POST-CRISIS STRATEGIES TO ENHANCE PRUDENTIAL SUPERVISION AND REGULATION TO PROMOTE FINANCIAL STABILITY

Panel Remarks By

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Introduction

Your Excellencies, Distinguished Guests and Colleagues, I am pleased to have the opportunity to participate in today's program. At the outset, let me state that the opinions expressed are my own, and do not necessarily represent the positions of either The SEACEN Centre or Bank Negara Malaysia.

Central banks and monetary authorities, regardless of their precise statutory mandates, have long played a key leadership role in promoting financial stability. Executing monetary policy, serving as the lender of last resort, and monitoring banks' safety and soundness are critical underpinnings of systemic financial stability. Many central banks have direct responsibility for prudential supervision.

Effective prudential supervision helps to promote sound, stable, and resilient banks positioned to meet the productive credit needs of their customers, which is a precondition to achieving sustainable economic growth. Reliable access to bank credit and risk intermediation services is particularly critical in jurisdictions where capital markets are still developing.

Studies of the Global Financial Crisis of 2007-2009 ("GFC") have identified a long list of contributing causal factors. Unfortunately, it is evident that ineffective financial sector regulation and supervision contributed to the onset and severity of the crisis. The global economy will continue to experience significant structural shifts and volatility that will provide future challenges to financial stability. I will focus my remarks on ways to strengthen the prudential oversight of banks to meet those challenges.

Primary Causes of the Financial Crisis from a Prudential Supervisory Perspective

Based on various analyses of the GFC by industry experts, and my own experiences as a bank supervisor, the most significant underlying causal factors related to regulation and supervision are:

- Allowing banks to operate with excessive leverage.

- Failure to conduct regular on-site supervisory inspections or examinations at reasonable intervals and in sufficient depth.
- Improper implementation of the concept of risk-based supervision.
- Failure to identify ineffective bank risk management methods and governance structures, as well as other shortcomings in bank risk cultures.
- Overemphasizing institutions' historic operating results and static financial conditions in assessing risk, not fully considering potential vulnerabilities.
- Overreliance on off-site surveillance systems to either detect or timely identify "red flags" and emerging risks.
- Failure to understand the risks and policy implications of new bank products and services, and changing bank business models.

Please allow me to elaborate on several of these points and possible actions to enhance the quality of prudential supervision.

Excessive Leverage

The quantity and capital of capital was allowed to diminish during the pre-crisis period. Some jurisdictions inappropriately permitted banks to count capital instruments in their Tier 1 capital that did not possess the basic attributes of capital -- permanence and the ability to absorb losses on a going-concern basis. Some banks' published financial reports erroneously represented reduced institutional risk through asset "sales" or risk "transfers" to third-parties, when the substance of the transactions included some form of recourse or risk retention. Also, the complexity of regulatory capital standards provided regulatory arbitrage opportunities -- some banks exploited unintended interpretational flexibility that allowed them to categorize certain assets so as to receive a lower capital risk-weighting.

The Basel Committee on Banking Supervision ("Basel Committee") has spent considerable time and resources revising and strengthening international capital standards in its Basel III initiative, which

also covers liquidity risk. The revised standards incorporate lessons from the GFC and embody a "back to basics" approach. Bank regulatory authorities are now pursuing implementation of the revised capital standards in their jurisdictions, which in some cases includes both Basel II and Basel III. Effective and timely implementation of the revised standards is critical to maintaining public and market confidence. Bank supervisors should also emphasize forward-looking analysis through close review of bank capital stress testing models and capital planning processes.

Basel Committee's Revised "Core Principles of Effective Supervision"

The Basel Committee issued its "Core Principles for Effective Supervision", commonly known as the Basel Core Principles, or "BCP", in 1996. They were revised in 2006 and again in September. The BCP comprise a critical part of the IMF/World Bank Financial Sector Assessment Program, which focuses on whether a jurisdiction possesses the necessary pre-conditions to support an effective program of bank supervision. National supervisory authorities should periodically self-assess their conformity with the BCP. Some jurisdictions, in the interest of transparency and accountability, publish their assessments. Any instances of non-compliance with the BCP should be expeditiously remedied.

Critical Importance of On-Site Supervision

Relatively short and more regular business cycles help to inhibit the build-up of excessive risk through the operation of market forces in adjusting asset valuations. The period preceding the onset of the GFC in many jurisdictions was characterized by an extended period of seemingly benign economic conditions, punctuated by only a mild downturn of short duration. These circumstances induced complacency among some bankers and regulators, allowing less stringent bank risk management and supervisory practices to proliferate. Bank credit underwriting standards – especially assessing borrower repayment capacity and valuing collateral – became lax. Banker compensation schemes became tied to improper incentives, such as loan portfolio growth, inducing imprudent risk-taking. At the same time, regulators in some jurisdictions lengthened their on-site

examination cycles in the mistaken belief that such action was justified by the extended period of favorable economic conditions that showed no signs of ending.

The GFC clearly demonstrated that there is no substitute for a regular program of on-site inspections/examinations at appropriate intervals, conducted by professional bank supervisors, performing an appropriate level of transaction-testing. Supervisors need to have proper legal authority 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.

Personal interaction during on-site examinations provides the opportunity to assess the quality and depth of bank management first-hand. Policies and procedures may look good on paper, but their effectiveness is best determined by experienced bank supervisors who evaluate bank practices and condition through direct interaction and dialogue with bank management, through a “lens” of healthy skepticism and conservatism.

On-site inspections and examinations also allow bank supervisors to understand a bank’s risk culture, its risk appetite, the adequacy of its systems and controls, and its risk management competency. How well does bank management and its board of directors measure, monitor, and control risk? Will current practices allow the bank to remain stable under less favorable or volatile economic conditions?

Over the last fifteen 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 GFC, 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.

Off-Site Surveillance

Off-site analysis can be useful screening tool for detecting "red flags" and outliers among supervised institutions, but it is not a substitute for on-site examinations. It is historical and based on bank management's self-reporting. Erroneous or overly-optimistic reporting (such as in loan loss provisioning or assumption-driven asset valuations) can undermine or nullify its integrity and reliability. As it provides only a "snapshot" of a bank's financial condition, it affords very limited insight as to the soundness of bank risk management practices and corporate governance. Off-site monitoring can be useful in influencing the timing and intensity of on-site supervision, but it is not a substitute for the supervisory insights obtained through on-site interaction with management and transaction testing that occurs during on-site examinations and inspections.

Achieving Proactive Supervision and Regulation

Technology and interconnectedness of institutions and markets have increased the speed of transmission and 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 remain relevant in this sometimes rapidly changing risk environment.

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 can bank supervisors do to accelerate detection of abnormal risk or emerging policy and supervisory issues, as close to "real time" as possible?

1. Conduct thematic or cross-sectional reviews covering emerging or higher risk areas, to obtain actionable intelligence for related policy development or issue industry risk alerts.
2. Develop organizational feedback mechanisms to raise awareness of increasing institutional and industry risk and emerging issues. For example, some regulators have established regular teleconferences 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 new or revised regulations.
3. Regular dissemination of information on emerging policy and risk issues to front-line supervisors. Readily available technology allows cost-effective, accessible, secure web-based interactive discussions. Some regulators already conduct periodic interactive examiner teleconference or video teleconference briefings.
4. Use the same technology to discuss issues and related regulatory expectations with the industry, particularly with banks' board of directors, to help them fulfill their fiduciary duties and legal responsibilities more effectively.

5. Ensure that regulatory bank risk rating systems are "forward looking" and consider institutional practices, and do not overemphasize current financial condition.
6. A few supervisors publish periodicals, available on-line, dedicated to advancing prudential bank supervision practices, focusing on bank risk management and corporate governance issues.
7. Timely information-sharing arrangements with other regulators is essential to properly supervising banks operating under multi-tiered corporate structures, or cross-border in multiple jurisdictions, to ensure comprehensive, consolidated supervision of risk.

Professional Competency

Various practitioners who provide professional services to the financial industry are required to obtain and maintain formal credentials evidencing their professional competency. Some bank supervisory authorities have developed in-house credentialing protocols and have formally defined the skills development necessary for career progression. Typically, progressively more challenging apprenticeship training is supplemented by formal classroom training and self-study. This allows bank supervisors to develop and hone their skills to accurately assess the financial soundness and risk management competency of banks of increasing size and complexity. A professional examiner certification program can provide objective assurances that certified bank supervisors meet agreed-upon standards of professional competency. Additionally, continuing professional development requirements help ensure that supervisors maintain their skills.

Conclusion

I have briefly outlined some actions considerations that supervisory authorities can consider to enhance the effectiveness of prudential supervision, based on the lessons of the GFC and changing industry risk characteristics. Perhaps there might be opportunities for supervisors to collaborate in developing additional techniques and methods to address supervisory challenges in a changing risk environment. I look forward to your comments and questions.