

Improving the Effectiveness of Bank Supervision

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1. Background and Introduction

Keeping national banking systems safe and sound throughout the business cycle, while giving banks the flexibility to remain competitive and meet the productive credit needs of their customers, is a challenging task. And yet, this is what is expected of bank supervisors.

Bank supervision is an inherently judgmental process in which experienced professional bank supervisors assess risk by taking into account the context in which bank strategies and practices occur. This process requires the application of practical skills gained over many years of apprenticeship and training. Effective bank supervision is not a mechanical, “checklist” process with binary outcomes. It requires evaluations by highly skilled and experienced professionals who apply expert judgment in considering a variety of risk factors.

Personal interaction during on-site examinations enables bank examiners to assess the quality and depth of bank management. Policies and procedures may look good on paper, but their effectiveness is best determined by experienced bank supervisors who evaluate bank practices and condition based on direct interaction and dialogue with bank management.

On-site inspections and examinations enable bank supervisors to understand a bank’s risk culture, its risk appetite, risk governance, the adequacy of its systems and controls, and its overall risk management competency. How well does a bank’s senior management and its board of directors identify, measure, monitor, and control risk? Do business heads understand and buy into the bank’s risk appetite statement? Are strategies and practices in place that will enable the bank to adapt and remain stable under less favorable or volatile economic conditions?

The Global Financial Crisis (GFC) erupted in 2008 in the U.S. and Eurozone, with adverse spillover effects impacting many other economies. Studies of the GFC have identified a long list of contributing causal factors. Some problems originated outside of the banking system, governmental policies sometimes permitted incentives for excessive risk taking, and many banks’ risk management practices and risk cultures did not provide effective checks and balances to monitor and control excessive risk. It is evident that ineffective financial sector regulation and supervision contributed to the onset and severity of the GFC.

To contain the GFC, many large financial institutions received government support to prevent them from failing. This bailout of major banks was hugely unpopular politically. It put tremendous pressure on the U.S. and European governments, central banks, and supervisory agencies to devise measures going forward to ensure the public that government would never again be forced to use taxpayer funds to rescue big banks.

This article discusses the authors' views of the key factors in achieving successful supervisory programs based on our personal experiences in dealing with previous banking crises, and lessons learned from the GFC.

2. International Regulatory and Supervisory Standards

For many years, supervisors at the national level developed their own rules tailored to meet the needs, structure, and level of sophistication of their national financial systems. Some did it better than others. But with the globalization of financial services, increased attention has been devoted to ensuring that the same prudential rules apply to all internationally-active banks. This helps promote a “level playing field” and reduce the opportunities for regulatory arbitrage, which can undermine financial stability.

Over the past several decades, an extensive set of minimum prudential standards and sound practices have been developed at the international level, mostly under the auspices of the Basel Committee on Banking Supervision (Basel Committee), to “strengthen the regulation, supervision and practices of banks worldwide.”¹ Most jurisdictions have passed legislation formally adopting these standards and national supervisory authorities have issued implementing regulations.

One of the first major attempts at developing an international prudential standard was the Basel Capital Accord, issued by the Basel Committee in July 1988. This standard, which was developed at the initiative of the United States and United Kingdom, was the first minimum capital standard for internationally active banks. The impetus for this initiative “...was a strong recognition within the (Basel) Committee of the overriding need for a multinational accord to strengthen the stability of the international banking system and to remove a source of competitive inequality arising from differences in national capital requirements.”² Bank supervisory policymakers came together and agreed on minimum international prudential standards, which they were then expected to implement at a national level.

A parallel international focus arose to promote global financial stability in the international financial system following the severe and unexpected financial crises in Southeast Asia in the late 1990s. The G-7 Finance Ministers and Central Bank Governors created the Financial Stability Forum (FSF). Its objective was to periodically bring together central bankers, supervisors and treasurers from the major developed countries, the heads of the various financial sector standard setters such as the Basel Committee, along with the IMF and World Bank, in an effort to identify risky trends and market practices ahead of the next crisis.

Following the GFC, which originated in several of the advanced economies, the FSF membership was expanded to include major emerging markets and its charter was converted to a more powerful Financial Stability Board (FSB), which assumed the role of promoting the global adoption of more comprehensive, detailed, and conservative supervisory policies. An important part of the FSB's authority derives from its ability to track and publically report on the progress of its members in implementing agreed-upon policies.

Beginning in 2010, the Basel Committee commenced an extensive effort to revise international standards and supervisory practices related to capital, liquidity and other banking system risk factors, based on lessons learned from the GFC. That effort has included both standards development as well as tracking how well the standards are being implemented across countries. The Basel Committee and its governing body provide periodic progress reports to the G20 leaders on post-GFC reform efforts.

3. Regulatory and Supervisory Standards versus Supervisory Discretion and Judgment

Post-GFC, there has been a major effort by international bank regulatory standards-setters, primarily the Basel Committee, and national supervisory authorities, to revise existing regulations and supervisory standards and develop new ones to prevent a repeat of the recent crisis. While in many cases, the former rules were found to be inadequate, placing too much of a focus on new and improved rules, may not accomplish the overarching goal of preventing future crises.

As the rules have become more detailed and complex, there is a risk that bank supervisors may be forced to place a disproportionate emphasis on assessing compliance with rules, rather than judgment-based assessments of bank risk, management capabilities and practices that are at the heart of effective supervision. This focus will in turn force banks to devote more of their resources on compliance – huge sums are now being spent by banks hiring ex-supervisors to staff compliance offices – and less on what are the fundamental risks facing the bank and its management.

Clearly some of the rules leading up to the GFC were inadequate and needed to be revisited. It was unhealthy that some financial institutions had come to be viewed as so large or important that governments felt obligated to use taxpayer money to prop up these banks rather than allow them to go out of business.

Technology and interconnectedness of institutions and capital markets have increased the speed of transmission and the contagion potential of adverse external events. Financial innovation may produce new banking products and strategies whose risk characteristics are not well understood and/or may be excessively risky if not adequately managed or controlled. Existing supervisory tools and methods need to be continuously refined and enhanced to keep pace with innovation. Above all, however, expert judgment based on experience, is critical in assessing the vulnerabilities arising from new and evolving risks in the banking system.

A critical question is whether the revised rules and standards will provide a sufficient safeguard against future crises? In the context of a global financial system with numerous large complex financial institutions, and a wide range of institutional arrangements and stages of financial development, how much reliance can be placed on new and revised detailed rules to materially reduce the likelihood of the next crisis? Can economic models and stress tests be devised to pick up the vulnerabilities and build up in risks? To what extent do we need to balance the focus on detailed rules and economic models with an equal amount of attention to improving the quality and effectiveness of hands-on supervision and a focus on the more qualitative aspects of banking such as governance, risk appetite, and business acumen?

For example, can capital requirements, set at a global level, be equally effective in all circumstances? While it may be feasible to set minimum bank capital requirements, these requirements are minimums, and would presumably only be appropriate for those banks that are well run, have diversified business models, proven management, operate in economies that are stable and highly transparent, and have well-developed, predictable legal systems. Most banks should hold more capital than the minimum. How much more capital will depend on various factors, which are not easily prescribed in advance. Capital add-ons tied to empirically-based economic models may not be an adequate substitute for an experienced supervisor with the ability, willingness, and political backing to exercise supervisory judgment.

Bank supervisory authorities use a combination of supervision and regulation to reduce the level of risk in the commercial banking sector. Bank examiners must be able to routinely provide expert opinions and assessments on such diverse matters as:

1. A bank's overall financial strength and condition, the adequacy of its strategies, policies and practices, and its ability to withstand the onset of adverse business conditions.
2. The adequacy of a bank's corporate governance arrangements and practices, including the performance of senior executive management and the quality of oversight and level of engagement of the bank's board of directors.
3. The bank's overall capabilities to identify, measure, manage and control risk.
4. A bank's "risk appetite" and strategies, judging whether they are reasonable in relation to its financial strength and its risk management capabilities.
5. The quality of a bank's loan portfolio and loan administration practices.
6. Remedial actions when there are weaknesses or unsound practices or conditions in evidence.

Accurate assessments of these matters and quantifying related risks can best be achieved by a thorough analysis of a bank's business model, accompanied by a program of on-site supervision that has a reasonable level of transaction-testing and first-hand inspection of the bank's books and records. These assessments, in turn, form the basis for meaningful qualitative discussions with senior executive management. Is management aware of the bank's key vulnerabilities and does it have a strategy to address such vulnerabilities?

4. Supervisory Effectiveness Varied Greatly during the GFC

One indication of the importance of supervision is the way some similarly situated countries fared better than others during the GFC. We believe that differences in financial sector supervision are a key factor in explaining disparate outcomes.

A noteworthy example is the performance of the Canadian banking system.³ Canada avoided the severe problems in its banking system that occurred in many other advanced economies. Why the difference? All advanced countries' banking systems operated broadly under the same regulatory standards. They all had well-established bank supervisory agencies that were instrumental in the creation of the international supervisory standards in Basel. The supervisory agencies all believed that they had implemented these standards faithfully. And yet, the performance of banking systems among the advanced countries varied widely.

Despite the proximity of Canada to the United States and the active participation of Canadian banks in the U.S. retail market, Canadian banks avoided many of the problems encountered by U.S. banks. Canadian banks did not generate large volumes of subprime mortgages, nor did they take large positions in subprime mortgages, mortgage-backed securities, or related derivatives. Unlike U.S. banks, the credit quality of Canadian banks' domestic portfolios of loans and securities remained high throughout the Crisis years.

While there are size and structural differences between the Canadian banking system and other advanced countries, we believe a key difference in outcomes was Canada's bank supervision practices.

The Office of the Superintendent of Financial Institutions (OSFI) supervises Canada's banking system. It practices intrusive or "close touch" supervision and is not reluctant to take pre-emptive supervisory actions when necessary – the type of action that may sometimes be successfully blocked by the industry in some other jurisdictions. It has a clear mandate, which grew out of bank failures in the late 1980s, focused on prudential issues and an emphasis on early supervisory intervention in problem banks to minimize potential losses to depositors.

An example is supervisory action to raise capital requirements during a rapid credit expansion - the supervisory equivalent of having "the punch bowl removed just when the party (is) really warming up."⁴

Before the GFC, OSFI established higher capital requirements than required under Basel rules, emphasizing both the quality and level of capital, and retained a formal leverage limit. By contrast, supervisors in some other advanced economies allowed leverage at big banks to increase, and allowed inclusion of debt-like instruments in computing banks' capital, even though such instrument did not provide loss absorbency.

It has also done a good job of communicating its supervisory expectations to the public. OSFI has established a formal system of placing institutions into one of four stages of supervisory intensity and intrusiveness based on OSFI's assessment of the risks posed by the institution. The process of "staging" an institution is described in a public document⁵ issued jointly by OSFI and the Canadian Deposit Insurance Corporation (CDIC).

5. Core Elements of Supervisory Effectiveness

In reflecting on the lessons learned from various crises, we believe there are seven key principles that are the core drivers of effective supervision:

1. Supervisors need a clear and unambiguous mandate, with accompanying regulatory authority, focused on the safety and soundness of the banking system.
2. Supervisors need the legal authority and political independence to be able to intervene in an institution early, while it is still solvent and before a small problem can turn into a crisis.
3. The supervisory function needs to be able to build and retain a cadre of experienced supervisory personnel, with adequate resources to support their activities.

These elements need to be combined with:

4. A clear and well-communicated strategy – what is it that the supervisors expect to achieve?
5. Effective working relationships among relevant national authorities (central banks, other bank regulatory authorities, market conduct regulators, deposit insurance agencies, resolution authorities, and ministries of finance).
6. A constructive and independent relationship with the banking industry.
7. Proper regulatory accountability.

A detailed discussion of these principles follows:

First, a clear and unambiguous mandate to promote a healthy and well-functioning banking system.

A key goal of banking supervision is to promote a healthy banking system that meets the needs of its customers through prudent risk-taking. The supervisor's mandate should include the authority to do whatever needs to be done, in their expert opinion, to achieve this goal.

Making this goal explicit, educating legislative bodies on what this mandate means, and then holding supervisors accountable for meeting this goal, can go a long way to promoting effective supervision.

It is very important that the supervisory mandate place safety and soundness ahead of other goals. Assigning a supervisory agency multiple, potentially conflicting mandates, such as market access and development of the financial sector, can lead to ineffective supervision.

An example of this is the former U.S. Federal Home Loan Bank Board (Bank Board), which was created in the 1930's after the Great Depression to supervise savings and loans. The Bank Board was also assigned the goal of promoting the U.S. residential housing market. These two mandates at times conflicted, particularly during periods of high interest rates, when the housing market suffered from the high cost of housing loans. Holding the Bank Board accountable for the dual objectives of supporting the housing market while supervising the savings and loans meant that occasionally it had to choose between maintaining the flow of credit to the housing market versus enforcing prudential lending rules in the savings and loan industry.

This conflict was a contributing factor to the crisis in the U.S. savings and loan (S&L) industry in the mid-1980's, when undercapitalized savings and loans were permitted to continue to take on new residential mortgage loans. (An FDIC staff analysis⁶ in 2000 estimated that "As of December 31, 1999, total direct costs attributable to the closing of insolvent thrift institutions over the 1986 - 1995 period amounted to US\$145.7 billion." This amount does not include the substantial capital dissipation that the institutions also experienced prior to government intervention.)

When in 1989, the mandate of the S&L supervisor was changed to emphasize dealing proactively with weak institutions and promoting a healthy savings and loan sector, the industry rapidly recovered. Following the closing of the weak savings and loans, which represented close to a quarter of the industry, the surviving institutions became highly profitable and well capitalized and were able to support the housing market in a prudent fashion.

Second, supervisors need discretionary legal authority and the resolve to impose extraordinary requirements on riskier institutions early.

Preventing problems may require supervisors to take judgmental, discretionary actions, such as raising lending standards ahead of any problems manifesting themselves, or increasing reserves for possible loan losses through increased loan loss provisioning requirements, even when the loans are to important sectors of the economy.

Post-mortem analyses of the GFC in the U.S. (and of the earlier savings and loan crisis in the 1980s) showed that problems in the housing market had been identified pre-crisis, but that there was a failure to follow-through – a failure to support front line supervisors in confronting the management of risky institutions.

This highlights the importance of a supervisory culture that encourages early intervention by supervisors in institutions when problems arise and which requires concrete remedial actions even when management in the institution argue that the problems are immaterial or that with time, the problems will go away.

It helps to have clearly communicated expectations that it is the role of the supervisor to act preemptively, and the implicit backing by government in support of such extraordinary measures.

Third, prudential authorities need adequate financial and human resources to carry out their mandates.

Attracting and retaining quality talent in a bank supervisory organization requires a reasonable level of compensation and an opportunity for career progression. While it is recognized that there are limitations on government compensation arrangements, there often is need to make exceptions to government salary scales to retain experienced bank supervisors and other supporting staff with specialized skills. Unlike many other parts of government, financial sector regulators compete directly with the private sector in attracting the expertise necessary to carry out their mandates.

The cost of maintaining a properly resourced and effective supervisory function, which is often funded by levies on the banking industry rather than the general revenue of the government, is more than justified when compared to the direct and indirect costs, including economic output losses, which typically arise in a banking crisis.

Fourth, banking agencies need to have a clear and well-articulated strategy that is conveyed to political leaders and the public.

During 1986, in the early phases of the U.S. S&L crisis, the leadership of the responsible regulatory agency, the Bank Board, initially described the problem as involving a few weak savings and loans with about US\$5 billion in losses. This turned out to woefully understate the problem. Over a quarter of the industry – close to a 1,000 institutions – were found to be close to insolvency. After the initial estimates, there were frequent upward revisions in the size of the problem. This caused credibility problems with legislative bodies and undermined public confidence in the S&L industry and its regulator.

When legislation passed abolishing the old Bank Board and creating a new supervisor (the Office of Thrift Supervision), new leadership was brought in. To generate public support for ridding the industry of weak institutions, the new agency embraced a policy of total transparency. It began holding quarterly press briefings where it outlined: (1) the financial condition of the industry; (2) the number of institutions deemed to be in danger of failing; and (3) detailed progress toward resolving these institutions. Each press conference was well attended by both print and electronic media. For a period of several years, an average of 4 to 5 non-viable institutions were

closed every week and turned over to the Resolution Trust Corporation. This process prompted weaker institutions that still had some value to seek out new sources of capital and/or merger partners. As the list of problem institutions became smaller and smaller, the thrift industry's problems were no longer newsworthy and the major news networks stopped sending reporters to the press conferences.

During this period when institutions were being shut down, the regulator would receive calls from Congressmen and state politicians attempting to intervene on behalf of their local troubled institutions. The solution to preventing such political interference in the regulatory process was the introduction of a policy of sending a letter from the agency head to the Chairs of the Congressional banking committee each month describing every call received from a politician related to a specific institution. Not surprisingly, the number of such calls dropped dramatically once that policy was made known.

Fifth, it is important for a bank supervisory agency to maintain effective working relationships with other relevant national authorities, especially those that form the financial sector “safety net” (central banks, other financial regulators, deposit insurers and finance ministries).

Canada's federal financial sector regulatory structure includes OSFI, a standalone bank and insurance supervisor, the central bank, a deposit insurer, a financial consumer protection agency, and a department of finance. (Securities supervision occurs at the provincial level.) Unlike many other countries, supervisory information, including institution-specific information, is shared among these safety-net participants on a timely, confidential basis. This sharing of information facilitates more informed federal policies and coordination. The heads of each entity work together collaboratively – a concerted effort is made by the agency heads to truly cooperate. During the GFC, this group met at least once a week.

By contrast, in post-mortems of other countries, there are accounts of ineffective communications and even a lack of collaboration among safety net authorities during the GFC. Information was not shared and some agency heads were cut out of decision-making. The result was sometimes confusing messages to markets and the public and lost time, resulting in inefficient decision-making and in some cases increased costs to taxpayers.

Sixth, a healthy and open relationship with industry is beneficial, to reinforce agency credibility and authority, so that regulatory policies and actions are understood and taken seriously.

Periodic meetings with key industry officials, such as CEOs and Chief Risk Officers, can be valuable sources of market intelligence, allowing supervisors to be more aware of emerging industry risks and thus more proactive in related supervisory activities.

Transparent rule-making and supervisory guidance are also helpful in promoting industry buy-in. While bankers may not be able to persuade supervisors to adopt all of their suggestions, they at least should believe they were given a chance to provide meaningful input into the decision-making process and hopefully will better understand the supervisory objectives of the final rules.

Regular meetings between supervisors and board members, particularly chairs of board committees such as those covering risk and audit, help to enhance the understanding of the regulatory process and reinforce bankers' and boards' fiduciary duties and responsibilities.

Seventh, regulatory discretion and independence requires proper public accountability.

In exchange for independence and flexibility being granted to supervisory authorities to carry out their responsibilities effectively, supervisors should expect to be subject to close oversight and transparency.

Supervisors should have to report to the public on their priorities, use of resources, key decisions, and, as far as possible, the effectiveness of their activities in relation to their goals and objectives. The last aspect may be challenging because of the traditional policy of supervisors avoiding disclosure of confidential examination and supervisory information; it may be especially difficult when a jurisdiction has a small number of institutions. At the same time, the public needs to be assured that the supervisory authority is performing effectively and is properly using their resource.

6. Conclusions and Recommendations

Effective prudential supervision is difficult to achieve. Post-GFC, there was an intense focus on developing and revising regulations and standards at the global level, which were in turn adopted by national regulatory authorities. Less attention was given to ways of enhancing actual supervisory methods. This may be due in part to a sense that promulgation of detailed rules would be easier to implement in a uniform fashion across different supervisors than softer policies governing intensity or intrusiveness of supervision.

However, the GFC and other banking system crises clearly demonstrate a critical component of a healthy banking system is a regular program of intensive on-site inspections/examinations at appropriate intervals, conducted by experienced professional bank supervisors who perform a reasonable level of transaction-testing and review of bank records and documents. Supervisors need to have proper legal authority to require banks to take timely action to curtail and remedy objectionable and undesirable practices and/or conditions. They need to be supported in the proper exercise of those authorities.

The “art” of supervision is at least as important as the quality (and quantity) of regulations. It is too easy for governments to fall into the trap of writing complex and detailed rules when, in fact, what really matters is having a cadre of experienced and empowered supervisors who have the freedom to exercise judgment, in return for being held accountable. The Canadian approach to supervision exemplifies that expert judgment and intrusive supervision is critical part of achieving effective supervision.

The Asia Pacific region has avoided a significant cross-border banking crisis since 1997-1998. While the region was adversely impacted by the GFC, jurisdictions experienced mostly secondary effects that were managed by central banks and other national authorities. Now is a good time, during a non-crisis period, for jurisdictions to evaluate their supervisory approaches, processes and resourcing. A key determination is whether their supervisory functions are able to detect and curtail excessive risk or unsound banking practices and strategies at their incipient stages. Further, do supervisory authorities and processes, and the supervisory culture promote timely remedial actions to prevent or lessen adverse outcomes that could contribute to future episodes of instability and crisis? Achieving these goals requires an intrusive, judgement-based supervisory approach, avoiding undue reliance on prescriptive rules. The foregoing principles may provide some insights in that regard.

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Endnotes

1. BCBS (2013), p. 1.
2. BCBS (2015), p. 2.
3. See IMF (2014), “Intensity and Effectiveness of Federal Supervision in Canada - Technical Note.”
4. Martin (1955), p. 12.
5. OSFI (2014).
6. Curry and Shibut (2000), p. 32.

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