

ACHIEVING EFFECTIVE SUPERVISION: AN INDUSTRY PERSPECTIVE



IMPROVED SUPERVISION HAS A CENTRAL ROLE IN REINFORCING AND SUSTAINING THE SOUND PRACTICES BEING DEVELOPED AND CONSOLIDATED IN FINANCIAL FIRMS AND IN BUTTRESSING STRENGTHENED REGULATION AND RESOLUTION ARRANGEMENTS. GLOBAL SUPERVISORY REFORM AND IMPROVEMENT SHOULD THEREFORE HAVE A PLACE AT THE CENTER OF THE G-20 AGENDA FOR THE COMING YEARS.

Well-run firms have every reason to welcome strong and effective supervision. This additional focus on the company in addition provides the management of a firm with a valuable alternative perspective. More generally, good supervision provides essential discipline and acts as a corrective on the industry as a whole, which reduces the risk that firms, their customers, their shareholders, and the general public will have to bear the cost of failings in other firms.

The Board of Directors of the IIF, the Special Committee on Effective Regulation (SCER) and the Effective Supervision Advisory Group. It reflects a thorough consideration of the role of supervision and how it can be improved both nationally and globally. The IIF believes that supervision needs to be more intensive, challenging, and action-focused than before.

The Report reflects the strong recognition of the industry that it has a major responsibility to support credible and effective supervision and that high-quality supervision is a common interest and a shared responsibility. Through the Effective Supervision Advisory Group, the IIF has developed

a set of twelve core recommendations aimed at effecting the necessary changes in many firms and improving the level and nature of engagement with supervisors. These recommendations cover data provision, greater engagement of Boards, and, above all, the approach to interaction with supervisors, i.e. "no surprises", with full and open communication.

The Institute is grateful to member firms for the commitment of time and resources in developing this Report, in particular the members of the Effective Supervision Advisory Group. We are extremely grateful to Mrs Kerstin af Jochnick, Managing Director of the Swedish Bankers' Association for her role in leading the work of the Group.

The lists of the IIF Board of Directors, the membership of the SCER, and the members of the Effective Supervision Advisory Group are included in the Report.

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FOREWORD

Strong, effective and independent supervision is critical to ensure a sound financial sector. Successful supervision gives the management of financial institutions a valuable secondary perspective and bolsters the work of firms' risk management teams and structures. Intensive supervision also acts as an essential discipline on the industry as a whole by setting risk management standards and providing a source of challenge against any relaxation of controls or build up of risk in individual firms. In doing so, effective supervision can contribute to greater financial stability and reduce both the likelihood of individual institutions failing and their potential impact if they do so. Getting supervision right is in everyone's interest, both the authorities and the financial sector.

There are four principles that I believe are common to effective, high quality and intensive supervision:

Prioritisation: Supervision should focus on the issues that will most enhance governance, improve risk-management and increase the effectiveness of firms' controls. However, this should be focused on strengthening the boundaries and avoid the temptation to try and directly manage the risks that firms take on. Moreover, increased activity and the imposition of more requirements in themselves should not be mistaken as the more effective supervision.

People: Supervisors must have a comprehensive and thorough understanding not just of the risk profiles of individual firms but also of the industry in which they operate. This should be informed by effective cross-sectoral and cross-border analysis and needs to be premised on cooperation with other national supervisors. Supervisors need to have the tools, techniques and expertise to analyze this information and it is critical that they have adequate staffing and resources to be able to challenge firms effectively.

Policy: There is great benefit in supervisors being extensively consulted on the formulation of regulatory policy where their first-hand experience of implementation can be invaluable. There also needs to be a feedback loop where once implemented policy is refined based on the experience of firms and supervisors.

Philosophy: It is essential that supervisors have clear mandates and powers and that there is clarity on how these will be used. Supervisors should be transparent regarding the principles, objectives and practice of supervision and on their priorities in deciding where to act. The operational independence of supervisory authorities is fundamental to that accountability.

Supervision needs to be more intensive and challenging than in the past. Supervisors' powers, responsibilities and accountability must be clear and their actions need to be proportionate and transparent. This report explores the changes that are necessary for firms to achieve better and more comprehensive engagement with supervisors. Equally, supervision should not be about shadow-running firms or second-guessing all decisions. Good supervision is a shared interest, and should be a shared priority for the future of the financial industry.



Peter Sands

Chair, IIF Special Committee on Effective Regulation
Group Chief Executive
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CONTENTS

Preface ii

IIF Board of Directors 2

IIF Special Committee on Effective Regulation 4

IIF Effective Supervision Advisory Group 8

Executive Summary 11

Introduction 13

Section 1 – The Nature and Role of Supervision 15

Section 2 – Achieving Effective Supervision 19

Section 3 – Working Together: The Supervisory Relationship 27

Conclusion 31

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EXECUTIVE SUMMARY

Improved supervision has a central role in reinforcing and sustaining the sound practices being developed and consolidated in financial firms and in buttressing strengthened regulation and resolution arrangements. Regulation alone cannot create a safer financial system—it can only do so if partnered with improved industry practices and a strengthened global supervisory system. Global supervisory reform and improvement should therefore have a place at the center of the G-20 agenda for the coming years.

Responsible and well-run firms have every reason to welcome strong and effective supervision. It provides another pair of eyes trained on the company that is able to identify potential risks and problems at an early stage, often drawing on an industry-wide perspective. It gives the management of a firm a valuable alternative perspective on what is going on in the company and, in doing so, bolsters the work of the Chief Risk Officer (CRO) and risk management operations.

Intensive and effective supervision also acts as an essential discipline and corrective on the industry as a whole, by holding all regulated financial institutions to demanding risk management standards and providing a source of challenge to any relaxation of controls or build-up of risk in individual firms. In doing so, it contributes to the greater stability of the system in general and reduces the risk that firms, their customers, their shareholders, and the general public will have to pick up the cost of failings of other firms.

As the Financial Stability Board (FSB) has recognized, supervision needs to improve across the board. It needs to be more intensive, challenging, and action-focused than before, based on clear mandates, powers, and full accountability. It needs to be adapted to the size, complexity, and interconnectedness of the financial institution being supervised.

A more intensive and challenging approach will bring significant benefits only if it is combined with appropriately high-quality supervisory methodologies. Simply being more active or substituting intensity for quality will produce adverse effects rather than reductions in risk. The aim should be to achieve high standards of governance and risk management across the industry.

Supervisors must have a comprehensive and thorough view of the risk profiles of individual firms as well as a full understanding of the industry in which they operate. This needs to be informed by effective cross-sectoral and cross-border analysis and reinforced by cooperation with other national supervisors, including through cross-border supervisory colleges. Good supervision needs to be informed by a comprehensive understanding of the totality of the financial sector, including those parts outside of the core regulated sector. This is a demanding task, and firms must constantly endeavor to assist supervisors in this.

Firms need to ensure that supervisors have full access to the data necessary to understand an individual firm and the broader context in which it operates. Supervisors need to have the tools, techniques, and expertise to analyze this information. They need to have adequate staffing and resources and be able to use expertise and judgment in challenging firms both nationally and globally.

There must be no tolerance of jurisdictions with insufficient supervisory quality or resources, and active measures to tackle any weaknesses here.

Achieving all of this may entail significant new costs, but the industry is prepared to meet these if they deliver the kinds of improvements sought. The industry is also keen to play its role by supporting and upgrading the level of secondments both into and out of firms, and it is willing to work to set out a Code of Best Practice to address potential conflict of interest issues.

The industry has a major responsibility to ensure that supervision is credible and effective. Individual firms and the industry as a whole must do much better than in the past. High-quality supervision is a common interest and a shared responsibility, and the industry needs to recognize this and act on it.

Through its Effective Supervision Advisory Group, the Institute of International Finance (IIF) has developed a set of twelve core recommendations aimed at effecting the necessary changes in many firms and improving the level and nature of engagement with supervisors. These recommendations cover data provision, greater engagement of Boards, and, above all, interaction with supervisors on the basis of “no surprises” and full

communication and openness. Senior management and the Board must set the right tone at the top and ensure that an appropriately supportive attitude to supervision becomes pervasive throughout groups.

On their own, supervisors and the industry can only go so far. The challenge now is for national jurisdictions to make a clear commitment to providing supervisors with the resources to enable them to recruit and retain the highest caliber of staff and to ensure their complete independence and accountability. G-20 leaders and the FSB should continue to foster the conditions for much greater levels of cross-border supervisory convergence and mutual reliance in colleges premised on comparably rigorous standards across all jurisdictions.

Since the onset of the financial crisis, there has been an extensive program of regulatory reform aimed at increasing financial stability and avoiding crises of the kind seen over the past three years.

These reforms have focused primarily on regulatory policy, requiring that banks and other financial institutions have increased levels of high-quality capital and liquidity; that markets are more closely regulated and transparent; and that moral hazard is reduced. The industry has welcomed and supported the broad direction of these reforms.

The industry, for its part, has also adopted reforms, focusing on the identification and implementation of sound practices aimed at putting in place the right risk management systems and culture so that financial institutions are prudently and sustainably run.¹ The long-term resilience of the financial system depends fundamentally on the application of such sound practices. Identifying and implementing these is a significant challenge but one that is well underway across the industry. Embedding these practices securely for the long term is an essential but demanding objective.

None of these essential reforms will be fully effective in achieving a more stable financial system if they are not accompanied by more effective supervision both within countries and on a comprehensive global basis. This is necessary to ensure that improvements are sustained as economic conditions improve and memories of the financial crisis fade.

Getting supervision right is an important common interest of the authorities and the financial sector. Financial institutions benefit from well-resourced and effective supervision. Such supervision provides another pair of eyes trained on the company able to help identify potential risks at an early stage—often drawing on an industry-wide perspective. It gives the management of the firm a valuable alternative view on what is going on both within the firm and more widely and, in doing so, bolsters the work of the firm's risk management team and structures.

Intensive and effective supervision acts as an important discipline and corrective on the industry as a whole, by holding all regulated financial institutions to demanding risk management standards and acting as a source of challenge to any relaxation of controls or build-up of risk in individual firms. In doing this, it contributes to the stability of the entire system and reduces the risk that firms, their customers, their shareholders, and the general public will have to pick up the cost of failings of other firms. For all these reasons, supervisory reform and improvement need to have a place at the center of the G-20 agenda for a considerable time to come.

Over the last year, there has been an increased and welcome focus on supervision, building on many examples of good practice around the world and learning the lessons of the crisis. In November 2010, the FSB released its report, *Intensity and Effectiveness of SIFI Supervision*. This report made a number of recommendations for improvements. The G-20 at its summit in Seoul in November 2010 endorsed these recommendations and set a number of deadlines for further work.

Given its shared interest in effective supervision, the industry both collectively and at the individual firm level needs to make changes and engage fully in making supervision significantly more effective and durable. With this in mind, in October 2010, the Institute established an Effective Supervision Advisory Group under the chairmanship of Kerstin af Jochnick, Managing Director of the Swedish Banking Association and former Chair of the Committee of European Banking Supervisors, to see how the Institute could most effectively engage and contribute. Members of this group included senior participants from a variety of backgrounds, including a number of former senior supervisors. The Institute also held a high-level symposium on supervision in Toronto in May 2011, with senior regulators, supervisors, and industry leaders from around the world to discuss lessons for supervision from the financial crisis, changes that can be made to enable supervision to become increasingly

¹ See, for instance, the IIF's reports: *Final Report of the Committee on Market Best Practices* (July 2008); *Restoring Confidence, Creating Resilience* (July 2009); *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System* (December 2009); *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions* (June 2011); and *Risk IT and Operations: Strengthening capabilities* (June 2011).

effective, and how to ensure the most effective relationship between supervisors and firms.

This paper is the product of this work. It aims to contribute to the strengthening of supervision by setting out a constructive industry perspective on making high quality and intensive supervision fully effective. It does not attempt to comment on individual country practices. Rather, it sets out a number of universal principles along with the actions that the industry needs to take to help put these principles into effect.

The paper is organized into three sections:

Section 1 covers the nature and role of post-crisis supervision.

Section 2 looks at how more effective supervision can be achieved in practice.

Section 3 looks at how the industry can contribute to more effective supervision.

SECTION 1 – THE NATURE AND ROLE OF SUPERVISION

Key Messages

It is essential that supervisors have clear mandates and powers and that there be clarity and communication on how these will be used.

Supervision needs to be more intensive and challenging than in the past. Supervisors' powers and responsibilities need to be clear and their actions need to be proportionate. Supervision should not be about shadow-running firms or second-guessing all decisions.

Good supervision should be seen as a shared interest of both supervisors and firms. Holding firms to established practices can create a positively reinforcing dynamic between improved industry practices and an enhanced mode of supervision. The industry has recognized the need for such sound practices and has carried out a major work program to ensure that they are implemented. Effective supervision will act to bolster these improvements and help ensure that good intentions are sustained.

There is no case for adopting fundamentally different approaches to groups of firms that may be judged to be systemic. Instead there should be a consistent approach, albeit with adjustments depending on the size, complexity, and interconnectedness of the firm concerned.

If supervision is to play a full part in preventing a recurrence of the problems of recent years, it is essential that there is clarity on its central purpose and nature and how these aims will be delivered in practice. Supervisors and supervised, market participants, and all other stakeholders need to be aware of what supervision is meant to deliver and have a clear sense of the borderline between supervisory discipline and market discipline.

The principal purpose of supervision must be to seek to ensure that firms' pursuit of their commercial objectives is consistent with the public interest in resilient and smoothly functioning financial markets that serve the sustained growth of the global real economy. The Institute believes that supervision needs,

on a risk-based basis, to be markedly more intensive and challenging than in the past if it is to be effective. Where necessary, supervisors must be ready to take firm and concrete actions to mitigate firm-specific and system-wide risks.

This, however, need to be strongly grounded in a view of supervision as being designed to achieve effective controls, good governance, and high-quality risk management. This goes beyond the narrow limiting of risks. Healthy economies require dynamic and diverse financial firms. The role of supervision is to ensure that they are well managed and run, rather than to restrict them to a centrally determined set of options.

Intensive, Risk-based Oversight

Supervisors need to be confident that firms' strategies and processes are sound and that their governance, management, controls, and financial resources are commensurate with the risks being taken.

Supervision needs to go beyond the narrow implementation of regulations, to support the development of increasingly sound and sophisticated industry practices. The complex process of creating consistent day-to-day and case-by-case supervision is key to the stability of the financial system. To that end, regulation needs to set clear minimum standards but must avoid over-prescription.

Supervision needs to be about well-informed, assertive supervisors developing a clear understanding both of a firm's risk profile arising out of its business model and of its governance, management, controls, and financial resources. To achieve this, supervisors need to ask intelligent, tough, searching questions to which they have a right to expect clear and comprehensive responses.

Firms and the authorities have a powerful shared interest in achieving effective supervision. For the authorities, supervision is an essential tool for delivering regulatory objectives rather than merely ensuring compliance with the letter of regulation. Effective supervision based upon a comprehensive understanding of risks both firm-specific and system-wide can help ensure that these are being properly

addressed and controlled. There is great potential benefit in supervisors being extensively consulted on the formulation of regulatory policy, where their first-hand experience can be invaluable.

For firms, supporting and fully engaging with effective supervision contributes to the provision of a long-term stable environment in which to carry on business. It provides an important source of challenge to their business models and their internal governance and control processes, to the longer-term benefit of shareholders and creditors alike. It also allows firms to draw on the unique perspective that supervisors have on Industry-wide sound practices, and it can assist the development of better internal practices and supervisors' understanding of these.

To achieve these objectives, supervisors should:

- i. Have a clear, industry-wide vision of how well-run firms operate, how they decide on their business models, and how they are governed, managed, and controlled.
- ii. At the level of the individual firm, get a clear understanding of how the firm is operating and whether this measures up to actual risks and the required standards.
- iii. Develop comprehensive and effective two-way communication to reach this clear understanding through access to all necessary information and a willingness to challenge on material issues. Supervisors need to be clear about their information requirements and expected standards and be willing to listen.
- iv. Insist on improvements where these are needed, where there are shortfalls in relation to minimum standards, and where management or controls are deficient and not commensurate to the risks being taken.

This means, for instance, that when dealing with Boards, supervisors should ask tough questions and be willing to challenge Board members. At a minimum they should aim to establish the extent to which individual Board members have the necessary skills and understanding to undertake their roles. Ultimately however, the object is to establish whether the Board as a whole is really making a difference in terms of determining strategy and risk appetite and making certain that interaction with senior management and the business is sufficient to ensure that Board guidance is being adhered to.

Supervisors should question and challenge the roles of the Board and management in setting the risk

framework and monitoring compliance with it. Key to this will be how the risk appetite, risk controls and limits are monitored and operated.

To do this effectively, supervisors need to develop a thorough and rigorous understanding of the firm's strategy and business model and have access to all internal data and analysis necessary to do so. They should be willing to challenge the assumptions and analysis underlying these (i.e., market share analysis, comparative strengths, pricing, and profit projections) and, if necessary, point out the weakness or impossibility of certain strategies. They need to be in a position in which they thoroughly understand and are able to challenge banks' business models, while recognizing that (not the supervisor) senior management has responsibility for these.

In the event of supervisors concluding that a firm's business model or strategy is a significant source of risk, supervisors need to challenge further (e.g., at the Board level) and, if still not satisfied, insist on an appropriate strengthening of internal controls or, in extreme cases, limitations on the activities concerned.

Supervision should therefore be:

- **Intensive:** shining a strong light on what is really happening in the firm, on the strength and weaknesses of its business model, risk profile, and supporting risk measurement and management practices, as well as how the firm's management and governance and internal control processes are responding in practice to firm-specific and system-wide risks and how these measure up to sound practices.
- **Challenging:** exerting continuous pressure on the firm to explain and, where necessary, review, the extent to which it has established and maintains an effective and well-managed strategy, how this is implemented and fits within a coherent and well-defined risk appetite, and how it is supported by strong internal processes for measuring and managing the risks involved.
- **Action-focused:** reaching clear judgments and being ready to act upon them, where necessary, by intervening to ensure that any shortcomings are corrected.

These characteristics will become more, not less, necessary as the economy recovers and as we move further away from the crisis. As the FSB report argues, "*In the future, supervisory authorities must conduct themselves with a 'through the cycle' mentality.*" This is equally true for the industry and individual firms.²

² As a recent IMF Staff Position Note - *The Making of Good Supervision: Learning to Say "No"* (May 2010) - points out: "Prudential supervision is most valuable when it is least valued; restricting reckless banks during a boom is seldom appreciated but may be the single most useful step a supervisor can take in reducing failures."

But in doing so, it is essential that this intensity, challenging nature, and focus on action be seen as components of more effective and intelligent supervision rather than as ends in themselves. There is a significant risk that increased activity and the imposition of more requirements will themselves be mistaken for the more effective supervision sought. Any such tendency to see supervisory activism as an end in itself should be resisted as it will not achieve the aims of firmly embedding enhanced governance, improving risk-management, and increasing the effectiveness of controls.

It is important that supervisors not be tempted by the financial crisis to tear up existing supervisory approaches. Good supervisory practices before the crisis remain good supervisory practices after the crisis. The discipline of proportionality needs to be maintained through the cycle. Notwithstanding the need to review a number of aspects of effective supervision, supervision should therefore remain proportionate, consultative, and fully accountable.

In the boxes in the following sections we provide some examples of how supervision with these characteristics might differ from less effective modes of supervision.

What the crisis showed is that those jurisdictions that had a more intensive and challenging approach were better able to weather the storm. That said, there needs to be clarity about the limits of supervisors' powers and responsibilities. It is in neither the interest of the supervisor nor of the firm—nor indeed of financial safety and soundness—for supervisors, in effect, to shadow-run individual firms or second-guess their every move. It is important that managements run firms under the direction of their Boards, which represent the interests of shareholders, and that the strategy of a firm stays within the responsibility of that Board. We look at these issues in more detail in Section 3.

The Institute believes that a fact-based, intensive, challenging, and action-focused approach is, in principle, appropriate for all firms. It will be appropriate and necessary to adjust the intensity and focus of supervision, together with the resources deployed, according to the size, complexity, and interconnectedness of the institution concerned. However, there is no case for adopting supervisory approaches that are fundamentally different for firms that may be judged to be systemic.

Sound Cycle-Proof Practices

Supervision needs to act in a mutually reinforcing way with sound industry practices. At an early stage in the crisis, the Institute recognized the need for intensive

work by the global industry to identify and elaborate on sound practices across the full range of firms' activities. This work included corporate governance, risk governance and management, valuation, compensation, and credit underwriting, as well as other areas. In its *Final Report of the IIF Committee on Market Best Practices (CMBP Report)* of July 2008, the Institute developed a range of detailed proposals and recommendations to firms in each of these areas.

Recognizing that this was only the start of a process of strengthening industry practices, the Institute established a major work program, led by its Steering Committee on Implementation (SCI), to follow up on this first phase by promoting, facilitating, and monitoring the implementation of these principles and recommendations across the global industry. In December 2009, the SCI published *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*. Based on a detailed survey carried out by Ernst & Young, this report noted that while good progress was being made in the implementation of the earlier report, a great deal remained to be done. The report also included revised recommendations, including significant further analysis in the areas of risk culture and risk appetite.

In 2010, the SCI conducted a follow-up review to assess areas where progress has been made and where challenges remain. Again, Ernst & Young supported this by undertaking a second survey, the results of which are summarized in the April 2011 report, *Making Strides in Financial Services Risk Management*. The results indicate that the industry is making deep and sustainable progress in improving internal risk practices, but that firms recognize that the job is by no means complete and that further effort needs to be made in a number of areas. Two of these—risk appetite and risk IT—are the focus of separate SCI reports released in June 2011. In addition, the Institute is undertaking another detailed survey of the reform of compensation practices based on 2010 results, the outcome of which will be published later this year.

As part of its work on sound industry practices, the Institute has had important and fruitful discussions with the Senior Supervisors Group. It is clear from this dialogue that both the official sector and the industry are pursuing closely related goals and objectives in this area.

It is also clear that both sides, while focused in the immediate term on the implementation of better practices, are concerned to identify the best means to ensure that once implemented, such practices will be durable and not subject to erosion during cyclical upswings. While there is no simple solution to this, the

creation of a positively reinforcing dynamic between improved industry practices and an enhanced mode of supervision has a potentially key role.

The Mandate, Powers, Independence, and Accountability of Supervisors

If strengthened supervision is to be delivered in the future and is to reinforce sound practices, it is essential that supervisors have clear mandates and powers and that there is clarity about how these will be used. Supervisors should be transparent regarding the principles, objectives, and practice of supervision and on their priorities in deciding where to act.

Such clarity of mandate helps make supervisory decisions more transparent and predictable and allows responsible financial institutions to act in a way consonant with supervisory objectives, with less need for direction, rules, and sanctions. It also helps ensure a consistency of approach across supervised institutions and the financial sector, an issue to which supervisors should be particularly attentive. Equally, the more that supervisors move toward clear, common, and convergent mandates globally, the easier it will be for them to cooperate and trust one another. The industry, therefore, agrees with the recommendation in the FSB report that Basel Core Principle 1 be clarified to provide much greater detail and for the International Association of Insurance Supervisors (IAIS) to consider enhancing the relevant Insurance Core Principle.

The operational independence of supervisory authorities is essential and will become even more important as markets continue to globalize. There

must be no doubt of the ability and will of supervisory authorities to take tough actions even—and perhaps especially—when these go against the short-term goals of government, legislative, or industry players. The industry therefore agrees with the FSB report that the Basel Core Principles should be expanded and made more detailed. It would also favor rigorous monitoring being carried out by jurisdictions against these Principles. Equally, if supervisors are to exercise this independence, they must benefit from an extremely high degree of budgetary autonomy that guarantees adequate resources.

Fundamental to that independence and autonomy is accountability. The supervisor should have a duty to explain and defend their overall approach and cross-industry decisions on an ex post basis, while having independence with respect to individual decisions. Supervisors should be required to set out the broad approach that they intend to take and explain how this is convergent with that of supervisors in other jurisdictions.

The purpose, mandate, independence, and accountability should be the same irrespective of whether the supervisor is overseeing a large complex financial institution in a developed market or a small financial institution in an emerging market. The industry therefore strongly supports the revision to the Basel Core Principles and the IAIS Core Principles being carried out and the more rigorous approach to monitoring implementation proposed. Supervisors should be able to have confidence in their counterparts in all jurisdictions.

SECTION 2 – ACHIEVING EFFECTIVE SUPERVISION

Key Messages

Supervisors need to have a comprehensive and thorough understanding of a firm, its strategy, and its business model, which will allow them to detect emerging problems or potential vulnerabilities and, once detected, to act quickly and effectively. This needs to extend across the financial institution or group and needs to be coupled with a clear understanding of the wider context and market environment in which the firm is operating.

Good formal and informal communication between supervisors and supervised at all levels is key to this understanding. Firms should ensure that supervisors have access to all relevant data and, equally important, that they are aware of its limitations. Supervisors should employ a well-considered approach to data collection that maximizes the use and benefits relative to the cost of production, and consult with firms to the extent possible.

In addition, supervisors must equip themselves with the techniques and tools necessary to analyze this data and constantly upgrade these techniques and tools. Horizontal reviews, stress testing, and financial statement and business model analysis can all be useful here. To make fully effective use of these, supervisors will need to have appropriate training and expertise.

Supervisors must be ready to act on a graduated basis and, if necessary, to intervene when the risks run by firms are judged to be unacceptable. However such action should be effective and foreseeable by the firm. Action and intervention should be focused primarily on ensuring that the governance, controls, and risk management of the firm are commensurate to the business and risks being undertaken. As noted in Section 1, it should not be about shadow-running the firm.

Supervision can only be truly effective if supervisors have adequate staffing and resources both nationally and globally. This may entail significant new costs, but the industry is prepared to

meet these if they deliver the kinds of improvements sought. It would be a far better use of additional financial demands on firms than generalized levies or broad purpose funds. The industry is keen to play its role by supporting and upgrading the level of secondments both into and out of firms, and it is willing to work on a Code of Best Practice to address conflict of interest issues here.

All of this needs to be underpinned by a more global approach to supervision. There needs to be far greater cooperation, coordination, and information sharing in colleges and far greater cross-border convergence. Whatever the difficulties, there are no excuses for not doing this. There also needs to be sustained pressure and action on jurisdictions that do not meet the necessary standards.

As discussed in Section 1, effective supervision means that supervisors need to have:

- A clear understanding of generic risk and how this can manifest itself in the specific area of the financial services sector in which the firm is located.
- A comprehensive understanding of the specific risks being run by the firm and the wider industry. Supervisors also need to have a clear view of potential systemic risk, looking beyond existing regulatory boundaries.
- Effective powers to intervene and require change where necessary, together with predictability regarding the general circumstances in which this will take place and state-of-the-art analytical tools and techniques both nationally and globally.

Supervisors need to have adequate resources and training to allow them to do their job and fully hold firms to account. Moreover, the crisis has demonstrated that it is no longer enough to consider this from a purely national perspective. The international dimension of the supervisory task as it applies to international firms needs to be carefully considered and acted upon.

Risk in the Firm and the System

If supervisors are to be in the most effective position possible to ensure the safety and soundness of individual firms, they need to develop a comprehensive and thorough understanding of the firm and the wider market and systemic environment in which it operates. This will allow them to detect emerging problems or potential vulnerabilities in firms and, once detected, to act quickly and effectively to mitigate them.

As the IMF Staff Position³ Note puts it: “*Supervision is premised on an intimate knowledge of the supervised entity.... Supervisors in the financial sector should not be viewed as hands-off or distant observers, but rather a presence that is felt continuously.*”

In the case of complex and potentially systemically important firms, there is no template for accomplishing this. The firm’s activities and, to some extent, its management and control structures will be unique. Supervisors, therefore, need to be equipped with an intellectual “framework,” or set of generic hypotheses about risk and its management, within which it will be possible for them to make an assessment of these firm-specific issues. Developing this framework and making flexible use of it is a major challenge for all supervisors. It is essential that the industry assist with this through openness in communicating up-to-date industry-wide technical information and identifying and sharing sound industry practice.

Once equipped with this general framework, supervisors need to develop an intimate knowledge of each firm. They need to have all the information necessary to allow them to make an assessment of its size, complexity and any other factors that will determine the appropriate supervisory approach and intensity. They will need to develop a full understanding of the firm’s business model and strategy and its governance, management, and control functions, in particular, the adequacy of arrangements for measuring and managing risk in stressed as well as business-as-usual circumstances. This understanding of potential risk should derive from the firm’s business model and risk controls and should also be alert to any risks arising out of new products or practices. Where necessary, other authorities and macroprudential authorities may need to be alerted to these.

The purview of good supervision needs to extend beyond the individual firm or entity. This means that a group’s supervisors must collectively be clear about the totality of the risks facing the financial institution or group. Supervisors must therefore engage effectively with others, either elsewhere within the same

supervisory authority (depending on the supervisory structure) or with other agencies and, where necessary, with supervisors in third countries. The industry very much welcomes the recognition of this in the FSB report. Colleges of supervisors will have a central role to play here.

Beyond individual financial institutions or groups, the crisis has underlined the need for a much broader systemic view. Supervisors need to have an understanding of the wider risks being built up in the system and, if necessary, intervene. The emphasis in the FSB report on this is welcome.

If supervisors are to arrive at a comprehensive view of risk, it is critical that they have access to all relevant data and that firms continuously make best efforts to provide them with this. The industry agrees with the recommendation in the FSB report that supervisors study their data needs and data processing capabilities and address any deficiencies.

The industry itself is collecting more—and more granular—data than in the past for internal risk management purposes. Given the significant overlap between the needs of well-run firms and those of their microprudential supervisors, there should be substantial overlap between these data. Macroprudential oversight, however, is likely to deal much more with externalities and there may, in consequence, be far less congruence in requirements. Firms and the industry as a whole nevertheless have a duty to provide data for such purposes, and it is firmly in their best interests to do so. Once again, the industry accepts that a “no excuses” approach should be taken here. The IIF has addressed these issues in more detail in its July 2011 report, *Macroprudential Oversight: An Industry Perspective*.

Data, however, are usually only meaningful within a context. Supervisors need to be aware of the limitations of data per se, and firms need to be willing to engage in a dialogue designed to explain its content, context, and limitations. This will help ensure that the data are put to the best use.

Supervisors therefore need to employ a well-considered approach to data collection that maximizes the use and benefit of data relative to the cost of production. They should consider their data requirements carefully and whether the information sought is necessary and best suited to the task at hand and will be used appropriately or whether the same information exists in data that has already been collected by themselves or others, such as other college members. Wherever possible, consultations with individual firms and the industry should be held to

³ IMF Staff Position Note op. cit

help determine whether data collection is taking place in the most cost-effective way. The more consistent and predictable an approach that supervisors can take here, the more that a firm will be able to embed such data requirements into its own IT systems and data collection. Ex post reviews of data usage could also help improve effectiveness.

Such a well-considered approach is not only in the interests of cost-efficiency and proportionality, it is in the interests of supervisors themselves because it allows them to target and analyze relevant data rather than be overwhelmed with extraneous information. This type of approach also promotes the kind of effective cooperation with firms and sound risk management by those firms discussed in Section 3 below. Supervisors should use data to test firms' risk controls rather than to supplant them.

An essential component in this understanding of the risk of a firm will be the audit report. Such reports can be a valuable source of information to supervisors on control problems and areas of potential risk. Regular dialogue, meetings, and onsite evaluations are critical for both sides and will facilitate risk assessment, whether the auditor is an internal or external one. When dealing with the latter, it continues to be extremely important that auditors be adequately protected against liability for information disclosed in good faith to supervisory authorities, and that there be a legal gateway for the supervisor to disclose information that is of relevance to the external auditor. Risk management reports can also be a valuable source of information.

Yet even these improvements will be of only limited value to the supervisors of cross-border firms if there is not an accompanying move to greater cross-border cooperation and consistency. Just as firms need firm-wide data and data aggregation, so supervisors need a genuinely group-wide perspective and approach, which requires aggregation of supervisory intelligence and efforts. There should be no gaps in supervision or oversight of global groups. The more that supervisors can minimize overlaps of supervision and avoid conflicting requests or instructions both in normal times and in stressed circumstances, the stronger their effective oversight. Critical to this will be increased reliance on supervisory colleges and much improved exchange and circulation of information, including joint risk assessments within and possibly across colleges. The industry believes that the G-20 should give far greater impetus to the work of colleges.

In June 2010, the IIF wrote to the Basel Committee on Banking Supervision (BCBS) on this subject in

response to a consultation. The Institute argued that colleges should be given a strong and clear role as bodies with a clear objective of making supervision more effective and efficient. To that end, there should be clear internal accountability within colleges, with supervisors being held to account to follow up on commitments made. The BCBS should set ambitious targets for more effective collaborative work. Colleges should also work toward collective common interpretations of rules, and much greater attention should be paid than in the past to joint working and joint exercises (such as group-wide stress tests) aimed at arriving at a comprehensive and common view of group-wide risk. The industry, therefore, strongly agrees with the recommendation in the FSB report that the BCBS Standards Implementation Group and the IAIS study the effectiveness of improvements made to colleges, but would encourage supervisors to go much further on this issue.

As with supervision in general, improving the functioning of colleges will pay huge dividends for firms as well as contributing directly to financial stability. Solid cooperation between the members of a college and between the college and the firm should be premised on stringent confidentiality standards and information security arrangements and, provided these are in place, confidentiality should not be used as a pretext for withholding relevant information from other college members with a legitimate need to know. The industry has a major role to play in working with supervisors in colleges to promote cooperation and alert supervisors to any problems or conflicts.

There also needs to be far greater supervisory cooperation on crisis management and resolution. The IIF recommended this as part of a move to a comprehensive global resolution regime in its May 2010 report, *A Global Approach to Resolving Failing Firms: An Industry Perspective*, and made a number of further suggestions in its April 2011 submission to international authorities, *Addressing Priority Issues in Cross-Border Resolution*. There has been encouraging progress both on more convergent resolution powers and regimes and on greater cooperation and information sharing within crisis management groups, but far more could be done.

The Techniques and Powers of Effective Supervision

The crisis demonstrated that in many cases supervisory techniques failed fully to keep up with IT or business developments in firms and that, consequently, supervisors were unable to challenge these adequately. Given this, the industry fully agrees with the FSB report

that there needs to be a constant process of upgrading supervisory techniques to strengthen the intensity of supervision.

It is important that supervisors and firms develop and implement analytical techniques and expertise to enable them to subject firms' models and assumptions to tough challenge. If they are to be fully credible, supervisors must be seen as equals to their counterparts in firms in terms of both general standing and technical expertise.

This will depend partly on supervisors having the appropriate training and other formal approaches to developing expertise. The industry, which, by definition, will always be at the forefront of technical and market developments, has a key role in supporting these. There is also compelling evidence that horizontal reviews of a number of comparable financial institutions can be very helpful, both from the perspective of reducing systemic risk and from that of detecting problems across firms.

The FSB report highlighted the importance of horizontal reviews and suggested developing "*a means for the broad, thematic (i.e., not firm-specific) results of domestic horizontal reviews*" to be shared within the FSB.

Such reviews allow supervisors to understand, scrutinize, and respond to emerging industry trends and how firms are responding to these. They also allow supervisors of complex firms to develop (with specialist support) the generic framework referred to above, within which they can better assess individual firms' management of risks.

Reviews are also of great value to firms when used as a source of advice and guidance on Industry practice. Supervisors have a unique and privileged oversight of the financial system and the firms operating within it. The information distilled from this—subject to confidentiality constraints—is of great value to firms eager to know where they stand in relation to market practice. Statements from supervisors such as, "[W]e have examined ten firms' practices in this area, and yours are among the weakest for the following reasons..." or "[E]merging industry sound practice is moving in the following direction..." are of real value.

The industry believes that supervisors should go further and promote much greater use of international horizontal thematic reviews or involvement of third-country supervisors in the reviews. Such reviews, if conducted across a number of jurisdictions and a suitable peer group of internationally active banking groups, can play an important role in fostering a new quality of supervisory communication and joint supervisory work within and across supervisory

colleges. They can also contribute enormously to the international convergence of supervisory cultures and concrete supervisory practices, including the development of coordinated and, ideally, joint, micro- and macroprudential risk assessment and risk mitigation at the international level.

The industry would strongly encourage the development and conduct of such horizontal reviews as part of an internationally coordinated supervisory strategy based on an annual supervisory planning process. The FSB would be an ideal forum for this. It could draw on other sources of available expertise in identifying the most relevant micro- and macroprudential issues to be covered in the reviews and provide the infrastructure for a coordinated implementation of the supervisory plan across all participating jurisdictions and supervisory colleges.

A formalized public-private dialogue during and after the exercise, including summary reports of findings and recommendations much like the publications of the SSG would be of considerable value. Close interaction and, as appropriate, collective public-private work to address emerging risks and risk trends would foster the resilience of the international financial system and contribute significantly to a continuous improvement of sound market practices well beyond regulatory minimum requirements.

At the very least, the FSB proposal to move to the sharing of results within the FSB Peer Review Council should be implemented.

Stress testing should primarily be seen as a key tool of high-quality risk management and through this to systemic stability and lasting resilience. In the Institute's *Final Report of the IIF Committee on Market Best Practices* (July 2008), a number of key principles and recommendations were set out to incorporate strong and effective stress testing as part of firms' risk management. There was an urgent call for refinement of stress testing methodologies so that they are consistently applied as well as flexible and versatile. In the follow-up report, *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System* (December 2009), a range of improvements that had already been achieved were set out.

The use of effective stress tests should form part of the supervisory relationship, and the new European Banking Authority (EBA) should continue, in close dialogue with the industry, to identify and implement sound supervisory practices in this area. A distinction can be drawn between institution-specific stress testing undertaken as part of a firm's risk management practices and what might be considered systemic

stability stress testing. The latter serves a very different purpose, and this paper is concerned principally with the former. Firm-specific stress tests should be carried out at the group level and need to be designed to assess the resilience of a firm to extreme but plausible events. The results of such testing undertaken for internal risk management purposes should not be made public in any form, for to do so would be to change the tests' essential nature and significantly undermine their ability to achieve their essential objectives.

The Institute agrees with the FSB report that financial statement analysis by supervisory experts can play a valuable role in ensuring the right intensity of supervision—allowing supervisors to ask the right questions and, in turn, alerting firms to potential areas of weakness. Supervision does, however, need to be done on the basis of discussion between supervisors and supervised entities in which the supervisor interprets the results of financial statement analysis intelligently.

The industry also supports the FSB call for greater challenge of business models and product-oriented risk analysis as a way to subject firms to stronger scrutiny. This again should be used intelligently as a way of supporting other analysis and as a way of enabling supervisors to ask tough questions. Supervisors also need the right quality of staff and resources to be able to do this.

Graduated Action

Even with the most sophisticated supervisory techniques and cooperation from firms and the industry, there will be a need for supervisors to act when they are concerned about the risks being run by firms—especially if these pose a threat to the stability of the financial system—when there are material divergences between the risks being assumed by a firm and its ability to measure and manage them in a prudent manner or if there is a real and imminent risk of the firm's failure. The industry therefore recognizes the need for a strong and decisive mandate under which such actions at these various points can take place.

Supervisory action on a “going concern” basis, in which the firm is running unacceptable risks relative to its ability to manage them but where failure may not be imminent, needs to involve a graduated set of responses on the part of the supervisor that are effective and foreseeable by the firm. Where possible, supervisors should also use firm management or governance processes to effect needed improvements, while of course being mindful that their objective is to ensure that the governance, control, and risk management within the firm are appropriate to the business and risks

being undertaken rather than to limit the business or risks undertaken to a restricted set of options.

Once a supervisor starts to identify serious issues, there should be a clear process in place to allow such issues to be speedily escalated upward within the firm and the supervisory body. This is likely to involve:

- Challenging the basis of the business model or strategy, seeking a full understanding of the basis for the relevant decisions, and, if necessary, a statement from the Board that it has approved these decisions and actions.
- Understanding fully how this business model or strategy fits within the firm's risk strategy and appetite. All strategies will entail some degree of risk; the issue is always whether the firm has fully understood and quantified these and put into place the necessary monitoring and control mechanisms. If firms are not following sound practices in this regard, supervisors should insist on necessary improvements and use various possible tools to achieve these.
- 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.
- 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. In such relatively rare instances, there may be a case for the supervisor to insist on a limitation or prohibition in the product or business being provided or undertaken by withholding the necessary permissions for the firm to engage in the activity concerned on penalty of enforcement. This would not extend to prescribing alternatives.
- Because of the strong tension between imposing such limitations and the important benefits that derive from a diversity of business models and approaches, such an approach should be highly unusual and seen as a last resort once all other measures have been implemented without success. Such decisions should be taken at the highest levels in the supervisory authority and extensively justified on legal grounds. Regular use of such powers would indicate deficiencies in the overall supervisory standards or resources that would need to be addressed at a more fundamental level.

Effective Supervision: Examples of a More Intensive Approach

Effective supervision will involve a more intensive and challenging engagement by supervisors with firms on the full range of issues that determine the firm's risk profile and how that is managed. In this box two examples are set out to show how more intensive supervision can be expected to differ from less effective approaches but without intruding into the running and management of firms' businesses.

Scrutiny of Firms' Business Models

In the past, many supervisors would take firms' business models largely as a given—provided, of course, that these were not obviously reckless or illegal. The emphasis in many cases tended to be on seeking assurance that controls and financial resources were adequate in light of the risks arising out of the model.

The more intensive approach promoted in this paper would see the firm being subjected to much closer scrutiny about its choice of business model. Firms should expect to be challenged on such matters as the basis for choosing a business model; the quality of market analysis, including market share projections and the profits trajectory; comparative advantages of the firm; and the role of the Board. This should be a real and demanding dialogue.

It is quite possible that the supervisor, in light of his or her industry-wide knowledge and with expert support, may be satisfied that the firm is not running unacceptable risks. If the supervisor is not satisfied, however, the matter will need to be revisited and, ultimately, intervention may be necessary. The supervisor may, for example:

- Insist on stronger controls and/or Pillar 2 capital add-ons.
- Challenge management or the Board to revisit the assumptions or analysis behind the choice of business model, which is a legitimate action given the supervisor's sector-wide perspective.

In some exceptional cases the supervisor may still judge—and feel able to make a defensible case—that the business model is unsustainable or an unacceptable source of risk. In these rare cases, intervention may take the form of actively limiting the firm's activities. This could occur, for example, through adjustment or suspension of the firm's

permissions to undertake certain businesses under penalty of enforcement.

Supervisors will need to take this step with the full consideration and agreement of their senior management if it is necessary to forestall demonstrable and significant risk. It is essential that such exceptional interventions are limited and do not involve supervisors prescribing particular strategies or business models but rather restricting or prohibiting activities that can defensibly be judged to pose a threat to the financial system. There should be no question of such actions being taken routinely—something that could be perceived as shadow-managing the firms concerned and ultimately creating moral hazard. Supervisors will also need to be accountable for their decisions at the very highest level.

Board Engagement in Risk and Risk Appetite

There is a growing recognition on the part of firms and supervisors that Boards need to be more actively engaged in the setting of risk parameters for the firm (the 'risk appetite') and monitoring compliance with these. In the past there tended to be excessive supervisory emphasis on the *existence* of governance structures, with insufficient attention to the much more difficult issue of the *effectiveness* of these.

The more intensive approach being promoted in this report would see Board members and senior management subjected to much closer scrutiny in these areas. This might be expected to involve close questioning on such issues as the frequency, nature, conclusions, and minuting of Board discussions of risk appetite, evidence of a more pro-active stance in relation to risk and risk appetite, examples of key parameters used to give practical expression to the risk framework, Board members' individual understanding of the issues, the interaction of the Board with the CRO and risk function, and the management information received on the issue.

As with the example of the business model, in many cases it is likely that the supervisor, with their sector-wide perspective and the benefit of specialist advice, will be satisfied with regard to the role of the Board and its members. If this is not the case, however, they would insist on having a channel to the Board Chairman and/or CEO to discuss what they see as deficiencies.

In general, the role of the supervisor should not extend to systematically approving individual Board members, which entails considerable moral hazard and compromises the role of shareholders.

The Importance of Convergence

The supervision of cross-border groups will be strengthened if there is also a move to a greater commonality and convergence of supervisory approaches and standards. Supervisors need to feel confident that their college counterparts are operating along similar systems and in a predictable way.

This is not simple. Most supervisory bodies have long traditions and entrenched cultures and deeply believe in “their” way of doing things. And there are indeed valid differences of approach due to legal and cultural differences across jurisdictions.

However, within these constraints, it is desirable to move as far as possible in the direction of harmonized supervisory approaches. The recent establishment of European Supervisory Authorities in light of the 2009 de Larosière Report on financial supervision in the European Union is both a recognition of this and a demonstration that it is possible given the right level of political will.

The question should not be, “Is exact convergence necessary?” but instead “Are differences in approach really justified?”; “Will remaining differences complicate supervision to an unacceptable extent?”; and, most important, “Are supervisors aiming for, and achieving, comparable outcomes, notwithstanding the differences of approach?”

The crisis has highlighted the fact that far more can and needs to be done in this area. The recommendations of the FSB report repeatedly refer to the need to amend or further clarify both the Basel Core Principles and IAIS Core Principles. The industry strongly supports such efforts, but as with colleges, believes that the G-20 should give far greater impetus to this process.

Ultimately, this needs to be seen as a confidence-building process. The work of the World Bank and IMF through Article 4 and the Financial Sector Assessment Program (FSAP) has brought real and significant improvements. Yet despite the best efforts of these institutions and the supervisors seconded to take part in assessments, more could be done to ensure a consistency of approach and depth of analysis and to compel assessed countries to comply with any recommendations. The FSB has an essential role here in working with the BCBS and IAIS to check compliance.

Maximum pressure needs to be placed on deficient jurisdictions, which may include other jurisdictions placing strict limits on the activities of firms domiciled in the non-compliant countries.

Having the Resources

However clear the purpose and mandate of supervision, however complete the vision, and however strong the powers and techniques, supervision can only be truly intensive, challenging, and action-focused if supervisors have adequate staffing and resources and are able to use expertise and judgment in challenging firms.

Such judgment and challenge can only be credibly undertaken by supervisors who have a deep understanding and experience of the firms they supervise within the wider context of the industry and system-wide risks. This experience allows supervisors to spot potential vulnerabilities or trends that should be explored in thematic rather than firm-specific reviews. Supervisors with experience outside the supervisory authority often can help to better see through the smoke and challenge firms in an appropriately focused manner.

Relative numbers of supervisors are important and should be broadly aligned to absolute and relative levels of risk posed by institutions. The industry agrees with the FSB report that supervisors should review the allocation of resources annually. Supervisors also should have access to data that allows them to make comparisons with other jurisdictions both with regard to past levels relative to the number of financial institutions and capitalization and with regard to third-country staffing levels. While national approaches may differ, there is no inherent reason why resource levels should vary much across countries for comparable firms. For such comparative exercises to be genuinely useful, supervisors need to have the flexibility (within limits) to redeploy staff in the face of changing risks.

There are special challenges in the recruitment and retention of specialists in areas such as risk management and risk IT and how they can be best used to the benefit of the supervisor. Recruiting and retaining appropriately high-quality staff costs money and can seem politically unattractive in the short term. However, in the long term, the economic benefits from the increased safety and soundness of the financial system undertaken by skilled and confident supervisory staff will more than offset higher costs of supervision. The industry does not object to paying such costs per se if it can see that they are translated into higher-quality supervision that produces a more stable financial system. This would represent a far better use of funding than an indiscriminate use of levies on banks.

The industry believes that raising the quality of supervision can be self-reinforcing in that increasingly high-quality staff will be attracted to this activity. Professionals wish to be associated with activities that derive status from being of proven value, and the more supervision is seen as being of high quality and involving valuable and scarce skills, the more firms will value those with supervisory experience. In addition, interchange between supervisory bodies and the industry creates a virtuous circle, thus improving the quality still further. This would be greatly assisted by the removal of excessively high barriers that inhibit – even prevent – movement of staff between the private and official sectors in some countries.

Supervision cannot be based on a static set of skills and experiences but instead needs to be adaptive. Both supervisors and those in supervised entities need to make a conscious effort to stay on top of regulatory and supervisory developments, domestically and internationally; new analytical and risk management techniques and Risk IT; and market and business developments. One way of promoting this might be through the creation of centers of excellence for training on supervisory skills and trends, similar to civil service colleges. One jurisdiction is already exploring this potentially valuable idea. Equally, secondments and internships to financial institutions should be firmly encouraged. The industry would be keen to play its role in this by supporting and upgrading the level of secondments that take place.

There are potential conflict of interest issues that may arise, but these can and should be readily addressed. The industry is willing to work to set out a Code of Best Practice in this area and is keen to work with regulators and supervisors on this issue. One way of reducing such potential conflicts of interest might be for secondments to firms outside the jurisdiction being supervised. This would create an understanding both of the firm but also of the supervisory practices of partner jurisdictions. It is also in the interests of firms and supervisors to encourage secondments and internships in the other direction.

As with the vision, techniques, and powers of supervision, the industry believes that there would be considerable benefit in taking a more global approach to the issue of resources and quality. If supervisors are to feel confident in relying on each other, they

need to have the resources to engage with one another and feel confident in the resources and quality of other supervisors. The system will be undermined if supervision is intense in some jurisdictions but inappropriately relaxed in others.

Therefore, it is important that supervisors allocate appropriate resources to international supervisory issues and that their staff include a mixture of specialists on international law/issues and staff with wider supervisory experience. The industry believes that the FSB should set appropriate minimum staffing and resource levels for supervisors to have the capacity to operate effectively and cooperatively in colleges. Consideration could be given to a new Basel Core Principle that supervisors must devote adequate resources to supervisory cooperation and prompt cooperation.

In line with the FSB report view that “[t]here should be zero tolerance in the global supervisory community for authorities who are operating without an adequate suite of powers,” there must be no acceptance of inadequately resourced or supervised jurisdictions. While the industry recognizes that there are jurisdiction-specific principles involved, given the interconnected nature of the global financial system, supervisory authorities must be in a position to be confident about the quality, staffing levels, and supervisory resources available to their counterparts. Inevitably, jurisdictions with smaller or less developed financial systems will have supervisory arrangements that reflect this. It is nevertheless in the interests of the global financial system as a whole that they be adequately staffed and resourced. Thought should be given to whether transfers of know-how or resources are necessary and whether a mechanism to deliver this (possibly through the IMF/World Bank) could be considered, analogous to the “twinning” programs run by the European Union in the lead-up to the 2004 EU Enlargement.

Secondments both from the industry into less-resourced supervisory bodies and between supervisory bodies may have a role to play here. Firms can also help colleges work by pointing out weaknesses or vulnerabilities and areas where gaps in resources are making a material difference to the quality of their work.

SECTION 3 – WORKING TOGETHER: THE SUPERVISORY RELATIONSHIP

Key Messages

Effective supervision is a shared responsibility that requires cooperation and engagement from individual firms and the industry as a whole, as well as effective supervisors. The industry must do better than it did before the crisis if it is to rebuild the trust between supervisors and supervised entities.

At a collective level, the industry needs to continue to promote improvements to sound industry practice, while resolutely resisting pressures for standards to slip over time as the chastening effects of the crisis fade. To prevent this, supervisors should draw on established sound practices as a benchmark against which to judge the performance and internal controls of firms. If these are not met, they need to take action or increase the intensity of supervision. There is a need for communication and dialogue between supervisors and the industry as a whole on trends and potential problems, building on the work done by the Senior Supervisors Group.

The real focus, however, must be on the behavior of individual firms. Senior management and the Board must set the right tone from the top on cooperation with supervisors and ensure that this is implemented at every level of the organization and across groups, including through regular training. Supervisors should rigorously and continuously assess this culture and be willing to use it as a basis for deciding how much they are willing to place reliance on a firm.

Both sides must work to build a culture of disclosure, openness, and communication in which there are no surprises. The Board should take a significant part of the responsibility for this, and there should be no closed doors to supervisors. The supervisor though must also take responsibility, reacting intelligently and proportionately to information passed.

To achieve the objectives set out in this paper, the following recommendations are made to firms and the industry in general:

List of Recommendations

1. Firms and the industry as a whole should be open in communicating up-to-date industry-wide technical information and pro-active in identifying and sharing sound industry practices.
2. On information and to the extent not done so already:
 - Individual firms should provide supervisors with all information material to high-quality effective supervision, including risk reports, management information, internal audit reports and exceptions reports, and should engage in open dialogue with supervisors on this.
 - Firms should provide information needed by micro- or macroprudential authorities in their assessment of systemic risk, even if this is information they would not normally collect for internal purposes.
 - Firms should take the initiative in providing explanations and interpretations of data to allow supervisors to get maximum value and to arrive at a consistent understanding of it.
3. Senior management and the Boards of firms should take all necessary steps to create a “tone at the top” that recognizes the importance of the supervisory relationship. They should take the necessary steps to establish and disseminate such a culture throughout the firm, including through clear and consistent communications and actions supporting a culture of supervisory cooperation. Firms need to recognize that there will be supervisory consequences (in terms of their treatment) if these efforts are seen to be deficient.
4. Firms should interact with supervisors on the basis of “no surprises”. They should be open in sharing their candid assessments of the main

risks they face and should alert supervisors to any actual or prospective changes in their risk profiles.

5. Firms should engage actively and positively with supervisors on the development and implementation of analytical tools or techniques designed to improve risk management.
6. Firms and the industry as a whole should contribute positively to supervisors' horizontal reviews, alerting them to possible issues and approaches. They should not withhold information on sound practices on the grounds that these involve proprietary information.
7. Firms should be willing to bear additional supervisory costs to the extent that they translate visibly into higher quality supervision.
8. The industry should upgrade the level and quantity of secondments and temporary internships from supervisors both within and across jurisdictions. The IIF would be willing to work on a Code of Best Practice to address potential conflicts of interest.
9. The industry should actively encourage and incentivize secondments and internships from individual firms to supervisors.
10. The IIF will continue to monitor and review implementation of sound industry practices. Firms should affirm their commitment to implementing sound practices and review progress on a regular basis.
11. Firms should release their audit reports to supervisors if requested and should ensure that their audit teams cooperate fully with supervisors.
12. Firms should ensure that supervisors have access to a primary point of regulatory contact tasked with understanding the supervisor and its needs and meeting these in the most constructive way possible.

In looking at the issue of ever higher quality and more effective supervision, members of the Effective Supervision Advisory Group have been mindful from the start that this cannot be delivered unless it is seen as a shared responsibility: as much about cooperation and engagement from individual firms and the industry as a whole as it is about improvements in supervisory techniques, powers, and resources.

It is important that firms do not revert to earlier unacceptable practices that a minority was prone to and which contributed to a loss of trust between supervisors and supervised entities. Many supervisors legitimately feel that they were not given sufficient information by firms and that some firms looked to obfuscate, withhold information, or even outwit them rather than cooperate. Supervisors must be alert to such practices and make it clear that they are unacceptable and that the response will be more intrusive and costly supervision.

Trust will take time to rebuild, but doing this is overwhelmingly in the interests of both the industry and supervisors. The more that supervisors can reach a position where they can rely on the information and cooperation of individual firms and the industry as a whole, the stronger the financial system will be. The industry must continue to understand though that it cannot expect predictability of supervisors and supervisory action if it is not itself willing to behave in a predictable manner.

If trust is to be rebuilt:

- Firms and supervisors need to work together to leverage and reinforce sound industry practices.
- There needs to be a culture of cooperation throughout the firm and industry.
- Firms must accept and adhere to principles of full disclosure, openness, and communication.

The only way for this to work is for senior management and Boards to take the lead and recognize that effective cooperation, disclosure, and communication with supervisors is a core component of a strong risk management culture. Boards and senior management should take an active role in working with supervisors. Challenge from supervisors can help to highlight problems in firms, and, as such, should be welcomed and followed up on by managements that are truly risk aware. Supervisors have a key role in bolstering the role of the CRO and risk management operations by providing a professionally skeptical view over the business strategy of the firm, questioning assumptions, and, as noted in Section 1, occasionally pointing out their impossibility.

Leveraging and Reinforcing Sound Industry Practices

As noted in Section 1 above, the industry has recognized from the start of the crisis the need for improved standards and sound practices and is well advanced in the identification and implementation of these. In its reports, *Principles of Conduct and Best Practice Recommendations; Reform in the Financial*

Services Industry: Strengthening Practices for a More Stable System; Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions; and Risk IT and Operations: Strengthening capabilities the IIF put special emphasis on improving decision-making and methodology on risk appetite, risk culture, and risk models and statistical measures of risk, as well as risk management across economic cycles.

Boards and senior management have a responsibility to ensure that these changes are both implemented and maintained. However, the industry is realistic about the perceived credibility of any internal monitoring of compliance and alert to the dangers that as the economy recovers and memories of the crisis fade, there will be pressures for standards to slip.

The industry believes that intensive supervision can draw on identified sound practices as a way to ensure sound risk management and controls and can work with the industry to monitor compliance over time. These practices can be used as a benchmark against which to judge the performance and internal controls of firms and, if not met, provide a standard against which to take action or increase the intensity of supervision.

Even beyond this, there is a valuable role for information, communication, and dialogue between supervisors and the industry as a whole in identifying trends and seeking ways to correct potential failings. The use of horizontal reviews discussed above can provide valuable feedback to firms about their own performance relative to others in the industry and can encourage the industry as a whole to modify or upgrade its practices.

At an international level, the work of the SSG in collaborating with major financial institutions, particularly in its reports of October 2009, on *“Risk Management Lessons from the Global Banking Crisis of 2008* and December 2010, *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure”* can provide clarity and guidance to firms and to the industry.

The industry believes that more can be done to improve cross-sectoral and international communication between supervisors and the industry on trends and potential areas of risk. Speeches by national supervisors often draw attention to such matters, but there could be real value in a more systematic approach to such activities by the FSB, BCBS, and IAIS. Reports could draw on issues identified by national supervisors that are likely to be of wider relevance to firms and supervisors. This should be complemented by an ongoing dialogue to help communicate key messages from the international supervisory community and to provide a forum for the

industry to share views on current and emerging risks. At a national level, there can be important synergies between the work of supervisors and firms. In a number of jurisdictions, supervisors have carried out joint research with firms, alleviating resource constraints on both sides.

Promoting a Strong Culture of Cooperation with Supervisors

Industry practices and cooperation will deliver results, but the real focus must be on the behavior of the individual firm and ensuring a positive culture of cooperation. Creating this is neither easy nor quick. It requires a decision at the highest levels in the firm regarding attitudes and modes of behavior. These then need to permeate the firm on the basis of clear communication and set the tone by behaving consistently and incentivizing staff at all levels to do likewise. It involves making best efforts to understand and then comply with all supervisory requests.

Regular training within firms on compliance issues is an essential part of this, but staff need to be given a full range of support and incentives aimed not just at ensuring narrow compliance with supervisory requirements but also a wider spirit of cooperation. Supervisors can assist this by getting to know firms, making themselves available for training, and providing honest feedback on their interactions with firms.

Boards and senior management must be attentive to—and supervisors must be prepared to raise—any concerns about a lack of cooperation or responsiveness by individuals or departments, and these must be dealt with effectively.

Supervisors should rigorously and continuously assess the culture of cooperation in a firm toward supervisors and be willing to make active use of this in their interventions with the firm—for example, as a basis for discriminating in terms of the extent to which they are willing to place reliance on the firm as opposed to insisting routinely on independent verification on key issues. In turn, firms should recognize the consequences in terms of their treatment if they make insufficient efforts on this.

Disclosure, Openness, and Communication

Positive and effective supervision requires a culture of disclosure, openness, and communication on both sides in which there are no surprises. Firms must ensure that supervisors are not taken by surprise by announcements of material developments of which they could have been apprised at a much earlier stage. Supervisors for their part need to communicate effectively so that

perceived deficiencies are shared with the firm before they become the subject of supervisory reports, let alone give rise to early intervention. Firms need to be clear what is needed from them and what will happen if they do not comply.

This openness should extend to a full discussion of risk profiles and risk appetites. Members of the Risk Committee should be willing and able to discuss the firm's risk appetite, what this means for the firm's strategy, and how the Board is satisfied that the risk appetite is being communicated and complied with across the firm.

Firms should be candid and keep the supervisor informed about business objectives and performance and risk issues and alert them to material changes. They should have the flexibility to respond sensibly to strong questioning and challenge from supervisors and, if necessary, to make changes in light of those comments. This should be regarded as a badge of cooperation rather than an act of submission.

Where appropriate, Boards should be asked to provide endorsement in some areas. They might, for example, be asked to attest that they are aware of and agree with changes to the business model or risk appetite. As part of the ongoing supervisory assessment of a firm's governance, Board members should be able periodically to point to instances in which they have made a difference in adjusting the risk profile or model.

As noted in Section 2, audit reports can be very helpful to supervisors, and firms should be ready to release these. This is a requirement in a number of jurisdictions, but the practice should be extended globally. Firms should also ensure that their own audit teams cooperate fully with supervisors. Similarly, firms should stand ready to share the findings of self-assessment programs, including the follow-up processes to address identified issues.

Once again, much of the responsibility for this rests with the Board. The Board should ensure that supervisors have access to all necessary documents, meetings, and Board members. It should ensure that the firm provides all the information required to allow the supervisor to make an assessment of its size and complexity and other factors that will determine the appropriate supervisory approach and intensity. There should be no closed doors to supervisors. At the same time, supervisors need to be mindful of the limitations of using information generated principally for internal risk management purposes. An excessive or systematic

reliance on such material is likely to result in changes to its character in ways that will make it of diminishing value over time.

Supervisors need to have access to a key contact point to whom questions and concerns can be addressed in the first instance. One idea would be for there to be a special unit responsible for coordinating relations with the supervisor and ensuring that a supervisor's needs are met in the most constructive way. It is important, however, that such individuals or units play a role that is facilitating and constructive. There should be no suggestion that they should be gatekeepers controlling access to personnel or documents.

But cooperation, openness, and communication need to extend both ways. The supervised entity has to have confidence in the willingness and ability of the supervisor to react intelligently and proportionately to information passed to them, as well as respect for the ability of the supervisor to challenge.

Supervisors and firms need to balance formal communication with more regular, more informal communication at all levels. It is important that both sides disclose and explain concerns and issues at an early stage rather than leaving this to the stage at which communication becomes formalized. Firms must not withhold information or risk judgments or fail to be candid about areas in which policy is under development. Supervisors for their part must not over-react to information provided by firms. In the past it has proved difficult for some supervisors to obtain industry perspectives on new or emerging areas of risk because the firms concerned were fearful of the consequences of admitting that they had not yet fully worked through responses to them.

Supervisors and supervised entities need to adjust the mix of tools, including the balance of onsite inspections and offsite work in proportion to the level of trust and confidence established. The more that firms have a demonstrably open and trusting relationship with supervisors, the less that techniques such as onsite approaches, which contain elements of close monitoring, will be needed.

Trust has to be earned, however, and supervisors will need constantly to test whether it is still warranted. Factors such as the openness to supervisors, the willingness to report bad news on a no surprises basis, the demonstrable quality of internal controls and internal audit, and the speed and thoroughness with which follow-up actions are taken should be taken into account.

CONCLUSION: A COMMON INTEREST IN MORE INTENSIVE AND DURABLE SUPERVISION

Supervision should not be seen as a mere adjunct to wider regulatory and industry reform, but rather as a central pillar in this. It should have a place at the center of G-20 and FSB discussions over the coming years.

The objective must be to ensure that the governance, controls, and risk-management of the firm are adequate to the business and risks being undertaken. The emphasis must be on establishing a more challenging, action-focused, and, above all, intensive approach to supervision that is based on a comprehensive vision and understanding of the firm, the market environment, and system-wide risks. This should be based on a high quality dialogue, relevant and material information, analytical data, and supervisory techniques applied by sufficient numbers of highly trained and qualified staff able to interact credibly at all levels in firms. More needs to be done by supervisors and firms both nationally and increasingly at a global level to give effect to this vision.

Effective supervision is in the interests of all. The industry recognizes the part that it has to play in effecting the increases in standards that the FSB has advocated. There is a need for many firms to change their cultural approach and level of its cooperation and to engage with supervisors on a more open and constructive basis. This will be necessary to rebuild the trust damaged by the crisis. Stronger, more effective supervision should be regarded as a shared endeavor in which each gains from the efforts of the other and,

conversely, each suffers where there are weaknesses or vulnerabilities.

The key focus must be durability. It is vital that the good intentions of today are sustained over the years as financial sectors recover, memories fade, and competitive pressures reassert themselves.

The industry has already taken a major step by making real progress in implementing improved risk management practices, but more needs to be done. With this in mind, it has developed the above list of core recommendations to firms against which the industry should be held by supervisors in the decades to come. It will actively seek to engage with supervisors on how, drawing on this, interaction with supervisors can be improved and existing sound practices embedded and strengthened.

On their own, supervisors and the industry can only go so far. The challenge now is for national jurisdictions to give a clear commitment to provide supervisors with the resources to enable them to recruit and retain the highest caliber of staff and ensure complete independence and accountability. The FSB and G-20 leaders also need to continue to foster the conditions for much greater levels of cross-border supervisory convergence and mutual reliance in colleges, premised on comparably rigorous standards across all jurisdictions.

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