the confidentiality of the evaluation process DNB could be informed about the main findings and the high level implementation plan, i.e. how and when the SB is going to address the main issues. In our experience the best way for DNB to receive this information is to have a discussion with the SB on the outcome of the evaluation process and the action plan that follows from the evaluation. This is crucial. If DNB would require that the full evaluation report is provided (which it legally can) than the report in all likelihood will not address the crucial and salient points. DNB will then receive compliance proof but non-informative evaluation reports since the SB and MB will not fully trust DNB to abstain from immediate and possibly unwarranted action. This would defeat the whole purpose of evaluations. If the evaluation would point at performance issues of individual SB or MB members, the report to the external supervisor should only mention that some performance issues have been identified and that the SB is confident they can and will be addressed. DNB should trust the SB that they will execute the implementation plan. The SB could, if requested, provide a short progress report to DNB on a quarterly or semi-annual basis. In this case (A), the interviewees will probably be open and candid and all relevant issues will be put forward.

In case of (B) we face a more serious dilemma. When issues are so critical and urgent that DNB may have to be informed, at least some of the interviewees will be aware of those. Obviously, these issues should be discussed by the SB in its regular processes and should not be delayed until a formal performance evaluation is undertaken. Nonetheless it may happen that one or more fundamental issues are only revealed during a board evaluation. When SB members would openly share their worries with the evaluator, knowing that DNB might be informed and will

probably take appropriate but unpredictable action, the interviewees may not honestly answer all questions and be less open and/or play down the severity of the issue(s), partly because the interviewees are to some extent responsible for the critical and urgent issues. Consequently, the evaluation may not be fully effective, in circumstances where it is most needed.

DNB also recognises this dilemma (see, for instance, the contribution of Groothuis et al. in Chap. 8) but has not solved it, witnessed also in the contribution of Nuijts and de Haan in Chap. 10 when discussing the studies by DNB on conduct and culture of financial institutions. In the first sentence of the last section they state "There is in any event one thing that DNB is not going to do: it has no intention of qualifying cultures as 'good' or 'bad'." That indicates clearly that the authors are aware of the danger of interfering in 'soft' matters. At the same time, in the last sentence of that same last section, they state "Evidently, undesirable behaviour is not accepted, and where this occurs action will be taken, using the resources provided by the Dutch Financial Supervision Act (Wft)." Keeping a distance because of the intricacy of soft matters, but still remaining willing and able to intervene when behaviour is deemed unacceptable, that is the dilemma. And that is exactly why board members will be quite reluctant to fully disclose their concerns on the functioning of the (members of the) SB or MB vis-à-vis DNB.

What to do, which sea monster to prefer: Scylla or Charybdis? When urgent and critical issues would be shared with DNB, interviewees might not be open, so there might be nothing to share at all. So, this is the dilemma: DNB should be informed about critical and urgent matters, but if it would be fully informed, no critical and urgent matters might be reported. It is like the hairdresser of Syracuse who cuts the hair of everybody who does not cut his own hair. Question: who cuts the hair of the hairdresser of Syracuse?

How to solve the dilemma? It is unacceptable that 'critical and urgent matters' that ought to be reported to DNB will not be reported. Consequently, the risk has to be taken that interviewees are less open then they might have been when such matters would not be disclosed to DNB. However, chances are not very high that if critical and urgent matters occur, nobody, or only very few people, will mention them, which limits the risk of an ineffective evaluation. Moreover, it might also be dangerous for interviewees not to mention serious shortcomings, dysfunctional behaviours or incompetence of board members.

In order to further mitigate the risk of non-openness or dishonesty one should agree upfront on a clear process with DNB in case the evaluation produces critical and urgent issues DNB would feel compelled to act upon. Such a procedure should indicate the various steps and, amongst other things, what information will be shared with DNB and who will be interviewed by DNB.

A periodic and sound external evaluation of the SB would not only benefit DNB but in the first place the SB and the financial institution itself. The SB not only obtains a clear and actionable assessment of its own functioning, but it also provides a clear process for the role and interference of DNB. Put differently, when the process and the role of DNB in the evaluation process are clear, it should prevent

DNB from obtaining certain information in a different way and can thus limit the use of certain other supervisory and regulatory tools and methods.

Two final cautionary remarks on (supervision on) external board evaluations. Firstly, also external board assessments have their dangers and come and go in different guises. We have stressed openness and honesty of SB and MB members and all others involved. But that is just the first step. The next step is to produce an evaluation report that on the one hand reflects and succinctly lays out all issues that were identified, including mechanisms behind it, yet on the other hand in such a way that the recipients, i.e. those same board members, not only recognise but also accept the reflection of the mirror that is placed in front of them. In our experience, this not a given, on the contrary.[19] Especially personal behavioural and capability issues and topics concerning group dynamics are not likely to be welcomed easily. By implication, this means that it is relatively easy to produce a board report that contains many interesting insights and critical notes but does not address the more fundamental behavioural and capability issues. Such a report will be consumed with great ease, precisely because the malfunctioning of the female SB member is not properly addressed, nor the bullying CEO, nor the immutable hierarchy within the SB, nor the superficial assessments of all the 'yes men' in the MB, nor the absent chairman of the audit committee, nor the non-existent succession planning, nor the chairman's limping back, etc.[20] But the CEO is happy, as are the chairman, the female SB member and the chairman of the audit committee, and especially the prudential supervisor is happy that a profound evaluation was done and that so many interesting and useful insights were pulled up.

Secondly, a board evaluation is just a means, not en end. Its purpose is not just an objective, timely, honest and comprehensive assessment of the SB's performance in all its facets. The assessment serves to allow the SB to significantly improve its performance, ideally addressing all issues identified. Once all performance issues have been discussed, digested and accepted, then the journey begins. A fully committed action plan, which identifies what issues will be tackled, how and when and by whom how they will be monitored and how necessary adjustments will be carried out along the way.

These are two supplementary reasons why impactful board evaluations are not an easy matter, and why it is neither a hands down exercise for the prudential supervisor to safeguard such a process.

[19] On one occasion, which was not even an official board evaluation, we interviewed executives and non-executives from various boards to identify typical issues that boards are faced with. We then summarised the interviews in the form of nearly literal, but anonymous, quotes and presented those to the group. Little shocks and some outrage went through the room, ''this is not at all what we said", said some of the persons being quoted. The mirror provided an anonymous yet all too clear image, and was thus rejected.

[20] These are all real life examples we have witnessed in various board reviews. A well-known example of a global bank with severe (board) performance issues – as became clear later on - where an external board review was performed that did not reveal any serious issues was ABN Amro (see Smit 2009).

9.6 Concluding Remarks

Recent history has convincingly shown the need of strongly improved supervision of financial institutions in the fields of strategy, business model, and conduct and culture. But by whom and how should that be done? What are the roles of the internal supervisor, the SB, and the prudential supervisor? Acknowledging that internal supervision by SBs has failed in these areas may seduce a prudential supervisor to take on too big a role in these areas itself. Too big for a prudential supervisor not only because they also have failed in some respects, but also because they are essentially disadvantaged relative to internal supervisors. Proper supervision requires independence, expertise, appropriate authorities and adequate information. Although the prudential supervisor is independent and has some (but not all) of the required authorities, it is fundamentally disadvantaged in terms of information and expertise in these fields. Moreover, external supervision of financial institutions in matters of strategy and culture with great modesty and restraint would be commensurate to the limitation of liability that DNB and foreign external supervisors enjoy.

As a guiding principle, one could state that the larger the distance between the supervisor and the actors (i.e. MB and the financial institution at large), the larger the information asymmetry and the more formal rules, controls and audits will be needed and hence the less effective supervision will be. It will result in more formalism, less customization, more bureaucracy, more errors and, consequently, more distrust. That leads us to the internal supervisor, the SB, to be the prime and principally best-equipped supervisor of the MB.

The fundamental and actual governance weakness then to be addressed is to safeguard the proper functioning of the SB. That is not something SBs naturally do well, on the contrary. In order to try to prevent severe mismanagement to happen again there is a strong need for the SB to evaluate its performance rigorously. In order to ensure sufficient objectivity, an external, experienced and independent party should be involved in such performance reviews regularly. Although for reasons of potential distrust, conflicts of interest and expertise that party cannot be the prudential supervisor, it could and should safeguard that external evaluations are carried out properly. Facilitated by qualified external parties at regular intervals and making sure that identified performance issues are being addressed promptly and adequately.

Openness and honesty of all parties involved is critical in such evaluations, but will not happen if confidentiality, also vis-à-vis the external supervisor is not guaranteed. That puts us between a rock and a hard place: transparency of the process and outcome of the evaluation to enable the external supervisor to safeguard proper functioning of the SB versus compliance proof but non-informative evaluation reports. We strongly believe quality should prevail over transparency. We have indicated why, and how the risks of limited transparency can be mitigated.

It is not a pure dichotomy. Prudential supervisors such as DNB should not fully refrain from taking views regarding strategy, business model, and conduct and

culture of financial institutions. But in order to maximise its effectiveness as external supervisor it should focus on safeguarding the proper functioning of the SB, not on second guessing or (dis)approving individual board decisions or conduct. In other words, trust over control. Not because it is popular and sounds better, but because it is the better way to possibly help preventing the next financial crisis.

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Chapter 10
DNB Supervision of Conduct and Culture

Wijnand Nuijts and Jakob de Haan

10.1 Introduction

An important lesson from the financial crisis is that supervisors should not only focus on the solvency and liquidity of financial institutions, thereby ignoring risks ensuing from institutions' conduct and culture. In fact, an institution's financial figures may suggest that the continuity of the institution is not at stake while at the same time its conduct and culture may pose risks for the institutions' long-term viability. De Nederlandsche Bank (DNB), which is responsible for prudential supervision of financial institutions in the Netherlands, has therefore given supervision on conduct and culture of financial institutions a prominent place, forming a valuable supplement to more 'traditional' prudential supervision. DNB pays explicit attention to such matters as leadership and leadership styles, convictions and values of staff members, openness of discussions and unconscious group patterns of behaviour. These soft factors are often 'informal' (see Fig. 10.1) and are thus less easily observable and less tangible. However, they are crucial for sound functioning of financial institutions.

By reacting alertly to risks related to conduct and culture, intervention is possible before the risks materialise. Importantly, DNB tries to make an institution aware of potential risks related to conduct and culture and how they may contribute to the origination and continuation of prudential and integrity risks. In this way, supervision of conduct and culture contributes in a preventive manner to the realisation of DNB's supervisory objectives: safeguarding the soundness and integrity of both individual financial institutions and the financial system as a whole.

The basis for the supervision of conduct and culture is formed by the DNB policy vision 'The seven elements of a sound culture'.[1] The content of these seven elements can be summarised as follows:

[1] Available at: http://www.dnb.nl/en/supervision/view-of-supervision/index.jsp.

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structure, rules, procedures, division of work, reporting lines, policies, targets, technology, finance, products	formal organisation
coalitions, psychological needs, power, informal leadership, conflict, morals, informal standards, sensitivities, social codes, loyalty, friendships, emotions, perceptions, risk appetite	informal organisation

Fig. 10.1 The formal and informal dimensions of organisations

- **Weighing of interests/balanced action:** when making decisions, the (long-term) interests of all stakeholders of the financial institution must be recognised, carefully weighed and visibly taken into account.
- **Consistency of action:** the financial institution and all its employees must act in accordance with the strategic and other objectives formulated by the financial institution.
- **Openness:** the degree to which a positive critical attitude exists within and between all ranks of the financial institution and to which it is possible to discuss decisions, other viewpoints, errors and taboos.
- **Exemplary conduct:** good behaviour at the top (setting a good example).
- **Practicability:** setting realistic (long-term) targets and removing perverse incentives and temptations.
- **Transparency:** recording and communicating objectives and principle choices to all internal and external stakeholders.
- **Enforcement:** attaching consequences to non-compliance.

As it is of great importance to DNB to gain better insight into conduct and culture of financial institutions and any potential risks involved, a new centre of expertise was set up, the Expert Centre on Culture, Organisation and Integrity (COI). The Expert Centre develops new supervisory methods and gives advice on difficult cases. Supervision of conduct and culture requires different knowledge and skills compared to 'traditional' supervision. Supervisors should be able to identify behaviour and behavioural patterns of a financial institution and subsequently to discuss them with the institutions concerned in a constructive manner. To meet these demands, DNB has recruited organisational psychologists and change

experts. To support policy-making, several research projects on conduct and culture were started by DNB's Research Department.[2]

Risks related to conduct and culture are often reflected in corporate decision-making processes. That is why DNB focused on decision-making by thirteen banks, pension funds and insurers in its first two thematic examinations of conduct and culture. In these examinations concrete decisions, such as decisions on an investment and an acquisition or the institution's strategic development, were analysed. Three questions were at the core of the examination: (i) is the decision-making process balanced; (ii) is it consistent; and (iii) was the board effective in its decision-making? Balanced decision-making refers to what extent the interests of the various stakeholders are visibly recognised and considered. Consistent decision-making requires that decisions taken are consistent with the corporate strategy. In the context of board effectiveness, DNB specifically focused on leadership styles. In addition, the examination also paid attention to several other elements from the DNB policy view as outlined above, such as leading by example (tone at the top), openness to discussion (is an attitude of positive criticism regarding decision-making stimulated?), feasibility of decisions taken and transparency (are objectives and basic choices adequately recorded and communicated to stakeholders?).

In this contribution, we will zoom in on this examination as an example of supervision of conduct and culture in practice. The focus of the examination, i.e. is the decision-making process balanced and is it consistent, has a solid basis in academic research, which will be briefly discussed in Sect. 10.2 of this contribution.[3] Section 10.3 will provide more details about the examination. The final section will discuss the lessons learned so far.

10.2 Academic Research

10.2.1 Leadership

According to Sternberg (2007), unsuccessful leaders share common fallacies. For instance, there is an *egocentrism fallacy*, when a manager believes only her interests are important or an *omniscience fallacy* when the manager believes to know everything. Related is the *invulnerability fallacy,* when managers think to be able to get away with everything. Finally, there is the *unrealistic optimism fallacy*, when managers believe it pointless to worry about the outcomes of their behaviour or decisions, in particular the long-term ones, as everything will work out fine.

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[2] The DNB research programme is available at: http://www.dnb.nl/en/onderzoek-2/dnb-onderzoeksbeleid/index.jsp.

[3] This section heavily draws on de Haan and Jansen (2011).

That leaders may suffer from individual biases or fallacies need not be worrisome. However, once leaders take up a dominant position, there may be insufficient possibilities to correct these biases, which can affect an institution's stability and viability. There are several studies suggesting that unsuccessful firms are often led by dominant CEOs (see, for instance, Miller and Friesen 1977). Dominant leaders tend to be wedded to their own wisdom, greatly discount the potential contributions of subordinates, which can lead able employees to move on in frustration (Hambrick and D'Aveni 1992). By doing so, dominance restricts the information flow within the organization. This is strengthened by the fear of subordinates to raise issues that run counter to what the executive prefers (Haleblian and Finkelstein 1993).

When the need for information processing is low, dominant leaders provide for minimum process loss by limiting unnecessary communication and conflict. However, because problems in a turbulent environment require substantial information processing, information restrictions can lead to poor performance. In line with this reasoning, Haleblian and Finkelstein (1993) find that dominant CEOs performed worse in a turbulent environment than in a stable environment. In addition, this effect is significant when top managers have much discretion in strategic decision-making, but is not significant in a low-discretion environment. In related work, Brown and Sarma (2007) report that both CEO overconfidence and CEO dominance are of importance in explaining the decision to acquire another firm. The results suggest that CEO dominance is especially important in case of diversifying acquisitions, with the probability of a diversifying acquisition almost doubling with a 10 % increase in CEO dominance. Finally, they find that the presence of more independent directors on the board reduces the effect of CEO overconfidence and CEO dominance on acquisition decisions.

10.2.2 Board Decision-Making

It is often assumed that in board discussions there is full disclosure of private information, rational updating, and convergence of individual beliefs. However, the social psychology literature provides many reasons to doubt that this is an accurate representation of board decision-making, with possible implications for optimal board size. For instance, individuals often fail to take full advantage of others' opinions and they also do not seem to share fully their own information with other group members. For instance, Stasser (1991) and Wittenbaum and Stasser (1996) find that groups often do not discuss all the information that their members possess, but concentrate instead on information that members initially share. When the group has to use information that is initially not shared to make a correct decision, the bias towards discussing shared information can lead to an incorrect decision. When group members do exchange information, the available information is often not incorporated into the decision (van Ginkel and van Knippenberg 2009).

What determines the extent to which groups exchange and integrate information? De Dreu et al. (2008) develop a model for the motivation of individuals in group-decision making. In their set-up, they distinguish between epistemic motivation and social motivation. Epistemic motivation, which can be high or low, is the willingness to achieve a deep understanding of the group task or decision problem at hand. Social motivation, which can be pro-self or pro-social, is the preference for outcome distributions between the individual and the other members of the group. People with a strong pro-self motivation aim to maximize their own results, while they show little interest in what others achieve. The decision-making process is perceived as a competitive game. Individuals with a pro-social motive try to establish a decision that values and incorporates their own, but also others' interests. These persons tend to see the process as a collaborative game in which fairness and harmony are important. De Dreu et al. (2008) also argue that epistemic motivation interacts with social motivation in predicting the quality of group judgment and decision-making. This interaction, in turn, is conditioned by decision urgency and member input indispensability.[4]

Problems associated with failure to exchange views are highlighted in Janis's (1982) famous analysis of "groupthink" in a series of case studies. According to Janis, certain circumstances (for instance, directive leadership) produce a concurrence-seeking tendency, excessive confidence of the group, closed mindedness, and pressures toward uniformity, which in turn can lead to defective decision-making, including an incomplete survey of available options, a failure to assess the risks of the preferred option, and a selective bias in processing information. In addition, Bainbridge (2002, p. 28) points to social loafing, where some members choose not to actively participate in board decision making, and herd-type behaviour where a decision maker "imitates the actions of others while ignoring his/[her] own information and judgment with regard to the merits of the underlying decision." Likewise, Westphal and Bednar (2005) find that pluralistic ignorance can occur in boards, i.e. board members fail to express concerns based on others not expressing concern.

Building on Janis (1982), Neck and Moorhead (1995) point to closed leadership style (when the leader discourages participation, states opinions first, does not encourage divergent opinions, and does not emphasize the importance of reaching a good decision) and methodical decision-making procedures as moderator variables.[5] These two variables explain why within the same group, groupthink may occur in one situation and not in another. Schulz-Hardt et al. (2000) provide evidence that groups prefer supporting instead of conflicting information when

[4] Related work on motivation and group decision-making includes Scholten et al. (2007) and De Dreu (2007).

[5] A moderator variable affects the direction and/or strength of the relationship between an independent variable and a dependent variable.

making decisions. As more group members chose the same alternative prior to the group discussion, the more strongly the group prefers information supporting the alternative.

10.2.3 Diversity

One definition of diversity is "differences between individuals on any attribute that may lead to the perception that another person is different from self" (van Knippenberg et al. 2004, p. 1008). Diversity can have positive effects on group performance since it endows a group with flexibility, which can be valuable if the group's tasks change or become more complex (Hall 1971). In addition, if individual private information is valuable and is not fully correlated across board members, it would thus seem that a more diverse board would collectively possess more information and therefore would have the potential to make better decisions.

In the organizational psychology literature, diversity has been widely debated. If anything, the effect of diversity is complex and depends on context. On the basis of a meta-analysis, Webber and Donahue (2001) find no support for a relationship between various types of diversity and group cohesion or performance. According to Mathieu et al. (2008), most studies suggest that diversity – along various dimensions – is not positively related to performance.

A recent line of literature has tried to rationalize potential negative effects of demographic diversity. Lau and Murnighan (1998) introduce the notion of 'faultlines'. Faultines divide a group on the basis of one or more characteristics, such as gender, age or race. Lau and Murnighan compare these faultlines to faults in the earth's crust, which can go unnoticed for many years, but can lead to sudden physical cracks. Faultlines increase the likelihood of subgroup formation and conflict. Subgroups are most likely to form in the early stage of group formation.

Many papers have built on the idea of faultlines. In a quasi-field study using 79 groups, Thatcher et al. (2003) find that measures of faultlines are related to conflict and performance. Rico et al. (2007) find that teams with weak faultlines performed better and showed more social integration than teams with strong faultlines. Veltrop et al. (2012) argue that board members may not be independent actors, but representatives of stakeholder factions (like representatives of employers and employees in pension fund boards in the Netherlands). Accordingly, when diversity aligns with such representative affiliations, diversity is likely to lead to social categorization processes, rather than informational differences in perspectives, making boards more susceptible to disruptive influences. Using data on 313 Dutch pension fund boards, they find that demographic factional faultlines are positively related to competitive conflict management and negatively related to cooperative conflict management. Interestingly, their results also indicate that reflecting on board processes ameliorates social categorization processes fostered

by factional demographic faultlines. Thus, whether demographic differences between factions hurt board functioning depends in large part on whether boards reflect on their internal processes.

10.2.4 Culture

There are various ways in which corporate culture have been conceptualised. One succinct description sees organizational culture as 'a system of shared values (that define what is important) and norms that define appropriate attitudes and behaviours for organizational members (how to feel and behave)' (O'Reilly and Chatman 1996; see also Sørensen 2002).

As culture is mainly formed by non-observables (values and norms), the challenge for the outsider is to learn and understand an individual company's culture. To understand cultures, Hofstede (1991) compares them to an onion: a system that can be peeled, layer-by-layer, in order to reveal deeper layers. At the core of culture are values: deeply held convictions about how things ought to be. From the outside, it is not straightforward how to penetrate to this level. Still, inference can be made from the stories and language that organization members use. According to Hofstede (1991), values are manifested through three layers: symbols, icons and rituals. Symbols are words, pictures, objects, acts or events that have a special meaning. Icons are persons like sports persons or pop-stars who are admired by a specific group. Rituals are ways of showing respect, trends and behaviour, like wearing expensive watches or having a lavish office layout.

Many authors have studied corporate culture and its relationship to company success. In a recent survey, Sackmann (2011) identifies 55 papers published since 2000 that study culture and performance. Most of these papers find support for a direct link between corporate culture and firm performance. Weinzimmer et al. (2008) list various propositions on the relationship between culture and performance. First, risk tolerance or acceptance of mistakes is important. In this context, Van Dyck et al. (2005) discuss the concept of error management culture. Firms with sound error management make sure that errors are noted and effectively handled. Analyzing the experience of 65 Dutch and 47 German organizations, Van Dyk et al. (2010) conclude that this positively contributes to firm survival. Second, market-orientation seems important as well. Narver and Slater (1990) describe this as having an understanding of customers; creating value based on needs and wants of customers; and a focus on strengths and weaknesses and long-term capabilities of current and potential competitors. Third, acceptance of change, which relates to the willingness to undertake action on various dimensions, such as technology, matters (Stanley et al. 2005). Due to increased competition, business organizations are forced to maintain comparative advantages continuously. It has become important to develop capabilities for improving core processes and to foster continuous learning (Sørensen 2002; Hung et al. 2010). This is often referred to as dynamic

capability: the firm's ability to integrate, build and reconfigure internal and external competences to address rapidly changing environments. Using data on over 1100 Taiwanese companies, Hung et al. (2010) find that an organization's learning culture significantly contributes to organizational dynamic capability and, in the end, performance. Finally, employee development is important. According to Jacobs and Washington (2003), this refers to programs that provide company staff with the necessary know-how to contribute successfully to the organization. It also refers to activities that are relevant to understanding values, goals and beliefs of a company (Maurer et al. 2002). When an organization supports the learning of corporate culture, employees are more likely to show commitment, and have high performance levels (Ripley 2003).

10.3 Thematic Study: Decision-Making by Seven Financial Institutions

In 2011 DNB carried out a thematic study focusing on balanced decision-making and consistent decision-making. Based on actual decision-making processes, the study looked at how much account is taken of the interests of stakeholders when making decisions and to what extent those decisions reflect the strategic and other objectives formulated by the organisation. The study also looked at how realistic the goals were, and at the willingness to listen to opposing views from within the organisation (see Table 10.1).

In order to gain proper insights, DNB relied on various methods and instruments. First of all, by means of desk research, DNB gained an impression of the institution and of the decision-making processes concerned. Subsequently, several interviews were held. Discussions were held with members of the Boards of Management, Members of the Supervisory Board and second and third-line staff members of the banks and insurers that were examined. At pension funds, discussions were held with board members, members of accountability boards, visitation committees and members' councils as well as pension administrators. For the first time, DNB also used organisation-wide surveys in which employees from all layers of the organisation were asked to respond to questions/statements such as: "Senior managers and directors behave in accordance with the core values of the organisation" or "I am encouraged to adopt a constructively critical attitude within this organisation." Finally, DNB attended a meeting of the Board (of Management) and/or the Supervisory Board as an observer. This enables DNB to form an opinion of board dynamics, the actions of the various board members and the intensity of the discussions that precede decisions. The instruments used provide a good insight into relevant behavioural patterns within the financial institutions examined. They also provide information on issues such as the degree to which management is capable of self-reflection – something that is crucial in determining whether a board of management is able to adjust its own actions effectively when needed (see also Sect. 10.2).

Table 10.1 Issues addressed

Examples of questions addressed in the study
Were all relevant departments/layers involved in the decision-making process?
Was there scope for stakeholders to hold deviating opinions or to challenge the prevailing thinking?
Were all interests involved in the decision identified and visibly taken into account in the decision-making?
Were the decisions in line with the strategic objectives, were they achievable and were they known by and communicated to employees within the organisation?
Is there a dominant leadership style, and if so, are the leaders themselves aware of this, and again if so, what measures have the leaders/the organisation taken to counter this? Are the leaders capable of self-reflection?
How are decisions taken in the boardroom?
What stance does the Supervisory Board adopt vis-à-vis the Board of Management: (constructively) critical or submissive?
Are collective behaviour patterns observable which are not recognised by the organisation?

The examination showed that most institutions examined had a dominant leader (Table 10.2). This is not exceptional and need not be problematic, provided that the leader and his environment are aware of this, recognise the potential risks and take adequate measures to mitigate these risks. However, for some institutions this was not done sufficiently. This was mostly caused by the dominant behaviour of one or more directors and their conviction that it is unnecessary to involve others. At one institution there was also a certain degree of 'family culture', with loyalty to the institution and its leaders being assigned primary importance. This may lead to a passive, insufficiently critical attitude on the part of staff vis-à-vis management. With respect to leadership, DNB observed the positive effects of facilitating leadership, especially by the chairman of the Supervisory Board. This type of leadership encourages participation of all members of the board, thereby enhancing a constructive challenging attitude and, in the end, the quality of the decisions being taken.

Acting consistently in line with the objectives and the fundamental choices made provides guidance for the acts of the institution and the people who work there. Considering the risks of acting in an inconsistent manner, it is of major importance that the board communicates the objectives and the choices in a clear manner. The board should pay extra attention to decisions that deviate from company objectives; it is important that this is transparently motivated. DNB's examination showed that this is not always (sufficiently) done. A clear vision or a mission may be lacking, in some cases the board is unduly focused on the issues of the day or the importance of consistent decision-making is not recognised. This makes itself felt in the patterns of behaviour shown in Table 10.3.

Some of the risks identified relate to a strong informal organisational culture. Although an informal culture is not at risk by itself, it may constitute a breeding ground for risks. During the examinations, DNB observed that an informal culture may manifest itself in several ways and that each of these manifestations involves different risks as shown in Table 10.4. A corporate secretary may contribute to a

Table 10.2 (Unduly) dominant leader and submissive organisational structure

Observed manifestations of dominance	Observed risk
CEO/board governs and dictates	Other decision-makers and consultative bodies are not or insufficiently involved in decision-making. As a result, not all relevant information is considered and risks are insufficiently weighed up, possibly causing low-quality decision-making
	The institution's vulnerability increases owing to dependence on qualities and pitfalls of a single person
Limited critical input from senior management	Truly fundamental choices are not proposed or are avoided. This may endanger the organisation's continuity
Limited involvement and/or influence on the part of compliance / legal department / in-house supervisor (internal auditing) owing to insufficient connection with the board	Equanimity and impassive reactions on the part of senior management and staff (adopting a submissive attitude)
Input from the organisation is not (seriously) considered	Limitation of innovative power within the organisation
Degree to which input is discussed depends on CEO's willingness	Brain drain: talented staff members usually do not accept this and resign, or are absent anyway
Risk management function lacks mandate or clout	Insufficient awareness of risks
Dominance is warded off with dominance (dominant CEO thinks that dominant co-directors will have a mitigating effect on him)	Decision-making is affected not on the basis of arguments but on the basis of hierarchy (dominance only respects even stronger dominance)

more transparent decision making process. In his role as assistant to the chairman of the Supervisory Board, the corporate secretary is responsible for organising the process. By securing the proper process, consistency with company goals can be enhanced.

The findings of the examination have been discussed with board members of the institutions concerned. This serves to confront them with the results of their own actions, which is especially effective if these actions have not been successful. By recognising the adverse consequences of their own actions, directors may become more prepared to change their behaviour and to address the ultimate cause of the problem. Only through genuine change may repetition in the future be prevented and may a sustainable improvement of the conduct of business be set in motion in an effective manner.

The examination has helped to convince the institutions concerned of the need to pay attention to the risks of conduct and culture. This has led some institutions to take measures on their own initiative. Expectations are that, as a result, in the future these institutions will be able to recognise and address high-risk behavioural patterns at an earlier stage.

Table 10.3 Acting insufficiently consistently in line with objectives

Observed manifestations of failure to communicate mission	Observed risks
Lack of a clear vision	Guidelines are lacking, causing loss of sense of direction
Opportunistic decision-making: objectives are chosen to fit the issues of the day	Doubts among management and staff on board's intentions (is it serving corporate interests or its own interests?)
Unrealistic mission out of line with current reality / institution's market position	Objectives are not seen as feasible within the organisation; this encourages high-risk behaviour (in order yet to attain the objectives)
	Decisions to perform an acquisition or make an investment that is out of line with the mission, strategy or business model. Leads to lack of credibility
Vision, mission and corporate objectives are unknown or unclear to senior management and staff	Guidelines are lacking, causing loss of sense of direction
	Lack of clear in-house course makes organisation (unduly) susceptible to influences from external parties or conditions
	Board is not taken seriously by management and staff and loses legitimacy and/or support, causing failure to (sufficiently) implement decisions. This poses a risk to continuity and to the quality of corporate performance

DNB has also informed the rest of the financial sector about the main outlines of the study. This will enable the sector to become further acquainted with the nature of the supervision of conduct and culture and help raise awareness about the risks inherent in decision-making processes.

The decision-making study has been followed up by a thematic study of 'Board Effectiveness', focusing on both Boards of Management and Supervisory Boards. Their effectiveness has been assessed not only in the light of the objectives that the organisation has formulated for itself, but also against the background of whether the boards' performance serves the interests of the various stakeholders (customers, employees, shareholders, etc.). The dynamics within and between the Boards of Management and Supervisory Boards has also figured prominently in the study.

10.4 Conclusions: What Have We Learned?

The supervision of conduct and culture represents a new activity for DNB. To a greater extent than in the past, the culture of the financial institution and its conduct will form part of supervision – not as a replacement of 'traditional' supervision, but as a supplement. Psychologists will work alongside auditors, economists and legal

Table 10.4 (Unduly) strongly developed informal organisational culture

Observed manifestations of informal culture	Observed risks
‘Genuine’ decisions are mostly taken during informal discussions (outside the formal decision-making fora)	Some formal decision-makers are not involved in informal decision-making. As a result, not all relevant information is considered in decision-making, detracting from its quality
Formal discussions strongly appear to serve merely to confirm decisions taken earlier in informal consultations. There is little time and room for careful and well-balanced risk analysis and for considering the various interests or the discussion of critical input	Risks are insufficiently considered or insufficiently thoroughly or are not considered at all, causing (opportunistic) low-quality decisions to be taken which insufficiently allow for risks. This leads to a risk of financial losses, customers who feel let down, poor in-house climate, etc
(Unduly) limited recording of decision- making process in, for instance, minutes	Limited transparency. If interests are properly considered at all, this process is recorded insufficiently clear. Thus, decision-making is insufficiently clear and verifiable for internal and external stakeholders and supervisors and cannot serve as a guideline for in-house acting
In terms of substance, decisions are insufficiently underpinned or not all relevant interests are considered	Risk of low-quality decision-making
Staff members indicate having little grip on decision-making and feel their input is not considered	Unmotivated staff, giving rise to the risk that the institution will be unable to attain its objectives

experts. The combination of the two perspectives will generate new and deeper insights contributing to achieving the objectives of DNB’s supervision. The earlier DNB is aware of risks relating to conduct and culture that could adversely affect the financial institution’s performance the sooner something can be done about them.

DNB is convinced that conduct and culture are factors that help determine the results of financial institutions: a ‘good’ culture leads to ‘good’ and ‘healthy’ businesses, which base their actions on a long-term vision and on the interests of all stakeholders. In other words, businesses that are balanced, consistent, sustainable and effective. With this in mind, every financial institution should devote serious effort to developing a culture that helps achieve this, as aimed for in the Banking Code and the Insurance Code, for example. It is not only the Board of Management that has a role to play within these organisations, but also the Supervisory Board, the internal audit department and the compliance department, all of which can help ensure that a dialogue is opened within the organisation about the importance of conduct and culture, that ideas are challenged, that the organisation acts in line with the strategy and that there is scope for critical self-review. With its supervision of conduct and culture, DNB is also seeking to play a binding role in order to create – together with banks, insurers and pension funds, as well as the world of science, consultants and other stakeholders – an attractive future perspective in which a clear picture can be presented of the added value of a

healthy corporate culture. A long-term perspective in which core values such as solidity and integrity are complemented by values such as consistency, balance and sustainability, and a perspective that is moreover good both for institutions and society at large.

There is in any event one thing that DNB is not going to do: it has no intention of qualifying cultures as 'good' or 'bad'. What DNB will do is target its supervision at identifying and eliminating risks relating to conduct and culture. As part of this process, DNB will continually ask the question of how much the culture of the enterprise and/or conduct of management and employees could adversely impact on the financial position or integrity of the enterprise in the short or longer term. As a result, the supervision of conduct and culture will fit in seamlessly with the prudential and integrity supervision with which DNB is charged, to ensure 'controlled and sound business operations'. The supervision is also aimed at effectively influencing behaviour. Engaging in dialogue and holding up a mirror (which can be somewhat confrontational) are the most appropriate instruments for this. Evidently, undesirable behaviour is not accepted, and where this occurs action will be taken, using the resources provided by the Dutch Financial Supervision Act (Wft).

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Chapter 11
How Can Principles-Based Regulation Contribute to Good Supervision?

Femke de Vries

11.1 Introduction

"Effective supervision of banking organisations is an essential component of a strong economic environment (..)" according to the Basel Committee on Banking Supervision (BCBS 1997, p. 10). Financial supervisory legislation is one of the pillars underpinning effective supervision. Financial supervisory legislation must contribute to 'good' market conduct and must enable market parties to intervene wherever necessary.

In the past two decades, the trend in financial supervisory legislation was to replace detailed rules with more open 'principles'. Financial institutions were increasingly instructed to achieve a certain outcome (for instance, 'adequate conduct of business'). *How* that outcome was achieved, was left to the institution itself. In this period the Financial Services Authority (FSA) elevated principles-based supervision to an art form. Likewise, Euro Commissioner Mc Creevy confidently asserted that "We believe that a "light touch", principles-based regulation is the best approach for the financial sector" (Mc Creevy 2008). And even in the United States, with its deep-rooted rules-based tradition, there were calls for a more principles-based approach (Black 2010).

Principles-based supervision represented a world in which flexible supervisors guarded over higher ethical standards. These standards were adhered to by responsible institutions. Any differences over the interpretation of the principles could be resolved through consultation between the supervisor and the supervised institution. Detailed rules suddenly conjured up associations with 'nit-picking bureaucracy'; an approach that put compliance before outcome (Black 2010, p. 3). Black

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(2008, p. 430) explains how principles-based supervision appeared to promise the advent of a 'regulatory Utopia':

> In this regulatory Utopia, regulation is targeted and focused, (..) regulated firms are given the flexibility they need to get on with running their businesses, and consequently regulatory outcomes are achieved with no undue costs to business.[1]

The principles-based approach fitted perfectly with the spirit of the times where all financial institutions were perceived to be alert, prudent and responsible entities, while the market was regarded as a self-correcting mechanism. Lord Turner, Chairman of the FSA, attributed the predisposition towards a strong principles-based approach to the combination of the dominant economic philosophy that markets corrected themselves and the notion that firms were in the best position to manage their own risks. "This economic philosophy was coupled (..) with a political attitude which was regulation should be 'light touch'" (Black 2010, p. 14).[2] The United Kingdom, incidentally, was not alone in embracing this philosophy. In the Netherlands, too, the government made its position clear in its Framework on Supervision:

> It is the government's task to ascertain to what extent (. . .) the responsibility for enforcing certain rules can be left to the institutions themselves. Greater responsibility in society (. . .) is the best way to achieve good supervision.[3,4]

But as Black (2010) rightly observes, the higher the climb, the bigger the fall. And this also appeared to be the fate of principles-based regulation. After the crisis, principles-based regulation was seen as part of the problem: "light touch regulation that placed too much reliance on firms themselves to behave responsibly" (Black 2010, p. 6). As early as March 2009 the Chief Executive Officer of the FSA, Hector Sants, announced a new approach of the FSA: "(..) the limitations of a pure principles-based regime have to be recognised. (..) a principles-based approach does not work with individuals who have no principles." Armed with this new

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[1] Black also points out that the battle between London and New York to be the world's leading location for the financial sector was also instrumental in the rise of principles-based supervision. "PBR was a weapon in the fierce battle for business between London and New York." (Black 2010, p. 12).

[2] Black (2010, p. 14). In his explanation to the Treasury Selection Committee, Lord Turner literally said "I think there was a philosophy of regulation (..) which was based upon too extreme a form of confidence in markets." Source: Treasury Select Committee, Minutes of Evidence 25th February 2009, Lord Turner Response to Q2145.

[3] The Dutch government's opinion on this subject is that: "It is the government's task to ascertain to what extent (. . .) the responsibility for enforcing certain rules can be left to the institutions themselves." Government Framework for Supervision, Parliamentary Papers II, 2005–2006, no. 15, p. 4.

[4] Also interesting in this context is the observation of Hartmann and Keupink (2011, p. 86) that "Current society [evidently] perceives (..) many risks and [evidently] wants to shift, or at least share, the related responsibilities."

wisdom, the FSA would in future pursue a more outcomes-focused approach.[5] A year later, Sants (2010) announced that the new British financial markets supervisor intended to make more use of detailed rules than the FSA: "In contrast to the FSA, it is likely that there will be a shift towards more detailed prescription."

All this suggests that principles-based supervision was quickly carried to its grave after the crisis. The reality is less clear-cut, however. Financial supervisory legislation, as it stands today, remains a mix of detailed rules and open standards. Therefore, it is still highly relevant to explore whether the criticism of the principles-based approach was justified and to establish whether principles-based regulation contributes towards the desired market conduct and 'good supervision' of the financial sector.

To answer these questions, we will first look at what principles-based supervision entails and its underlying philosophy. Supervisory practice shows that the principles-based approach gives rise to paradoxes in several areas. These are discussed in Sect. 11.3. Next, Sect. 11.4 looks at whether and how principles-based supervision helps to influence market conduct effectively and whether the principles-based approach contributes to good supervision. And if so, what it demands from the supervisor, the supervised institutions and the judiciary.

11.2 Different Forms of Principles-Based Supervision

There is no uniform definition of principles-based regulation or supervision. Principles-based supervision is generally associated with 'open standards'. A standard is open if its content is not defined in detail in a formal law. A good example is the provision prescribing that the day-to-day policy of a financial institution must be determined by people who are 'suitable'.[6] But the law does not specifically say when a person is suitable.[7] The legislator regularly uses open standards to set out a legal framework which leaves scope for more detailed interpretation at a lower regulatory level. In this case the open standard serves as a peg on which to hang further rules. One clear example of such a peg in Dutch legislation can be found in Article 3:17 of the Financial Supervision Act (Wft). This article stipulates that a financial institution must organise itself so as to guarantee controlled and sound operations.

Wellink et al. (2008, p. 231) identify the following characteristic of principles-based supervision:

> (..) not only the standard as laid down in the formal law is open, but compliance with that standard is also left to a high degree to the party at which the standard is directed. (..) To do

[5] FSA admits weakness of 'principles-based' regulation, IFAonline.co.uk.

[6] Article 3:8 Financial Supervision Act.

[7] The Dutch supervisors DNB and AFM have defined the term "suited" in more detail in the Policy Rule on Suitability 2012. See http://www.toezicht.dnb.nl/en/2/51-201878.jsp.

> genuine justice to the spirit of principles-based legislation, the supervisor must not 'nail down' the principles (..) with detailed and comprehensive policy rules.

Black (2008), however, applies a broader definition of principles-based supervision. She argues that principles-based supervision can also occur in situations where more detailed rules are laid down. According to her, the determining factor is not the actual content of the rules, but how they are applied. She distinguishes four types of principles-based regulation:

1. Formal
2. Substantive
3. Full
4. Polycentric

As in the definition of Wellink et al. (2008), formal principles-based supervision is characterised by the fact that principles are contained in the rules. The regulatory framework indicates which general principles must be observed and why, without prescribing in detail how the principle must be achieved.[8] One well-known example of principles-based regulation is the 'Principles' as applied by the FSA. The general characteristics of these principles are that they have a fairly high level of abstraction, use qualitative instead of quantitative terms, express the objective behind the rules, and call attention to the desired conduct (for instance, the 'reasonable care' with which a firm must organise and control its affairs responsibly and effectively).[9]

Black (2008), however, asserts that the degree to which principles-based supervision occurs does not depend on the degree of regulatory detail. According to her, the presence of detailed rules does not preclude principles-based supervision. Vice versa, the inclusion of principles in laws and regulations does not automatically lead to principles-based supervision. For her, the overriding factor is how the supervisor deals with the rules. In situations where the supervisor leaves scope for interpretation, she refers to 'substantive' principles-based supervision. The main characteristic of substantive principles-based supervision is that the supervisor and supervised institution share responsibility for the interpretation of the rules. One important element here, according to Black, is the "regulatory conversation", the dialogue between the supervisor and supervised institution and a focus on the company's internal control mechanisms.[10] Where both the rules and the supervisor's approach are characterised by a focus on the 'principles', Black speaks of 'full principles-based supervision'. Finally, Black points out that the relationship between the supervisor and the supervised institution is not the only relevant factor

[8] In this connection Black (2008, p. 438) says: "(..) a regulatory regime is principles-based at the level of form if it contains norms which use simple general terms and which express the reason for the rule and if the norms are seen as expressing the fundamental obligations that all subject to them should observe."

[9] See Black et al. (2007).

[10] In the literature this is also referred to as 'meta-regulation' or 'management based regulation'. Parker and Lehman Nielsen (2011) use principles-based regulation and meta-regulation as synonyms.

in answering the question of whether supervision is principles-based. Other parties, such as trade associations, also often play a role in explaining the rules. Black calls this polycentric principles-based supervision.[11]

Principles-based supervision thus occurs in many shapes and guises, and the lines of demarcation between these different forms are often less sharp than suggested above. In many cases, the supervisor's legislation or approach consists of a combination of 'principles' and 'rules'.

11.3 Arguments for Principles-Based Regulation

The reasons put forward by the FSA for its principles-based approach to the financial sector were that 'principles':

- Are effective (in a rapidly changing financial sector, you can never capture everything in rules),
- Durable (principles make it possible to respond quickly to changes so that legislation needs to be changed less often),
- Contribute to the accessibility of regulations (companies need not find their way through a mass of detailed rules), and
- Encourage compliance in the spirit instead of exclusively the letter of the law.

Similar considerations can be found in the Dutch legislator's explanation of the Financial Supervision Act. In general, one of the most important convictions underlying the rise of principles-based regulation is the notion that complex reality simply cannot be captured in rules. Principles-based legislation makes it possible to respond better and faster to new developments. Supervision based on detailed rules would unleash a regulatory race, with legislators scrambling to devise new rules to close one regulatory gap after the other. In all likelihood, such a regulatory proliferation would create more opportunities for evading the rules and would regularly leave the supervisor gnashing its teeth in frustration as companies comply with the letter of the law, while flouting its spirit. Moreover, the deluge of detailed rules would spawn cultures within financial institutions where 'if it is not forbidden, it is allowed'.[12]

[11] Black (2010, pp. 9–10) mentions the Financial Sector Assessment Program (FSAP) which assesses whether regulators meet the demands of 'standard setting bodies' as an example of polycentric principles-based regulation. "(..) it is through the network of principles (..) that regulators seek to regulate other regulators."

[12] Black (2010, p. 34) also observes that "PBR can facilitate a more ethical approach but it could result in an erosion of ethics." This could be the case because compliance officers and lawyers tend to exercise greater freedom in assessing risks. "When lawyers become risk managers they approach the task of managing compliance risks with non-compliance as a viable option." The question is no longer "is this the right thing to do but are we likely to be able to get away with it."

This line of reasoning led to the assumption that principles-based regulations would be ideal for a complex and rapidly changing environment, such as the financial sector. Proponents of principles-based regulations also argued that the use of principles would be salutary in requiring more responsibility from the supervised institution and greater professionalism from the supervisor.[13] Institutions, they said, would need to ascertain the best way of meeting each standard and would therefore focus on the intended outcome.[14] Moreover, legislation that merely sets out principles instead of prescribing rules enables institutions to comply with the principles in the manner that suits them best. This leads to greater efficiency and lower costs. If an institution is not sure which level of compliance is required to fulfil a 'principle', it may be inclined to err on the side of caution. Uncertainty, so it was believed, would instil a healthy fear of exploring the limits of the law (Wellink et al. 2008). The resulting over-compliance would lead to higher rather than lower administrative costs for the supervised institution. The reverse, of course, could also occur. If the minimum compliance criteria are not exactly clear, there may be a tendency to seek the bottom limit. The built-in uncertainty regarding the standard's exact scope would create a tension in regulatory practice. This tension is discussed in the next section.

11.3.1 Challenges Associated with Principles-Based Regulation

Due to uncertainty about the interpretation of an 'open standard', supervisors are confronted in practice with numerous questions from financial companies seeking guidance on the interpretation of that standard. In this connection, Wellink et al. (2008) point to the supervisor's dilemma, namely to provide sufficient clarity whilst resisting the temptation to prescribe detailed rules after all. This tension not only arises from the market participants' need for guidance, but also from the fact that a more detailed standard gives the supervisor a more powerful instrument to influence market conduct.

Supervisors in the financial sector offer substantive solicited and unsolicited guidance on the interpretation of the 'principles' as laid down in legislation. According to critics, this leads to precisely the proliferation of detailed rules that principles-based regulation was designed to avoid. Moreover, many of the interpretations draw on diverse sources, such as guidelines, speeches and interviews, so that their status is unclear. Black (2008) points out that the interpretation of rules can vary within the 'interpretive communities' – i.e. not only within,

[13] Explanatory Memorandum Wft.

[14] Mertens (2012, p. 22) notes that in an 'enforcement approach' "the supervisor is always left with the 'feeling' that things are under control today, but will that still be the case tomorrow? Is the organisation aiming to achieve the objective or merely to apply the rules?"

but also outside, the organisation of the supervisors (e.g. at companies, consultants or lawyers).[15]

Hartmann and Keupink (2011) note that the vagueness surrounding open standards and the lack of clarity about their interpretation greatly stretches the liability of the supervised institution or citizen, both under criminal and administrative law. Regarding statutory duties of care, for instance, it is not possible to know in advance when the supervised institution has fulfilled its duty of care.[16] The rise of vague standards makes institutions and their directors more susceptible to being held accountable for an infringement of the statutory rules. The question arises whether, and to what extent, this increased liability is compatible with the principle of the rule of law, particularly in cases where the supervisor or public prosecution impose penal sanctions. More specifically, Hartmann and Keupink (2011) point to the legality principle, and its inherent *lex certa* principle, on the grounds of which the standard must be knowable. The advent of increasingly 'vague' norms increases the chance of the institution unknowingly breaking the law. This issue has become all the more pressing in recent years, now that Dutch legislation not only makes it possible to penalise the institution but also the persons in charge of the institution that perpetrated the infringement.

In practice the Netherlands' highest court of law, the Supreme Court, accepts that a certain level of vagueness in legislation may be inevitable in order to avoid overly refined and unclear legislation.[17] The European Court concurs with this view.[18] In the Dutch situation, the interpretation of the vague duty-of-care standard will be strongly determined via judicial jurisprudence. The court will assess whether the supervised institution, given the facts and circumstances and the statutory framework, has done everything that could be reasonably expected of it.[19] This indicates, incidentally, that the judiciary has an important role to play in interpreting open standards. In cases where the legislator had no intention of giving the supervisor discretionary powers of judgment by deliberately leaving the standard open, the court can and must put its interpretation in the place of the supervisor.[20] The assurance provided by the judicial assessment does not prevent

[15] Black calls this the 'interpretive paradox' as the existence of all these different interpretations can compromise the principles-based character. See also Roth (2008), who says that supervisors often have internal differences of opinion about the interpretation of the standard, not to mention the legal validity of the interpretations.

[16] Hartmann and Keupink (2011) distinguish a duty of care in a 'narrow' and a 'broad' sense. They define a duty of care as a statutory obligation to perform or refrain from certain actions, thus 'taking care' to ensure that something does or does not take place.

[17] HR 31 October 2000, NJ 2011/14 (Krulsla).

[18] EHRM 22 November 1995, case 20190/92 (C.R of United Kingdom) legal ground 33–34, EHRM 15 November 1996, case 17862/91 (Cantoni v Frankrijk) legal ground 31–32 and EHRM 12 February 2008, case 21906/04 (Kafkaris v Cyprus) legal ground 139–141.

[19] Hartmann and Keupink (2011). See also Rb Rotterdam 9 June 2011, LJN BQ8039 (Inhout).

[20] See also Grundmann-van de Krol (2010). Simons (2008) notes that the prevention of arbitrariness and legal inequality and the assurance of legal certainty is also largely entrusted to the courts.

Hartmann and Keupink from concluding that "(..) the risks of any lack of clarity are entirely passed on to the citizen (..), which jeopardises the legal certainty that legislation should provide in a country governed by the rule of law."[21]

One further important objection to open standards, according to critics, is that when formulating their interpretation of such standards, the supervisors fail to observe the democratic safeguards that normally surround the legislative process. In failing to observe these safeguards, the supervisor might be acting in violation of the *trias politica* principle. Moreover, this would also make independent supervisors too sensitive to political influence – because their interpretation of the standard will almost inevitably be strongly determined by prevailing social and political opinions. This effect could be further reinforced by the tendency to focus, more than before, on countering damaging conduct ('conduct that causes damage to society') and not exclusively on illegal conduct ('conduct that is in conflict with laws and regulations').[22] For instance, the Dutch market conduct supervisor, the Netherlands Authority for the Financial Markets (AFM), recently announced that in its opinion complex index trackers should not be sold to private investors, even though no statutory standard opposes this.[23]

This emphasis on countering 'damaging conduct' could tempt supervisors to constantly change their interpretation of 'principles', depending on what society happens to perceive as damaging at that particular time. This, according to the opponents, would give rise to great uncertainty among supervised institutions – so much so, in fact, that the supervised institutions would not dare to deviate in any way from the supervisor's 'guidance', even if that guidance were non-binding. Or, as the chairman of the Netherlands Bankers' Association put it: "The [supervisor] may well add 'do it your own way if you like', but what the sector hears is 'do it your own way if you dare'. So nobody does it their own way."[24] Moreover, institutions consider it pointless to deviate from the supervisor's guidelines as the latter will immediately ask for a regulatory amendment as soon as its non-binding guidelines are not followed. AFM board member Kockelkoren (2011) parries the alleged lack of democratic content by pointing out that

> If a supervisor's interpretation of an open standard is perceived to stray too far from its intentions, the legislator can add more detail to the standard (..). The fact that the legislator can do this means that every professional supervisor will listen carefully to the legislator's body language.

[21] Hartmann and Keupink (2011). In this context see also Stijnen (2011, p. 593) who points out that "The stronger the negative impact of the decision on the legal position of the interested party, the more stringent the investigation must be (..), the greater the burden of proof on the management."

[22] Het Financieele Dagblad, 18 August 2012, p. 16. The distinction between 'damaging' and 'illegal' conduct is based on the ideas of Sparrow (2000) and is now widely applied in the day-to-day practice of financial supervision in the Netherlands.

[23] www.afm.nl.

[24] Het Financieele Dagblad, 18 August 2012, p. 17.

I wonder whether this mechanism actually works. In practice, the legislator usually converts the supervisor's interpretation into law, thus ratifying the interpretation of the 'open standard' at the highest legislative level. Where fundamental statutory standards are involved, this strikes me as the right approach, as it helps to ensure that the financial institution knows where it stands with regard to the law. However, any such ratification by law must be carefully measured in order to preserve the character of the open standard and to avoid encroaching upon the advantages of the open standard for the supervisor and the supervised institution.

The aforementioned advantages and disadvantages show that the supervisor is confronted in practice with several areas of tension that are inevitably linked with principles-based supervision. The most salient of these is the tension between the open standard and the supervised companies' need for legal certainty.[25] The supervisor must strike the right balance between interpreting the standard (with the advantages of influencing market conduct and offering legal certainty) and leaving the standard genuinely open (with all the advantages of principles-based regulations).

However perhaps the most important dilemma after the crisis might be what Black (2008, p. 456) calls the 'trust paradox': "[Principles-based regulation] can give rise to relationships of trust, mutuality and responsibility but these are the very relationships which have to exist for it to be effective." Black (2010, p. 22) correctly observes that this element of trust, which is so crucial for principles-based supervision, has virtually disappeared after the crisis. "(..) a central element of [principles-based regulation] is trust, and that trust has gone. Its disappearance has cast substantive [principles-based regulation] a potentially fatal blow."

The next section looks at the role that principles-based regulation can play under these circumstances in the supervisor's aspiration to achieve both desirable conduct of financial companies and 'good supervision'.

11.4 Does a Principles-Based Approach Contribute Towards Desirable Market Conduct and Good Supervision of the Financial Sector?

As noted in the introduction to this chapter, the contribution of principles-based regulations to 'desirable' market conduct and good supervision after the crisis has come under scrutiny. The question is whether there is sufficient reason to abandon the principles-based approach in financial supervision altogether. This section seeks to answer that question on the basis of a number of general insights into regulatory compliance and the five elements of good supervision from Viñals and Fiechter (2010).

[25] Black (2008) describes seven paradoxes: the interpretive paradox, the communication paradox, compliance paradox, the supervisory and enforcement paradox, the internal management paradox, the ethical paradox and the trust paradox.

11.4.1 How Does Principles-Based Regulation Help to Ensure Corporate Compliance with Standards?

Research into regulatory compliance shows that no clear answer can be given to the question of what kind of rules best serve 'compliance'. People's motives for adhering to rules range from fears of discovery and punishment to fears of harming their reputation and a sense of duty. People and firms have economic motives ('what are the costs/benefits'), social motives ('what do the people around me do and think') and 'normative' motives ('the law is just' or 'laws are made in a just manner') for observing the rules. Another important driver of regulatory compliance is the perceived justice of the process. Research by Tyler shows that "procedural justice is generally the superior explanation for how to motivate compliance especially in business settings" (Parker and Lehmann Nielsen 2011). People are much more prepared to comply with standards when they believe that these rules are made and supervised according to just procedures.

The degree of regulatory compliance depends both on incentives to comply and the compliance culture within the company. Black et al. (2007) conclude that the question of whether principles-based regulation contributes to compliance depends mainly on the circumstances of the individual case. Principles-based regulation, they assert, is mainly suitable for situations that permit 'creative compliance' and where the costs of non-compliance are high. They correctly point to the dangers of 'one size fits all' thinking. Detailed rules, in their view, work in situations where there is no room for 'creative compliance' or where the supervised institutions lack knowledge of the exact rules. In addition, detailed rules are said to be more suitable for prompting 'recalcitrant' companies to adapt their behaviour. And also for situations where large numbers of supervisors are confronted with large numbers of infringements, as detailed rules can then guarantee a uniform approach.

It is difficult to draw conclusions from these general insights regarding the extent to which principles contribute towards regulatory compliance. At first sight, principles-based regulation appears to meet, for instance, the economic motive for regulatory compliance. Principles, after all, enable the supervised institution to fulfil the rules in its own way and thus avoid unnecessary costs. One counter-argument, however, is that independent interpretation of the rules and the need to get professional advice on the correct interpretation can confront mainly small companies with substantial costs. It therefore seems justified to conclude that the economic motive to comply with principles-based regulations mainly appeals to large companies. Small firms may stand to benefit more from clear instructions on how a standard should be complied with.

Regarding the normative motive and the perceived procedural justice, principles-based regulation also appears to work in two directions. On the one

hand, principles-based regulation will contribute to the perceived justice as companies can partly decide for themselves how they comply with the standard. There is a good chance that they can find a way to comply that suits their own situation. On the other hand, with ‘open standards’ there is the risk that the perceived justice will decrease if the supervisor’s interpretation (which cannot be known in advance) regularly differs from the supervised institution’s own interpretation. As shown in the preceding section, when interpreting the principles, the supervisor can be accused of putting on the legislator’s hat and failing to uphold democratic principles. This, too, will diminish the perceived justice of the principles (and their interpretation).

Several authors point out that the proper operation of principles-based regulation places demands on the participants in the supervisory process, i.e. both the supervisor and the supervised institution. For instance, a strong involvement and correct attitude of the senior management regarding regulatory compliance is vital (Parker and Lehmann Nielsen 2011). Scheltema and Scheltema (2009, p. 6) actually go a step further by stating that principles-based regulation can only work if the incentives that the organisation receives from its environment are adjusted. They note that

> (..) [regulatory compliance, FV] is largely determined by the manner in which private law works. It is private law that determines the company’s structure and, hence, also the interests that must prevail in the company’s actions, including any benefits to be achieved. The same applies to financial companies. In addition, other parts of private law also contain rules that create incentives that are at odds with the public interest.

In this light, these authors argue that thinking about supervision should also take on board the manner in which private law gives shape to the structure of the financial sector.

The general literature about regulatory compliance thus seems to provide little tangible guidance for answering whether principles-based or rules-based regulation is the best way to achieve compliance in the financial sector.

The Basel Committee’s revised Basel Core Principles on banking supervision also contain no explicit statements on the most desirable system for financial supervisory legislation. According to the Committee, the Basel principles are “neutral with regard to different approaches to supervision, so long as the overriding goals are achieved.”[26] Principle 9 prescribes that “The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach.” And it follows from Principle 8 that “An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups (..).” Principle 11 stipulates that the supervisor must have the disposal of “an adequate range of supervisory tools to bring about timely corrective actions” which enables the

[26] http://www.bis.org/publ/bcbs213.pdf.

supervisor to intervene at an early stage in the event of "unsafe and unsound practices or activities that could pose risks to banks or to the banking system".[27] As to whether the supervisor should be given rules or principles to achieve this aim, the Basel Committee does not say. The principles do seem to suggest that financial supervisory legislation must offer the supervisor extensive powers and must allow a flexible response to emerging risks.

The next section assesses the advantages and disadvantages of principles-based regulation on the basis of certain elements of good supervision.

11.4.2 Assessment Based on Elements of Good Supervision

Viñals and Fiechter (2010) published an analysis of the question as to what elements the supervisors lacked in the financial crisis. They point out that the reaction to the crisis had hitherto mainly focused on "more and better regulations". But they rightly add that: " (..) expanding the rule book alone will not be sufficient in itself to solve the problem." (p. 5). Viñals and Fiechter come to the conclusion that to achieve good supervision it is essential that the supervisor not only has the 'ability' to act (in the form of appropriate resources, authority, organisation and constructive working relationships with other agencies), but also 'the will' to act. They conclude that there are risks in a supervisory approach which emphasises compliance with rules.

> There are risks in taking a mainly compliance-based approach, particularly where associated with relatively detailed rules-based regimes. It can lead to excessive focus on more easily observed noncompliance (..) and to insufficient understanding of key business drivers and flaws in risk management practices. (p. 7)

In addition, these authors pose that such a compliance-based approach is mainly 'backward looking' and thus harbours the danger of missing future risks. Although they do not go on to discuss which type of regulation could make the biggest contribution to good supervision, their analysis does identify a number of elements that can help to answer this question.

Supervisors stayed on the sidelines and did not intrude sufficiently. They relied too much on internal (risk management) systems of supervised institutions, without ascertaining whether the 'governance' structures of the companies were sufficiently robust to justify this trust. In addition, supervisors were insufficiently proactive in dealing with emerging risks and adapting to the changing environment. They confined their interest to the risks that occurred within the supervised institutions and failed to look further for 'systemic risks' (see also the contribution of Houben in Chap. 13). On the grounds of this diagnosis, Viñals and Fiechter (2010) identify five

[27] The Basel principles as such have a principles-based character incidentally. Principle 16, for instance, 'only' prescribes that "The supervisor sets prudent and appropriate capital adequacy requirements for banks".

elements for good supervision as discussed in the contribution of Kellerman and Mosch in Chap. 1.

Viñals and Fiechter (2010, p. 14) add to this that "Supervisors (..) also must have the ability, in law and in practice, to act. They must have authority to be intrusive; and authority to challenge management's judgment in a proactive way." Regarding their "legal authority", this means that "agencies need strong regulatory capacity to make rules and issue guidance; as well as an established legal framework that allows for a range of swift regulatory responses to both ongoing and emergent situations." As for the "will to act", it is also important for supervisors to have "a clear and unambiguous mandate". "Objectives should be realistic – supervisors cannot be expected to detect, prevent or take enforcement action against every instance of noncompliance." (Viñals and Fiechter 2010, p. 16).

So where does this bring us with regard to the question of whether financial supervision and the financial sector are better off with principles-based or rules-based regulation? An open standard system appears to at least meet the recommendation to create a 'legal framework that allows for a range of swift regulatory responses'. Open standards permit a more flexible response to new developments. The recurring theme in the analysis of Viñals and Fiechter (2010) is that supervision must be more forward-looking and must attach consequences to the identified risks. Regarding the "proactive", "comprehensive" and "adaptive" elements, the conclusion I draw is that these are best-served with a principles-based regulatory framework. One of the important advantages of principles-based regulation is that it permits a better response to new developments. A rules-based regulatory framework will in all likelihood obstruct the supervisor's ability to adopt a "proactive", "comprehensive" and "adaptive" attitude. Despite seeing new emerging risks, the supervisor will often be forced to conclude that these cannot be effectively countered with the existing rules. No such restriction of action will apply in the case of 'principles' which, for instance, prescribe a 'controlled or adequate conduct of business'. Such an open standard gives the supervisor more latitude for bringing any future undesirable developments and emerging risks within the scope of the standard. Obviously, the supervisor does not have endless liberty to do this. The supervisor will have to defend any changes by providing convincing arguments that without these changes the objective of the standard is in jeopardy. Moreover, in this connection, the supervisor must not just focus on the company's procedures but also on its outcomes.

Viñals and Fiechter (2010, p. 9) correctly note that "We have learned (..) that implementation of regulation (..) matters as much as regulation itself (..)". The question of whether 'principles-based supervision' contributes to good supervision will depend mainly on the way in which the supervisor deals with these principles. Principles-based regulation does not automatically lead to the supervisor remaining less on the sidelines. In fact, due to the lack of clarity about the exact content of the standard, principles-based regulation can even make the supervisor adopt a more hands-off approach towards enforcement. Sometimes the supervisor may hesitate to enforce an open standard because the company had no way of knowing its exact interpretation of that standard. But in my view, in exercising this caution, the

supervisor is ignoring the fact that the supervised institution also carries a responsibility for complying with the standard and for doing this in the spirit of the law. For good supervision, you need a supervisor who is not reluctant, but willing, to act. It follows that also with open standards, the supervisor must be prepared to act with resolve and determination, even at the risk of being corrected by the courts.

Such an open standard system implies a high degree of freedom for both the supervisor and the supervised institution. This system can only work properly if both parties *and* the judiciary meet certain conditions. These conditions are set out in the following section.

11.4.3 What Is Necessary for Effective Principles-Based Supervision?

What Is Necessary on the Part of the Supervisor? The advantages of principles-based regulation would be lost if the supervisor continually attached all sorts of detailed rules to the standard. In my view, therefore, supervisors must exercise their freedom to interpret open standards with restraint. Excessive interpretation would hamper the supervisor's own flexibility and ability to respond to a changing environment. Restraint in interpreting the standards is particularly appropriate in situations where the legislator has deliberately left the standard open and has not explicitly stated in the law that further rules can be set. In some situations, however, it may still be desirable for the supervisor to interpret the rules in more detail. This applies, for instance, when the standard raises lots of questions from the sector and/or the supervisor is confronted with a large number of infringements that are probably attributable to a wrong understanding or interpretation of the norm in the sector. In such cases, the supervisor should clear up any confusion about its own interpretation of the standard.

One important question is how the supervisor avoids being excessively influenced by political and social pressure when interpreting the rules. In this connection it would be good if the supervisor had clear criteria for determining in what cases an open standard requires further interpretation. The Netherlands Authority for the Financial Markets opts to provide guidance on the interpretation of an open standard when:

(a) It has the impression that many companies are unsure how to interpret the standard
(b) Little direction and guidance is given by publications of market organisations
(c) There is little or no jurisprudence
(d) The cumulative struggle of the companies leads to substantial problems in the market (Kockelkoren 2011)

These criteria are useful in themselves, but they mainly focus on problems that market parties experience when interpreting the standard. I can imagine that the

supervisor will also want to take the risk of social damage into consideration when deciding whether to interpret a standard in more detail. The greater the social damage, the greater the justification for a more detailed interpretation of the standard. Obviously, if an open standard is interpreted in more detail that interpretation must be accessible and known in order to prevent the supervised institution losing its way in a labyrinth of rules. Even where the supervisor initially opts *not* to interpret the rules, it is important to ensure that any subsequent interpretation of the rules in individual cases is consistent and predictable. In addition, if the supervisor opts not to interpret the open standard in advance, it is important to ensure that the supervised institution has sufficient room for arriving at its own interpretation. The supervisor must focus on the question of whether the supervised institution's interpretation serves to achieve the intended objective of the standard. The test for compliance should therefore be whether the supervised institution does what can be reasonably expected from it, and not whether it does this in the manner that the supervisor would prefer to see.

Working with open standards places high demands on the knowledge of supervisors and their understanding of the working of financial companies. The supervisor must be able to assess whether the company's interpretation of the standard leads to the desired outcome. If this knowledge is absent, there is the risk that the supervisor may not dare to judge on how the company has chosen to carry out the rules or confines itself to giving an opinion on procedures. A good example of this is the enforcement of Article 4:23 of the Dutch Financial Supervision Act. This article is about the provision of advice by financial companies to customers. The AFM's decisions to impose penalties on the grounds of this Article are often based on the institution's failure to obtain the necessary information about the customer's financial position, objectives, risk appetite and knowledge (and hence its failure to follow the correct procedures), but it does not establish whether or not the actual advice was suitable for the customer (and, hence, whether the underlying standard to give good advice was satisfied).

The literature correctly asserts that a principles-based supervisory regime can only work if institutions believe that the supervisor will genuinely intervene if the principles are not adhered to. But this raises the question as to how open standards should be enforced. Too little enforcement and too much enforcement both impair the effectiveness of principles-based supervision. A supervisor who is too restrained basically invites the supervised institution not to take the supervision too seriously. On the other hand, an opportunistic enforcement policy raises the danger of creating uncertainty among the supervised institutions and prompting calls for more 'guidance' on the interpretation of the standards.

Black (2010) points out that even an active enforcement policy vis-à-vis open standards can damage a principles-based supervisory regime. She calls this the 'supervisory and enforcement paradox': "(..) principles need enforcement to give them credibility but over-enforcement can lead to their demise." The latter can occur, according to Black, when active enforcement discourages companies from deviating from the supervisor's own interpretation of the standard, leading to increased calls for detailed prescriptive rules. In line with her theory about

'substantive' principles-based regulation, Black (2010, p. 7) says that "The point (..) is not what rule type is most effective for which type of regulated firm, though that is relevant, but the enforcement approach used."

Experience shows that 'principles-based' regulation may not only have a paralysing effect on financial companies, but also on supervisors. Particularly in cases involving the possible use of sanctions, the supervisor will have to convincingly demonstrate that a principle has not been satisfied. If the standard is genuinely 'open' and has not yet been interpreted in the form of guidelines or jurisprudence, the supervisor runs the risk that his interpretation will not stand up in court. In one case, for instance, where DNB had imposed an instruction on a pension fund, the court concluded that the supervisor had insufficiently demonstrated that the pension fund's investment policy was in conflict with the 'prudent person' principle. After winning the case, the pension fund announced it would claim the damages suffered (reportedly EUR 10 million) from the supervisor.[28] Due to uncertainty regarding the interpretation of the standard, the supervisor may decide to exercise restraint or to focus on the procedural aspects of the standard, rather than on the intended outcome. This applies in particular – but by no means exclusively – to situations where the supervisor can be held liable for any damage arising from its decision.

One important question, finally, is whether a limit should be placed on the openness of the standard. In this connection, reference can be made to Hartmann and Keupink (2011) who observed that too broad a definition of standards greatly stretches the liability of the supervised institution – so much so, in fact, that the legality principle is undermined. As a rule, the more general the standard the greater the uncertainty at the supervised institution. One interesting development in this connection is the recently announced bill of the Dutch Minister of Finance to amend the "duty of care" for financial institutions into an obligation to "act in the customer's interests". With such an extremely open standard, it would seem wise for the supervisor to indicate how it expects the company to act regarding specific aspects of this obligation. In the example of a very broadly defined duty of care, the supervisor could, for instance, name certain specific areas that it intends to focus on, such as the sale of products that suit the customer or a commission structure that serves the customer's interests.

And What Does Principles-Based Supervision Require from the Supervised? As many authors have correctly observed, the senior management's attitude in the company is an essential element of effective principles-based supervision. Senior management must adopt an active attitude and act in the spirit of the law in its efforts to adhere to the open standards. Particularly where the supervisor provides no 'guidance', the financial company has a responsibility to act independently in accordance with the spirit of the law. The company may not hide behind the absence of an explanation from the supervisor. Another important factor is the quality of the internal compliance function. According to Scheltema and Scheltema

[28] www.rechtspraak.nl: LJN BV9210, Rechtbank Rotterdam, AWB 11/2632 BC-T2.

(2009), it is necessary to find out whether private law contains any incentives that may have a negative impact on regulatory compliance needs to be explored further.

Firms have a responsibility to know the interpretation of the rules. As noted before, this task may be made more difficult if the interpretation of the rules is based on different sources (speeches, individual decisions, judicial decisions). To assist companies with the correct interpretation of the principles, the supervisor could periodically publish an anonymised update of its opinions on individual cases and indicate the recurring theme that emerges from these opinions. This, obviously, will only be effective if the supervised institutions keep track of these updates in the areas that are relevant for them. This may be a problem for smaller companies, but trade associations could provide assistance in this connection.

And, Finally, What Does Principles-Based Supervision Demand from the Judiciary? Principles-based supervision not only places demands on the supervisor and the supervised institution, but also on the judiciary. It is important that the supervised institutions can put differences of opinion with the supervisor about the interpretation of the standard to a court of law.[29] The risk with an 'open standard' is that a supervised institution is charged with infringing the standard, even though it had no way of knowing in advance how the supervisor would interpret the standard. In general, the court will be inclined to test a supervisor's interpretation of a 'principle' against existing and knowable policy. But in the case of an 'open standard', such a policy will not always be available. This is an inevitable consequence of principles-based regulation. In the absence of policy, the court should, in my opinion, not conclude that the interpretation should be left entirely to the supervised institution and that the supervisor has no right to voice an opinion unless it has already published its view on the policy. Such a stance would compel the supervisor to give an advance interpretation for all 'open standards'. Both the supervisor and the court should assess whether the supervised institution has done everything that could be expected of it to fulfil the standard. Obviously, to assess whether an open standard has been sufficiently complied with, the court needs to have sufficient knowledge of the operation of financial markets and must keep the higher objective of the rules firmly in sight. It also goes without saying that both the supervisor and the courts must make sure that all supervised institutions are treated equally.

Mutual Trust Is Key. One question that is hard to answer is how to deal with Black's 'trust paradox'. This paradox entails that whereas principles-based regulation can only work in a situation of mutual trust between supervisor and the supervised institution, it is precisely this trust that has been severely damaged by the financial crisis. However, the financial sector and the supervisor should, to my

[29] In this connection it should also be noted that, at least in the Dutch context, by no means all of the supervisor's interpretations of a standard qualify as a 'decision' of the supervisor that can be put to the court. So the company will not always be able to take a difference of opinion with the supervisor to the court.

mind, also remember that it is precisely principles-based supervision that can help to restore that trust.[30]

11.5 Conclusion

This chapter provided an overview of the rise and near-fall of principles-based regulation. Clearly, principles-based regulation has not led to the 'regulatory Utopia' that proponents envisaged in the 1990s. Like the traditional 'rules based' approach, a system of open standards also has many drawbacks and is susceptible to abuse. FSA CEO Sants recently said that principles are not suitable for people 'who have no principles'. I fear, however, that the latter category of individuals will be equally disinclined to adhere to detailed rules. One possible answer to the question of whether principles-based regulation has a future is: it all depends. It depends on the institution that is being supervised and the interest that is being protected with the rule in question. In general, however, we can conclude that principles-based regulation has a future in the financial sector. It is hardly conceivable that such a complex and rapidly developing environment as the financial sector could exclusively be 'governed' by detailed rules.[31] This would inevitably unleash a race to find the gaps in the law and would also entail the added risk of the supervisor and the supervised institution losing sight of the envisaged 'outcome'. A principles-based approach is more suited to the need to make the supervision more forward-looking and better able to respond flexibly to emerging risks. On the other hand, an entirely principles-based approach is also not conceivable. Under certain conditions, the supervisor or legislator must interpret the standard in order to prevent social damage or remove uncertainty in the sector. It is therefore perhaps not entirely surprising that the future of financial supervisory legislation lies in a combination of rules and principles where the legislator and the supervisor must make sure that the balance is not gradually tipped towards detailed rules. It would seem logical to work on the basis of a pyramid where the apex consists of a set of general standards which, depending on the situation and the sector, are worked out by the supervisor in more detailed rules or 'guidance'. The use of 'principles' does place demands on the supervisor, the supervised institutions and the judiciary. The supervisor must combine knowledge of the company and the financial sector with a "will to act". The supervised institution, for its part, must show a "will to comply". Only then can a system of principles-based regulation genuinely contribute towards

[30] See also May and Winter (2011).

[31] See also OECD Recommendation of the council on regulatory policy and governance: "Principles-based legislation is likely to be the most appropriate way of meeting policy objectives in complex or rapidly changing policy environments." http://www.oecd.org/regreform/regulatorypolicy/49990817.pdf.

good supervision over the financial sector and help to restore trust between the supervisor and the supervised institution.

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Chapter 12
Experiences with the Dutch Twin Peaks Model: Lessons for Europe

Marco van Hengel, Paul Hilbers, and Dirk Schoenmaker

12.1 Introduction

For many years, a proper debate on the future of financial supervision in Europe did not take place, because Member States preferred to maintain national authority over their financial sector. However, the financial crisis has made it clear that an integrated European financial sector requires an appropriate model for European supervision in order to ensure financial stability. Recent changes in Europe have raised interesting questions about the implementation of supervision, including the institutional architecture and available tools.

Based on the report of the De Larosière Group (2009), three new European Supervisory Authorities were created for banking supervision (EBA), insurance and occupational pensions supervision (EIOPA) and supervision of financial markets (ESMA). These new authorities have powers for setting binding technical standards to harmonize regulation in the EU and to create a single rulebook. In addition, the European Systemic Risk Board (ESRB) was created and will be responsible for macroprudential oversight of the financial system in the EU.

This European System of Financial Supervisors (ESFS) came into force as recently as 2011 and is still in the process of coming to full development. However, the deepening of the European crisis has urged policy makers to already consider the next step. At the European summit of 29 June 2012, it was concluded that ”The European Commission will present proposals for a single supervisory mechanism”, involving the ECB for banks in the euro area.

While this provides a clear ambition of European leaders, there are also several uncertainties about the structure and governance of this European supervisory system that still need to be fleshed out. This chapter provides a contribution to

The views expressed in this paper are those of the authors and do not necessarily represent those of their organizations.

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the debate, based on experiences in the Netherlands during the crisis. Section 12.2 describes the main characteristics of the Twin Peaks model. Section 12.3 gives an overview of the international trends in supervisory architecture, while Sect. 12.4 describes tools and principles for the strengthening of European supervision. Section 12.5 concludes.

12.2 The Objectives and Structure of the Twin Peaks Model

The Netherlands has introduced a Twin Peaks model in 2002. Under this model, financial supervision is integrated in two ways. Prudential supervision of the different financial sectors is combined under the responsibility of a single supervisor. In addition, supervision is placed under the roof of the central bank (DNB). A separate supervisor, the Netherlands Authority for the Financial Markets (AFM) is responsible for conduct of business supervision for all financial institutions.

The most important argument for the financial reform was that dynamic and innovative developments in the financial system caused the boundaries of traditional sectors to disappear. This led to the conviction that supervision should not be sector-specific, but should be built upon the different objectives of financial supervision (Kremers et al. 2003). This so-called functional approach of supervision should ensure that no financial activity falls outside the scope of supervision.

To determine the appropriate organisational structure, four objectives can be distinguished (see Fig. 12.1). The objectives are different and each policy area requires its own instruments and responsibilities. The solid lines indicate the primary impact. At the same time, the objectives are also interrelated. Actions in one policy area can support or undermine other objectives (as indicated by the dotted lines). This implies that there is synergy in combining objectives within a single institution, but there are also trade-offs from conflicts of interests. The choice in the Netherlands for a Twin Peaks model was based upon the following three considerations.

First, there is a strong link between financial stability and sound financial institutions. Instability within institutions is often caused by adverse developments in the macro-economic environment. Supervision of financial institutions thus benefits from a clear macro-economic analysis of developments in the financial markets. Conversely, an important lesson from the recent crisis is that sound financial institutions are a necessary but not sufficient condition for a sound financial system. This implies that macroprudential supervision needs to be recognized as a separate field of expertise (see also the contribution of Houben in Chap. 13). Macroprudential measures will have an impact on individual financial institutions and need to be taken carefully into account.

Second, the integration of prudential supervision within the central bank is driven by the potential of synergy arising from knowledge of monetary policy and financial market developments within supervisory practice. These synergies stem from the combination with central bank tasks, analysis and expertise in the area of financial stability as well as the central bank's role as liquidity provider of

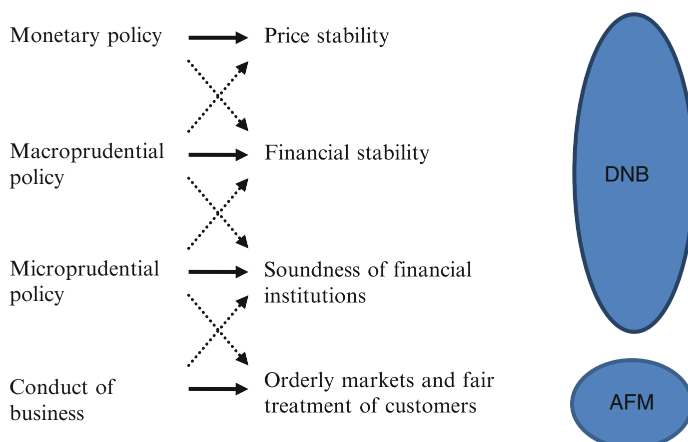

Fig. 12.1 Objectives of financial supervision (Source: Based on Kremers and Schoenmaker (2010))

last resort. In the same vein, this set up facilitates assessments and adequate decision making in times of crises. Risk management at the central bank would also benefit from better access to counterparty information derived from supervision. The integration has the additional advantage that supervision benefits from the reputation and independent position of the central bank. Moreover, empirical research indicates that an institutional setting with central bank involvement is more likely to produce a macro-approach (Goodhart et al. 2002).

Finally, the objective of conduct of business supervision is considered to be inherently different from prudential supervision and requires a separate supervisor with its own mandate and focus. This follows from the fact that prudential supervision and conduct of business supervision are separate responsibilities. In an integrated setting of prudential supervision within the central bank, there is the risk that the conduct of business objective may receive inadequate attention. Also, cultural differences may arise. Conduct of business supervision is publicly and politically more visible. This can conflict with the confidentiality that is needed in prudential supervision.

The Twin Peaks model thus tries to combine the different objectives of financial supervision in an effective manner. However, it is also recognized that there is not a single best institutional model of supervision (IMF 2004). The strength of the Twin Peaks model is determined by the potential synergies it may be able to achieve in practice, while preventing downside risks as a result of conflicts of interest. The crisis has provided relevant insights in this respect.

The first 10 years in the Netherlands under the Twin Peaks model have been a turbulent period. The reorientation of supervision was underpinned by a challenging reform of legislation to transform existing sectoral rules into a single and cross-sectoral law (Act on Financial Supervision), including changes in underlying regulations. In addition, there has been a merger between DNB and the insurance

and pension supervisor and the Netherlands Authority for the Financial Markets (AFM) was created as conduct of business supervisor. Shortly after this transition process was concluded, the financial crisis emerged in its full intensity.

It is clear that the Twin Peaks model has not been able to shelter our financial system from the consequences of the financial crisis. However, this should primarily be regarded the result of the large and international character of the Dutch financial sector, rather than the result of the model of supervision. On the contrary, despite the turbulence that has been experienced, there is still strong support for the Twin Peaks model with the different stakeholders (Ministry of Finance, the supervisors themselves as well as supervised financial institutions). This is endorsed by analyses of the National Audit Office (Algemene Rekenkamer 2009). Also the IMF concludes that the case for the Twin Peaks model remains strong (IMF 2011a, b). The opportunity should be used to further refine the model, based on the experiences during the crisis.

12.3 International Trends in the Architecture of Financial Supervision

The financial crisis and the lessons learnt have stimulated an international wave of institutional reform in the supervisory model.

Since 1998, almost 80 % of the OECD countries have made changes to the organisational structure of supervision (Masciandaro and Quintyn 2009). This reform is characterised by two trends: consolidation of sectoral supervision and a larger involvement of central banks (ECB 2010) (Table 12.1).

An important trend is the move of financial supervision towards the central bank. This can be attributed to the macro-economic weaknesses and financial market turbulence in the recent crisis. These are issues where central banks typically have comparative advantage and are therefore in a natural position to strengthen supervision. Moreover, macroprudential supervision is more explicitly recognized as a separate individual task that is best performed by the central bank (De Haan et al. 2012). In the period 2006–2010 there were 10 EU countries where the central bank has been given new supervisory powers or responsibilities. As a result there are currently 18 EU countries in which the central bank fulfils a supervisory role, whereas the remaining countries have (institutionalized) forms of coordination.

Another trend is consolidation in supervision towards a unified supervisor. The growing importance of insurers, pension funds and securities markets and non-bank financial intermediaries made it clear that supervision of financial stability should not be limited to the banking sector. Also, the emergence of large complex institutions and the development of financial innovation created more room for regulatory arbitrage, underlining the need for a cross-sectoral approach. The creation of the UK FSA in 1998 induced a trend to unify supervisory agencies that was soon followed in the rest of EU.

Table 12.1 Trends in supervisory structures in the EU

	Sectoral model	Twin peaks[a]	Single Supervisor[b]	NCB has supervisory tasks or responsibilities
Belgium	--------	---> X		X[c]
Bulgaria	X			X
Czech Rep.	--------	----------------	----> X	X
Denmark			X	
Germany	--------	----------------	----> X	X[c]
Estonia	--------	----------------	----> X	
Greece	X			X[c]
Spain	X			X
France	--------	---> X		
Ireland	--------	----------------	----> X	X[c]
Italy	X	(X)		X[c]
Cyprus	X			X
Latvia	--------	----------------	----> X	
Lithuania	X			X[c]
Luxembourg	X			X[c]
Hungary	--------	----------------	----> X	
Malta	--------	----------------	----> X	
Netherlands	--------	---> X		X
Austria	--------	----------------	----> X	X[c]
Poland	--------	----------------	----> X	
Portugal	--------	---> X		X[c]
Romania	X			X
Slovenia	X			X
Slovakia	--------	----------------	----> X	X
Finland	--------	----------------	----> X	
Sweden			X	
UK		X <----	--------------------	X[c]
Total	**9**	**5**	**13**	**18**

Source: ECB (2010)

[a]The Twin Peaks column includes countries in which prudential supervision and conduct of business regulation are attributed to two different authorities
[b]The single supervisor column refers to countries that do not have a separate conduct of business regulator
[c]Recently strengthened

The combination of the two trends of consolidation and central bank involvement seems to imply a move towards a Twin Peaks model, although the dimension of a separate conduct of business supervisor is less frequently observed, as some countries have created a single supervisor. In addition, an important observation in

recent changes in governance is that supervision is placed within the proximity of the central bank, but also recognized as a separate responsibility.

12.4 Tools and Principles for the Design of European Supervision

12.4.1 Financial Trilemma

According to the EU declaration of 29 June 2012, the decision of European leaders to move towards a European banking union seems to be primarily driven by the objective that a European banking union, comprising a pan-European supervisory regime and a European deposit insurance and resolution fund could break the vicious cycle between banks and sovereigns. But even without this immediate cause, a European banking union would inevitably be the next step in Europe. This can best be illustrated by the concept of the financial trilemma (Schoenmaker 2011).

The financial trilemma is inspired by the well-known Mundell-Fleming model (Mundell 1963) in international economics, which states that a fixed exchange rate, capital mobility and national monetary policy are three policy objectives that cannot be achieved at the same time (see Fig. 12.2). For example, prior to the introduction of the euro, the Netherlands already did not have its own monetary policy, because it maintained a fixed exchange rate with Germany with free movement of capital. Any interest rate differentials (other than liquidity effects) would have been unsustainable because of arbitrage opportunities. In the same vein, the financial trilemma states that financial stability, financial integration and national financial policy objectives cannot be achieved at the same time. Two policy objectives can be achieved; the third one has to be given up.

The European financial sector is so closely integrated with institutions that operate at a European or global level that developments at the national level create external effects that directly affect the financial stability in other countries. The problems in the Greek banking sector and the recapitalization of the Spanish banks had a direct impact on the financial stability in the rest of Europe. Decision-making is thus required from a European rather than a national perspective. Similarly, in the event of crisis management, the failure of a national authority to take into account contagion or spill over effects of their actions, may lead to a suboptimal result. In the hypothetical case that a financial institution is not systemically important in its home country, national authorities may decide to not (fully) rescue that institution, whereas this might create huge costs in host countries.

Looking at the financial trilemma, it is clear that financial stability is not an objective that can be given up. On the other hand, winding down financial integration and move towards small financial sectors within national borders is neither plausible nor wise, given the existence of the Single Market, the international character of economic activity, economies of scale and existing regulation. As a

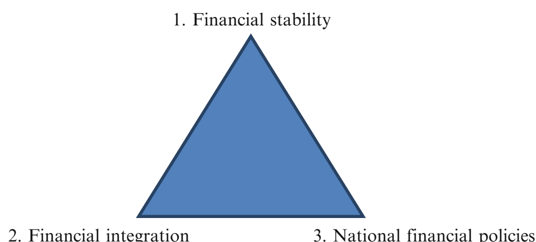

Fig. 12.2 The financial trilemma (Source: Schoenmaker (2011))

result, independent national supervisory policy tends to become unsustainable within Europe in the long run.

The direction towards more European supervision is thus clear, but the future organisational structure is still unclear. Based on the lessons from the Twin Peaks in the Netherlands, some tools and principles can be developed to guide the discussion on the design of a European banking union and the steps that can be taken.

12.4.2 Integration of Supervision and Central Bank

Experience with the Twin Peaks model during the crisis has shown that synergy effects primarily stem from the integration of central bank and supervision. This crisis originated from vulnerabilities in the macro-economic environment. In its supervisory role, DNB could benefit from the comprehensive and macro-economic view from the central bank side of DNB. The Financial Stability Division fulfilled a central, connecting role in this coordination process between the supervisor and central bank. Also, the fact that DNB encompasses all relevant disciplines within a single institution made it possible to act quickly and decisively. When the crisis started to emerge, a coordination group was created within DNB that brought together the experts from different disciplines from the markets, payments, supervision, monetary and legal divisions. This team met regularly and was able to share information freely among the group. This coordination proved to be a great benefit in anticipating developments and responding to the crisis. For example, DNB was able to respond swiftly in the case of necessary interventions, because it was well informed about market developments and had up-to-date knowledge about the liquidity position of the institutions, which provided crucial information at a time when developments changed by the hour.

An important advantage was that the laws allowed for information sharing in the context of crisis management. Already before the crisis, DNB and the AFM had concluded a covenant that specified cooperation and joint responsibilities between both supervisors. The respective roles of DNB and the Ministry of Finance in crisis management were described in a Memorandum of Understanding. On that basis a crisis management group was set up to include also representatives from the Ministry of Finance and the AFM, which met daily. The clear divisions of powers

and responsibilities in the Twin Peaks model were instrumental in achieving effective coordination during the crisis.

In line with the integration of supervision in the central bank, the design and agency structure of European supervision could follow the structure of the Eurosystem, where the national central banks operate under the responsibility of the ECB. In this system, the European supervisor should create a common framework of supervision and have the ultimate authority to take the most important decisions. In daily practice, supervision could still primarily be executed at a national level, where proximity and local expertise are more important. National supervisors work within the single system with the European supervisor at the centre. This system would apply to both large cross-border financial groups, as well as smaller domestic financial institutions, because experience with for instance the Spanish cajas has shown that also smaller, domestic-oriented institutions can threaten financial stability in Europe. This system would supplement and to a large extent replace the existing structures of colleges of supervisors that are now organized by home supervisors.

The second element of integration under the Twin Peaks model, the cross-sectoral integration, seems more difficult and less urgent to achieve. This does not mean that harmonization of sectoral rules is not important. The new strengthened sectoral rules may provide room for regulatory arbitrage. Also, this crisis has shown the potential contagion effects between the banking and insurance sectors. However, there are some practical challenges to achieve a cross-sectoral model in Europe in the short run. For example, practice in the Netherlands has shown limited success of a cross-sectoral approach of the financial sector through financial conglomerates. As a result, financial institutions tend to move away from the model with two equally important separate business lines and rather focus on a single sector. This development coincides with the observation of the IMF that there tends to be a sectoral approach in supervision (IMF 2011a, b). Another complicating factor is that the current European framework is still primarily based on sectoral legislation (CRD IV and Solvency II), which makes it difficult to maintain a cross-sectoral approach in national legislation. A final obstacle would be that the current European Treaty excludes that tasks are transferred to the ECB with regard to insurance undertakings. This would mean that at this moment, the ECB can only operate in a sectoral approach, instead of a Twin Peaks model or single supervisor. Given these observations and the fact that financial vulnerabilities mostly prevail in the banking sector, it appears most practical to start with the strengthening of banking supervision in a European banking union.

12.4.3 Integration of Macroprudential Policy

An important lesson from the recent crisis is that macro-prudential policy needs to be well integrated in supervision, particularly because risks can build up in the

financial sector as a whole, while individual financial institutions still appear to be sound. Although, most risks that prevailed during the crisis were to a certain extent recognized well in advance, it has proven difficult to translate these risk into supervisory actions. DNB has developed several mechanisms to strengthen this link.

Operational guarantees have been strengthened. DNB has created a separate department responsible for macroprudential supervision. This department has developed a structured approach to increase the knowledge, awareness and follow-up of the observed risks (DNB 2010d). There is an active communication policy, including publication of semi-annual Financial Stability Overview reports. Furthermore, risks are translated more systemically into concrete recommendations and actions and more attention is paid to the follow-up of these recommendations, including intensified monitoring of the risks.

In addition, a new supervisory approach called Focus! (DNB 2012) has been developed. This approach contains a separate macro-module that will be the starting point for microprudential supervision. To support supervisors in their work towards individual institutions, the Financial Stability Division will develop and maintain a so-called macro-register which contains a summary of the most important macro-prudential risks, including indicators and thresholds values that signal vulnerability. Supervisors must evaluate and score these indicators as part of their risk analysis process.

Finally, and in line with international developments – the separate role of macroprudential policy will be more clearly recognized (DNB 2010a), with a clear mandate and separate instruments and responsibilities for DNB as macroprudential authority. A Financial Stability Committee has been developed with DNB, the AFM and the Ministry of Finance, to regularly analyze macroprudential developments and discuss potential actions. The involvement of the AFM is important, because orderly markets and transactions between professional parties have also proven to be an important aspect of macroprudential supervision. Recently, European initiatives have been taken to better regulate this part of these markets, but further steps can be taken.

With regard to the organizational structure, there are strong arguments to place macroprudential policy close to the central bank, because the nature of macroprudential analysis is closely linked to the systemic, macro-economic role of the central bank. For this reason, the ECB also fulfills the secretariat role for the ESRB. This observation completes the circle. Micro-prudential supervision benefits from integration with the central bank and needs to be integrated with macro-prudential policy, which itself is also best placed with the central bank. This leads to the conclusion, that the ECB could fulfill a central role in European supervision. However, there are also some pitfalls – as also indicated by the report of de Larosière – that need to be taken into account. The ECB can only fulfill its role effectively, if there are adequate safeguards with regard to the reputation of the ECB, political independence and accountability.

12.4.4 Preserving a Sound and Strong Reputation

The ECB is a highly respected institution with experienced staff and solid analyses. This seems to provide an extra argument to give the ECB an important role in financial supervision, because experience has shown that supervision benefits from authority and a good professional reputation of the supervisor (IMF 2005).

However, this also works in the opposite direction. The recent crisis has shown that failures of financial institutions create high media attention and can lead to criticism on supervisory actions. This can negatively affect the independent position of the central bank. Notwithstanding, the current strengthening of prudential regulation, there will always remain financial institutions that will experience financial problems. Under a comprehensive approach of supervision, if effective recovery cannot be achieved, there should ultimately be a resolution mechanism under which these institutions should be allowed to fail. If such problems would arise in the context of European supervision, reputational effects could affect the position of the ECB, damaging the institution as a whole, both in its role as supervisor as well as monetary authority.

It would therefore be useful to create some organizational compartmentalization within the ECB to distinguish monetary policy from prudential supervision. This could be created by means of a formal structure, like in the UK where the newly created Prudential Regulatory Authority will be a subsidiary of the Bank of England, or in France where the Autorité de Contrôle Prudentiel (ACP) is an autonomous agency with close institutional linkages to the Banque de France. In the Netherlands, the division has been established within the current setting of a single entity (Box 12.1).

The advantage of the recent changes is that it makes the different roles of DNB more visible. Potential reputational damage to the central bank should be contained, while still benefitting from the synergy effects between supervision and the central bank. This structure is in line with recent developments in supervisory structures at a national level as described in Sect. 12.3 to create two separate strong pillars for central bank and prudential supervision that act in close cooperation. Monetary policy would then continue to be determined by the Governing Council, while supervision would be delegated to a separate body within the ECB.

Box 12.1 Recent Changes in the Governance Structure in DNB

Within DNB, there have been recent changes in governance, either legally induced or as a result of an internal reorganisation.

The role of prudential supervision is more clearly recognized. Within the Board of DNB, a single Executive Director has been appointed Chairman for Prudential Supervision, who is primary responsible for prudential supervision. In the internal organisation, this is further specified by the creation of a separate consultative body – the Prudential Supervision Council for Financial

Institutions. This Council, which is chaired by the Chairman for Prudential Supervision, prepares decision-making in the field of prudential supervision. In addition, there has been an internal reorganisation where a new separate department has been created and made responsible for timely intervention measures towards institutions. Furthermore, a Committee of Financial Stability has been created to conduct macroprudential supervision. This committee will monitor macro-economic developments and give recommendations for mitigating measures in the case of risks for financial stability.

The three different roles of DNB are thus now more clearly recognized with separate bodies for microprudential and macroprudential supervision under the roof of DNB, which is also the monetary authority. The aim is to address the lessons from the crisis and to make supervision more intrusive and comprehensive with an increased focus on macroprudential risks.

12.4.5 Independence and Accountability

For its monetary policy, the ECB is a supranational organization that needs to be sheltered from political interference and maintain its independence. This is particularly true at the European level, as the conflict of interest between monetary policy and financial supervision is stronger at the ECB than at the national level, because national central banks within the EMU do not have a separate responsibility as central bank anymore, whereas the ECB does. This adds to the argument that monetary policy at the ECB should be separated from its supervisory tasks. In recent years, the ECB has been confronted with circumstances where its monetary policy decisions were linked to complex decisions with regard to financial stability. For example, its securities market program (SMP) and long-term refinancing operations (LTRO) were unconventional measures that were necessary at that time because of the pressure of exceptional circumstances. In a structural situation, monetary policy of the ECB would only be responsible for its price stability objective, so that the monetary independence of the ECB is preserved at all times.

In the case of supervision, the argument of political independence does not hold to the same extent. A supervisor should only be independent in its individual supervisory actions (operational independence), but the legislative framework is ultimately determined by a political responsible body, such as the European Council. There needs to be a system of checks and balances, because a European supervisor may need to take decisions about interventions and rescuing or winding down a financial institution, especially when public resources are required. There should thus be a clear formulation of the mandate, tasks and responsibilities of the European supervisor with procedures to hold the supervisor democratically accountable for its supervisory actions.

Experience in the Netherlands has shown that the approach can work with an independent monetary authority and a separate supervisor. The monetary side of

DNB is part of the European System of Central Banks (ESCB) and falls under the articles of the Treaty. For its supervisory activities, DNB is a non-governmental agency with delegated authority with a separate budget process, accountability framework and annual report. In addition, the Minister of Finance is politically responsible to Parliament for the supervisory activities of DNB. The recent change in governance, with a more clear separation between central bank and supervision and the introduction of a Chairman for Prudential Supervision has facilitated this distinction to create a balance between independence and accountability for the different roles of DNB.

12.4.6 Effective Crisis Management and Resolution

In previous sections, we have argued that if the ECB would become the European supervisor, three different dimensions would need to be distinguished within the ECB with regard to (i) micro-prudential supervision, (ii) macro-prudential policy and (iii) central bank tasks.

In addition, there needs to be an effective European resolution regime to complement the single European supervisory mechanism. Transferring supervisory powers to the European level could create new incentive distortions if deposit insurance and resolution would remain at the national level (Schoenmaker and Gros 2012). It would create conflicts of interest between the European supervisor that would take the decisions and the national authorities that would finance the rescue operations. Also, it would not break the vicious cycle between sovereigns and banks. To prevent strategic behavior and moral hazard, a European resolution regime should have adequate funding through a pre-financed deposit guarantee scheme to finance possible rescue operations. Decisions on interventions should be taken from the perspective of the European financial sector as a whole and costs should be distributed according to a burden sharing mechanism on a well-defined ex-ante basis.

With regard to the organizational structure, it is important to separate the responsibility for this resolution regime from the microprudential and monetary tasks of the ECB, because of potential conflicts of interest.

First of all, there can be tensions between supervision and resolution that may hinder timely intervention. Supervision is pursued with the objective to preserve sound individual institutions and support financial stability. At the same time, effective resolution requires that supervision needs be intrusive with the will to act when necessary (Viñals and Fiechter 2010). These interventions can – at least in the short term – have negative consequences for financial stability. This trade-off is referred to as the moral hazard effect (Masciandaro and Quintyn 2009) and can lead to a certain inaction bias to intervene. Second, the ECB is an independent, supranational organization that needs to be sheltered from political interference. This could become difficult if decisions need to be made about rescuing or winding down a financial institution, especially when public resources are required. The ECB would not be in a good position to take these decisions, because national taxpayers' money

would be involved and the ECB could end up in a complex situation where it has to negotiate with national authorities.

These arguments indicate that a European regime for resolution should be recognized as a separate responsibility. This can be organized within the existing organizational structure of the supervisor or through the creation of a separate authority. DNB has chosen for the first option and introduced organizational changes to better ensure timely intervention (DNB 2010c). DNB has created a separate department, outside the division directly responsible for operating regular supervision. This department coordinates intervention measures. It operates as an outside expert and develops an intervention strategy together with the responsible supervisor. It formalizes the intervention policy of DNB and prevents that necessary decisions about intervention are unduly postponed. This intervention department is an example of a functional separation within a single organization. A more institutionalized approach would be to create a separate resolution authority, such as the FDIC in the US, with a pre-described policy for prompt corrective action. This would provide more institutional safeguards, but also require further actions to ensure that the synergy between central bank and supervision is maintained.

12.4.7 A European Conduct of Business Supervisor

The Netherlands has benefitted from the creation of a separate conduct of business supervisor. The working relation between DNB and the AFM needed to develop at first, because the AFM was a new organization that decisively took its position in the financial sector with its own and independent approach that differed from that of DNB. Nonetheless, cooperation between DNB and the AFM was effective when needed with frequent meetings, a clear division of responsibilities and effective information sharing. Rescue actions were jointly coordinated, with DNB as the lead institution in the case of interventions. In the case of the ban of naked short selling (a measure that is supervised and enforced by the AFM but had prudential objectives) both supervisors acted jointly and in good cooperation. Furthermore, the experiences of the crisis have sparked several initiatives that will contribute to a further strengthening of the working relation and the Twin Peaks model, including better coordination, information sharing and joint inspections.

In this vein, European supervision may benefit from the creation of a separate conduct of business supervisor (Gerritse 2012). Several markets have already developed themselves into a true European network, such as central counterparty clearing houses (CCPs), credit rating agencies (CRAs), infrastructure, stock exchanges and trading platforms. Objectives of proper behavior of financial institutions, protection of customers' interests and orderly functioning markets require a strong European supervisory authority with sufficient countervailing power and a separate mandate for conduct of business supervision. A strengthening of conduct of business supervision is also particularly important, because this crisis has taught us that supervision should not only look at the traditional quantitative

indicators of capital and liquidity to assess the position of a financial institution, but also at more qualitative, prospective indicators such as a sound business model, proper governance structure and culture and conduct within the institution (Hilbers 2011 and DNB 2010b). The ESMA could ultimately take up the role of European supervisor. To this end, it should develop from a cooperation network between national authorities into a full-fledged European supervisor with its own authority and powers. This would constitute a next step towards a European version of the Twin Peaks model that could meet the challenges of a complex and integrated financial sector in Europe and thereby contribute to financial stability in Europe.

12.5 Conclusion

The decision to create a single supervisory mechanism in Europe constitutes an important and ambitious leap forward to bring supervisory practice in line with economic reality of an integrated European financial market. However, there is not a national blueprint of a supervisory model that is best suited for meeting the challenges of today’s international and complex character of our financial sector. Based on the experience in the Netherlands with the Twin Peaks model and existing trends in Europe, this paper has identified some guiding principles in the current discussion of a single European supervisory mechanism.

The ECB will have an important role in this European system, based on the synergy effects that result from the integration of supervision within the central bank and the translation of macroprudential policy into supervisory policy. At the same time, transferring supervisory tasks to the ECB requires safeguards and institutional compartmentalization within the ECB to protect its independent position and preserve its well-respected reputation. In addition, the new European system of supervision needs to be complemented with a European regime for effective crisis management that needs to be separated from regular microprudential supervision.

These different elements require a fine balance that need careful consideration to take into account all the different dimensions and trade-offs. It will take time to develop a well-thought system, but such a comprehensive design will be just as important for financial stability in Europe as a timely introduction.

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Chapter 13
Aligning Macro- and Microprudential Supervision

Aerdt Houben

13.1 Introduction

The financial crisis that started in 2007 brought numerous financial institutions around the world to the brink of collapse, and often beyond. In the United States alone, some 500 banks have failed and an additional 700 financial institutions have been shored up with more than USD 400 billion state support.[1] While the number of bank failures in Europe is much lower, owing mainly to a more consolidated banking industry, the size of state support has been comparable. In fact, EU Governments have provided almost EUR 350 billion in capital injections to 44 institutions and have guaranteed bank funding worth over EUR 2.500 billion (European Commission 2010). The crisis has also specifically hit the Netherlands, where one bank was nationalised (the Dutch parts of Fortis Bank, including ABN Amro), two small banks failed and substantial amounts of public support had to be provided (EUR 14 billion capital injections, EUR 53 billion funding guarantees and about EUR 25 billion asset protection).

The causes of the crisis have been extensively analysed. Reviews have identified the system-wide origins of the crisis and have sought to draw lessons for policy-making.[2] A main message has been the need to strengthen macroprudential supervision, including through the creation of public authorities with systemic stability as primary goal and the development of macroprudential policy instruments.[3] Others have focussed on strengthening microprudential supervision, emphasizing the importance of a greater willingness to act.[4] However, to date, relatively little attention has been paid to how macroprudential supervision can dovetail with

[1] Federal Deposit Insurance Corporation (2012), United States Department of Treasury (2011).

[2] See, for instance, De Larosière (2009), FSA (2009) and FSF (2008).

[3] Borio (2011), Goodhart (2010), De Bandt and Hartmann (2010), Houben and Kakes (2011), Houben et al. (2011), Schoenmaker and Wierts (2011), De Haan et al. (2012), Bank of England (2009) and DNB (2010b).

[4] See, for instance, Viñals and Fiechter (2010) and DNB (2010a).

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microprudential supervision in order to contribute to their largely overlapping objectives (Crockett 1996, 2000).

This chapter discusses how to align macro- and microprudential supervision. In essence, to be effective, macroprudential analysis needs to feed into supervision at the micro-level. By incorporating macro risks, microprudential supervision contributes to the stability of the system as a whole. Conversely, macroprudential analysis needs to assess information from microprudential supervision in order to capture risks in systemic institutions, common exposures and nascent risks stemming from financial innovations. Thus, the focus of this chapter is not on how to mitigate macro risks with macroprudential instruments, nor on how to mitigate micro risks with micro measures, but rather on how to align macro- and microprudential supervision.

The structure of the chapter is as follows. Section 13.2 depicts the rise in systemic risk in recent years. Section 13.3 spells out the distinction between macroprudential and microprudential supervision, and how they interact. From a macro perspective on the crisis, Sect. 13.4 then draws ten key lessons for microprudential supervision. Section 13.5 concludes.

13.2 The Rise in Systemic Risk

The financial sector changed fundamentally in the run-up to the crisis. On the back of liberalisation and deregulation, the financial system expanded at a significantly higher pace than economic production (Table 13.1). By consequence, total financial assets grew to a multiple of domestic GDP in many advanced economies and the smooth functioning of the real economy became increasingly dependent on the stability of the financial sector.

Moreover, in the decade before the crisis, advances in risk management models led to belief that the system was safer and that institutions could optimize risk, given their willingness and ability to carry such risk. Internal models based on short time series without periods of strain created a false sense of security. Financial sector leverage rose and regulators accommodated complex but looser capital standards. Risk had become a commodity that could be traded on markets and that offered prospects of higher returns. Financial sector growth thus took place with greater interconnectedness, within institutions, between institutions, cross-sector and cross-border. This has resulted in higher correlations within the financial

Table 13.1 Growth of financial sector 1995–2011
Consolidated assets of commercial banks over GDP

	US (%)	Germany (%)	UK (%)	Spain (%)	Netherlands (%)	Switzerland (%)
1995	56	214	241	196	184	354
2000	61	297	289	203	390	503
2007	77	313	451	304	591	664
2011	82	311	480	365	469	494

Source: ECB, IMF

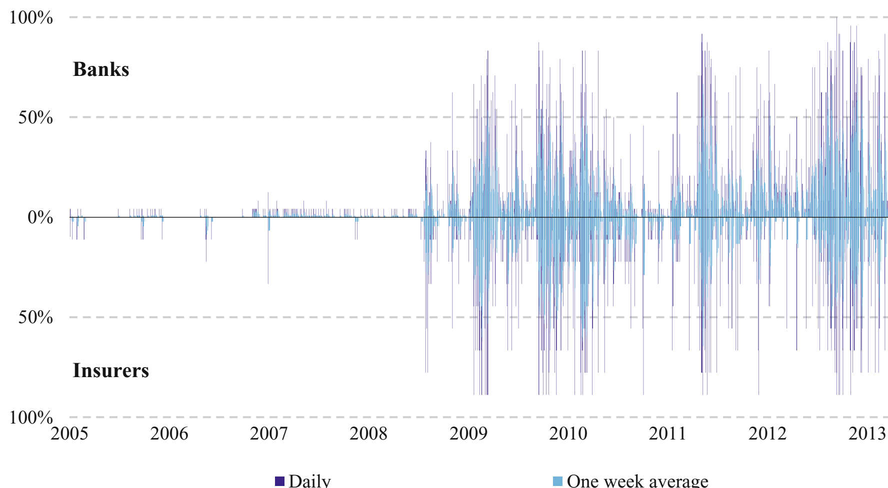

Fig. 13.1 Rising systemic risk for European banks and insurers
Percentage of banks and insurers with simultaneous extreme rise (>5 bp) in CDS premium. Average based on 5-years CDS premiums of European sample of 24 banks and 9 insurers (Source: Thomson Datastream and own calculations)

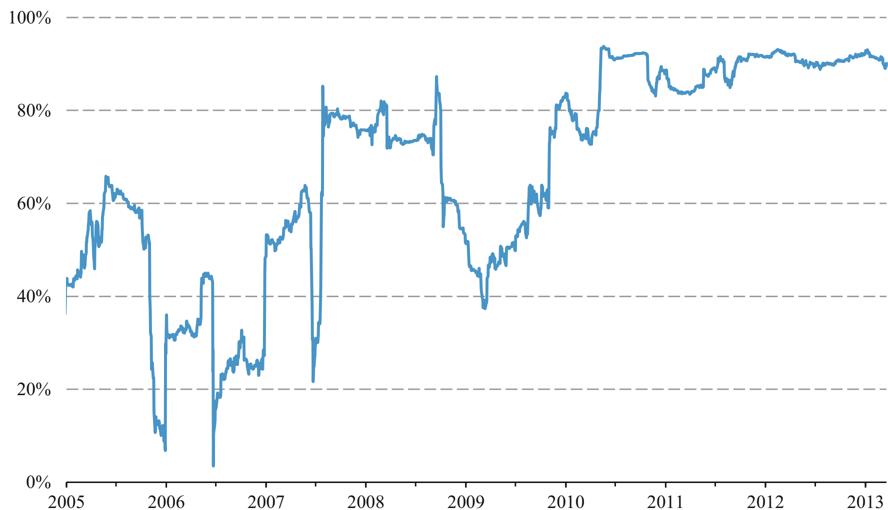

Fig. 13.2 Rising correlation of CDS spreads in Europe
Correlation of absolute changes to CDS spreads of banks and insurers over 125 days. Based on correlation between changes to of 5-years CDS premiums for sample of 24 European banks and 9 insurers. (Source: Thomson Datastream, DNB)

sector. Figure 13.1 illustrates that, in the run-up to the crisis, extreme movements in the perceived risks of banks and insurers (proxied by CDS spreads) were both limited and largely idiosyncratic. From 2008 on, risk perceptions of these two financial sectors became increasingly correlated, as depicted in Fig. 13.2. Besides

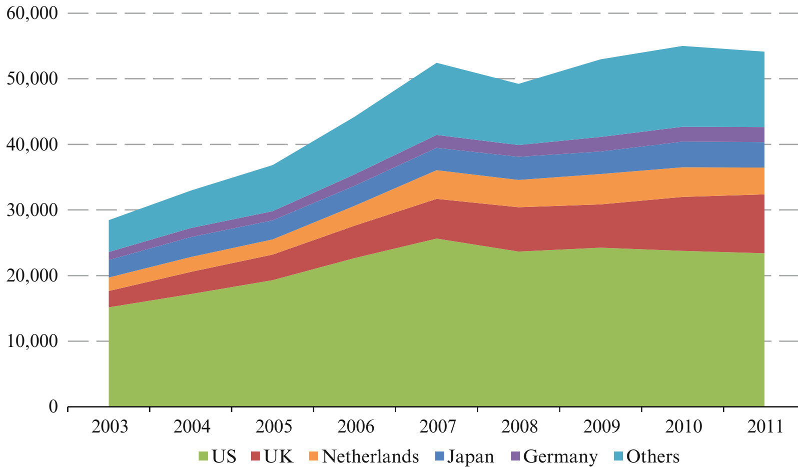

Fig. 13.3 Growth of financial institutions outside banking system
In USD billion. Definition: comprises non-bank financial entities other than insurers and pension funds. This concept is broader than shadow banking (Source: DNB, FSB)

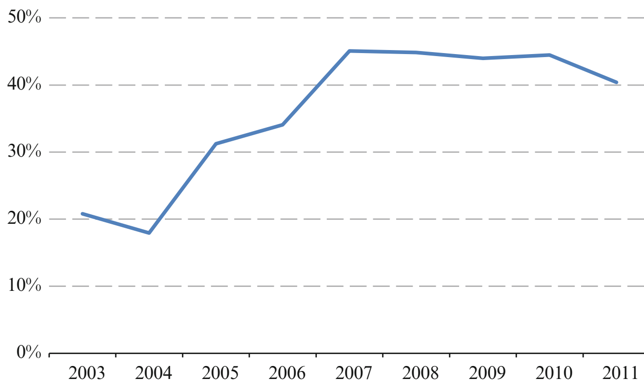

Fig. 13.4 Rise of shadow banking in the Netherlands
Total assets of shadow banks over total assets of MFIs. Definition: estimate of shadow banking comprises special financial institutions (related to banks and other financial firms), structured finance vehicles, finance companies, hedge funds and money market funds (Source: DNB)

these developments, innovation spurred financial activity outside the regulatory perimeter, where prudential safeguards are lower and safety nets are absent (while Fig. 13.3 portrays such activity according to a wide definition, Fig. 13.4 focuses on narrowly defined near-banks). Moreover, the rise of mark-to-market valuation, homogenous risk management models, rating-based triggers and variable remuneration fuelled the cyclicality of the financial sector. Together, these changes dramatically increased systemic risk.

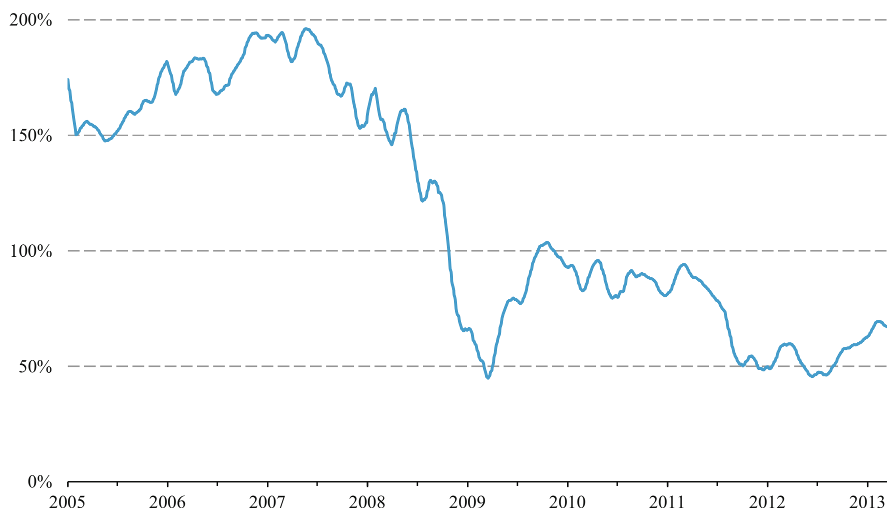

Fig. 13.5 Market-to-book value of big European banks
Based on: Banco Santander, Barclays, BNP Paribas, Commerzbank, Credit Agricole, Credit Suisse, Deutsche Bank, ING, Lloyds, Nordea, RBS, Societe Generale, UBS, Unicredit (Source: Thomson Datastream, Bankscope)

The depth and length of the unrelenting financial crisis are testimony to this rise in systemic risk. Five years on, financial systems are still in disrepair and the solidity of financial institutions remains in question, as illustrated by the sustained gap between their book and market values (Fig. 13.5). This markdown reflects doubts about the quality of outstanding assets and future profitability, as well as concern about the risk outlook. In this context, a negative feedback loop has emerged between the financial sector and the real economy, and growth prospects remain anaemic. These circumstances have underscored the need to lower systemic risk. Notwithstanding the essentially macrofinancial drivers of the crisis, this depends considerably on microprudential measures.

13.3 The Distinction Between Macroprudential and Microprudential Supervision

Macroprudential and microprudential supervision are largely complementary: a stable financial system needs solid financial institutions and vice versa. But at the same time they are distinct. Fundamentally, macroprudential supervision has a system-wide perspective, while microprudential supervision focuses on individual institutions. Thus, while macroprudential supervision aims to limit the costs to

society from system-wide distress, microprudential supervision aims to protect depositors by limiting risks to individual institutions. By implication, a key difference is that macroprudential supervisors take account of the collective behaviour of institutions and of second-round effects, while microprudential supervisors take these risks as given since they are independent of the behaviour of an individual institution.[5]

Although macroprudential and microprudential supervision are generally mutually supportive, their different perspectives may on occasion prescribe opposite measures. For example, in times of system-wide liquidity strains, a macroprudential authority may stimulate institutions to lend out available funds, while a microprudential supervisor may request institutions to limit their risks by hoarding liquidity. Similarly, in a cyclical downturn the macroprudential supervisor may advocate a release of capital to foster recovery, while the microprudential supervisor will tend to prescribe higher capital to offset increasing risks. Resolving these differences requires separate instruments to address dynamic developments. This explains the introduction of a countercyclical buffer in the capital requirements framework, the need for a buffer function in the liquidity requirements and, more broadly, the efforts to expand the macroprudential toolkit.

An important practical distinction is that macroprudential policy tools are still rudimentary, while microprudential instruments are well developed. Indeed, notwithstanding the growing consensus on the need for active macroprudential policies, practical experience with their application in developed countries is limited.[6] Besides calibration and governance issues, the interaction with other macroeconomic policy instruments raises complex challenges. This underscores the importance of reducing systemic risk by feeding macroprudential risks into microprudential risk mitigation.

Figure 13.6 displays the interlinkages between macro- and microprudential supervision. Besides the different macro (system-wide) and micro (individual institution) perspectives, a distinction can be made between risk identification and risk mitigation. The top left-hand panel thus covers macroprudential analysis, which has grown in importance, as illustrated by the increasing number of financial stability reports. The top horizontal arrow reflects the conversion of this analysis into macroprudential policy. This relates to instruments aimed at mitigating system-wide imbalances, rather than addressing the specifics of an individual institution at a given point in time. Examples include generic loan-to-value ceilings, limits on leverage, countercyclical capital buffers and standard margin requirements on collateral. The bottom left panel concerns microprudential risk identification, which is the bedrock of traditional supervisory activities. This comprises the customary risk factors (such as credit, market, operational, interest rate, country, strategic and liquidity risks) and disregards second order effects. These risks are

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[5] Borio (2011) and DNB (2010b).

[6] Lim et al. (2011) describe practical experiences with macroprudential policies, most of which in emerging markets.

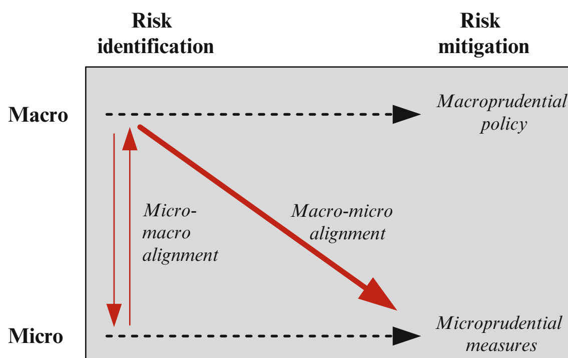

Fig. 13.6 Alignment of micro and macroprudential supervision

translated into microprudential supervisory measures, including minimum capital, liquidity and governance requirements as well as other risk-mitigating instruments.

The alignment of macro- and microprudential supervision occurs between these two levels, with two-way traffic. This creates synergy. On the one hand, microprudential information enriches macroprudential analysis, for instance, to identify common exposures, concentration risk and network resilience. On the other hand, macroprudential input is essential for an adequate assessment of risks to individual financial entities. Indeed, this is arguably where supervision can be most readily strengthened and where most lessons can be drawn from the financial crisis.

13.4 Macroprudential Lessons for Microprudential Supervision

This section offers ten practical macroprudential lessons for microprudential supervision. These cover analytical, regulatory, institutional and operational issues, and together translate the broad concept of financial stability into practical steps to align macro- and microprudential supervision. In essence, these lessons aim to reduce systemic risk by strengthening microprudential standards and practices.

Lesson 1: Acknowledge Fundamental Uncertainty and Insist on Larger Buffers. One lesson from the crisis stands out: our limited ability to predict the future. In mid-2008, following a year of financial strain in which Bear Stearns was rescued and Northern Rock was not, it was impossible to anticipate with a reasonable degree of certainty how developments determining the fate of individual institutions would unfold. The uncertainties were wide-ranging: would Lehman Brothers and AIG receive official support, would the US Troubled Assets Relief Program (TARP) get political backing and how would these decisions interact with market sentiments? No reliable forecast could be made. Those that did predict the impact of Lehman's failure were generally way off the mark. Indeed, the authorities' refusal to rescue Lehman was initially well received in the financial press, as this was seen as a

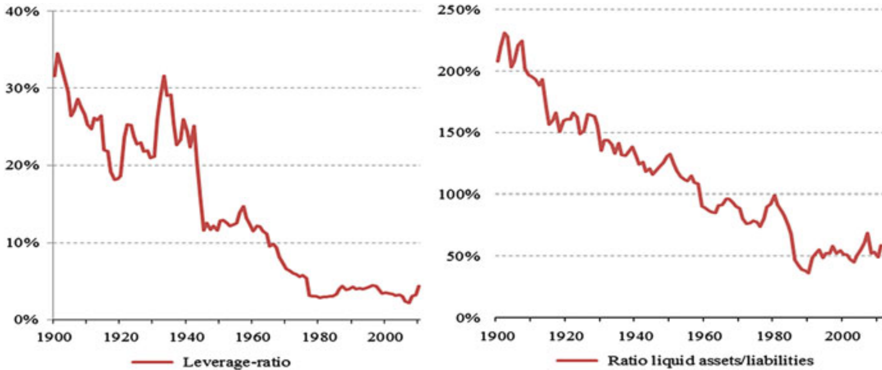

Fig. 13.7 Leverage and liquidity of Dutch banks in historic perspective
Explanation: Leverage ratio is equity (including capital reserves) over total assets. Liquidity ratio is liquid assets (short terms loans plus equity holdings) over liquid liabilities (including short term deposits, liquid savings and securities) (Source: DNB)

non-systemic investment bank.[7] In the event, Lehman's demise triggered a course of events that was not foreseen, including a standstill of the interbank market, many large financial institutions with acute funding difficulties, a plunge in consumer confidence throughout the developed world and the uncovering of the Madoff investment scandal. The outcome of the European debt crisis is another case in point. When Greece ran into financing problems in May 2010, the size of the impending commercial debt write down and the widespread contagion to other peripheral countries were remote perils. While a course of events can be readily explained after the fact, it is only one of countless possibilities at the outset.

The practical implication of this lesson is as simple as it is important. If future developments are subject to 'unknown unknowns' – fundamental (Knightian) uncertainties that cannot be quantified – the system needs adequate buffers to buttress its resilience under adverse circumstances (Blommestein et al. 2010). Of course, the key question is how large capital reserves need to be to absorb unpredictable but unavoidable losses. It is ironic that advanced risk models were used as a justification for lower reserves at a time when the increasing complexity, interlinkages and cyclicality in the system should have argued for larger reserves. In this context, Fig. 13.7 presents the development of the leverage and liquidity ratio of Dutch banks since 1900. Whereas these banks started the twentieth century with an average unweighted capital ratio well over 30 %, this ratio had dropped to under 3 % when the crisis erupted. The development of liquidity holdings has also shown a steep decline. While the ratio between liquid assets and liquid liabilities was above 200 % at the beginning of last century, it had dropped to around 50 % in recent years.

[7] See Annex 1 for real time statements by leading economists on the systemic relevance of Lehman.

In short, supervisors need to acknowledge fundamental uncertainty as well as the limited coverage of quantified risk estimates, and to insist on larger buffers in terms of both capital and liquidity. These buffers serve a microprudential purpose in sustaining an institution's life under adverse circumstances and a macroprudential purpose in limiting the contagion of any individual failure on the system as a whole. Only when buffers are higher than strictly needed from a micro perspective, can they be reduced when lower buffers are called for from a macro perspective.

Lesson 2: Adopt the Precautionary Principle and Err on the Side of Caution. Are prudential supervisors prudent enough? Prior to the crisis, financial stability reports by multilateral institutions and central banks had noted many of the risks that subsequently emerged, including increasing risk tolerance, search for yield, leverage, complexity and interlinkages, as well as specific shortcomings in risk modelling (see Annex 2). While these risks were thus on radar screens, they were evidently not translated into risk mitigating supervisory actions. In part, this reflected data gaps and shortcomings in converting abstract macro risks into practical micro actions. But uncertainties surrounding the risk assessments and lack of decisive proof that action needed to be taken, also played a role. In effect, there was limited willingness to accept the certain short-term costs of restrictive measures for the uncertain long-term benefits of lower prudential risks.

Mitigating uncertain but potentially calamitous risks is difficult when these risks are vague or remote. This is a challenge also faced in other policy fields. Examples are environmental policies (such as those related to global warming) and health and safety regulation (flu pandemics). To protect these policy fields against society's myopia regarding uncertain threats, the so-called 'precautionary principle' has been developed as a basis for action. According to this principle, policymakers are expected to take action to mitigate a particular risk, even when decisive scientific proof on the importance of that risk is not (yet) available. The burden of proof is thus reversed: the supervisor only refrains from action if hard evidence exists that the risk is not significant.[8]

The precautionary principle is controversial, especially when interpreted strictly. Adherence to this principle may prompt excessive risk aversion and discourage innovation. It may also be ambiguous in its application, as the principle can have opposing prescriptions depending on the timeframe. For instance, limits on competition will tend to reduce risks in the short term, but raise risks in the long term owing to market indiscipline and moral hazard. Nonetheless, a moderate interpretation, in which the precautionary principle is weighed alongside other

[8] The 1992 Rio Conference formulated this as follows: "In order to protect the environment, the precautionary approach shall be widely applied by States according to their capabilities. Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effectiveness measures to prevent environmental degradation".

principles such as proportionality and cost effectiveness, would seem to belong in the prudential domain, particularly on issues with systemic dimensions.[9]

How would the precautionary principle apply to supervisory decisions in practice? In cases where activities or exposures involve systemic risks, but proof thereof is lacking, the supervisor would explicitly err on the side of caution. An obvious example is the size and composition of capital and liquidity buffers, which are set above the level quantitative risk assessments based on historical data suggest. Other examples are direct restrictions on financial institutions' size and activities (such as the Volcker Rule), prohibitions of strategic changes creating substantial – but unclear – systemic risk (such as the hostile takeover of ABN Amro) and extensions of authorities' crisis resolution tools at the expense of shareholder rights. When validating internal risk models, the precautionary principle would emphasise the risk of mistakenly approving false models, while accepting that tougher standards increase the risk of erroneously discarding correct models (thus limiting Type II rather than Type I errors). According to this principle, combinations of high credit growth and real estate price increases would trigger higher risk weights unless there is firm evidence that risks are not increasing.

Given the difficulties to assess vulnerabilities in the financial system, the inaction bias when risks are uncertain, the high potential costs of financial failures and society's tendency to underestimate such costs when they have not occurred for a while, prudential decisions should be taken in the context of the precautionary principle. Those that take issue with a prudential measure need to demonstrate that risks in absence of this measure are adequately contained. While this will not rule out failures altogether, it sets a higher security norm when uncertainties are pronounced. When risks have a systemic dimension, better be very safe than very sorry.

Lesson 3: Allocate Supervisory Capacity According to Systemic Risks. The systemic crisis has underscored the importance of focusing supervisory resources on those issues and institutions that pose the greatest risk to the financial system, rather than on the observance of supervisory rules per se. This often implies changing the supervisory approach from compliance-oriented to risk-oriented. In practice, this means prioritizing supervisory attention for unclear but potentially significant threats above that for immaterial violations of financial regulations. Such an approach calls for flexibility in the deployment of resources and an organisational structure that emphasises expertise on risks over account management with individual institutions. Supervisory efforts are more likely to focus on generic risks and cut across different institutions, than to focus on a single risk at an individual institution. This approach also requires a wider, multidisciplinary supervisory skill set. After all, an encompassing assessment of risks involves a broader

[9] The 1992 EU Maastricht Treaty mentions the precautionary principle as one of the underlying principles for environmental policy. Later, the European Commission (2000) issued a more general discussion on the use of the precautionary principle for various policies. The Commission advocates a careful application, emphasizing even-handedness with other principles and inclusion of stakeholders.

supervisory judgement than checking compliance with regulations. In cases where the prudential mandate is geared at supervising institutions, this may need to be broadened to include activities directed at the stability of the financial system as a whole. In all, a risk-oriented approach thus involves macro–micro interaction, a flexible distribution of resources and possibly also a wider supervisory mandate.

Lesson 4: Strengthen Data Collection on Systemic Interlinkages. Accurate, timely and consistent information is key to both micro and macro risk management. In the decade before the crisis, data architecture lagged well behind the financial innovation and structural changes that markets and institutions were undergoing. Severe data gaps handicapped supervisors in detecting the build-up of risks, assessing their materiality and steering crisis solutions (Eichner et al. 2010). This was especially the case with information on the larger, systemically relevant institutions that had the most complex structures on the one hand, but were indispensable for financial stability on the other. Because of data shortcomings, macroprudential supervisors failed to recognize the sustained rise in system-wide leverage, maturity mismatch and interconnections. And once the house was on fire, microprudential supervisors could not assess how individual decisions – such as whether or not to rescue Lehman Brothers – would impact the system as a whole.

In absence of solid data on the resilience of the overall financial system, microprudential supervisors are destined to underestimate risks. This is evident in the case of concentration risks that only become visible when granular data on different institutions is combined and common exposures are detected. For instance, prior to the crisis, granular data would have revealed excessive risk concentration within AIG and disproportionate exposures to structured products financed through a growing reliance on short-term wholesale funding. By the same token, reliable information on the inter-linkages between financial institutions would have enabled authorities to identify likely contagion channels and to restore market confidence by providing detailed information on the system. With the benefit of hindsight, data shortcomings on concentration, funding, market and sovereign risks have made it difficult to address the negative macro–micro feedback loop.

Improving data on major financial institutions' interlinkages and common exposures thus strengthens both micro and macro supervision. At a micro level, better data on exposures and funding dependencies will support risk management by institutions and supervisors alike. Information on the nodes in the financial system will also allow timely identification of those spots that need extra prudential attention. At a macro level, network analysis will highlight systemic exposures to specific sectors, guide preventive measures to enhance the system's robustness, and allow for better-informed judgements on spillover effects and crisis resolution. Besides, data on interconnections with non-bank financial institutions will help to monitor the shadow-banking sector and to establish the regulatory perimeter. While work to strengthen data collection on globally systemic institutions is underway,

national and regional authorities are well advised to collect similar data for institutions they consider systemically important domestically.[10]

Lesson 5: Use Macro Signals to Drill Down Micro Risks. Financial sector regulation and supervision react to developments within institutions and markets, and are continuously in danger of falling far behind. Indeed, prudential standards take years to make and are excellent at winning the last war – the financial crisis is testimony to this adage. In a dynamic environment, much therefore depends on the alacrity with which new risks are picked up and the extent to which forward-looking elements are part of the supervisory process. A prime challenge is to structure these processes in a way that shortens the time span between the identification, analysis and mitigation of risks. In this context, macro data can serve as a red flag for supervisors. For instance, when macro data point at sustained credit growth to a certain sector, in combination with steep related asset price increases, alarm bells should be ringing.[11] At this point, a drill-down exercise at the micro level can establish the threat of a sectoral asset bubble. In turn, this may prompt ad hoc reporting requirements, a tightening of governance arrangements for these credits or an adjustment of sectoral risk weights. Similarly, flow of funds and balance of payments data can point at certain shadow banking or cross border risks that need further examination. Micro supervision can then establish 'themes' to be investigated swiftly within a certain population of financial institutions. Recent examples include inspections of risks related to the CDS market, foreign exchange lending, European banks' US dollar funding needs and country risk exposures. In a nutshell, macro data can provide pointers to micro-supervisors.

Lesson 6: Collect Micro Signals and Examine Their Broader Relevance. Just as macro developments can point to burgeoning risks that need to be examined at the micro level, so micro developments can highlight upcoming risks that deserve attention across the financial sector and at the macro level. All risks start out small. Here, too, the earlier the identification, the easier the mitigation. Coordination mechanisms between institution specific supervisors, market experts and macroprudential analysts can advance a more timely recognition and better understanding of new and upcoming risks. Indeed, information on specific exposures, interlinkages and financial innovations can feed into systemic risk analyses. Of course, it needs to be carefully assessed whether micro observations have systemic relevance, but if so these can influence not only microprudential priorities across the sector, but also macroprudential and even

[10] Global efforts to gather information on systemic inter-linkages are spelt out in FSB (2011); initial progress by the Federal Reserve is set out by Tarullo (2010).

[11] Borio (2010) emphasizes both the value and limitations of using macro signals. Such signals have a strong track record, particularly over longer time periods, but their generality does not allow firm-specific conclusions.

monetary policy setting (Orphanides 2012). The unconventional monetary policy measures taken by the largest central banks over the past few years illustrate the importance attached to an adequate functioning of the financial sector in the quest for price stability.

Lesson 7: Think the Unthinkable and Develop Stress Testing. Crises happen. Every so often, tail events become the baseline scenario. This was the case in 2008. The financial crisis proved to be far more extreme than the most adverse scenarios the financial industry had been working with. Years of rising returns had taken the edge off risk management. Financial institutions were ill prepared for tail events and public authorities across the globe had to step in to keep financial systems afloat. In effect, the crisis uncovered the shortcomings of quantitative risk models with statistical loss estimates based on historical data.

In the wake of the crisis, stress testing has come of age. Institutions have been required to complement their backward-looking models with forward-looking stress tests that assess their resilience to adverse but plausible macroeconomic circumstances. In both the United States and Europe, stress tests were used to establish the minimum level of capital for individual institutions to ensure they could withstand a possible further deepening of the downturn. This was done transparently, not only to pressure the banks to deliver, but also to instil outside confidence in the solidity of their balance sheets. Since then, stress testing has become a standard instrument in the supervisory toolkit.[12]

Stress testing brings macro and micro together. The scenario design is generally based on the macroprudential risk outlook. It is subsequently tailored to the institution's specific exposures, activities and vulnerabilities. Different stress tests including sensitivity analyses shed light on an organisation's weaknesses and reveal whether these are in line with its risk appetite. Reverse stress tests determine the distance to default under combinations of events. This defines the bottom line for risk management. Micro outcomes can be aggregated to test their plausibility. A majority of banks assuming market share growth is an easy inconsistency to spot. More challenging is to take account of feedback loops from aggregate bank behaviour to the real economy and from the real economy back to bank credit portfolios. The same is true for second round effects transmitted through financial markets. Several iterations may be needed to get a true sense of the impact of a tail event. The results of bottom up stress tests can also be checked against a top down outcome. While most stress tests may focus on capital adequacy, liquidity stress tests can identify vulnerabilities to funding risks (Van den End 2010). Beyond this, the interaction between the two can be assessed and contingencies can be established to secure viability.

Developing and implementing a comprehensive stress testing capacity thus involves an interplay between micro and macro perspectives. These tests strengthen the understanding of an institution's interrelated risks and help guide decisions on

[12] The Federal Reserve System (2012) provides detailed guidance on the integration of stress testing in regular risk management practices.

activities and exposures. Selecting a sufficiently extreme but not wholly unrealistic scenario is as important as the conversion to loss rates and other stressed variables. An example from DNB's experience helps make this point. When DNB conducted a liquidity stress test in December 2007 and required banks to simulate their reaction to a 28-day closure of the interbank market, risk managers retorted that the test lacked realism. Nine months later, they wished the interbank freeze would last as short as in the test. In sum, think the unthinkable and be prepared.

Lesson 8: Look at the Big Picture and Implement Top Down Risk Management. Against the background of increasing financial interlinkages and cyclicality, recent experience has shown that the fate of financial firms is determined more by common than idiosyncratic risks. Put differently, the danger of an institution running into difficulties on account of developments in the macrofinancial environment is larger than that of succumbing to an institution-specific mishap. By implication, microprudential supervision needs to be structured in a way that places considerable weight on macroprudential risks. This can be done through a top down risk management approach that first looks at the big picture and then focusses on the specific vulnerabilities of an institution under review.

The starting point of such a top down approach is a macroprudential analysis that identifies the key risks to the financial sector as a whole. These risks are often cyclical, but may also relate to changes in funding patterns, corporate strategies, financial infrastructure, legal circumstances and the like. The macroprudential analysis is then converted to the level of individual institutions. The exposure of each institution to specific macro risks is gauged and, if relevant, translated into a risk-mitigating program.

In practical terms, in the Netherlands, macroprudential risks are derived from the central bank's Financial Stability Review and inserted into a 'macro register'. This register is a tool provided to microprudential supervisors that describes the main macro risks relevant to individual financial institutions, explains how each risk can impact an institution's financial accounts, establishes indicators for an institution's exposure to this risk and determines ranges for risk levels. Based on these indicators and ranges, as well as expert judgement, supervisors then score each institution (on a scale 1–4). In turn, this score guides the need for risk mitigation, in terms of urgency and magnitude. The tool also allows analyses of peer groups and indicates the distance from best practice.

Lesson 9: Strengthen Systemic Institutions While Reducing Their Systemicness. The widespread contagion from Lehman's collapse made public authorities determined to avoid any further failures that risked such spillover effects. The term SIFI (Systemically Important Financial Institution) was coined for institutions with such a pivotal role in the financial industry that their failure would disrupt the financial system and economic activity at large. When these institutions came under pressure, public authorities had no other option than to provide support, notwithstanding the damage to public finances and private incentives. Subsequently, international efforts within the Financial Stability Board (FSB) have aimed at addressing this too-big-to-fail problem, by increasing these institutions' resilience, while reducing their systemicness (Knot and van Voorden 2012).

Implementation of this FSB policy line requires macro and microprudential supervisors to interact. This first involves establishing the systemicness of individual institutions, for which national authorities have implemented similar – but not uniform – frameworks based on assessments of size, interconnectedness, substitutability, complexity and resolvability. This is not a mechanical exercise and unavoidably involves some supervisory judgement. The next step is determining the required additional loss absorbency and linking this to individual institutions. The FSB bucketing approach, with surcharges for global SIFIs ranging between 1 % and 3½ % additional common equity, provides a framework for domestic SIFI surcharges, although national financing constraints may lead the latter to be higher (other things equal).[13] In the Netherlands, the range for domestic SIFI surcharges has been set at 1–3 %, similar to the surcharges set in other small economies with large financial sectors. Beyond this, contingent capital and specified bail-in instruments can further reduce tail risks.

But increasing resilience is more than just raising capital. Since 2012, systemically relevant institutions are mandated to prepare Recovery Plans. Setting up these plans is an iterative process between the financial institution and its supervisor, aimed at identifying measures that can be taken in a near-default situation. The plan spells out early activation triggers, governance procedures and strategic options. While predetermined triggers prevent inaction, governance procedures clarify key decision makers and relevant procedures, and strategic options specify both available and preferred contingency measures. This process sharpens the institution's risk awareness and tests the realism of its envisaged recovery measures, from both a micro and a macro vantage point.

The second pillar of this approach is to reduce an institution's systemicness, therewith diminishing the need for public support. This is done through Resolution Plans, to be finalized by end 2013. These are again developed in an iterative process between an institution and its supervisors, although the latter carry out the brunt of the work. Here, interaction between micro and macroprudential supervisors is key, since resolution requires intimate knowledge of an institution's financial, legal and operational structures, alongside an assessment of its vital systemic activities. Resolution planning aims to safeguard those activities that are essential for the economy at large, while containing moral hazard and limiting risks to tax payers and retail depositors. An open question remains to what extent effective resolution planning includes financial, legal or organizational changes in peacetime. Prospects for effective resolution are undoubtedly improved by measures that advance the autonomy of separate legal entities, in both financial and operational terms, for instance by restricting intragroup guarantees and double leverage. There is a clear case for banks to be steered in this direction.

[13] See Basel Committee on Banking Supervision (2011, 2012) and Financial Stability Board (2010).

Lesson 10: Adopt an Institutional Structure That Brings Macro and Micro Together. The financial crisis has shown that in a world with large, intertwined financial institutions, macro- and microprudential perspectives overlap. The supervision of systemic institutions is by definition both macro and micro. Besides this, the feedback loop between macro and micro importantly determines the impact of these micro risks. Thus, institutional structures that bring macro and micro supervision close together contribute to effectiveness and efficiency. Synergies can be reaped in different parts of the supervisory process. To start with, a structure that couples central bank functions with microprudential supervision contributes to an early identification of financial market and system-wide risks. Such a structure creates informational synergies, contributes to technical expertise and focuses microprudential supervision on systemic risks.[14] This is particularly beneficial in the case of banking supervision, given the systemic nature of banks on the one hand and the central bank's presence in financial markets and its role as overseer of payments systems on the other. Moreover, an integrated central bank supervisor fosters rapid decision-making and consistent communication, especially during crises when time is of the essence. In these circumstances, an integrated approach is needed on issues related to emergency liquidity assistance and resolution of institutions with essential economic functions. The messy failure of Northern Rock illustrates just how time-consuming and costly the separation of central bank and supervisory functions can be.

Although combining central banking and supervision also has disadvantages – in terms of potential conflicts of interest, blurred responsibilities, reputation risks and undue power concentration – recent institutional changes show a clear trend towards integration. Within Europe, Belgium, Germany, Greece, Ireland, Portugal and the UK are recent converts and two thirds of central banks now have supervisory responsibilities, which is already the case in the US for major banks. Looking forward, plans for a European banking union have supervision under the wings of the ECB.

13.5 Concluding Remarks

The financial crash of 2008 has many root causes. Leverage was too high, risk aversion too low, securitization too easy, risk management too backward-looking, financial oversight too fragmented, accounting rules too cyclical, rating agencies too dependent, compensation too short-sighted, and so forth. An overarching cause is that financial regulation and supervision were too lax because common risks were woefully underestimated and macroprudential policy was effectively absent. While the financial system as a whole became increasingly vulnerable, the prudential focus on idiosyncratic risks to individual institutions failed to pick this up.

[14] See DNB (2004) and Bank of England (2011).

Looking ahead, a key challenge is to better mitigate common risks. It remains to be seen to what extent macroprudential instruments will be relied on. But irrespective of this, system-wide risks can be effectively reduced by incorporating them into the microprudential framework. This involves macro–micro interplay and can be done in a number of ways. At a normative level, prudential decision-making should be governed by the precautionary principle, implying that uncertainty may not preclude cost-effective measures to reduce systemic risks and that the burden of proof lies with those that wish to avoid such measures and not with the prudential authorities. In practical terms, in recognition of fundamental uncertainty, capital and liquid reserves should be kept significantly higher than risk quantifications suggest, also to provide scope for some depletion of reserves when the financial cycle turns. At the same time, strengthening data collection on systemic linkages, weighing the relevance of micro signals and drilling down macro risks at the micro level will help establish those risks that deserve the most immediate attention. Hereafter, at an operational level, risk management may be conducted top-down, looking at individual institutions within the frame of the big picture. This will allow supervisory resources to be tailored to the prime risks facing the system. In this process, stress testing can link the macro risks with the institution's risk appetite. In the special case of systemically important financial institutions, prudential safeguards should be higher. Overall, these macro–micro synergies can be more easily reaped in an institutional structure that brings the macro and micro prudential supervisors close together.

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Annex 1: Ambiguity in Risk Assessments: Initial Assessments of Lehman's Collapse

On 15 September 2008, the U.S. investment bank Lehman Brothers filed for bankruptcy. This triggered a sharp deterioration in market sentiment and precipitated a global systemic crisis. However, at the time of the decision whether or not to provide public support, the assessments of Lehman's systemic nature were ambiguous, if not mistaken. The then prevailing uncertainty and ambiguity, as illustrated by selected quotes from editorials and leading economists, contrasts sharply with the systemic relevance that became evident in retrospect.

FT Editorial "Decisive Inaction", 11 September 2008

The U.S. government has bailed out Fannie Mae and Freddie Mac. The market now seems to view Lehman Brothers (...) as next in line, with possibly more to come. It is time for the authorities to step back. Further such rescues should be avoided like the plague. It is the job of a government to save the financial system, not individual institutions. What has been done so far should be enough. Yes, banks are going through tough times. (...) Yet a sudden failure, such as that of Bear Stearns in March, seems unlikely, since liquidity is assured by the Federal Reserve's decision to open the discount window to investment banks. This is

buying damaged institutions time needed to come up with a private sector solution. That is what they must seek. Apart from offering short-term liquidity, the Fed and the Treasury should remain on the sidelines.

Willem Buiter (ft.com/maverecom), 15 September 2008
We may have a test as early as tomorrow morning (Tuesday, 15 September 2005), of whether there are significant systemic externalities from the failure of a household-name investment bank. I am optimistic that investment banks will turn out to be more like normal businesses than like the negative-externalities-on-steroids painted by the Fed and the Treasury during the Bear Stearns rescue.

Martin Wolf, "The end of lightly regulated finance has come far closer", 16 September 2008
(...) Today, however, the authorities must also ask themselves whether what they are doing will make the system safer after the crisis is over. By these standards, the decision not to bail out Lehman looked right. (...)

Willem Buiter (ft.com/maverecom), 18 September 2008
(...) From a long-run financial stability perspective, the decision not to put public money behind a bail-out of Lehman Brothers also would seem to be the correct one. While it may well have increased short-term volatility and uncertainty, the deleterious effect of tax payer support for a bank that was not systemically significant on incentives for future investment, lending and borrowing would have been horrendous – an open invitation for excessive risk taking. (...)

Annex 2: Warnings Prior to the Crisis

In the run-up to the crisis, financial stability reports by multilateral institutions and central banks noted many of the risks that subsequently emerged, including increasing risk tolerance, search for yield, leverage, complexity and inter-linkages, as well as specific shortcomings in risk modelling. While these risks were on the radar screens, their relevance was subject to considerable uncertainty and supervisors evidently did not translate them into adequate mitigating actions.

BIS (Annual Report), 2002
Recent years (...) have also seen very strong growth in markets for credit derivatives (...). These markets have contributed to resilience in a number of ways. (...) Against this generally positive background, recent developments give rise to a number of potential concerns. First, to some degree, the growth of credit risk transfer instruments has been driven by regulatory arbitrage.(...) Second, interdependencies within the financial system have increased (...). Third, the development of complex financial instruments can make it more difficult to assess the overall level of risk and its distribution within the financial system. And finally, (...) the development of instruments that allow credit risk to be easily transferred can facilitate the build-up of leverage in the corporate sector.

DNB (Overview of Financial Stability), December 2005
Spurred by the low risk-free interest rate, the search for yield has continued, resulting in a high risk propensity among market parties. Illustrating the point is the high net inflow into hedge funds (about USD 35 bn worldwide in the first half of this year with total assets under management estimated at about USD 1,000 bn) and the strong demand for credit

derivatives and other complex financial products. The financial institutions engaging in such transactions may be exposed to new counterparty and reputation risks.

IMF (Global Financial Stability Report), April 2006

(. . .) rating agencies have played a significant role in the acceptance of new products by investors, (. . .) heavily reliant on sophisticated quantitative modelling. Not surprisingly, the development of structured credit markets has coincided with the increasing involvement of people with the advanced financial engineering skills (. . .). In fact, (. . .) the application of such skills may have become more important than fundamental credit analysis. Some questions remain as to whether all investors fully understand the risk profile of these instruments, and how it differs from that of similarly rated corporate bonds. In particular, structured credit products are likely to suffer more severe, multiple notch downgrades, relative to the typically smoother downgrade paths of corporate bonds. Many investors (and their senior management) may therefore be negatively surprised during the next rating downgrade cycle.

Bank of England (Financial Stability Report), July 2006

The market for CDOs has grown rapidly in recent years. (. . .) The very complexity of these instruments makes it difficult for investors to determine precisely how exposed they are to particular risk factors. (. . .) Modeling difficulties can also lead to errors in hedging, so traders can find themselves with residual exposures that they thought they had hedged. In such situations, they may wish to reduce the residual exposure if credit losses rise. But with the liquidity of CDO markets still developing, especially for some of the more complex instruments, a shortage of secondary market liquidity could potentially amplify price movements in the event of a shock.

VaR measures have not risen as much as the rise in trading income might suggest (. . .) This could mean that firms are diversifying their portfolios more efficiently. But it may also support the widely held view that VaR is an imperfect measure of risk in the trading book (. . .) Given the lack of data on more innovative and complex instruments, it is possible that the models used to price them and evaluate their risks will turn out to be inaccurate during times of stress.

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Chapter 14
Supervision: Looking Ahead to the Next Decade

Julie Dickson

14.1 Introduction

The financial crisis that started in 2007 was not the first and will certainly not be the last that financial supervisors have to face. One important question is whether the toolkit currently available to supervisors is sufficient to allow them to recognise the build-up of vulnerabilities, even during good times when there are no signs of problems, and to take action to manage the risks in good times. What else can supervisors do? And what can society expect of them in the future?

14.2 Supervision in the Limelight

The next decade should be an incredibly important decade for supervisors because the global financial crisis has shone a spotlight on the craft of supervision, separate and apart from the craft of writing new regulations. Regulation is about setting speed limits and mandating the use of airbags. It is about rule-making, such as Basel III capital rules, liquidity rules, and leverage rules – an extremely important activity. Supervision is about oversight of financial institutions' implementation of these rules. It is about putting up yellow flags to slow things down and trying to ensure that banking is carried out safely without putting depositors and taxpayers at risk. It is about determining whether there could be a breakdown in risk management controls at an institution, and whether the culture of the institution and its appetite for risk will create dangers that could lead to the bank running off the road (i.e., becoming insolvent).

To explain further, supervisory oversight is about the kind of attention financial institutions receive from supervisors on a regular basis. It is about the questions we ask, what we say to institutions, how we say it, the type of information we request, the people we ask to meet, how we deal with push back, what we do when we go on-site or otherwise deal with an institution, and the extent to which we tick boxes or think about the core risks and how they are being managed.

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In short, supervisors are the people on the front lines who seek to identify weak risk management systems at individual institutions and decide what to do about them. Supervisors must decide, for example, whether to tell an institution to stop growing a business until its problems are fixed or require an institution to raise more capital to absorb unexpected losses. It is the supervisor who may require an institution to do more stress testing, or require an institution to hire expertise in a particular area, or to spend money on data systems so that risks can be more readily and accurately aggregated and assessed. Such supervisory actions are costly to the institution, but are intended to help make institutions safer and limit losses.

The combination of rules, and supervisory oversight and judgment, are critical.

The link between regulation and supervision is clear when one talks about capital. A bank's reported capital number is only as good as parties that oversee these numbers. That includes a bank's senior management, the internal and external auditors, and bank supervisors. Bank supervisors must be on the lookout for practices that inflate the capital position, such as: banks that avoid downgrading bad loans; banks that choose to interpret some capital rules by the letter of the rule versus the spirit; banks that place mechanical reliance on models; banks that write business based on what the capital rules require versus what the real risks are as products and circumstances change (the banks bulk up on business that may be risky but for which capital rules erroneously assign low risk weights); and banks that assume that risk weights assigned under the capital rules are the end of the analysis (for example, banks that assume that sovereign debt has zero risk).

Further, if regulations rather than supervision become the focus, a system with more risk may be created. Rules often have unintended consequences, which can take quite some time to see (see the contribution of Nouy in Chap. 4). Our record in getting rules right is not perfect.

Also, globally, there are many more people involved in supervision than in writing the rules, which suggests we have a vested interest in determining what makes supervision effective. At the same time, supervision is difficult to assess as it is typically carried out behind the scenes. Importantly, it is much more time consuming to change supervision or build supervisory capacity than it is to change a rule. There is no quick fix if a supervisory function is weak.

Supervisors should seize the opportunity provided by the global financial crisis and take advantage of the attention and recognition being paid by the Financial Stability Board (FSB) and others to the craft of supervision and the drivers of an effective supervisory system.

14.3 What Is Effective Supervision?

Under the auspices of the FSB's Supervisory Intensity and Effectiveness Group (SIE), there have been global discussions about different supervisory approaches around the world, and about how to strengthen supervision.

Despite its importance, there is surprisingly little information on what constitutes an effective supervisory regime. Perhaps this explains why there are some different approaches to supervision around the world. As noted later in this chapter, different approaches are not all bad – the nature of banking systems varies greatly and some trial and error can also be good. But over time, there should be some convergence on what constitutes good practices and what does not.

Some of the differences include:

- The extent to which supervisors focus on compliance versus risk identifycation and mitigation (the latter is more difficult);
- The role of the supervisor in corporate governance (some supervisors have more of a hands-off approach; some routinely question and probe directors in an attempt to assess effectiveness; some send observers to sit in on board meetings, and some put potential directors through intense interviews prior to their appointment);
- The extent to which work is outsourced to consultants or external auditors, versus being performed by qualified in-house staff, which can have positive or negative impacts on quality of work and corporate memory at the supervisory agency;
- Different styles of oversight (this covers a range of practices, from working behind closed doors with institutions to get problems fixed; working via public admonishment to get problems fixed; working via relationships that are too cozy or, at the other extreme, too toxic);
- Different levels of attention being paid to issues such as succession planning; oversight of models; oversight of operational risk (some supervisors focus largely on capital while other supervisors are also very active determining whether institutions have processes in place to ensure operational risk is constantly considered); and oversight of capital markets activity; and
- The attention paid to the risk culture at an institution; and the willingness of supervisors to assess and question the business model of an institution, its planned source of future profits and to engage with the board and management in a review of the adequacy of the institution's long-term strategy.

14.4 The Fundamentals: Independence, Resources and Mandates

If regulatory and supervisory agencies fail, it may be due to factors including inadequate mandates, inadequate powers, and inadequate independence. A necessary condition for success is having supervisors who have the ability to exercise strong independent judgement. Also, to be an effective supervisor, adequate resources and appropriate mandates are necessary. But FSAPs have shown that these three areas – independence, resources and mandates – are often the areas with the weakest assessment results.

The next decade will not be promising in terms of achieving intensive and effective supervision if these three fundamentals are not in place. Fundamentals, such as independence and properly constructed mandates, target supervisory incentives, which drive supervisory actions and judgements.

Independence. Many supervisory decisions can cost institutions money in the short term (for example, when supervisors require banks to invest in IT systems, or place limits on bank growth). That is why supervisory independence and freedom to make unpopular decisions are important. Independence has long been recognized in central bank/monetary policy literature, where various reports over many years emphasize institution and incentive design as a key ingredient for success. In the case of supervisory agencies, there is a less literature and less attention in practice to this issue, and thus less of a foundation for independence for supervision, although these considerations are also very important for sound supervision

Mandates. Mandates that are geared toward active early intervention can drive behaviour and accountability. As noted by the SIE,[1] whenever supervisors take an early intervention approach, there are often no tangible risk indicators (i.e. how does one measure the absence of losses) to confirm that this intervention was needed. This makes it difficult to convince firms and their boards that such measures are appropriate to deal proactively with emerging areas of risk in a systemically important financial institution (SIFI). Mandates that create the expectation that supervisors will act early help to set the stage for a healthy tension that ought to exist between the supervisor and the industry. By contrast, mandates that suggest that supervisors ought to promote development of the country as a financial centre, or that place more emphasis on promoting competition within the industry versus prudence, may adversely affect incentives and the ultimate system of regulation/supervision.

Resources – Budgets. From a budgetary perspective, resources includes resources for salaries to obtain the necessary skills and number of staff, resources for IT systems to analyse information from financial institutions, resources for travel and training, and resources for physical premises (a professional looking office). All are important if bright and energetic individuals are to consider making the function of supervision a lifetime career.

As has been noted by the SIE, a model based on industry fees versus one derived from government budgets seems preferable as it helps guarantee a more stable funding source over the cycle and shields supervisory agencies from fiscal vacillations.

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[1] In the aftermath of the financial crisis, the Financial Stability Board and the G-20 Leaders identified as a priority the need for more intense and effective supervision, particularly as it relates to systemically important financial institutions. As a result, the FSB created the Supervisory Intensiveness and Effectiveness Committee, or SIE, which is chaired by Julie Dickson, Canada. The SIE has issued three reports on supervision, which can be found on the FSB web site.

While high quality resources in sufficient numbers are needed to conduct intensive and effective supervision, inadequate resources continue to be a problem in many countries. This is despite the obvious cost to national economies caused by weak supervision. It is also despite the costs placed on institutions if they have to spend too much time dealing with supervisors who do not have adequate skills or a good grounding in their business or on the issues.

Some supervisors are much further ahead than others in having the resources they need; even then they often say that they are barely keeping their heads above water as new demands on supervisors are imposed. The necessary resource level is a moving target and it is difficult to put a number on the level of resources needed for new approaches to supervision and for new initiatives such as living wills.

The resources issue is not an issue that will be quickly or easily solved. It is affected by the lack of independence of some agencies to hire the resources they need, by head count and salary constraints that are imposed in some countries, and perhaps even by the tone "at the top" of agencies or central banks. While all of these issues can be solved if there is a will, resource quality is also affected by softer factors.

For example, even with flexibility to hire, it is not usually possible to hire a ready-made "supervisor". Rather, agencies hire people from the industry or elsewhere and it takes time for such new hires to learn what it means to be a supervisor. On the other hand, some central banks with responsibility for supervision do not feel supervision is a "real" career and require rotation into central banks after 3–5 years.

Industry has suggested that the problem could be reduced by doing interchanges of employees between firms and supervisory agencies. But some financial institutions do not want to see the employees of competitors going to a supervisory agency to learn about the inner workings of all institutions in that country, and then returning to compete against them, knowing all of their practices. As well, some people would raise the revolving door issue, i.e. people moving between industry and regulatory agencies, and whether the judgements made by such supervisors would be affected by their goal of ultimately re-entering industry.

As noted by the SIE in its report of November 2010 (SIE 2010), some supervisors feel that hiring specialist skills from the market is critical, as such people have a perspective that cannot be obtained from being a career supervisor, while others feel that internally home-grown supervisors do the job better and have a more questioning attitude toward market "fads". Some central banks with responsibility for supervision feel that the challenge of mixing people hired from industry with central bank PhDs is too difficult and opt for training instead. While high-quality training programs are important, they vary significantly from country to country.

Understanding the skills needed is critical. While most would say that a supervisory agency needs people with skills such as credit, market and operational risk, tenure and experience are also vital (such as people who have been through many financial cycles). Having access to financial historians can add value, because if people do not know history it is hard to avoid repeating history.

Even where resources are deemed broadly adequate, new areas are emerging where specialized resources may be in short supply globally, such as more resources to focus on models used by SIFIs (SIE 2010). Another issue is staff turnover; while some turnover is necessary, constantly changing supervisory teams can really affect knowledge of an institution and hamper risk assessment and early intervention.

Unless focus is placed on resources, supervisory intensity and effectiveness will suffer. If supervisory agencies are understaffed or staffed inappropriately, or there are high levels of turnover, and if training is inadequate, the implications for safety and soundness and financial stability can be profound.

Resources – Culture, Presence and Soft Skills. The previous section focused on important issues that many supervisory agencies are trying to address in the area of resources.

But the issue of culture, "presence" and soft skills, such as the ability to effectively communicate with CEOs and directors, deserves its own section. Having supervisors who can tell the chair of the board of a global bank that the board does not have the skills needed, or who can tell a CEO that the bank's business model does not make sense under various scenarios – especially when there are no losses – requires a set of skills that may not be typically found in many agencies.

Also, while supervisors have a wide range of powers to force action, being able to convince an institution of the need for change (and therefore getting buy-in) leads to a far better outcome, as the institution gets behind the changes versus doing things reluctantly in order to pacify a supervisor.

14.5 Avoiding Supervisory Complacency Through Cycles

The basic expectations of supervisors are covered by the BCBS core principles on banking supervision (BCPs). The crisis revealed that in some cases many supervisors did not meet the BCPs. In other cases, supervisors met the BCPs and received very good ratings under FSAPs, but the problems uncovered by the crisis indicated otherwise. One explanation for this was the methodology for the FSAP rating itself. FSAP ratings were based on supervisors meeting *essential criteria* in BCPs but not *additional criteria* in BCPs. The *additional criteria* really spelled out what supervisors should have been doing, especially in regard to SIFIs.

Such problems have been addressed via stronger BCPs and new assessment methodologies for FSAP assessors. Importantly, more checks and balances are being put in place to monitor what supervisors are actually doing.

More checks and balances seem to be a clear need and hopefully will help address human nature, and the natural tendency to become complacent over time. Indeed, the material we are writing today about the importance of risk management, governance and quality supervision is really no different than what we wrote years ago. We all know these issues are important, but for some reason, the follow-

through is weak and we do not get around to implementing what we know to be important. Measures that require us to constantly look over our shoulder – like rigorous and frequent FSAPs, FSB peer reviews, and BCBS peer reviews – make it more difficult for various players to not implement the things they say are important.

One can see this phenomenon in the 5 years since the financial crisis began. The pendulum swung far to one side post 2008, and then back somewhat as banks and even some governments pushed back on capital requirements, and has now swung back again given events in 2012 ("whale" trades, LIBOR manipulation, and US AML violations). The BCPs, and rules such as Basel III, are designed to be a set of core principles or rules for all times (based on the knowledge we have today). BCBS and FSB peer reviews, and FSAPs, are designed to constantly test adherence and implementation. The added emphasis on looking over the shoulders of players should help deal with the swinging of the pendulum and human nature.

Notably, some supervisory agencies which have done well through the crisis have also decided to hire supervisors from countries where the opposite occurred, to ensure that the agencies do not become too complacent about their abilities to recognize risks.

14.6 Supervisors and the Link to Economic Research

Major efforts are currently being put into research – research about adequate capital levels; research about how risks are transmitted across financial institutions and markets, and the feedback loop between the financial system and the economy; research into optimal size of financial systems as a percentage of domestic GDP; etc. Supervisors need to be aware of and contribute to this work from their own perspectives.

Some of this research could make the job of supervisors easier. If early-warning indicators, such as credit growth, provide leading information about banking crises, or improve our assessment of risks to financial systems, not only would supervisors be better informed, but they would have even more evidence to back up unpopular supervisory decisions (such as explaining why capital needs to be increased).

But supervisors also need to be cautious about these developments. Before the crisis there were many debates about optimal regulation. For example, before the crisis, some academics and regulators promoted the efficient markets theory, which led to "light touch" regulation in some countries, which subsequently led to major problems in these countries' financial systems.

Supervisors need to be sceptical and ask questions about everything we are told – not only by banks but also by others, including academics and researchers.

Financial system modelling is in its infancy, as is research on the build-up and bursting of bubbles. We clearly need to advance this thinking, while recognizing that the real world is ever-changing, dynamic, and innovative, with no complete

understanding on the part of macroeconomists and regulators and supervisors of how the parts acting on their own will affect the system.

In an effort to promote stability, academics and researchers try to model the real world but they have to make many assumptions about behaviours under stress. Given complexities, some may assume away a lot of things – like taxes, bankruptcy costs, agency costs, and asymmetric information. Some may assume away some of the complexities that arise due to the fact that real people run firms – people with egos, people with all sorts of incentives, and people who do things that are not always consistent with standard economic theory. This is where supervisors come in – they can see what is happening on a day-to-day basis within firms and observe various behaviours. Here, again, in practice the idea is to have different perspectives and different skill sets informing decision-making.

Supervisors should work to add value to these efforts by informing themselves of the research being done and providing their views on what goes on day-to-day in banks. Above all we need to be cautious as theories can be proven to be incorrect.

At the same time, supervisors cannot go it alone and need to better leverage other talent pools. A blended approach involving front line supervisors, economists, and quants is now often seen, because bringing different perspectives to the table results in more accurate problem identification and more thoughtful solutions to problems. To be successful, however, such teams will need to bring matters to conclusion quickly so that supervisors can take action early to respond to issues. It should be noted that managing such teams successfully can be challenging.

14.7 New Vulnerabilities Will Arise from Solutions Advocated Today

Some suggest that new measures agreed to by BCBS and FSB have fixed the problems that led to the global financial crisis. On the other hand, some suggest that Basel III is too complex and needs to be greatly simplified.

What we can agree on is that new vulnerabilities are likely to arise as a result of the changes we are making to the system today. We must constantly be on our guard to identify these vulnerabilities.

An example is Centralized derivatives clearing. This is a critical initiative, but also one that poses risks if central counterparties are not appropriately risk proofed. Thus, risk-proofing must be a focus of efforts on all fronts and we must be vigilant in detecting activity that has resulted from our decisions which may require a further response from regulators and supervisors.

Macro stress testing, which all supervisors are embracing, is another example. Macro stress testing should give both supervisors and financial institutions more information, which is always useful. But stress tests can also lull us into a false sense of security. This is because macro stress tests probably are unable to provide a realistic picture of the dynamics of distress, especially the adverse effects. Indeed, a

shock is called a shock because the unexpected happens – the system does not behave the way you think it might, making it much more vulnerable than a stress test might suggest. Partly, this is because stress tests, by their nature, focus on tail risk and extreme events, which we don't understand very well and are difficult to model. Further, even where we might have such data, tail-risk events are unique and vary over time, so history *alone* can be an unreliable guide. Importantly, stress tests generally focus on the first-round impacts, and models can have difficulty representing how behaviour might evolve after such initial impacts – and it is often those difficult-to-predict behavioural changes that cause the most trouble in real crises. Stress tests, especially those without sufficient regard for the preceding considerations, can also show the system to be highly resilient when it is not. So, as always in supervision, reliance on multiple information sources and an asymmetric regard for downside risks are important.

The key benefit of stress testing exercises is that the results provide a platform for supervisors to have critical discussions with banks, informed by stress test data. In other words, it is about the process, and the discussions supervisors have with the banks that matter the most – the numbers that come out of the exercise are of secondary importance given all the assumptions that go into the exercise and the unavoidable uncertainty that characterizes analysis of such tail-risk events.

Firms and supervisors should spend as much time on why the stress tests results might be wrong – resulting from things that might not play out as they expect – as they do in taking comfort from the results. In short, the limitations of stress testing must be understood or a false sense of invincibility, or a false sense of crisis, can arise.

14.8 Communication with Industry

The extent to which supervisors communicate with industry at senior levels about what is going on at the institution and in the industry is very important. Communication between knowledgeable senior supervisors and senior financial institution representatives can be a good way to challenge the views of both supervisors and institutions about current practices and risks. Supervisors have valuable knowledge about risk management practices across the industry and this is information that is harder for institutions to obtain. And institutions themselves see practices day to day in the industry or in their own institutions that can greatly increase a supervisor's awareness. Conversations about such matters can be extremely rewarding when they lead to new insights.

Communication should not be confined to junior levels. Contact with industry may be ineffective if all contact is at junior levels and is seen as more of a box ticking exercise.

Different types of communication should also be sought. For example, while on-site reviews will include a necessary degree of cross-examination (i.e. posing questions and verifying answers), opportunities should be sought for different

types of conversations (less exam focused) which, given their less formal nature, can pave the way for more wide ranging discussion, and thus a more complete understanding of the institution and its culture.

Contact with industry may be ineffective if the relationship between the supervisors and financial institutions is strained to the point of being toxic. While supervisors must be sceptical and tough, the willingness to seek out views of the industry and to listen are as important.

14.9 Internal Processes to Identify Risks

Having methods and processes in place to ferret out important information from the markets and industry and to digest such information and determine whether it is important pays dividends. Supervisory Committees like "Emerging Risk Committees" to exchange ideas and views about risk can be very helpful.

At the same time, prior to the crisis there was much discussion about emerging risks and many believed that the way the system had responded to various disturbances prior to that showed the system was resilient. Again, this seems to force supervisors back to the basics – nothing can replace basic "roll-up-the sleeves" old-fashioned supervisory processes.

Up to now, many supervisors have been trying to catch up to expectations that had existed all along (e.g. many did not review acquisitions even though this was a Basel Core Principle, many did not have the resources to carry out what BCPs suggested they should be doing). Beyond that a range of new demands has been placed on them such as preparing recovery plans and focusing on resolution. New activities are also being adopted by virtue of the enhanced knowledge and experience that oversight of a dynamic industry brings. In some countries, stress testing is becoming far more advanced, oversight of models is being treated far more seriously (including pillar 1 models and more recently models outside of pillar 1), and more use of horizontal reviews is being promoted. Oversight of operational risk is also changing as supervisors recognize its importance. Governance and succession planning processes are also moving to the forefront, as is risk appetite and risk culture.

Indeed, as supervisors around the world have set out to "up their game", a variety of approaches are being tested and different supervisors are doing different things. For example, some supervisors may spend more time on assessing the people in key functions such as the CRO role, while others might spend more time on doing reviews of specific activities and coming to conclusions on the strength of the CRO in that fashion. Others may do a hybrid approach. Some supervisors may have permanent offices on site at banks while others may continue to prefer a model where offices are at a supervisory agency that is relatively close to the bank to facilitate interaction. Some may prefer to interview and approve new directors and senior management before they can assume their duties, while others would prefer to allow the institutions to make such decisions, and only act after the fact if

performance issues arise. Some supervisors sit in on board meetings; others prefer to increase their interaction with board members via separate meetings with supervisors. Some supervisors do not think a separation of Board Chair and CEO is needed.

Another area receiving attention is the thinking about risk based supervision. Risk based supervision means supervisors are not looking at everything – they have to pick and choose their area of focus. This will continue to be the case, as supervisory teams are small in number relative to the number of bank employees in risk management, internal audit, and compliance areas. In the years preceding the crisis, most supervisors focused on the quality of control functions in banks, such as the quality of people in risk management and the depth of their work. This was aimed at ensuring that banks self-policed themselves. Post crisis even more efforts are being devoted to this as supervisors focus on boards of directors, and delve more deeply into areas such as succession planning within control functions. At the same time, supervisors are asking whether the focus on self-policing by control functions is enough, and whether some old-fashioned approaches such as basic financial analysis, and follow-the-money analysis is needed, especially for SIFIs. This will continue to be discussed.

Institutions and others many complain about diversity in supervisory approaches. Institutions would like convergence of supervisory approaches and rules. They would like colleges of supervisors for banks to agree on the issues. They do not want different messages from different supervisors.

But supervisors are not always going to agree. Perhaps this is not necessarily a bad thing. Just as financial institutions say that it is unwise for all firms to have the same view on risks and the same strategy, it could be unwise if all supervisors looked at things identically.

It is also important to emphasize that, while a variety of new approaches are being explored, the major priority needs to be placed on fully implementing all of the long-standing Basel Core Principles on Effective Supervision. It is impossible for supervisors to get their arms around a bank by focusing on one new thing, such as focusing on boards of directors, or on who the CRO is, or on risk appetite statements, or on models, or on building the supervisory process more around stress testing and economic analysis.

Looking forward to the next decade, the challenge will be what it has always been – determining when to intervene, and how to intervene. This can be hugely judgemental. Decisions on the exact supervisory approach to follow will also require judgement, and will vary country by country. To be successful, however, there should continue to be a sharing of views and experience.

Will supervisors be seen to have done enough? When the next crisis hits, inevitably there will be questions about whether supervisors were "asleep at the switch". One of the challenges of the job is that the value that supervisors bring is not always measureable (one cannot measure losses that did not occur, or crises that did not occur). Further, there is very little public understanding of what a supervisor does (see the contribution of Adams in Chap. 7). The fact that supervisory teams are dwarfed by the teams at banks in risk management, audit and compliance, means

that the supervisor will typically be in less of a position to spot risk than the bank itself, but the public often thinks otherwise. This is a challenge that is very difficult to overcome. More public discussion of our role might help.

14.10 Conclusion

Many changes are being made as a result of the global financial crisis. Various proposals have often come with language about how effectively the problems of the past have been, or will be, dealt with. But in reality there is no single element one can point to that will guarantee financial sector stability. Strong financial systems reflect many different factors, including multidimensional oversight of banks by multiple parties (e.g. oversight by regulators and supervisors via strong rules and robust daily supervision; oversight by the market (investors, analysts, rating agencies); oversight by bank management; oversight by bank boards; oversight by external auditors who provide audited financial statements; and policy setting action by central banks and governments in the form of sound macro and micro policies). Debates continue about whether the solutions developed by various bodies – including BCBS and the FSB – are adequate.

It is virtually impossible for one party to do the job – not the CEO, not the board, not the regulator, not the supervisor, not investors with money at stake, not analysts poring over disclosures, not central banks and not governments. All parties play a role and must carefully perform their critical functions. And they must avoid creating incentives that affect the performance of these roles.

Anything that sharpens incentives for the market to monitor financial institutions, for financial institutions to manage their risk and for supervisors to act early, is important. An openness to consider the ideas of all members of the supervisory community is also important, as are any measures that force action even when complacency sets in, as it inevitably will.

Reference

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