Strengthening Bank Supervision: The Need for Forward-Looking, Intrusive Supervision and a Supportive Supervisory Culture

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1. Background and Introduction

Effective bank supervision is a critical part of maintaining financial stability by promoting sound, stable, and resilient banks positioned to meet the productive credit needs of their customers, which is necessary to achieve sustainable economic growth. Reliable access to bank credit and risk intermediation services is especially important in emerging economies where capital markets are still developing.

The U.S./Eurozone Crisis of 2008-2009 (the Crisis) was the most significant period of global financial instability since the start of the U.S. Great Depression, nearly 80 years earlier. Studies of the Crisis have identified a long list of contributing causal factors. Many problems originated outside of the banking system. However, there were many bank risk management practices and risk cultures that did not provide effective checks and balances on excessive risk taking in the years immediately preceding the Crisis. Governmental policies also created incentives for excessive risk taking. Unfortunately, it is also evident that ineffective financial sector regulation and supervision contributed to the onset and severity of the Crisis.

In the aftermath of the Crisis, global bank regulators and standards-setters have pursued an extensive regulatory reform agenda. While these efforts are very important, they do not guarantee supervisory effectiveness. This article explores some of the root causes of the Crisis and other episodes of banking system stress, and discusses qualitative considerations that are important to ensuring the future effectiveness of prudential supervision.

2. Primary Prudential Supervisory Factors Contributing to the Crisis

Analyses of the Crisis have been made by the Basel Committee, the Financial Stability Board, the IMF, and various national bank supervisory authorities. Some frequently cited causal factors related to bank supervision methods and practices include:

- Failing to conduct on-site supervisory inspections or examinations at reasonable intervals and in sufficient depth.
- Use of off-site surveillance systems as a substitute for on-site examinations.
- Overemphasizing institutions' historic operating results and static financial conditions in assessing risk, not sufficiently stress testing potential vulnerabilities.
- Failing to identify ineffective bank risk management methods and governance structures, as well as other shortcomings in bank risk cultures.

- Failing to take timely and appropriate supervisory follow-up/remedial actions.
- Improper implementation of the concept of risk-based supervision.
- Allowing banks to operate with excessive leverage.
- Failing to consider that a build-up of macroeconomic risks and vulnerabilities could adversely impact a number of banks simultaneously, posing systemic risk.

Some expert industry observers and current and former regulators have also carefully studied the Crisis in an effort to get past its symptoms and focus on its root causes and their implications. In that regard, some noteworthy comments appeared last year in this *Journal* in an article by William M. Isaac, a former Chairman of the U.S. Federal Deposit Insurance Corporation. Mr. Isaac was a bank regulator during periods of significant banking system stress in the U.S. In his article he states: "None of these crises occurred because of lack of regulatory authority but rather the failure of regulators to use their authority effectively to rein in excessive speculation by financial institutions." He then pointedly asks "What regulatory authority did U.S. financial regulators not have to rein in the risks taken by financial institutions that precipitated the latest crisis? I cannot think of any."[1]

Thomas J. Curry is the current U.S. Comptroller of the Currency, overseeing the U.S. Office of the Comptroller of the Currency (OCC), an independent bureau of the U.S. Department of the Treasury. The OCC charters, regulates and supervises more than 1,600 national banks and federal saving associations, and federal branches and agencies of foreign banks, comprising about two-thirds of the assets of the U.S. commercial banking system.[2]

In 2013, Comptroller Curry commissioned an external study of the effectiveness of OCC's supervisory program preceding the Crisis. The study group that conducted this high-level process review was headed by Jonathan Fiechter, former Deputy Director, Monetary and Capital Markets at the IMF, and former Senior Deputy Comptroller for International and Economic Affairs at the OCC. Other study group members included highly respected current and former bank supervisors from the Australian Prudential Regulatory Authority, the Canadian Office of Superintendent of Financial Institutions, and the Monetary Authority of Singapore. The study group's report, entitled "An International Review of OCC's Supervision of Large and Midsize Institutions: Recommendations to Improve Supervisory Effectiveness," was issued December 4, 2013. Observations and conclusions that apply to other regulators include:

- "The team noted instances of a material lag between the identification of an emerging risk and the issuance of guidance or rules to address the risk. This puts the onus on examiners on the ground to try and contain the risks at the institution level."

- The OCC had teams of examiners resident in some of the largest banking organizations. The study group recommended that this arrangement be changed, where practicable, to have examination teams move out of the banks and be co-located in OCC offices. This would allow for better information- and experience-sharing by OCC experts on common risk issues and allow specialists to more efficiently perform work on multiple institutions.

- Some OCC examination staff below the Examiner in Charge was assigned to the same institution for many years. "Examiners may get stale and become too familiar with the (middle) management of the institution, giving rise to perceptions of regulatory capture. Supervisory effectiveness may be hampered as a result of lack of comparative experience in other institutions—examiners, lacking good comparators, may simply assume an institution's controls are adequate."

A thought-provoking analysis of Crisis lessons learned related to bank supervisory practices was published by the IMF in a 2010 Staff Discussion Note[3] entitled "The Making of Good Supervision: Learning to Say 'No'." The paper provides valuable insights on what it terms "the essential elements of good supervision." I believe it should be "required reading" for all bank supervisors. Key points made in the paper include:

- To be effective, supervision must be "intrusive, skeptical, proactive, comprehensive, adaptive, and conclusive." "For this to happen, the policy and institutional environment (of the regulatory authority) must support both the supervisory will and ability to act."

- Intrusiveness: "…supervisors must be willing and empowered to take timely and effective action, to intrude on decision-making, to question common wisdom, and to take unpopular decisions."

- "Supervisors are expected to stand out from the rest of society and not be affected by the collective myopia and consequent underestimation of risks associated with the good times. In this role, society and governments too must support this approach and stand by their supervisors as they perform this unpopular role."

The following commentary provides my personal observations on achieving supervisory effectiveness from having been a senior banking supervisor during several banking crises.

3. Critical Importance of On-site Supervision

The onset of the U.S./Eurozone Crisis in those jurisdictions most directly affected was characterized by an extended period of seemingly benign economic conditions. These circumstances induced complacency among some bankers and regulators, allowing less stringent bank risk management and supervisory practices to proliferate over time. Bank credit underwriting standards became relaxed, tending to overemphasize escalating collateral values (mostly real estate) and not focusing sufficient attention on assessing borrower repayment capacity under changing circumstances (sometimes dismissing

the possibility that collateral values could level-off or fall). Some banks' compensation schemes became tied to improper incentives, such as loan portfolio growth, without proper qualitative considerations, inducing imprudent risk-taking.

The primary way to proactively detect potentially unsafe and unsound practices and conditions is through a sufficiently intrusive on-site examination process that is "forward-looking." "Intrusive" means that on-site examiners conduct in depth, on-site reviews of bank records and documentation. These reviews form the basis for detailed discussions with senior executives and other personnel to clearly understand strategies, policies, and transactions, and the level and trend of the bank's overall risk profile. These close personal interactions provide important insights on the capabilities of the executive management team and the board of directors in managing risk, including the ability to cope with less favorable external circumstances such as an economic downturn. Policies and procedures may look good on paper, but their effectiveness is best determined by experienced bank supervisors who evaluate bank practices and condition by direct interaction and dialogue with bank management, through a "lens" of healthy skepticism.

4. Priority, Frequency and Scope of Bank Examinations

There are no universally applicable standards or guidelines pertaining to the priority, frequency and scope of on-site examinations. Practices vary among jurisdictions, but an annual, full-scope on-site examination seems to be a frequency that is generally regarded as reasonable.

Pre-Crisis, regulators in some jurisdictions lengthened their minimum on-site examination frequency to a much longer interval, or cut back on the scope of on-site examinations, believing that such action was justified by the extended period of favorable economic conditions that showed no signs of ending. De-emphasis of on-site examinations was motivated in some cases by budgetary pressures, with regulators reducing the size of their supervisory staff. This was a false economy as the cost of a properly resourced examination function is a small fraction of the direct and indirect costs of even a small banking crisis. The time for bank supervisors to be most vigilant is during "good times" when banking practices may become lax, leading to excessive risk in less favorable economic circumstances.

Post-Crisis, bank supervisors in some jurisdictions, in an effort to be "ahead of the curve" and be more proactive, have supplemented their regular bank examination programs by conducting "thematic reviews." This entails selecting a sample of banks and conducting on-site reviews focusing on a specific risk area or issue. For example, a thematic review could be conducted assessing commercial real estate lending risk. Bank examiners review each sampled bank's practices. Institution-specific issues requiring supervisory follow-up are handled in the same way as a regular examination. Common concerns emanating from all of the reviews may form the basis for industry alerts or policy guidance from the regulators to try and control these risks proactively, since many banks might not be scheduled to receive a near-term examination.

5. Adequacy of Examination Staff Resources

Inadequate examination staff resourcing is a problem that usually cannot be remedied quickly. Bank examiners typically develop their unique skills proficiency through a three to five year training program, which emphasizes on-the-job experiences supplemented by formal training. Basic skills proficiency includes a working knowledge of banking law, commercial and transactions law, accounting and auditing techniques, and "soft skills" such as interviewing techniques and the ability to effectively articulate and present examination findings to bank management and obtain commitments for remedial action. It is difficult to hire people in the employment market who possess all of these skills. Hiring entry-level, trainee bank examiners immediately preceding or during a crisis does not provide subject matter experts who can effectively assist in dealing with the crisis. If fact, they may impose a heavy training burden on an already over-extended staff operating under the pressure of simultaneously addressing many urgent problems and priorities. Therefore, supervisory authorities need to anticipate their longer-term human resource needs and plan accordingly.

Over the past twenty years, bank supervisors have adjusted their on-site supervision methods to engage in "risk-based supervision," which generally means that finite supervisory resources are prioritized by allocating/targeting them to the greatest areas of perceived risk, both in individual banks and in the banking system. Pre-examination planning is done with the clear understanding that the scope of examinations can be expanded if there are "red flags" detected or matters surfaced which require further analysis. Unfortunately, in the period preceding the Crisis, some bank supervisors' risk-based supervision programs failed to allow scope expansion when necessary, resulting in failure to detect and curtail the build-up of excessive risk. Also, some risk-based supervision programs became oriented toward reducing banking industry regulatory burden, rather than as a resource prioritization tool. This approach, characterized by some as "light touch" supervision, in some cases prevented the timely detection and remediation of excessive risk, even contributing to institutional failures.

6. Off-Site Surveillance

Off-site analysis can be a valuable screening tool for detecting "red flags" and outliers among supervised institutions. However, it is not a substitute for on-site examinations and the transaction testing and management interactions they provide. Financial data is usually submitted on a lagged basis and is based on bank management's self-reporting. Erroneous or overly-optimistic reporting (such as in loan loss provisioning or assumption-based asset valuations) can undermine its integrity and reliability. Also, periodic reporting provides very limited insight as to the soundness of bank risk management practices and corporate governance. However, off-site monitoring is a very valuable complement to the on-site examination process in influencing the timing and intensity of on-site supervision. Combining bank reported data with market surveillance/environmental scanning and management reviews can sharpen risk profiling and support more targeted examination risk-scoping.

7. Achieving Proactive Supervision

Supervisory effectiveness is greatly improved by reducing the time between risk identification and supervisory response, allowing "proactive" versus "reactive" supervision. Understanding the changing risk environment, financial industry innovation, and actual bank practices as close to "real time" as possible:

- allows earlier supervisory detection of abnormal risks at individual banks, enabling faster regulatory risk mitigation efforts;
- accelerates regulatory policy development related to emerging issues and changing risks;
- reduces the opportunity for regulatory arbitrage; and
- helps to prevent the proliferation of unsound practices or inappropriate risk selection that can destabilize individual institutions and the financial system.

What are some of the supervisory approaches that bank supervisors can employ to accelerate detection of abnormal risk or emerging policy and supervisory issues, as close to "real time" as possible?

- Conducting thematic or cross-sectional reviews of emerging or higher risk areas, to obtain actionable intelligence for related policy development or to issue industry risk alerts to influence bank risk-taking.
- Developing organizational feedback mechanisms to raise awareness of increasing institutional and industry risk and emerging issues. For example, some regulators have established regular interactions between their leadership and senior on-site supervisors to discuss emerging issues and risks, greatly accelerating any needed policy changes, issuance of industry risk alerts and consideration of new or revised regulations.
- Regular dissemination of information on emerging policy and risk issues to front-line supervisors.
- Conducting periodic industry forums to discuss current conditions and emerging issues and related regulatory expectations with the industry.
- Ensuring that bank regulatory risk rating systems are "forward looking" and consider institutional practices, and do not overemphasize current financial condition.

8. Challenges in Asia Pacific: Ensuring Effective Consolidated Supervision

Asia Pacific jurisdictions are both home and host supervisors for large, geographically dispersed banking organizations that are part of financial conglomerates operating across the region. Some of these conglomerates operate systemically important banks in more than one jurisdiction. Also, global banking organizations operate

extensive regional banking networks. The region has increasing financial integration and many close inter-linkages have developed over the last decade. Countries' sound implementation of consolidated supervision is, therefore, an important part of promoting regional financial stability, especially timely and effective cross-border information-sharing among supervisors.

Prior to the Crisis, some bank regulators focused on a "top down" consolidated view of risks within banking conglomerates, which included multiple bank subsidiaries. These banking organizations' risk management and reporting protocols provided consolidated information on bank subsidiaries' condition and performance. However, this approach can be problematic. A consolidated view of banks' risks may, for example, reflect adequate capital and liquidity, even if some subsidiary banks have weaknesses or problems on a stand-alone basis. This analytical approach also implicitly assumes that capital and liquidity within a banking group is "fungible," that is, it can be reallocated among the various subsidiaries at will. This is not the case. There are frequently legal restrictions on transactions with affiliates.

9. Conclusion

The Crisis clearly demonstrated that there is no substitute for a regular program of on-site inspections/examinations at reasonable intervals, conducted by seasoned, professional bank supervisors, performing an appropriate level of transaction-testing.

Supervisors need to take timely action to curtail and remedy objectionable and undesirable practices and/or conditions to control financial stability risk. They need to be supported by their organizations in the proper exercise of those actions. Bank examiners sometimes need to deliver constructive feedback and, at times, criticism to senior bank officials and boards of directors. This type of interaction, a necessary part of effective bank supervision, is not always well received, and occasionally generates complaints against examiners who are properly fulfilling their duties. Bank examiners need to know that they will be backed-up by their senior management when they receive bank management criticism and push-back in reaction to the proper exercise of their supervisory responsibilities.

Banking crises usually produce substantial new laws and regulations that attempt to address the perceived root causes of the crisis. While such reform efforts are important, no amount of new legislation can guarantee supervisory effectiveness without a supportive supervisory culture and effective supervisory methods. Supervisory authorities need to candidly assess whether their actual supervisory methods used are sufficiently robust and intrusive, and are effective in proactively detecting excessive risks or imprudent practices at their incipient stages.

Michael J. Zamorski has been an Adviser to SEACEN on Financial Stability and Supervision since 2012. He has extensive experience in financial institution supervision and was a bank Chief Risk Officer. As Director of Bank Supervision for the U.S. Federal Deposit Insurance Corporation (FDIC), he oversaw prudential and conduct of business supervision for 5,200 U.S. banks. At FDIC, he was also directly involved in helping to achieve an orderly resolution of more than 300 failing banks and thrift institutions. Mr, Zamorski also served as Managing Director, Supervision for the Dubai Financial Services Authority, a cross-sectoral regulator with supervisory responsibility for banks, reinsurers, collective investment fund operators, other financial services providers, and accountants and auditors. He was a member of the Basel Committee from 2000-2006 and of the Basel Consultative Group during 2009-2010.

Endnotes

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1. Isaac (2014), p. 5.

2. Detailed information about the OCC's mission and activities is available at www.occ.gov.

3. This *IMF Staff Position Note* has a disclaimer indicating that the views expressed "…are those of the author(s) and should not be attributed to the IMF, its Executive Board or its management."

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