

Supervisory Intensity and Effectiveness

Progress Report on Enhanced Supervision

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Executive Summary

In the aftermath of the global financial crisis supervisors assessed their approaches and methods applied to the supervision of systemically important financial institutions (SIFIs), particularly those systemic in a global context (G-SIFIs), and highlighted areas requiring improvements. The Financial Stability Board (FSB), through the Supervisory Intensity and Effectiveness (SIE) group, has explored the tools and methods that are increasingly used by supervisors in order to intensify supervision, which is as important as strong rules on capital and liquidity, and becomes more relevant when capital and liquidity are inadequate. In particular, the SIE explored:

- the interaction between supervisors and boards, senior management (chief executive officer, chief risk officer and chief financial officer), and control functions such as compliance and internal audit;
- the formulation of enhanced supervisory expectations for institutions' risk governance frameworks (e.g. strong internal audit function, risk appetite frameworks, risk culture);
- ongoing focus on rigorous financial / business model analysis ("follow-the-money") and other forward looking risk analysis tools such as stress testing to detect early weaknesses or problems.

More intense and effective supervision remains a core element on the supervisory and regulatory agenda. It allows supervisory authorities to promote best practices, and identify and address risks before they become serious problems at financial institutions. The experience of the crisis showed that there was room for improvement in supervisory practices in many areas. Since then, there has been good progress in some areas. But more remains to be done. The sharing of supervisory experiences and the advancements of some supervisors in selected areas has acted as catalysts for other supervisors to improve on their practices and explore new approaches and tools.

The work is continuing. Enhancements to risk governance practices need ongoing focus as does supervisory interactions with boards, particularly on more difficult topics such as risk appetite and risk culture. Many supervisors believe it is time to take stock of progress and ensure the changes made to date, including the new tools and approaches, are effectively integrated into their "steady state" processes and assessments, in particular for G-SIFIs. This is a difficult process, which requires changes at many levels within supervisory authorities, especially in terms of the adequacy (quantity and quality) of their resources. To be successful, this change phase requires support from all stakeholders, starting from governments. The work ahead on more effective supervision will focus on drivers of supervisory empowerment and the measurement of supervisory effectiveness, including the search for proper input and output metrics.

1. Supervisory practices in 2008

Before the crisis, insufficient attention was being paid to SIFI supervision. Prevailing attitudes were *laissez faire* and there were few signals that anything was amiss. Supervisory frameworks in some countries had changed to become very light touch. Many supervisors of SIFIs had inadequate mandates, resources, independence, and supervisory methods, yet

received favourable results in the International Monetary Fund (IMF) and World Bank Financial Sector Assessment Program (FSAP) because they were being rated on very basic criteria and expectations that were not suitable for financial systems with complex, systemically important institutions, such as G-SIFIs. This contributed to a situation of:

- ***Inadequate supervisory resources.*** Insufficient attention was paid to supervisory skills and specialist skills were in short supply; supervisors of SIFIs were not necessarily the most experienced and many agencies did not have enough supervisors to do the work.
- ***Weak institutional governance.*** At institutions, chief risk officers were not senior enough and did not always have access to boards to express concerns; many boards were comprised of directors who lacked understanding of the institutions they were overseeing. The focus by both institutions and supervisors on concepts such as risk culture and risk appetite were not commonplace.
- ***Poor supervisory interaction.*** Similarly, many supervisors did not focus on effective risk governance frameworks and had little interaction with boards.
- ***No benchmarks.*** Supervisors often did not benchmark SIFI best practices, and supervisory teams for SIFIs within and between supervisory agencies were often not communicating with one another.
- ***Neglect of models.*** Many supervisors did not spend sufficient time reviewing capital models once models were approved.
- ***Insufficient data.*** Many supervisors had very little data as institutions successfully argued about burden; many supervisors did not have information technology (IT) systems to analyse data and track financial risk indicators.
- ***Failure to understand the business.*** Many supervisors spent time focused on effectiveness of controls, but not enough time on challenging the resulting risk profile. Understanding institutions' business models and how businesses were changing was not necessarily considered part of their mandate.
- ***Insufficient stress testing.*** Stress testing was not common practice at SIFIs or required by supervisors, and when done, the scenarios as well as stress testing methodologies were not very rigorous.
- ***Weak supervisory colleges.*** Colleges were generally ineffective; only a few were working effectively at the time of the crisis.
- ***No resolution planning.*** Little or no attention was devoted to recovery and resolution planning.

These shortcomings were combined with inadequate capital and liquidity, to contribute to the widespread financial fragility going into the crisis.

2. What has been done

In the past five years, supervisory attitudes have changed radically, with the determination to raise supervisory standards and the expectations for SIFIs. Standard-setters have strengthened their core principles¹ which are reflected in FSAPs; therefore, FSAPs are tougher today and outcomes are more robust. Still, much depends on the quality of the assessors, the focus on supervisory outcomes versus compliance with technical criteria, and the time spent to conduct FSAPs. In addition, the FSB Standing Committee on Standards Implementation (SCSI) peer reviews provide a horizontal view of implementation of standards and practices across national authorities and institutions in areas such as risk governance, compensation, and resolution. A further peer review of supervisory frameworks and practices is scheduled for 2014. Some notable advancements in supervisory practices include:

- ***More effective supervisory interactions.*** Greater supervisory interaction with boards has been achieved. A best practice has emerged that supervisors be made aware of board and senior management appointments in advance and have an opportunity to raise any concerns.
- ***Greater focus on governance, risk appetite and culture.*** There is more supervisory focus on risk governance, including the development of an institution's risk appetite framework and the assessment of its risk culture, which has been supported by new guidance and principles that aim to strengthen the dialogue with the board and senior management.
- ***Higher expectations for risk identification and measurement.*** Supervisory expectations have increased, particularly for G-SIFIs, for the institution's ability to aggregate risk data and strengthen IT and management information systems (MIS) in order to support more timely and better risk data reporting.
- ***Increased understanding of the business.*** Supervisors have an increased focus on understanding institutions' business models and the key drivers of revenue, as an approach to understanding an institution's prospective vulnerabilities and risks.
- ***More robust stress testing.*** Wider application of stress testing practices within institutions' risk analyses and capital planning processes, as well as within the supervisory review process more broadly is occurring; supervisory expectations for institutions to conduct more rigorous stress testing have increased along with supervisory practices for assessing stress testing models and scenarios.

¹ See Basel Committee on Banking Supervision (BCBS), *Core principles for effective banking supervision*, 2012 (<http://www.bis.org/publ/bcbs230.htm>); International Association of Insurance Supervisors (IAIS), *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, October 2012 (<http://www.iaisweb.org/Insurance-Core-Principles--795>); International Organization of Securities Commissions (IOSCO), *Objectives and Principles of Securities Regulation*, 2010 (<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>).

- ***Stronger resolution planning.*** Expanded use of recovery and resolution planning has helped to identify new sources of risk and impediments to resolution, such as the complexity of organisational and funding structures, higher operational risk than previously apparent, and complex booking and collateral management practices.
- ***Increased oversight of FMIs.*** The risks posed by financial market infrastructures (FMIs) have been reviewed with concerns expressed about the need to focus on the quality of supervision of FMIs.

3. What work remains

Increasing supervisory effectiveness is a journey. Despite the advancements made, more work is needed in particular in the following areas:

- ***Implementation of the enhancements.*** Supervisors need to remain focused on ensuring that the changes identified above take root and are appropriately embedded for future use and application. In general, there is a perceived need to go back and refresh what is being done by supervisors in many areas identified above – supervisors believe it is time to take stock and ensure changes are appropriately integrated into ‘steady state’ practices.
- ***Strengthen risk management and measurement.*** Supervisors need to continue to impress upon institutions the importance of strengthening risk management and measurement. The effective implementation of the BCBS *Principles for effective risk data aggregation and risk reporting*² at the banking group-wide and legal entity levels will be an essential step to support better risk identification and management. This is a critical precondition to the effective risk management of the institution, namely for implementation of an effective risk appetite framework and recovery and resolution plans. At the same time, for many authorities, IT systems for using data collected should be enhanced.
- ***Improve models.*** BCBS work has revealed issues with bank capital models which are partly due to poor internal models, variations in implementation of the BCBS standards, and inconsistent supervisory attention on ongoing monitoring of such models (and most supervisors suggest that the skills needed to oversee models are in short supply).

² See BCBS, *Principles for effective risk data aggregation and risk reporting*, January 2013 (<http://www.bis.org/publ/bcbs239.pdf>).

- **Enhance stress testing.** Supervisors need to advance further the implementation of the BCBS *Principles for sound stress testing practices and supervision*³ as a survey by the BCBS showed that very few countries do this well. SIE discussions suggest that there is a need for continued focus and creativity in stress test scenarios to ensure they sufficiently challenge assumed outcomes, and a need to ensure a strong relationship between supervisors and macroeconomists in developing those scenarios.
- **Strengthen resources.** Supervisors need to continue to strengthen their resources. The need for talent at supervisory agencies is affected by greater interaction with boards on issues such as risk appetite and risk culture, more focus on stress testing, supervisory intervention in capital models and better oversight and analysis of data collected from financial institutions.
- **Continue benchmarking.** The SIE will continue to benchmark supervisory intensity and will review further the number of supervisory resources for global systemically important banks (G-SIBs) – three G-SIBs from three countries have recently been reviewed and the remaining G-SIB countries are to be reviewed in April. This will bring new perspective on types and allocation of resources for more effective supervision of G-SIBs.
- **Assess supervisory effectiveness.** Supervisors need to develop methods to judge supervisory effectiveness in light of the changes implemented within supervision so far. This includes the related assessment of whether all the supervisory focus on boards and risk governance is paying off and institutions are becoming more effective in their risk governance.
- **Define supervisory risk appetite.** Supervisory authorities will need to focus on the risk appetite of supervisors (how much risk supervisors are prepared to tolerate) and on ways of ensuring that supervisors have reliable mechanisms in place to understand and discuss acceptable versus unacceptable risks.

³ See BCBS, *Principles for sound stress testing practices and supervision*, May 2009 (<http://www.bis.org/publ/bcbs155.pdf>).

Introduction

In the aftermath of the financial crisis, the FSB and the G20 Leaders identified as a priority the need for more intense and effective supervision particularly as it relates to SIFIs. The level of supervision applied by national authorities must be commensurate with the potential destabilisation risk that such institutions pose to their own domestic financial systems, as well as the broader international financial system. Supervision is not only about ensuring compliance with the letter of the rules but also with the spirit. A more intense and effective approach to oversight aims to deliver pre-emptive, rather than reactive, outcomes-based supervision.

Outcomes-based supervision is about the ability and willingness of experienced supervisors to focus on the big picture; to come to judgements that are forward looking; to anticipate risks that affect safety and soundness; and to engage in credible and sceptical conversation with the board and senior management on the institution's business strategy and effectiveness of its risk governance. As the global financial crisis showed, some supervisors were not successful in making these forward-looking judgements or in being pre-emptive.

At the foundation for effective supervision are the core principles issued by the standard setting bodies.⁴ More intense supervision builds on these foundational elements and hones in on key risk areas and in particular the areas that exhibited significant weaknesses during the global financial crisis. Supervisors also need to be armed with the necessary tools, including more reliable information to support their judgements and enable them to be more forward looking in their assessments of risk. A change in mind set at supervisory authorities is underway and authorities are focusing more on risks and responsibilities that, prior to the global financial crisis, were viewed as within the remit of the institution's management and hence areas in which supervisors should not intrude (e.g. business models, strategy).

As set out in the FSB report to the G20 on *Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)*,⁵ the policy development for implementing the SIFI Framework⁶ is largely done. However, policy changes alone are not enough – supervisory assessments must be more effective and more robust. This is particularly needed to ensure that G-SIFIs have effective recovery and resolutions strategies and sufficient loss absorbing capacity. Because of the high cost of the past performance failures in supervisory assessments, supervisory approaches, in particular towards SIFIs, have changed in order to make supervision more intense and more effective. The new paradigm for effective supervision poses the challenge of proactively engaging with institutions on their strategic choices and the implications of such

⁴ Ibid., 1.

⁵ See FSB, *Report of the Financial Stability Board to the G20 on Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)*, September 2013 (http://www.financialstabilityboard.org/publications/r_130902.pdf).

⁶ See FSB, *Reducing the moral hazard posed by systemically important financial institutions*, October 2010 (http://www.financialstabilityboard.org/publications/r_101111a.pdf).

choices in order to identify and address risks in advance of them becoming serious problems. This requires experienced supervisors and that authorities have the operational independence to act on supervisory findings.

Supervisory observations and areas of work

The following sections present some of the observations and findings of the discussions among members of the SIE group and point to some areas where more work is needed.

1. Mandates/Resources/Independence/Ability to Act

To lead by example, FSB member jurisdictions have committed to, amongst others, implement international financial standards and undergo an FSAP every five years. FSAP findings reveal that significant weaknesses continue to exist, particularly in regard to official mandates, resources and independence.

Aggregated FSAP country ratings on supervisory independence show that there are some recurring reasons for non-compliance with the standard setters' core principles related to supervisory independence, such as:

- *Prudential actions:* In some jurisdictions, ministerial approval is required prior to the supervisor taking certain prudential measures, while in others, supervisory rules or decisions can be overruled by the Minister or other governmental authorities, raising concerns about independence and influence.
- *Dismissal of supervisory personnel:* Some countries lack clear details outlining the circumstances for the removal of supervisory authorities as well as requirements for public disclosure of the factors/reasons for the dismissal of senior supervisory personnel. Taken together, the ability to arbitrarily remove supervisory authorities without proper public explanations compromises independence.
- *Resource levels:* Some countries lack full budgetary independence, which hinders the ability of supervisory authorities to obtain and allocate resources according to supervisory priorities.

The FSB and IMF are delving further into this issue in order to identify the key issues hindering supervisory independence.

SIE work indicates that the new regulatory environment (e.g. recovery and resolution planning, higher loss absorbency, structural changes) and more intense supervision necessitate changes in supervisory approaches which require a different skill set, and for many supervisory agencies, more resources.

Supervisory authorities need to assess how best to approach a change management process that is aimed at achieving more adequately skilled and effectively utilised resources. Change management processes could include reviewing the competencies that are expected of good supervisors, establishing talent management processes to ensure that good supervisors are retained and developing training programs to extend the needed supervisory competencies at all levels of the organisation.

The ability to act rests on operational independence, but must be accompanied by an appropriate accountability framework for the supervisory authority. This requires a robust, effective and transparent framework to assess supervisory performance. While FSAPs delve into supervisory effectiveness, and have the advantage of being independent and impartial, they are infrequent. In the meantime, efforts to improve the standards assessment process are welcomed. In this regard, assessors are now required to cover an extensive set of principles and detailed criteria which require senior level judgements; otherwise FSAPs run the risk of reducing the focus on supervisory outcomes and whether supervision is ultimately effective, thus defeating objectives.

2. Greater interaction with the board

The ultimate responsibility for the safety and soundness of a financial institution resides with its board. As such, supervisors are more focussed today on the quality of an institution’s risk governance framework, risk management, risk culture and the role that the board plays in ensuring they are appropriate and effective. These efforts are being underpinned by recently issued principles and guidance by the FSB:

- *Sound practices for effective risk governance*,⁷ which sets out an integrated and coherent list of sound practices that aim to help national authorities take a more holistic approach to risk governance, which comprises the board, risk management, and internal controls, rather than looking at each facet in isolation.
- *Principles for an effective risk appetite framework*,⁸ which establish common definitions for terms used in risk appetite frameworks to facilitate communication between supervisors and financial institutions as well as within institutions on the institution’s risk profile in relation to its business strategy and risk capacity.
- *Guidance on supervisory interaction with financial institutions on risk culture*,⁹ which provides guidance to assist supervisors in assessing whether the institution’s risk culture or behaviour towards risk are possible sources of supervisory findings that need remediation.

These principles and guidance are mutually reinforcing, collectively aim to strengthen supervisory interactions with the board and senior management, and increase the intensity of supervision in areas that are difficult to assess. Some authorities are embedding into their

⁷ See FSB, *Thematic Review on Risk Governance*, February 2013 (http://www.financialstabilityboard.org/publications/r_130212.pdf).

⁸ See FSB, *Principles for an Effective Risk Appetite Framework*, November 2013 (http://www.financialstabilityboard.org/publications/r_131118.pdf).

⁹ See FSB, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture, A Framework for Assessing Risk Culture*, 7 April 2014 (<http://www.financialstabilityboard.org/publications/140407.htm>).

regulatory and supervisory guidance expectations for governance arrangements at financial institutions and for the role of the board and senior management.

Supervisory reviews indicate that financial institutions have some distance to travel to meet supervisory expectations for risk appetite frameworks. While risk appetite frameworks are clearly documented, more work is needed on linking risk appetite with the institution's business strategy and cascading risk appetite throughout the organisation.

Renewed focus on the importance of the board's oversight role has resulted in more frequent and proactive meetings between supervisors and directors, and importantly, bilaterally with the chairman and chairs of key committees. Some authorities see benefits in observing board meetings to assess the interactions between directors, the decision-making process, and the degree of directors' understanding of the institution's business strategy, risk appetite, and risk profile. This approach is also seen by some supervisors as providing a window into the institution's culture and indication of the "tone at the top".

A number of supervisory authorities have instituted a process for assessing the suitability of directors in advance of appointment. Many authorities take the approach of having the right of refusal, but some have taken on a role of endorsing the suitability of the nomination through an interview process. Suitability requirements range from "fit and proper tests" to meeting specific criteria. Each review process has risks but provides an important opportunity to better understand the composition and overall competencies of the board, as well as to engage with directors from the beginning of their appointment and provide a better basis for supervisory interaction at a later stage. While the degree of supervisory interactions varies, it is always seen by supervisors as an important opportunity to engage and discuss necessary changes within the institution.

3. Increased understanding of SIFIs' business models

A key observation in reviewing supervisory effectiveness before the crisis was that supervisors had reduced their emphasis on detailed financial analysis and understanding an institution's business model to have more emphasis on controls. Since the global financial crisis, many supervisors have renewed their focus on rigorous analysis and applied more effort to understanding SIFIs' business models and the sustainability of the institution's business lines and products. This approach incorporates both quantitative (e.g. income statement, balance sheet, key financial metrics) and qualitative (e.g. strategy, competitive landscape) analyses, and requires greater communication with business lines and product heads, extending communication beyond control functions (e.g. risk management, compliance, audit).

Business model analysis involves among other elements examining the drivers of revenue generation and funding, the sustainability of comparative advantages, and the key dependencies underpinning the institution's viability and sustainability. This requires exercising judgement on whether the institution's projections are plausible in supporting its strategy in the context of the evolving market. This forward-looking approach aims to uncover issues early, allowing for more proactive and timely intervention, and provides a sound platform for supervisory discussions with the financial institution. Supervisory findings from the work undertaken include unrealistic strategic plans, overly optimistic growth

assumptions and profitability projections, as well as hurdles for effective implementation of recovery and resolution plans. The comparison of behaviours across peer institutions provides great value for supervisors in better understanding the business dynamics.

Supervisory approaches and depth of business model analysis varies across jurisdictions and institutions. In some cases supervisors have made significant investments in new resources and supervisory methods to introduce a “follow the money” approach. For other supervisors business model analysis has always been a relevant component of supervisory activities but their approach has evolved as the institutions they supervise became more complex. Business model analysis can be extremely resource intensive and supervisory authorities are looking to find the right balance in the level of detail and granularity in the review of complex business models and structures in order to uncover the major threats to the institution’s strategy and long-term viability.

4. More reliable information

The crisis highlighted material weaknesses in the ability of institutions to quickly and accurately aggregate their risk exposures to counterparties, geographic regions or products and come to an enterprise-wide assessment of risks across the whole group. Further, little consistent information was available on bilateral linkages between large globally active financial institutions, or on their common exposures and liabilities to financial sectors and national markets, information that is necessary to identify risk concentrations and the build-up of systemic risks. To address this information gap, the FSB was asked to develop a common data template for G-SIFIs for the purpose of better understanding the exposures of these institutions and provide authorities with a stronger framework for assessing potential systemic risks. The initial template is for G-SIBs, which builds on the work of the Senior Supervisors Group (SSG) and of the Bank for International Settlements (BIS) International Banking Statistics, and gives authorities clearer sight of the common exposures and interconnectedness of the largest financial institutions.¹⁰

Analysis of this data set by the SSG concludes,¹¹ however, that five years after the crisis institutions’ progress toward consistent, timely, and accurate reporting of top counterparty exposures fails to meet either supervisory expectations or industry self-identified best practices.¹² The area of greatest concern remains institutions’ inability to consistently produce high-quality data.

¹⁰ See FSB, *Data Gaps Initiative on a common data template for G-SIBs*, April 2013 (http://www.financialstabilityboard.org/publications/r_130418.htm).

¹¹ The SSG conducted a survey on the data collected initially by the Federal Reserve Bank of New York, which was prior to establishment of the data hub at the BIS in March 2013.

¹² See SSG, *Progress Report on Counterparty Data*, January 2014 (http://www.financialstabilityboard.org/publications/r_140116.htm).

In this regard, implementation of the BCBS *Principles for Effective Risk Data Aggregation and Risk Reporting*¹³ at the banking group-wide and legal entity levels is critical to the effective risk management of the institution, particularly for implementation of an effective risk appetite framework and recovery and resolution plans. Supervisory authorities for G-SIBs, which are required to meet these principles in 2016, now include regular assessments of progress on implementation to ensure resources remain committed to this effort through the cycle. Results of a recent self-assessment reveal that many G-SIBs still lack sufficient risk governance and IT frameworks in particular.¹⁴

5. Stress testing

Stress testing has become a key tool used by supervisory authorities to test institutions' resilience against risks in various scenarios, and to test how institutions would react to risks unfolding over protracted periods of time. Some stress tests are more targeted to specific types of risk, and are used by supervisors in a preventative way, to examine pockets of vulnerabilities. Stress testing is also being used to support a more forward looking analysis of risks and more effective supervisory interaction with institutions on strategy, business prospects, and capital needs.

Supervisory responses to stress testing outcomes vary, and include evaluating institutions' capital plans as well as driving the development of supervisory plans. The mapping from stress testing outcomes to the supervisory response is challenging in terms of both supervisory decisions and effective communication. Given the importance of forward-looking assessments of risk and resilience, supervisors should steer institutions to be "creative" in their macroeconomic scenarios, i.e. expand their scale and enlarge their scope by including more scenarios and more risk factors within selected scenarios. For example, recent supervisory discussions have focussed on interest rate risk, and the fact that scenarios should encompass both high asset price volatility and an overshooting of long-term interest rates relative to economic fundamentals. Some authorities include amplification factors in their stress tests to capture feedback (second round) effects, and have made more progress with respect to the challenges in constructing stress test scenarios. More interaction between front line supervisors and macroeconomists who develop the scenarios might help to uncover second round impacts.

While some supervisors might have developed top-down models, fairly disaggregated models are needed to explore pockets of vulnerabilities (for example, different asset classes can behave differently). Recent FSAP findings in regard to approaches used by national authorities, as well as adjustments made by the IMF in their stress testing assessment

¹³ Ibid., 2.

¹⁴ See BCBS, *Progress in adopting the principles for effective risk data aggregation and risk reporting*, December 2013 (<http://www.bis.org/publ/bcbs268.pdf>).

methodology, can provide some useful benchmarks for authorities that are still developing their stress testing frameworks.

6. Integrating recovery and resolution planning into SIFI supervision

Resolvability assessments are emerging as an integral part in the overall supervisory process, and are changing some aspects of ongoing supervision. Supervisory discussions with institutions increasingly focus on the necessary changes to their organisational and operational structure to facilitate effective recovery and resolution processes. Some supervisory authorities are conducting horizontal reviews of institutions' recovery planning processes to benchmark practices, identify best practices as well as weaknesses across selected areas, and inform evolving supervisory expectations for recovery planning. In some cases, the work on recovery and resolution planning has uncovered issues such as operational risk higher than previously thought due to structural complexity, complex interdependencies or issues around collateral management practices. Supervisory priorities and expectations have changed in light of the learnings from the recovery and resolution planning, and are increasingly focused on progress in removing barriers to resolvability. It is important that line supervisors and resolution unit staff (where these are separate) do not work in silos and share learnings and outcomes from their respective processes.

Building on the work of crisis management groups, which include supervisory and resolution authorities of home and key host jurisdictions, the resolvability assessment process for a number of G-SIBs is underway with a view toward reporting to the G20 Summit in Brisbane on the overall status of resolution planning processes for these institutions.

7. Stronger international cooperation

In principle, global financial institutions demand global supervision. Cross-border supervisory cooperation and coordination need to be intensified for enhanced supervisory approaches and methods to be effective for groups with global operations. The BCBS and IAIS are making progress toward enhancing their guidance on supervisory colleges to support better cooperation and coordination.¹⁵ Beyond supervisory colleges a multitude of selected activities could leverage and synchronise the supervisory resources at different authorities, such as regular exchange of supervisory agendas and views on G-SIFIs, and joint topical reviews.

A key element of the SIFI Framework is for home jurisdictions of G-SIFIs to enable the sharing of information for the purpose of rigorous co-ordinated assessments on the risks facing the G-SIFI through international supervisory colleges. Although progress has been made by home jurisdictions and by the relevant standard-setting bodies, more work is needed.

¹⁵ See BCBS, *Consultative Document Revised good practice principles for supervisory colleges*, January 2014 (<http://www.bis.org/publ/bcbs276.pdf>).

The TBTF Report requested supervisors of G-SIFIs working through core supervisory colleges to remove any remaining obstacles to achieving effective and coordinated assessments of the risks facing the G-SIFIs. To this end, the report asks the FSB, in consultation with standard-setting bodies, to develop proposals on how to strengthen the operation and effectiveness of core supervisory colleges, including information sharing, to enable coordinated assessments of the risks facing the G-SIFIs.

Some of the current difficulties in enhancing supervisory cooperation for global institutions are also related to the reorganisation of supervisory authorities and frameworks, including at the regional level, and challenges in implementation of other reform initiatives, such as the establishment and operation of crisis management groups to agree recovery and resolution plans and resolvability assessments. It is of paramount importance that cooperation for the supervision of global institutions on an ongoing basis regains prominence and is strengthened towards coordinated risk assessments.

8. Supervision and oversight of FMIs

One of the priorities for the medium term is for supervisory and oversight authorities to have enough resources and a good understanding of emerging supervisory challenges. One of the most important priorities is the analysis of the risks, including the potential for risk amplifications, of FMIs. The standard setting bodies, the Committee on Payment and Settlement Systems (CPSS) and IOSCO, have jointly issued the *Principles for Financial Market Infrastructures*,¹⁶ which set out consolidated rules for central counterparties (CCPs). For supervisors however the challenges are only beginning to emerge.

Supervisors and overseers of FMIs need a better understanding of the risks of FMIs and to challenge FMIs to be managers of systemic risk versus efficient, low cost service providers. The lessons learnt for other regulated institutions' risk management practices need to be applied in the supervision of FMIs, where decisions around risk are central to business models and policies, and at the same time risk management practices may be weaker than in G-SIBs. Banking supervisors in particular should make efforts to better understand how the risks from participating in a CCP might extend and feed back to banks' operations. At the same time, banks' participation in CCPs can help improve their resilience as banks are represented on the risk committees of clearing houses (in their capacity as clearing members) and hence can enhance the approach to risk management.

¹⁶ See CPSS and IOSCO, *Principles for financial market infrastructures*, April 2012 (<http://www.bis.org/publ/cpss101a.pdf>).

Standard setting bodies' work to enhance supervisory intensity

The standard setters are continuing to work to enhance supervisory effectiveness. Since it updated the Basel Core Principles almost two years ago, the BCBS has put renewed emphasis on supervision. The paper *A Sound Capital Planning Process: Fundamental Elements*¹⁷ codifies supervisory expectations for what constitutes sound capital planning; the *Revised good practice principles for supervisory colleges* consultative document¹⁸ seeks to ensure that the principles remain fit for purpose and that they describe how high quality supervisory colleges typically function; and the revised guidance for supervisory interaction with external auditors¹⁹ acknowledges the important role external auditors can play in identifying areas of risk. The FSB, in collaboration with the standard setting bodies and the International Forum of Independent Audit Regulators (IFIAR), continues to engage with external auditors on identifying and mitigating obstacles to open dialogue between supervisors and auditors.

The BCBS governing body of Central Bank Governors and Heads of Supervision recently endorsed its work plan that includes completing work in the next 12 to 18 months related to supervisory guidance on dealing with weak banks, evaluating bank corporate governance, assessing provisioning practices, and managing operational risk. Peer evaluations are underway in different areas that address aspects of supervisory effectiveness, such as risk data aggregation and risk reporting. Another BCBS study will look at the range of current practices in the way its members recognise problem assets. The BCBS has also just launched a project to study how member supervisory agencies manage, assess and report on their own effectiveness and accountability.

The IAIS adopted policy measures in July 2013 to be applied to global systemically important insurers (G-SIIs). Those include G-SII-specific requirements building on those included in the insurance core principles (which apply to all insurers) and in the Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs), or ComFrame, expected to be finalised by 2018. The G-SII policy measures²⁰ include the FSB SIE recommendations for more enhanced supervision, and the requirement for direct powers for supervisors at the level of holding companies for G-SIIs. ComFrame addresses governance and risk management requirements, including Own Risk and Solvency Assessment (ORSA), as well as supervisory review, including the requirement that all IAIGs must have a supervisory college. The scope of supervision under ComFrame includes holding companies, and in this regard all IAIGs will be required to develop profile to assist supervisors to ensure there are no regulatory gaps and that all relevant holding companies are identified. In addition, the IAIS agreed that

¹⁷ See BCBS, *A Sound Capital Planning Process: Fundamental Elements*, January 2014 (<http://www.bis.org/publ/bcbs277.pdf>).

¹⁸ Ibid., 15.

¹⁹ See BCBS, *External audits of banks*, March 2014 (<http://www.bis.org/publ/bcbs280.pdf>).

²⁰ See IAIS, *Global Systemically Important Insurers: Policy Measures*, July 2013 (<http://www.iaisweb.org/G-SIIs-988>).

supervisors should be required to have direct powers over the financial holding company of the IAIG; the IAIS should further consider the necessary powers over ultimate holding companies where these are not financial holding companies, as well as the precise nature of the direct powers necessary at the level of the financial holding company.

Next steps: Assessing supervisory effectiveness

In parallel with implementing changes toward more effective supervision, the work ahead will need to focus on the measurement of supervisory effectiveness, including the search for proper input and output metrics.

Assessing the effectiveness of supervision is a difficult task. The SIE work has focused on approaches to intensify supervision with the implicit assumption that more intense supervision will be more effective in terms of supporting early warning and early intervention. As noted above, the BCBS has recently initiated work on sharing good practices in measuring and assessing supervisory impact and accountability. However, assessing supervisory effectiveness from an output perspective is in its infancy. Various authorities are exploring ways to measure performance and effectiveness of supervision on an ongoing basis. This is extremely difficult as there are no natural metrics for supervisory effectiveness like the profit, return on equity or other metrics that are used by the institutions they supervise. Effective supervision might well yield no change in any indicator, i.e. no bank runs, no payments from deposit insurance, no “surprises”. Or it may yield indicators such as no failures or failures, both of which may be an indicator of effectiveness.

Some authorities regularly conduct industry surveys in an effort to seek feedback on their performance and identify areas for improvement. More research on ways to assess and measure supervisory effectiveness would be useful including understanding how well the decisions are formed and examining the processes used to support the development and review of supervisory judgments.

The 2014 FSB peer review on supervisory approaches in particular to G-SIBs²¹ will take stock of many of the changes being implemented by supervisors, and will be another important step in the direction of assessing supervisory effectiveness and getting at performance.

²¹ The scope of the review will include supervisory authorities that are home to a G-SIB, but additional non-G-SIB supervisory authorities will be invited to opt in.