Nout Wellink: The future of supervision

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the FSI High Level Seminar, Cape Town, 29 January 2009.

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I would like to share with you my views on the future of supervision. Even though we are still in the midst of a financial crisis and the situation continues to evolve, it is not too early to assess some of the lessons for supervisors learned from the crisis so far. I have a sense that the broad direction of supervision in the future will be "back to basics". In light of the lessons learned over the past two years, setting a strong foundation for supervision is becoming more important than ever. I would like to discuss the initiatives taken by the Basel Committee to help establish this sound basis for supervision, risk management and capital adequacy, as well as implementation of sound standards over the long run. I would like to start, however, with the basics, and for the supervisory community this means the Core Principles for Effective Bank Supervision.

Core Principles for Effective Bank Supervision

The Core Principles represent the basic philosophy of banking supervision, the foundation on which any strong supervisory function is built. In 2006 the Committee updated the Core Principles and their assessment Methodology to make sure that they reflected the changes in the global banking environment. A number of glaring risk management deficiencies during this crisis were lapses in some of the fundamental principles of governance and risk management. The Committee certainly cannot claim to be prophetic in stressing these fundamentals – failure to adhere to the basics is often at the core of banking problems in most crises.

Let me give you a few examples of the Core Principles' relevance in light of lessons learned from the crisis. One of the revised Core Principles stresses the importance of sound corporate governance and the essential need for strong risk management processes. The guidance states that a bank's board must have, collectively, a sound knowledge of the activities undertaken by the firm. This collective familiarity among the boards of some of the largest banks was strikingly absent. Another revised core principle discusses the importance of high quality risk management information that should be reviewed regularly by the board and senior management. This includes the ability to understand the implications and limitations of such information. Yet another example: proper risk identification and evaluation, that is, the ability to know what your firm-wide exposures are in the first place so that they could be managed and controlled effectively. In this regard, the assessment criteria concerning credit risks were revised to make clear that they include counterparty risks associated with various financial instruments.

Before we look to see what the future holds for risk management or supervision, it is essential that bankers and supervisors first make sure that a sound foundation is firmly in place. For supervisors, this foundation is the core principles.

Current areas of supervisory focus

Let me now say a few words about weaknesses that came to light during the crisis and which are likely to influence bank supervision in the future. The first of these relates to the need for supervisors to take a broader system-wide approach to regulation and supervision. While strong supervision of individual banking institutions remains essential, supervisors need to devote more resources to understanding interactions among banks as well as between the

banking sector and other financial sectors. The Basel Committee will be exploring the practical ways to implement such a "macroprudential approach". This more comprehensive approach to supervision and regulation will help reduce systemic risk more broadly. It will also enable supervisors to focus their limited resources on those supervisory and regulatory activities that contribute most towards making the domestic banking and regional financial system more resilient to stress.

Another topic of high interest relates to "regulatory gaps". The crisis has revealed that non-deposit taking institutions could be a major source of systemic risks. The first step for financial sector supervisors is to identify any regulatory gaps in their financial systems. The next is to employ the suitable supervisory response, which may range from traditional prudential tools, such as capital requirements, to enhanced disclosure and transparency. We need to take a fresh look at these issues so that the activity of the unregulated or under-regulated players – such as mortgage brokers, mortgage companies, hedge funds or others – are subject to adequate oversight commensurate with their potential to pose systemic risk. This in turn will reduce pressure on the core banking sector and help prevent a lowering of bank standards or practices in good times.

The question of whether or to what extent supervision is necessary is a difficult one. To give one example relative to this region, the Basel Committee has already started to reflect on the supervision of deposit-taking, microfinance institutions. We recognise that some of these institutions may be regulated differently from banks as long as they do not hold, in the aggregate, a significant proportion of deposits in a financial system. But at the same time, these organisations need some form of regulation commensurate to the type and size of their transactions. Through the Committee's International Liaison Group, we are working on illustrating what forms regulation can take, keeping in mind the diversity of the sector.

A third area of supervisory focus relates to cross-border cooperation. This is not a new area – the Committee was founded to promote cross-border coordination and cooperation. We recently completed a preliminary review of issues associated with the resolution of complex global banking organisations. This showed that existing national crisis management and resolution arrangements are not designed to deal specifically with cross-border banking crises. The Committee will deepen its analysis of the current crisis and the implications for resolving individual and groups of banks having cross-border operations. We will continue to promote pragmatic information sharing and the use of supervisory colleges to ensure that there are no gaps in the supervisory framework of banks during both normal times and periods of stress.

Capital adequacy

The crisis has shown that a strong capital base is critical to bank resilience and broader financial stability. The Basel II capital framework remains a top priority for the Committee as it provides incentives for banks to improve their firm-wide governance and risk management. Basel II should also help improve the quality of supervision and enhance market discipline. As you may know, the Committee recently issued a package of consultative documents to strengthen the three pillars of the Basel II capital framework. The enhancements we have proposed for the Pillar 2 supervisory review process should help strengthen the basics of risk management and supervision. Among other things, the supplemental guidance covers some basic governance issues that were found lacking during the crisis. The need for firm-wide governance and risk management is one example. There have been some very helpful initiatives from the private sector, such as from the IIF and the CRMPG, that aim to strengthen risk management. Pillar 2 plays a critical role in helping supervisors ensure that these efforts are in fact implemented over the long term.

Another issue the Committee is currently addressing is procyclicality, or the possibility that regulatory requirements amplify an economic cycle. Procyclicality is a difficult issue as there are other factors at play – such as valuation practices, loan loss provisioning or margining

practices – and banking tends to be a cyclical business irrespective of regulatory requirements. More generally, human behaviour is inherently procyclical.

Failure to adequately capture risk and other unexpected developments – risk concentrations is one example – can contribute to procyclicality. This is why the move to Basel II is so important. Improving the coverage of exposures, like liquidity lines to off-balance sheet conduits, will reduce the risk that surprises in risk management and capital adequacy cause a retrenchment at the worst possible time in the cycle.

With these difficult issues in mind, the Basel Committee has begun a comprehensive top-down review of the potential procyclicality of the Basel II framework. We need to retain the benefits of risk-sensitivity and differentiation across institutions. But we also need to mitigate the risk that excessive cyclicality of the minimum capital requirement magnifies the procyclicality of the financial system. The Committee is evaluating a range of measures that would help address procyclicality but could also have a countercyclical influence. For example, we are looking at ways to promote a high quality capital buffer that a bank would increase in good times and be allowed to dip into in difficult times. Also under discussion is the use of a simple, supplemental measure to reinforce the risk-based ratio. This could constrain the amount of leverage banks could have in good times and therefore also contain the degree of deleveraging in bad times.

Sound standards and effective implementation

Now let me say a few words about the importance of sound standards and, in particular, their implementation. Developing sound global standards in a thoughtful, inclusive manner is just the first step in the process toward the ultimate goal of better risk management and more effective supervision. The involvement of the wider supervisory community in developing sound global standards is a collective enterprise not limited to the 13 countries represented on the Committee: there are representatives from more than 20 other countries that participate directly in a variety of Basel Committee subgroups. The number of jurisdictions involved in the Committee's work is even higher when taking into account those participating in their capacity of representatives of a larger group. A few examples I can point to include the Banking Commission of the West African Monetary Union, EMEAP in Asia, and the Association of Supervisors of Banks of the Americas – ASBA.

The International Liaison Group – the ILG – serves as the Committee's main channel to liaise regularly with senior non-member supervisors, the IMF and the World Bank. The West African Monetary Union and the South African Reserve Bank are members of the ILG. This approach is meant to be a two-way street: it is an efficient way for the Committee to get input from these regions as well as to disseminate information to the members. Even if all supervisors cannot participate directly in the work of the Committee, all are given the opportunity to comment before our products are final. The issues the ILG is currently working on were suggested by the non-Basel Committee members. These issues include risk-based supervision, provisioning and microfinance, which I touched on earlier. This helps the entire supervisory community to have a common understanding of the issues.

The development of sound standards is only the first step and the critical next step is implementation. Supervisors must diligently implement the standards and consistently ensure that banks are adhering to and practicing the standards. This is another of the lessons learned during the crisis. Sound fundamental principles of credit and liquidity risk were not practiced. To help improve implementation of our sound guidance and standards, the Committee has broadened the mandate of the Accord Implementation Group. The new Standards Implementation Group (SIG) will continue to concentrate on issues relating to Basel II implementation but will also focus on all risk management guidance and standards.

Conclusion

I hope my remarks this morning have given you a sense of the direction in which supervision is moving. The stress witnessed over the past two years revealed major weaknesses in risk management or supervision that were not previously identified. There have certainly been a number of lessons that can already be drawn from this crisis. For supervisors, this includes greater focus on taking a system-wide approach to supervision and identifying potential regulatory gaps. It has also reinforced the Committee's longstanding commitment to cross-border cooperation. The crisis has focused the spotlight on capital adequacy and strong liquidity and has spurred extensive consideration of ways to mitigate procyclicality.

The financial crisis has also exposed many egregious examples where bankers have strayed from the basic principles of risk management and supervisors did not sufficiently follow-up to ensure implementation. Getting "back to basics" means banks and supervisors need to ensure risk governance and supervisory frameworks are underpinned by a strong foundation. In the case of supervisors, these are the Basel Core Principles. The crisis has reminded us of the importance of sound standards and has underscored that this must be accompanied by implementation and rigorous supervisory follow-up.