FINANCIAL STABILITY BOARD

Intensity and Effectiveness of SIFI Supervision

Progress report on implementing the recommendations on enhanced supervision

27 October 2011

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Executive summary

Increasing the intensity and effectiveness of supervision is a key component of the Financial Stability Board's (FSB's) efforts to reduce the moral hazard posed by systemically important financial institutions (the "SIFI framework"), along with requiring added capital loss absorbency and facilitating the orderly resolution of firms.[1]

On November 1, 2010 the FSB, in consultation with the International Monetary Fund (IMF), released a report on *Intensity and Effectiveness of SIFI Supervision* (the SIE report).[2] The SIE report observed that prior to the crisis, risk management processes at SIFIs were generally judged to be acceptable, but the crisis indicated otherwise. The report noted that supervisory work was often not geared toward "outcomes" but more focused on process, and said that supervisory expectations for SIFIs in particular needed to increase. The SIE report did not set out new supervisory rules and policies for SIFIs but set out 32 recommendations for making the supervision of financial institutions more intense, effective and reliable.

Members of the FSB Supervisory Intensity and Effectiveness group (SIE) met on several occasions to review progress in implementing the recommendations set out in the SIE report. Examples of supervisory practices that get to the essence of financial institutions' risk and how it is being managed were discussed as well as actions being taken to strengthen controls at SIFIs. Underpinning some of the discussion among SIE members were the outcomes from a questionnaire sent to members of the BCBS-SIG and a self-assessment conducted by FSB members against certain Basel Core Principles. These exercises were useful in identifying recent improvements and remaining challenges in supervisory practices at SIFIs.

Supervisors are making headway in addressing many of the issues identified in the SIE report (e.g. model risk management, enhanced scrutiny of boards and senior management, more emphasis on adoption of strong controls by SIFIs, deep dives and horizontal reviews, stress testing, supervisory colleges, macro prudential surveillance, and examination of risks associated with business models). To ensure changes to supervisory practices endure, supervisors will be held to higher standards. The Basel Core Principles (BCPs) on Effective Supervision – the global standards against which supervisors are assessed as part of the IMF-World Bank Financial Sector Assessment Program (FSAP) – are being revamped, and the bar is being raised, including with respect to resources and independence. Further, the FSB urges that the IMF and World Bank resources for FSAPs be increased to provide assessors the capacity to drill down to form more robust opinions on the effectiveness of supervision.

Supervisors are, however, being hampered by a number of factors (see section II). At the forefront are inadequate information systems (IT) and data architectures at SIFIs which are hampering risk management practices such as stress testing and implementation of effective risk appetite frameworks, and also hamper supervisory oversight. One of the most significant lessons learned from the global financial crisis was that firm management failed to require sufficient IT systems and data to support the broad management of financial risks. While many firms have significant IT projects planned or underway, these projects will require

[1] http://www.financialstabilityboard.org/publications/r_101111a.pdf.

[2] http://www.financialstabilityboard.org/publications/r_101101.pdf.

significant sponsorship, capital and commitment from the board and senior management to ensure that progress continues to be made through the economic cycle.

Further, many of the global initiatives underway will be challenged by weaknesses in firms' IT systems, in particular the resolvability of SIFIs. Improved IT capability will also be needed to implement other global initiatives that have been endorsed or requested by G20 Leaders. These include identifying domestic and international network connections (FSB Data Gaps Working Group); shadow banking monitoring frameworks (FSB Shadow Banking Task Force); improving data on OTC derivatives and complex structured products, including data reporting to trade repositories (FSB OTC Derivatives Working Group); and the recent FSB initiative on creating a global "legal entity identifier" system.

And second, resource constraints at many supervisory authorities are hampering their ability to intensify their supervision. Adequacy of resources (quantity, quality, and in particular, expertise) and their effective deployment was a common theme in SIE discussions and was an issue borne out from the self assessments and to some degree, the BCBS-SIG survey. While resources have generally increased since the crisis, many supervisors believe they are operating at levels that are keeping them "just above water" and note that they often lack the supervisory capacity and requisite talent to handle increased expectations, as well as to deal with any unexpected problems.

Other significant findings coming out of more intense supervisory efforts and SIE discussions include the following:

- Supervisors have varying degrees of involvement in assessing the risks associated with business models of firms, but where business model risks have been analysed more intensively, questions are being raised about the reasonableness of underlying assumptions in firms' projections, and about the extent to which these assumptions have been vetted by senior management and boards.
- Effective risk appetite frameworks (RAF) that are actionable and measurable by both firms and supervisors are not yet widely seen.
- Supervisory expectations for controls are rising but one area – the risk management function at SIFIs – was discussed extensively by the SIE and members concluded that many such functions at firms would still not be considered *strong*. In coming to this determination, supervisors discussed some high-level indicators of a *strong* versus *satisfactory* CRO function.
- Supervisors are engaging more frequently with the boards and the range of practice among supervisors continues to be wide (for example some require that they approve board members). Many firms have restructured their boards due to either the self-identified need to improve corporate governance or in some cases due to supervisory actions. Nonetheless, more intense supervisory oversight is needed to evaluate the effectiveness of improved corporate governance, particularly risk governance.
- Supervisory oversight of models used by SIFIs is seen to be an area in which implementation of existing standards continues to be challenging, with more focus being required.

- External auditors and supervisors are in a unique position to leverage each others' knowledge about SIFIs so as to more proactively identify risks. Focus should be brought to bear on this relationship to make it more effective.

This report covers other areas that the SIE was asked to review, including the risks associated with hostile takeovers, how effective supervisory colleges work in practice and challenges in stress testing exercises. SIE members also discussed supervisory methods to assessing corporate governance at firms and the use of a macro-prudential approach in supervisory processes.

In addition, the SIE discussed the self assessments conducted by FSB members of adherence to certain Basel Core Principles which are key to effective supervision. The IMF noted that the self assessments generally focus on setting out legislative mandates, rules and supervisory requirements, and cover much less of actual practice; hence no firm conclusions can be drawn from the self assessments about the extent of compliance with the Basel Core Principles. As part of the exercise, jurisdictions were asked by the FSB to report on remedial actions to address self-identified deficiencies. Reporting on corrective actions was uneven across the FSB membership, with some remedial action plans understandably still at early stages of specificity. Through the FSAP program, the International Monetary Fund and World Bank will be assessing countries against the forthcoming revised Basel Core Principles that incorporate these key supervisory principles and the FSB intends to monitor members' implementation of these principles.

While progress is being made toward implementing the recommendations set out in the SIE report, additional work is needed to support continuous improvement in enhanced supervision, in particular of SIFIs. The report draws some recommendations that flow from the discussions among members of the SIE group.

List of recommendations:

1. The FSB, in collaboration with the standard setters, will develop a set of supervisory expectations to move firms', particularly SIFIs, data aggregation capabilities to a level where supervisors, firms, and other users (e.g. resolution authorities) of the data are confident that the MIS reports accurately capture the risks. A timeline should be set for all SIFIs to meet supervisory expectations; the deadline for G-SIBs to meet these expectations should be the beginning of 2016, which is the date when the added loss absorbency requirement begins to be phased in for G-SIBs.
2. The FSB will by end-2012 assess in more detail the adequacy of resources at supervisory agencies for the supervision of SIFIs, including the approaches supervisors are taking to intensify their supervision of SIFIs and the kinds of resources that are needed to do so. Governments should follow up on their November 2010 commitment to ensure supervisors have the capacity to resource themselves to effectively meet their mandate, which in some jurisdictions is expanding to include areas of consumer protection.
3. By end of 2012, the FSB SIE group will submit a progress report to the FSB covering how the issues identified in this report are being addressed (e.g. assessing use of models by SIFIs, risk appetite frameworks, and SIFI business models), and will submit recommendations to the FSB on how to ensure supervision of these

areas, as well as any new areas that arise as a result of their discussions, is more intense, more effective and more reliable to promote financial stability. While such areas may be identified in FSAPs as well, the SIE's discussions represent an ongoing forum for unearthing issues early.

4. The FSB should conduct a thematic review on risk governance, which is critical to ensuring a strong risk management culture at firms. The review should assess risk governance practices at firms, focusing on the risk committee of executive boards and the risk management functions (e.g. the CRO organisation, Chief Auditor) and how supervisors assess their effectiveness.

5. The BCBS should review its 2008 report *External Audit Quality and Banking Supervision* in the light of recent experience to reinforce supervisors' confidence in audit quality, which remains one of the keys to effective supervision; to encourage improved quality controls at global accounting firms; and facilitate more meaningful dialogue between supervisors and audit firms, particularly of SIFIs. Supervisors should also engage with both securities regulators, who enforce consistent application of standards, and audit oversight bodies, who are charged with reviewing audit quality.

I. Introduction

Increasing the intensity and effectiveness of supervision is a key pillar of the FSB's SIFI framework, along with requiring greater capital loss absorbency and facilitating the resolvability of failing firms. The FSB, in consultation with the IMF, released in November 2010 a report on *Intensity and Effectiveness of SIFI Supervision* (the SIE report) which set out 32 recommendations primarily aimed at SIFIs, but there were lessons for the supervision of financial institutions more generally (see Annex A). Leaders at the November 2010 G20 summit endorsed the policy recommendations contained in the SIE report and reaffirmed that the new financial regulatory framework must be complemented with more effective oversight and supervision. They agreed that supervisors should have strong and unambiguous mandates, sufficient independence to act, appropriate resources, and a full suite of tools and powers to proactively identify and address risks, including regular stress testing and early intervention. This report focuses on implementation of the SIE report recommendations and additional issues raised by the FSB over the past year.

Discussions among senior line supervisors within the FSB Supervisory Intensity and Effectiveness group (SIE) reveal that many supervisors are making headway in intensifying their supervision of SIFIs and improving their supervisory tools and methods. Examples of supervisory practices that get to the essence of a financial institution's risk and how it is being managed were discussed, as well as actions being taken to strengthen controls at firms.

Despite progress made, SIE members agree that efforts toward improving the intensity and effectiveness of supervision are not proceeding as quickly as they should and are being hampered by a number of factors. These include the general weak state of firms' data aggregation capabilities; inadequate resources at supervisory agencies; immature risk appetite frameworks which are closely linked with weak IT systems and business strategies; risk management functions that tend to still exhibit traits of "average performance" versus "strong performance"; and finally, insufficient management of firms' model risk and the type of supervisory approach needed to address it. Each of these areas is discussed in section II.

In addition to following up on the recommendations set out in the SIE report, the FSB asked the SIE group to discuss and report on several other issues members discussed over the past year (see section III). These additional areas include supervisory approaches to acquisitions, particularly hostile acquisitions; the effectiveness of supervisory colleges; and whether stress testing is a meaningful supervisory tool. SIE members also discussed supervisory methods to assessing corporate governance at firms and the use of a macro-prudential approach in supervisory processes.

Underpinning some of the discussions among SIE members were the outcomes from a questionnaire sent to members of the Basel Committee on Banking Supervision Standards Implementation Group (BCBS-SIG)[3] and a self-assessment conducted by FSB members against certain Basel Core Principles, namely BCP 1, 23 and 24. While these exercises have limitations in assessing the intensity and effectiveness of supervisory processes, they were

[3] On 31 March 2011 the BCBS-SIG sent a questionnaire to BCBS members to assess implementation of the SIE recommendations made to National Authorities. See Annex A.

useful in identifying recent improvements and remaining challenges in supervisory practices for the largest institutions. Section IV, which summarises the self assessments and the range of practices identified, found that while supervisors generally have the formal authority required to carry out the principles, actual implementation is less strong. At the core of strengthened supervisory frameworks are the minimum standards set out by the Basel Committee for sound supervisory practices, which will be strengthened by end 2011.[4] The assessments provided useful background for SIE discussions.

In addition to the work undertaken in relation to banking supervision, the International Association of Insurance Supervisors (IAIS) has made significant progress in implementing the recommendations relevant to insurance supervision (see Annex E). Much of the work is embedded in the review of IAIS Insurance Core Principles (ICPs) which is scheduled to be approved by the IAIS Annual General Meeting in Seoul on 1 October 2011.[5] Also, as a supervisory response to the increasing globalisation in the insurance sector combined with the key lessons learnt from the financial crisis, the IAIS is building the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), which will foster cooperation among supervisors and close regulatory gaps.[6]

Based on the outcome of discussions among senior line supervisors within the FSB, several recommendations are set out to support continuous improvement in enhanced supervision, in particular of SIFIs. The key conclusions and recommendations are set out in the final section (section V).

II. Supervisory challenges

1. Data aggregation

One of the most significant lessons learned from the global financial crisis that began in 2007 was that firms' information technology (IT) systems were inadequate to support the broad management of financial risks. Most firms lacked the ability to aggregate and identify risk exposures quickly and accurately at the enterprise-wide level, across business lines and legal entities, and to other firms. Supervisors observe that aggregation of risk data remains a challenge for firms despite being essential to strategic planning, risk monitoring, and decision-making. The 2010 Joint Forum report *Developments in Modelling Risk Aggregation* found that the risk aggregation models used by firms to support decisions about capital allocation and capital adequacy and solvency have limitations that may prevent firms from seeing clearly or understanding fully the risks they face.[7] While firms are working toward improving their data aggregation capabilities, supervisors would like to see more progress and

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4 The SIE report recommended that the BCBS and IAIS review certain Core Principles. The BCBS is reviewing the Core Principles for effective banking supervision (BCP) as recommended by the SIE report; the work is expected to be finalised in summer 2012. The IAIS will finalise revisions to their Insurance Core Principles in autumn 2011.

5 Link to final ICPs when finalised.

6 http://www.iaisweb.org/__temp/6_July_2011__IAIS_ComFrame_to_close_gap_in_supervision_of_insurance_groups.pdf

7 http://www.bis.org/publ/joint25.pdf.

some are raising expectations for what is considered acceptable in firms' risk reporting capabilities, particularly at SIFIs.

Building robust infrastructure systems requires firms to commit a significant amount of financial and human capital, but is viewed as critical to the long-term sustainability and effectiveness of any improvements made in risk management and containment, including regulatory capital, liquidity, leverage, risk governance, risk appetite frameworks and stress testing. Moreover, the inability of IT systems to provide rapid, comprehensive data on the position of each of the firm's legal entities is one of the obstacles to resolving a SIFI when a crisis hits.[8] While many firms have significant IT projects planned or underway[9], in the past such projects have fallen behind schedule because of lack of management commitment. These projects will require significant dedication of funds, sponsorship, and commitment from the board and senior management to ensure that progress continues to be made through the economic cycle.

SIE members discussed expectations for firms' ability to aggregate data. While recognising it would be challenging to set precise standards in risk reporting given that firm's business models differ, SIE members generally agreed on some fundamental expectations for risk reporting:

- *Accuracy*: reports should be up-to-date, properly aggregated, validated, and fully reconciled.
- *Integrity*: reports should be based on data that is reliable and remains unchanged from its sources such that the same results would occur if the report was run with limited or no manual intervention.
- *Completeness*: reports should contain data at the enterprise-wide level (e.g. all legal entities, geographic regions, products and business lines).
- *Timeliness*: reports should be generated on regular pre-determined frequencies/ production schedules, e.g. monthly or more frequently as needed, to assess risk and enable effective decisions and actions.
- *Adaptability*: reports should meet all above expectations and can be generated on-demand (i.e. ad-hoc or as needed) for quick assessment and decision making.

Firms vary in the degree to which they can meet such supervisory expectations and they experience increasing difficulties with data accuracy, integrity and completeness when the frequency of reporting is increased (e.g. from quarterly to monthly to weekly). This underscores the lack of integrated IT systems and much more work needs to be done by firms. In order to ensure continued progress is made, supervisory expectations need to be clearly defined and timelines set by which firms, particularly SIFIs, should get data aggregation to the appropriate level; the deadline for G-SIBs to meet supervisory expectations should be the beginning of 2016, which is the date when the added loss absorbency requirement begins to be phased in for G-SIBs.

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8 FSB July 2011 Consultative Document on Effective Resolution of Systemically Important Financial Institutions which can be found at: http://www.financialstabilityboard.org/publications/r_110719.pdf.

9 See the IIF report, written in collaboration with McKinsey & Company, Risk IT and Operations: Strengthening Capabilities, June 17, 2011, which can be found at http://www.iif.com/download.php?id=uFCCVkX0UF0=.

2. Resources

The SIE report and the November 2010 G20 Leaders' declaration noted the importance of supervisors being adequately resourced. Adequacy of resources (quantity, quality and expertise) and their effective deployment remains a common theme in SIE discussions and was an issue borne out from the self assessments, and to some degree, the BCBS-SIG survey.

Many supervisors noted that since the crisis they have increased resources, but some have encountered difficulties in hiring. Even where resources were increased, this was accompanied by new supervisory initiatives that were much more time consuming and therefore resource intensive (e.g. stress testing, more deep dives or horizontal reviews, resolution work, business model analysis, supervisory colleges). The result is that even with the added resources, many stated that they were operating at levels "just above water".

Supervisors also generally felt that there was insufficient supervisory talent to deal with the added work agenda, particularly experienced supervisors and staff that had expertise in markets. As supervision of SIFIs intensifies, SIE members noted some concerns over diverting resources and focus away from the supervision of smaller firms and other supervised sectors such as insurance companies. The failure of a single small firm will likely not have a systemic impact on the global financial system, but if a number of small firms with a regional or sectoral (e.g. housing) concentration encounter difficulties, it could have a significant impact on the regional or local economy and this should be considered in resource sufficiency determinations.

While authorities have made some organisational changes to focus on SIFI supervision, it is difficult to compare across jurisdictions how supervisors in practice are intensifying their supervision. To help assess whether supervisors are applying similar intensity of supervision to various areas, four SIE members each benchmarked supervisory resources at one of their SIFIs, which have similar business models and global presence. Per SIFI, annual supervisory resources ranged from the equivalent of 50 to 155 people, but other members of the group with smaller and less complex SIFIs noted that they had significantly less resources. Jurisdictions on the lower end noted the difficulty in assessing how many resources were adequate as the resources needed for some new, more intensive supervisory initiatives are not yet complete. Jurisdictions that were able to devote higher levels of resources to their SIFIs stated that they have minimal spare capacity in the case of unexpected events. More work needs to be done to obtain a better understanding of the adequacy of supervisory resources to carry out core supervisory responsibilities in light of the additional demands placed on SIFI supervisors; supervisors are not only scrutinising a broader range of risks but need to credibly raise expectations for what is appropriate at firms of this size and importance to the macro economy and capital markets. Supervisors need to have sufficient resources to satisfy themselves that their expectations are being met.

It is very difficult to opine on the actual level of supervisory resources each country should have and on the benefit of assigning very large teams to SIFIs versus smaller teams. SIE members generally do agree, however, that the "will to act" is a more important precondition for effectiveness than the sheer size of the team. To create the necessary supervisory culture to promote a "will to act", it is essential that supervisors have the ability to attract and retain experienced senior staff with the ability to exercise supervisory judgment, and the ability to effectively challenge SIFI management. Supervisory agencies need to be independent, both from an operational and policy perspective, so that they have the ability to meet their mandate. Given the skill mix and demands placed on supervisors of large complex SIFIs, SIE members in some jurisdictions noted the difficulty in retaining and incentivising staff to oversee SIFIs. Further, the pressure and scrutiny on supervisors of SIFIs to perform is greater due to the disproportionate consequences of "getting it wrong" compared with the failure of a small firm.

It was also observed that reasonable increases of supervisory budgets are likely small when compared with the cost of a financial crisis and the disruptions that may follow. Industry groups are or could be called upon to bear the additional costs (where appropriate) of boosting supervisory resources, thereby, alleviating the pressure that budget increases would otherwise pose on general government appropriations. Recently, an industry group has noted that the banking industry benefits from strong supervision and expressed a willingness to bear additional costs for effective supervision.

3. Business models and financial analysis

Supervisors are increasing their understanding of firms' business models and the risk embedded in them. A starting point is a detailed analysis of firms' financial statements and reports to obtain a deeper understanding of the drivers of revenues and trends that are developing in the firm, and to determine whether these trends are consistent with the firm's stated risk appetite and sustainable. This "follow the money" approach enables supervisors to focus on key businesses whose failure would cause problems for the firm compared with other business units whose failure could have no or little impact on the firm.

While the degree of analysis varies across jurisdictions in part due to resource constraints, SIE discussions reveal some common issues. As business models are looked at more intensively, supervisors are finding weaknesses in underlying assumptions as well as firms' ability to articulate their corporate strategy. Some supervisors are taking a forward-looking and judgement-based approach, constructing methods to analyse the robustness of assumptions underlying business plans and the risk taken to achieve those returns. This is not about deciding the firm's strategy – that is the firm's responsibility – but it is about probing the risk and realism of the strategy.

Given that from a system-wide perspective, all firms cannot grow at an above average rate in the same business, some supervisors are constructing individual assumptions for each firm. This requires supervisors to have an understanding of the impact of the overall economic environment on firms' business models, together with a range of firm-specific factors including firm's strategy and risk appetite, economic drivers of profitability and returns, operational infrastructure, risk characteristics of products offered by the firm, and funding structure.

This analysis enables supervisors to focus on the key challenges affecting the viability of the firm, improving the level of engagement with senior management and the quality of supervisory decisions. Supervisors should be able to challenge firms' underlying growth assumptions, and hence provoke debate on the implication of failure to achieve firm projections, such as a weaker prospective liquidity position or an incentive to increase risk in order to improve returns.

Members observed that supervisory intensity in this area was uneven across countries (some countries were doing more in-depth reviews than others), and it was noted that it may be useful to share more knowledge about practices in this area.

4. Risk appetite

Putting in place an effective risk appetite framework (RAF) consistent with the firm's business model is a challenging task that requires more work on the part of both firms and supervisors. Firms' risk appetite frameworks are all encompassing, and include: i) board approval of the overall risk profile and appetite for the firm; ii) management implementation of such policies; iii) strategic planning and budgeting processes; and iv) ability to aggregate risk data as well as the capacity to bear risk. Firms need to set out the risk limits for each business line which tie into the firm's corporate strategy (including incentive compensation policies). In order to ensure business lines adhere to their risk limits, risk metrics need to be established and computed. As such, supervisors observe that weaknesses in firms' articulation of a business strategy and IT systems are challenging firms' capability to implement a RAF that is actionable and measurable. Supervisors consider an RAF to be effective when risk limits help to drive strategic decisions and ensure the actual risk profile of the firm stays within the parameters set in the framework; that is, risk limits should force institutions to exit a business activity and reduce the capital allocated to certain lines of product or business, or conversely, help decision-making in expanding a business when it fits within the risk-taking activities and risk-bearing capacity set in the framework. The BCBS work on the Internal Capital Adequacy Assessment Process (ICAAP) will help firms to integrate their RAFs into their strategic decision-making.

Many firms have made progress in conceptualising and articulating a risk appetite statement, but supervisors observe few changes in risk culture. While the risk management function should own the overall RAF, responsibility for the articulation of risk appetite within the businesses needs to reside firmly with business unit leaders. This requires the development of both communication and reporting capabilities to ensure an effective collaboration among risk management, finance and strategy functions, as well as an efficient and comprehensive IT system that provides a clear picture of risks both at business unit levels and in aggregate. The development of RAFs is important for firms and supervisors, and needs attention by both. Supervisors should discuss expectations for what a "good" RAF entails and how to supervise against these expectations.

5. Risk management

Due to the size and importance of large financial institutions, supervisory expectations for risk management functions (e.g. the Chief Risk Officer organisation, Chief Auditor) at SIFIs are increasing. Some supervisors are clearly communicating to SIFIs that *satisfactory* performance is no longer acceptable. The failure to have *strong* risk management functions can lead to ill informed boards and executive management teams. While in practice, expectations for risk management functions are higher for SIFIs, supervisors have not set out new rules or policies, but have expected more rigour by firms in implementing these policies. For example, to be *satisfactory*, a firm needs an acceptable corporate organisational structure and an appropriate risk management framework, including supporting processes. To be *strong*, a firm also needs a strong risk management culture and an influential and highly effective Chief Risk Officer (CRO) organisation. The CRO organisation plays a critical role in ensuring a *strong* risk management culture.

While progress is being made at both the supervisory and firm levels toward strengthening the CRO's organisation, it was noted that most are not yet considered *strong*. SIE members discussed how supervisors should assess effectiveness of CRO organisations, and set out some high-level essential elements of a *strong* CRO organisation.

High-level indicators of a *strong* versus *satisfactory* CRO organisation:

- CRO organisation has clear, earned stature within the organisation – demonstrated ability to challenge all levels of business line management versus second tier status. This requires quality leaders and good depth of talent versus adequate technicals among leaders and light depth.
- Overtly supported by CEO versus deferring or wavering with business line interests. Participates in strategic decisions versus informed of plans ex-post, and is proactive in highlighting and addressing issues/trends versus responsive to issues/events. Reports to the board and executive management call out big and emerging issues versus recapping findings from recent cycle of assessments.
- CRO meets independently with outside directors (both in-committee and one-on-one) versus meetings that also include members of management team.
- Board's risk committee overtly focuses on CRO and the succession planning and compensation of direct reports versus only focusing on the CRO.
- Strives for best practices (staffing, methods, etc.) versus being content with sufficient practices, and challenges both quality/propriety of policies and procedures and adherence versus just testing for adherence. Uses key risk indicators, including leading metrics, to measure and convey versus primarily using lagging indicators or measures of performance.
- Active dialogue with business line executives on findings and thinking versus communicating via conclusions. Business lines own risks and are held accountable for self identifying the bulk of issues versus discovery or identification by risk management or audit. Resolution is timely and repeat findings are rare versus business responses that periodically involve lags and/or repeat findings.
- CRO and risk management team input is sought and used in compensation decisions versus input not incorporated into final compensation decisions.
- Technology and MIS enable informed and timely assessments of risks, including concentrations versus fragmented, elongated, and trailing reviews.
- Firm-wide results over time reflect controlled volatility versus episodic surprises or evidence of not being prepared for contingencies in adverse markets or external events.

6. Model risk

SIE members agree that it is incumbent on supervisors to assess the appropriateness of the firm's model governance process. However, discussions revealed that supervisors encounter difficulties in overseeing models in use at SIFIs. It is an area for which standards often exist, but where implementation is quite uneven – some supervisors are much more active than others. Resources are often identified as an issue given the highly skilled nature of the work. More detailed discussion of implementation among SIFI supervisors should take place, including by BCBS for Pillar 1 models.

The usage of computational models at SIFIs is pervasive and supervisors may not be fully aware of the extent of model usage at firms. Models most commonly reviewed by supervisors include models used in the calculation of Pillar 1 capital charges, models used for valuations in capital markets businesses, and models used in the approval of credits. These are areas where model failure could have a particularly harmful impact on a firm's financial condition. As such, the BCBS is looking at how to review and validate Pillar 1 quantitative models in order to ensure consistency across banks and jurisdictions in the calculation of risk-weighted assets, which is critical to the integrity of the overall capital framework and will confirm how Pillar 1 models are working in practice.

The use of Pillar 2 models is also pervasive and supervisors may generally be aware of model usage for internal purposes but such models may receive less oversight from supervisors. Current BCBS work on developing supervisory expectations for bank capital planning processes with the aim of improving banks' internal capital adequacy assessment (e.g. ICAAP) is a good step to help deal with this but again the question is implementation.

The use of models invariably presents model risk, as models are by definition imperfect representations of reality and imply some degree of uncertainty and inaccuracy. Model risk can lead to financial loss, poor business and strategic decision-making, or damage to a firm's reputation. Supervisors should pay even more attention to models that are hard to validate given lack of data or price observability (e.g. level 3 assets), underscoring the necessity of robust IT systems to produce accurate and comprehensive data, and strong risk management and audit functions. Equally or perhaps more important are models with a potentially material impact on the firm's financial condition and results, which may or may not be the same as the models that are difficult to validate. Models that present material risk should receive relatively more attention from both supervisors and firms.

While the initial validation of models by firm personnel and subsequent supervisory review of this process is important, equally important is on-going monitoring of models to ensure they remain relevant and are continuously performing to the standards which were initially set out. This is a good example of the need to focus on outcomes. Back-testing is one way of analysing outcomes as it involves comparing model forecasts with corresponding actual outcomes. Some supervisors indicated that it was a challenge to allocate enough time to monitoring of models as new approvals were being rolled out. Again, this is a question of implementation.

Effective management of model risk encompasses governance and control mechanisms such as board and senior management oversight, policies, procedures, controls and compliance, and an appropriate organisational structure. Even if model development, implementation, use and validation are satisfactory, a weak governance function will compromise the credibility of the models and their use in firms. Supervisors should ensure firms maintain an inventory of models implemented for use, under development for implementation, or recently retired. Supervisors also should ensure that firms' internal policies and procedures are consistent with supervisory expectations, which will require resources with specific expertise.

7. External auditors

SIE members discussed their interaction with external auditors, and the extent to which this interaction has helped to identify risks at SIFIs. Members also discussed the important role of auditors especially in assessing the appropriateness of values assigned to illiquid assets (e.g. assets with level 3 fair values) and the extent to which supervisors review some of that work.

In general, supervisors often feel they should be able to have richer dialogues with external auditors and that there needs to be more reporting of matters by auditors to supervisors. Members discussed how the level of dialogue can depend on the audit partner and the relationship between the audit partner and supervisor. Supervisors question whether they are putting the right questions to external auditors, and more importantly, whether they are sending the right people to meetings with external auditors. Members also discussed the specific nature of the auditor's mandate (e.g. attesting to the integrity of accounts and financial information versus the broader nature of supervisory concerns). In many jurisdictions, there is no specific legal obligation for auditors to report formally to supervisors, while informal reporting may conflict with other legal obligations of auditors. Work is underway to help improve the relationship between supervisors and external auditors, and several jurisdictions have issued codes of practice for interaction between supervisors and external auditors.

The importance of auditor independence was emphasised, as it is the foundation for auditor's professional scepticism. Members discussed inherent conflicts of interests and the fact that a SIFI can represent a major business for the auditor. In order to enhance independence, some jurisdictions require firms to rotate their external audit partner within a certain number of years. While this causes some frictions as the new external audit partner reviews existing accounting policies, this exercise is considered beneficial to not only help to mitigate conflicts of interest but also to apply a fresh review of the firm's financial and risk reporting and internal controls. Supervisors noted the prominence of the four large audit firms and expressed some concerns over these "Big 4" audit firms' roles as external auditors for the majority of SIFIs.

III. Supervisory approaches to other areas

1. Acquisitions

In the period leading up to the crisis, a number of sizeable acquisitions were made by major global banks that did not receive adequate supervisory attention, either due to lack of powers or due to supervisory practices in place at the time. In some cases these acquisitions directly affected the viability of the acquiring institution.

Major acquisitions or investments can have a material impact on the risk profile of an institution (as can a series of small or medium sized acquisitions). As such, and in order to satisfy Basel Core Principle 5 (Major Acquisitions)[10], supervisors should have the power and a robust process to review acquisitions and investments – especially material transactions – in order to assess the possible risks prior to their closing and, where necessary, to prohibit the transaction or impose prudential conditions or additional measures to address any concerns identified during the assessment.

The importance of a supervisor being satisfied that an institution it regulates has adequate capital, management expertise, integration plans and experience to undertake a material transaction cannot be overstated. The often arduous and time consuming assessment of such a transaction, frequently involving the input of several technical disciplines, will focus on a number of factors.

First, is the impact on the acquiring financial institution's capital adequacy, current and future, and whether the institution should be required to raise new capital to fund the acquisition. Other important issues include the quality of due diligence done by the acquiring institution, as well as the institution's assessment of the target institution's strategic fit and impact on the group's risk appetite. In addition, assessing the ability of the acquiring institution, both from a technical and managerial/governance perspective, to successfully integrate the systems and processes of the acquired entity within a reasonable or specified timeframe is a key task for supervisors. The impact of any changes in the management (e.g. Chief Risk Officer) or board of directors of the entity as a result of the transaction should be considered. For example, in addition to changes that the acquiring institution must make to achieve synergies, new skills may be needed on the board or in senior management when transformational acquisitions take place. Finally, where applicable, supervisors should communicate with the financial regulator in the target financial institution's home jurisdiction to identify any potential areas of concern.

Post-transaction, it is critical that supervisors monitor, on an on-going basis, the integration of key internal processes and risk management and the impact of the transaction on the financial institution's financial results.

Hostile takeovers in the financial sector can pose a particular problem for supervisors, and ensuring the Basel Core Principles are met where a regulated institution proposes to carry out a hostile takeover may be particularly challenging. The ability of the acquiring institution to access sufficient information to perform comprehensive due diligence on the target institution poses a particular concern and may vary depending on the jurisdiction of that institution and on the particulars of the bid. Notably, hostile takeover bids are more common in some jurisdictions than others, the ability of the target institution to ward off the bid varies across legal regimes, and the ability of the hostile bidder to gain access to non-public information on the target institution if other bidders emerge may also vary across jurisdictions.

The supervisor must exercise increased vigilance in the case of major acquisitions or investments where the acquiring institution is unable to conduct adequate diligence, which may be more likely where a transaction is made on an unsolicited basis.

[10] http://www.bis.org/publ/bcbs129.pdf.

2. Supervisory colleges

Cross-border relationships did not work as well as they could have during the crisis and this shortcoming is being addressed through the establishment of colleges and cross-border crisis management groups. Members discussed how increased international cooperation and new regulation is a natural outflow from the experiences of the financial crisis, but can be very time-consuming and compete with resources for on-site supervision.

The role of supervisory colleges for purposes of institution-specific oversight differs depending on the size, and composition of the supervised group, which generally fall into three categories: (i) core colleges; (ii) universal colleges; or (iii) regional colleges. Crisis management groups are closely aligned with supervisory colleges in that they build on the core colleges and include central banks, resolution authorities, and finance ministries.

Supervisory colleges are considered an important tool and the BCBS and IAIS continue to study their effectiveness. The BCBS-SIG conducted a survey in March 2011 to benchmark current practices against the October 2010 BCBS *Good Practice Principles on Supervisory Colleges*[11] to gather early feedback on the challenges and inconsistencies in interpreting and implementing the principles and to identify pertinent challenges that could be valuable input on the need for additional tools to facilitate implementation of the new principles. The IAIS conducted an impact assessment survey of the October 2009 *Guidance Paper on the Use of Supervisory Colleges in Group-wide Supervision*[12] and is collecting information to assess the need to review and update the supervisory guidance.

While colleges have helped to increase the dialogue among supervisors, it is not common to undertake coordinated supervisory work, such as joint supervisory plans and joint examinations, although some countries have made progress in this area. One of the key challenges is legal matters which are constraining the ability for supervisors to share data, and this challenge becomes even greater the larger the college. Legal constraints were also identified as a barrier for information flow within colleges in the BCBS-SIG benchmarking exercise and the BCBS-SIG will review the principles in 2012.

Supervisory colleges will require some time to build trust among supervisors, in particular with respect to larger and more recently established colleges. Supervisors could draw lessons from more seasoned colleges such as in the Nordic region, where the first college was established in 1998 for a specific institution. Indeed, the Nordic colleges benefit from a strong track record of cooperation which may have been helpful to overcome some of the legal impediments to data-sharing as well as conduct joint exams and decision-making for firms. Such strong links such as in the Nordic area are not common, but these colleges have managed to remain open to information sharing even as members outside the region have joined.

On a positive note, supervisors indicated that colleges that result in supervisors emphasising the same issues with a SIFI were extremely helpful, as having more than one supervisor send the same message can be very powerful. In contrast, if supervisors send different messages to

[11] http://www.bis.org/publ/bcbs177.htm.

[12] http://www.iaisweb.org/__temp/Guidance_paper_No__3_8_on_the_use_of_supervisory_colleges_in_group-wide_supervision.pdf.

the same firm – which has happened – it is not entirely helpful and should be avoided. Further, while joint exams and coordinated supervisory work are not yet common, there have been examples of good discussions among supervisors, one being a discussion of the quality of the CRO function across a globally systemically important institution.

3. Stress testing

The use of stress testing has increased in recent years and firms have made progress in enhancing their stress testing tools and processes but still face significant challenges due to insufficient integration of data systems. In addition, running simultaneous stress tests for a number of firms by a specific date with external documentation is highly resource intensive and hinders the ability to conduct other supervisory work. Nonetheless, stress testing exercises are considered a valuable supervisory tool.

Many supervisors have made progress in developing system-wide stress test programs which have been beneficial to understanding pockets of risk in the system. Some supervisors conduct stress testing regularly (e.g. quarterly, annually) and SIE members discussed the issues associated with disclosing the results on an aggregated or individual firm basis (which is the case in some jurisdictions). While supervisors recognise the desire for greater transparency, some felt that the better solution was to require more disclosure by firms of specific exposures (e.g. sovereign debt). The disclosure of stress tests results might undermine their effectiveness as a supervisory tool as communication problems may become insurmountable. In addition, members discussed how public disclosure can constrain the ability to run more adverse stress scenarios which could hinder the effectiveness of stress testing as a supervisory tool.

The BCBS thematic peer review, which is currently underway, of implementation of the May 2009 BCBS *Principles for Sound Stress Testing Practices and Supervision*[13] will provide more insight into how much progress has been made in practice. The BCBS principles cover the overall objectives, governance, design and implementation of stress testing programmes as well as issues related to stress testing of individual risks and products and aim at deepening and strengthening banks' stress testing practices and supervisory assessment of these practices.

4. Corporate governance

The global financial crisis highlighted a number of corporate governance failures and weaknesses, including insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque firm organisational structures and activities. Many of these shortcomings were highlighted in an October 2009 report *Risk Management Lessons from the Global Banking Crisis of 2008* by the Senior Supervisors Group.[14] Effective corporate governance practices are essential to achieving and maintaining public trust and

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[13] http://www.bis.org/publ/bcbs155.pdf.

[14] http://www.financialstabilityboard.org/publications/r_0910a.pdf.

confidence in the financial system, which are critical to the proper functioning of the financial sector and economy as a whole.

Much progress has been made in this area at both the supervisory and firm levels. Supervisors are engaging more frequently with the boards and the range of practice is wide, with several requiring approval of board members and a few setting out supervisory guidance. Meanwhile, many firms have restructured the composition and quality of their boards but it is unclear what motivated such changes – improved corporate governance or in some cases supervisory actions. Nonetheless, more intense supervisory oversight is needed to evaluate the effectiveness of improved corporate governance, particularly risk governance, in affecting behaviour and improvements in this area will be ongoing and monitored.

5. Macro-prudential surveillance

Leading up to the crisis, the forward-looking surveillance functions at some supervisory authorities were either non-existent or failed to work. Supervisors have since increased their awareness of macro-prudential issues, including the potential for systemic risk to arise from concentrations and common exposures, even when institutions seem safe when considered individually. This is an area where supervisors are making headway, both in terms of supervisory methods and tools used and in terms of structure and internal organisation of national supervisors. As with other areas, the success of macro-prudential supervision is very much dependant on the "will to act" on indications of systemic risk. Challenges remain in terms of identification of macro-prudential instruments and the integration with traditional micro-prudential supervision. For those supervisors that are not part of central banks, increased cooperation with such institutions will be necessary. The joint FSB-IMF-BIS work on macro-prudential policy will trace the progress in national authorities' implementation of macro-prudential policy frameworks along three broad lines: (i) analytical advances in measurement and monitoring of systemic financial risk; (ii) the instruments and tools for macro-prudential purposes; and (iii) institutional and governance arrangements and international cooperation.[15]

The identification and availability of relevant data is critical for assessing systemic risk and calibrating policy responses. Improving information and data collection frameworks, as noted earlier in this report, is important to help authorities better understand interconnections within the financial system and common exposures to shocks that can lead to system-wide stress.

IV. Self assessments against certain BCPs

FSB members submitted self-assessments in June 2011 against certain Basel Core Principles (BCPs)[16] and reported on their ability to use the remedial tools specifically identified in the SIE report. The IMF took the lead in summarising the responses, and the range of practices.

[15] The joint FSB-IMF-BIS report will be submitted to the November G20 summit and published shortly thereafter.

[16] BCP 1: Objectives, independence, powers, transparency and cooperation;

BCP 23: Corrective and remedial powers of supervisors;

BCP 24: Consolidate supervision

The IMF also provided comments on national supervisors' progress toward achieving more effective SIFI supervision, and drew out a number of themes and recommendations from the self assessments. As noted by the IMF, the self assessments generally focus on setting out legislative mandates, rules and supervisory requirements, and cover much less of actual practice; hence no firm conclusions can be drawn from the self assessments about the extent of full compliance with the principles. SIE members discussed the self assessments, and in general, many felt the criteria were not clear. A more detailed summary of the findings are in Annexes C and D.

While the self assessments show that national authorities are making progress in strengthening the supervisory frameworks of SIFIs, they also highlight a number of key areas where more work is needed. Of particular mention are the following:

- **Mandates**: Although existing mandates are largely reported as sufficiently clear, there is a lack of explicit references to prudential matters in a number of jurisdictions. Furthermore, the treatment of competition concepts and/or industry competiveness in supervisory mandates deserve further attention, in particular because of the potential for conflicts that may reduce effectiveness and dilute supervisory focus. In addition, the self assessments highlight diverging approaches to early intervention and prompt action, with some FSB members currently proposing changes in their approach.
- **Independence**: While no country reported it is unable to carry out its core supervisory mandate due to independence constraints, the self assessments highlight instances where bodies other than the supervisory agency (notably Ministries of Finance) sometimes have been assigned a key role in supervisory decisions. However, the self assessments generally indicated that prudential analysis of relevant decisions is the responsibility of the supervisor and that operational independence had in practice been preserved. Some reported the potential for independence issues to arise as supervisory agencies are subjected to various budgetary restraint measures, regardless of whether their costs are borne directly from industry or taxpayers. Such issues, together with the material budgetary influence that such bodies can sometimes exercise over supervisory agencies, may hamper the operational autonomy of the supervisor. Some countries have also reported that they are less than fully compliant with requirements on the appointment and removal of heads of supervisory authorities and/or that they do not provide full legal protection to supervisors for acts committed or omissions made in good faith in the performance of their duties.
- **Resources**: Adequacy of resources (quantity and/or quality and expertise) appears to be an issue across the FSB membership. While few countries indicated that resource constraints were currently compromising supervision, resource demands will likely increase in particular to meet supervision of new global initiatives. This will require that supervisors have the ability and flexibility to attract and retain necessary staff. Some pointed out the potential issues of the actual or potential involvement of governments in the supervisory budgeting process in ways that may not be conducive to effective supervision, or in unduly limiting salary flexibility (though written assessments did not generally conclude that core prudential work had been

compromised) or supervisors in a few cases being totally dependent on the government appropriation process.

- **Supervisory powers**: Having a full set of supervisory powers and tools, and being confident that they can be exercised effectively, are essential to effective supervision. The results of the self assessment indicate some inadequacies in this regard. Some pointed out supervisory discretion in applying legal powers is sometimes too limited with their use constrained to application only after specific minimum requirements are breached. Moreover, an appropriate range of supervisory powers may not be available for application to complex banking groups, including at the holding company level, where holding companies are not subject to licensing and direct regulatory oversight**.** However, in general supervisors have adequate statutory powers to obtain information from banks in the form and frequency deemed necessary. In addition, supervisors generally report adequate broad legal powers to address compliance and to deal with safety and soundness concerns though some major gaps were discussed by SIE members (e.g. inability to approve acquisitions in one country).
- **Improved supervisory techniques**: Given their impact on financial stability, the required level of risk control frameworks in SIFIs – including strong risk management and internal audit functions, an effective risk appetite framework and robust capabilities for managing capital and liquidity – should be set very high. Effectively imposing such exacting standards may require that supervisory authorities improve their techniques of supervising such complex institutions. Supervisory agencies are making progress in this area, illustrated by their increased attention to financial institutions' business models, financial models outside Pillar 1 and banks' data aggregation capabilities. Simultaneously, standard setters are working on specific amendments of the BCP to address FSB recommendations concerning supervisory approach and supervisory techniques.
- **Group-wide and consolidated supervision**: There appears to be considerable variation in approaches across FSB members with several countries reporting room for improvement in their ability to exercise consolidated supervisory powers. In addition, the self assessments reveal a need for legislative and supervisory action in some jurisdictions, specifically the applicability of supervisory powers at the holding company level. The self assessments also highlight the need for significant improvement of the accuracy, timeliness and accessibility of bank and group-wide information.
- **Continuous and comprehensive supervision**: Supervisors believe that the quality of the dialogue with supervised institutions has improved during the financial crisis and that they are better informed of financial stability issues than in the past. A tool that has proven to be particularly useful to monitor developments across multiple institutions is horizontal reviews, the use of which is increasing across the FSB membership. Also, discussions of recovery and resolution plans with supervised institutions provide supervisory agencies with a detailed understanding of firms' *modus operandi* and potential transmission channels of risks across institutions. A recurrent concern across the FSB membership is that as SIFI supervision intensifies,

there is a need to ensure the replenishment of supervisory talent to ensure proper oversight of smaller banks.

As part of the exercise, countries were asked by the FSB to report on remedial action plans to address self-identified deficiencies. Reporting on corrective actions was uneven across the FSB membership, with some remedial action plans understandably still at early stages of specificity. The FSB intends to follow up on these actions in its future interactions.

V. Conclusions and recommendations

Supervisors are making headway in addressing many of the issues identified in the SIE report but face two particularly significant challenges: weak IT and data architectures that do not yet have the full capability to produce timely, accurate, aggregated MIS at firms; and resource constraints at supervisory authorities. Leaving these issues unresolved questions the implementation and sustainability of any improvements underway to supervisory oversight and risk management practices.

One of the most significant lessons learned from the global financial crisis was that firms' IT and data architectures did not have the full capability to produce timely, accurate, aggregated MIS to support the broad management of financial risks. Most firms lacked the ability to aggregate and identify risk exposures quickly and accurately at the enterprise-wide level, across business lines and legal entities, and to other firms. Supervisors observe that data aggregation remains a challenge for firms despite being essential to strategic planning, risk monitoring, and decision-making. While firms are working toward improving data aggregation capabilities, supervisors would like to see more progress made and are raising expectations for what is considered acceptable in firm's – and in particular SIFI's – reporting capabilities. The lack of robust, integrated IT systems undermines the effectiveness of supervisory tools, such as model usage for capital charges, liquidity, and credit; actionable, measurable and effective risk appetite frameworks; and stress testing. Further, many of the global initiatives underway will be challenged by weaknesses in firms' ability to aggregate risk. Improved capabilities will be needed to implement other global initiatives that have been endorsed and requested by G20 Leaders, including identifying domestic and international network connections (FSB Data Gaps Working Group); shadow banking monitoring frameworks (FSB Shadow Banking Task Force); improving data on OTC derivatives and complex structured products, including data reporting to trade repositories (FSB OTC Derivatives Working Group), including through creating a global "legal entity identifier" system.

Recommendation 1: The FSB, in collaboration with the standard setters, will develop a set of supervisory expectations to move firms', particularly SIFIs, data aggregation capabilities to a level where supervisors, firms, and other users (e.g. resolution authorities) of the data are confident that the MIS reports accurately capture the risks. A timeline should be set for all SIFIs to meet supervisory expectations; the deadline for G-SIBs to meet these expectations should be the beginning of 2016, which is the date when the added loss absorbency requirement begins to be phased in for G-SIBs.

Supervision of SIFIs has intensified and supervisors are not only scrutinising a broader range of risks but are raising expectations for what is appropriate for firms of this size and importance to the macro economy and capital markets. As such, supervisors need to have the resources to validate that their expectations are being met. However, many supervisors do not feel they have the capacity to take on expanded work, lacking the resources to conduct "deep dives" or horizontal reviews, which are resource-intensive for a period of time. Even where resources were increased, many supervisors believe that they are operating at levels "just above water" and lack supervisory talent to tackle unexpected problems. If a problem at a SIFI were to arise, supervisors would have to draw scarce resources from other firms or activities. Given the demands on supervisors of SIFIs in particular, it is difficult to attract and retain staff as compensation structures are generally rigid at many supervisory authorities; hence, supervisors of SIFIs are not compensated for the additional pressures of "getting it wrong" or for work-life imbalances. At one time, supervisors felt advantaged by being responsible for a SIFI or large, complex financial institution, which was often associated as a "reward" for being a strong performer. Today, in some jurisdictions this is less the case.

Recommendation 2: The FSB will by end-2012 assess in more detail the adequacy of resources at supervisory agencies for the supervision of SIFIs, including the approaches supervisors are taking to intensify their supervision of SIFIs and the kinds of resources that are needed to do so. Governments should follow up on their November 2010 commitment to ensure supervisors have the capacity to resource themselves to effectively meet their mandate, which in some jurisdictions is expanding to include areas of consumer protection.

Supervisors have improved their use of supervisory tools and methods. Horizontal reviews, deep dives and stress testing are increasingly being used, enabling supervisors to focus on key areas of risk and to identify any underlying weaknesses in firms' risk management practices. In some cases, supervisory expectations for risk management functions at SIFIs are increasing and some are clearly communicating that *satisfactory* performance is no longer acceptable (although most SIFIs' risk management practices are not yet considered *strong*). However, while progress is being made, more work is needed in several areas: assessing use of models by SIFIs, risk appetite frameworks, and SIFI business models.

Supervisors are increasing their understanding of firms' business models and the risk embedded in them. In order to understand firms' business models, supervisors are increasingly analysing financial statements to obtain a deeper understanding of the trends that are developing in the firm, and to determine whether these trends are consistent with the firm's risk appetite framework and sustainable. This "follow the money" approach enables supervisors to focus and dedicate resources on key businesses whose failure could have a significant impact on the firm. As business models are looked at more intensively, supervisors are finding weaknesses in underlying growth and profitability assumptions as well as firms' ability to articulate their corporate strategy. However, supervisory work to date in some jurisdictions suggests that more needs to be done in this area than was envisaged when the 2010 SIE report was written.

Firms are making progress toward setting out risk appetite frameworks (RAFs), which is a challenging task that requires more work on the part of both firms and supervisors. Risk appetite frameworks are about setting out the overall risk profile for the firm, and are clearly linked to the business model and ability to aggregate risk data. Firms need to set out the risk limits for each business line which tie into the firm's corporate strategy (including incentive compensation policies), and in order for the RAF to be effective, risk metrics need to be established and computed. Supervisors observe that weaknesses in firms' ability to aggregate risk data is challenging firms' ability to implement an effective risk appetite framework that is actionable and measurable.

Model usage permeates throughout SIFIs for analysing business strategies, informing business decisions, identifying and measuring risks, valuing exposures, conducting stress testing, assessing capital adequacy, and measuring compliance with internal risk limits. However, supervisors may not be fully aware of the extent of model usage at firms. Supervisors generally review and evaluate the validation processes used by banks to assess their models which are used in the calculation of Pillar 1 capital charges. But the risk management of models used outside of Pillar 1 are often not subject to similar reviews by supervisors in part due to resource constraints. While the initial approval of models is important, equally important is on-going monitoring of models after approval to ensure that models remain relevant and are performing to the standards which were initially set out. This is a good example of the need to focus on outcomes. Back-testing is one form of analysing outcomes as it involves comparing model forecasts with corresponding actual outcomes.

Recommendation 3: By end of 2012, the FSB SIE group will submit a progress report to the FSB covering how the issues identified in this report are being addressed (e.g. assessing use of models by SIFIs, risk appetite frameworks, and SIFI business models), and will submit recommendations to the FSB on how to ensure supervision of these areas, as well as any new areas that arise as a result of their discussions, is more intense, more effective and more reliable to promote financial stability While such areas may be identified in FSAPs as well, the SIE's discussions represent an ongoing forum for unearthing issues early.

Many firms have made progress in conceptualising and articulating a risk appetite statement; however, supervisors observe few changes in risk culture as Chief Risk Officer functions, which own the risk appetite framework, are not often *strong* and have yet to develop communication and reporting capabilities to ensure an effective collaboration among risk management, finance and strategy functions. To be *strong*, a firm needs a strong risk management culture and an influential and highly effective CRO organisation as it plays a critical role in ensuring strong risk governance. Many firms have increased the independence of the CRO function from business lines, and restructured the composition and quality of their boards due to either the self-identified need to improve risk governance or in some cases supervisory actions. More intense supervisory oversight is needed, however, in evaluating the effectiveness of improved risk governance. Improvements in this area will be ongoing and monitored by SIE members.

Recommendation 4: The FSB should conduct a thematic review on risk governance, which is critical to ensuring a strong risk management culture at firms. The review should assess risk governance practices at firms, focusing on the risk committee of executive boards and the risk management functions (e.g. the CRO organisation, Chief Auditor) and how supervisors assess their effectiveness.

External auditors play an important role not only in assessing the appropriateness of values assigned to illiquid assets (e.g. assets with level 3 fair values) but also in reinforcing strong internal controls and corporate governance. However, external auditors did not always live up to these expectations during the recent financial crisis. SIE members discussed their interactions with external auditors, and in general, most feel they should be able to have richer dialogues and that there needs to be more reporting of matters by auditors to supervisors. At the same time, supervisors question whether they are putting the right questions to external auditors, and more importantly, whether they are sending the right people to meetings with external auditors. Members also discussed the concentration of audit services for SIFIs at the four largest audit firms.

Recommendation 5: The BCBS should review its 2008 report *External Audit Quality and Banking Supervision*[17] in the light of recent experience to reinforce supervisors' confidence in audit quality, which remains one of the keys to effective supervision; to encourage improved quality controls at global accounting firms; and facilitate more meaningful dialogue between supervisors and audit firms, particularly of SIFIs. Supervisors should also engage with both securities regulators, who enforce consistent application of the standards, and audit oversight bodies, who are charged with reviewing audit quality.

[17] http://www.bis.org/publ/bcbs146.pdf.

VI. Annexes

Annex A: Recommendations from the SIE report

1. Mandates

Recommendation*: All jurisdictions should self-assess against all sections of Principle 1 in the current Basel Core Principles (BCPs) given that IMF-World Bank FSAPs continue to have findings in this area. Deficiencies identified and the intended corrective action should be reported in a letter to the FSB chair (and shared with FSB members) by the end of June 2011. Implementation could be subject to future peer reviews. In addition, insurance supervisors should self assess against the equivalent International Association of Insurance Supervisors ("IAIS") Core Principles (ICPs) within 6 months of their date of issue (expected to be October 2011). As in the BCP reviews noted above, deficiencies and corrective action plans should be outlined in a letter to the FSB chair and shared with FSB peers.*

Recommendation*: Consideration should be given to expanding on BCP 1 related to independence and mandates, but possibly also in BCPs 19, 20 or 23. The principles should express: i) a need for early intervention to be an element of the supervisor's mandate and, ii) it should expand on what is meant by "clear" when describing an authority's responsibilities and objectives. For action suggested by the end of December 2011.*

Recommendation*: The IAIS should consider enhancing the relevant ICP that relates to mandates by incorporating the appropriate references on mandates that are currently in the ICP 2 explanatory note.*

2. Independence

Recommendation*: Consideration should be given to expanding on BCP 1(2), specifically to consider providing more guidance on the key features and structures that should support operational independence and also expanding on some of the criteria for assessment. For instance some criteria that could be considered would be under what circumstances key decisions on individual companies be referred to the government; supervisory agencies should not manage or otherwise run the enterprises they supervise; the boards of supervisory agencies should not have directors who represent the industry. In addition, the criteria (or guidance) for appropriate budgets could be fleshed out more to highlight and promote those funding models that preserve budgetary autonomy and provide the management of supervisory agencies with the ability to establish their own budgets and line elements, with full transparency, and provide access to needed skilled staff, technology and outside resources required to carry out their responsibilities. This should also be supplemented with guidance (and associated criteria) on the desirable features of accompanying accountability structures that are needed to backstop operational independence and budgetary autonomy.*

3. Resources

Recommendation*: Consideration should be given to expanding on the Basel Core Principles (BCPs), in particular Principle 1 related to core resources. Specifically Principle 1(1), additional Criteria 1 on resource allocation, should expressly note that resource allocation* *must consider systemic risks posed by banks and should reflect the fact that for SIFIs, there is a minimum acceptable level of annual work that should not be breached.*

Recommendation*: As part of their annual resource planning exercise, supervisors should regularly (at least annually; on a rolling basis) take stock of existing skills and projected requirements over the short to medium term and review and implement measures that could be taken to bridge any gaps in numbers and/or skill-sets. Such measures could include more flexible hiring policies, schemes for secondment of staff to industry, or other supervisory national/international agencies. This effort would be aimed at providing access to specialist skills on a temporary basis as well as provide opportunities for supervisory staff to better understand industry practices.*

4. Supervisory Powers

Recommendation*: Consideration should be given to expanding the list of required supervisory powers in BCP 23 EC 4, 5 and 6 which cover corrective and remedial powers of supervisors. Since the crisis, the need for tools such as increased liquidity requirements, large exposure limits, imposing dividend cuts, requiring additional capital etc. have come to the forefront. Given that a full suite of powers is critical to a supervisor executing their role, the inventory of required tools should be updated. For action suggested by the end of December 2011.*

Recommendation*: All jurisdictions should self-assess against the tools noted above. Deficiencies identified and the intended corrective action should be reported in the same letter to the FSB chair referenced in Section 1of this report covering mandates, by the end of June 2011.*

5. Improved Techniques

Focus on Outcomes

Recommendation*: Supervisory authorities should determine whether their frameworks for risk assessment focus enough on the risk outcomes that result from the processes which are being evaluated. This would include both looking at trends in the quality of outcomes and "truing up" risk assessments against stress test outcomes (i.e. do business lines rated as low risk show outcomes that support this assessment in stress tests?).*

Horizontal Reviews

Recommendation*: Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. In particular, there should be greater discussion of the use of horizontal reviews and good practice around the use of this valuable supervisory tool.*

Recommendation*: The FSB should develop a means for the broad, thematic (i.e. not sensitive firm specific) results of domestic horizontal reviews involving one or more SIFIs to be shared within the FSB Peer Review Council allowing for peer supervisors to consider how their SIFI firms compare and to understand which supervisory issues are receiving attention in other jurisdictions.*

Assessment of Boards

Recommendation*: Consideration should be given to developing expanded BCBS guidance to supervisors on how to assess a board with the goal of being better armed with tools and techniques which enable better determination of board effectiveness.*

Financial Statement Analysis

Recommendation*: Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. In particular, there should be greater discussion of the use of financial analysis and the enhancement of supervisory practices around the type and depth of financial analysis that can help inform supervisory risk assessments.*

Business Models and Product Analysis

Recommendation*: Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. The BCPs should consider covering the area of business model assessment and product oriented risk analysis, such that supervisors are guided to better understand the risk embedded in the business models of the banks as well as in the design of their product offerings. In addition, the BCPs should reflect the need for supervisors to ensure that firms have processes to monitor post-approval alterations made to new products which may alter their risk profile. In such cases, the firm's new product approval process should be re-applied.*

Quantitative Models outside Pillar 1

Recommendation*: There are no BCBS standards for approving quantitative models outside of pillar 1. Given the pervasiveness of their use, consideration should be given to addressing quantitative model more fully in international guidance.*

Stress tests

Recommendation*: The FSB encourages the BCBS to conduct a peer review against the May 2009 Basel Committee paper titled "Principles for sound stress testing practices and supervision".*

Data Aggregation

Recommendation*: Supervisors should study their data needs and data processing capabilities in the context of the higher requirements for SIFI supervision. Where there are deficiencies in any or all of i) the type of data collected, ii) the authority's ability to process the data in a timely and fulsome way, or iii) their ability to collect ad-hoc data in a timely manner, these should be addressed as soon as possible.*

State of the Art Controls including risk management

Recommendation*: National supervisors should consider how their supervisory frameworks set control expectations for SIFIs, and they should be confident that the assessment criteria for the control environment at SIFIs reflect the fact that there is a "higher bar" for these firms to achieve in the areas of internal controls given the potential systemic impact that they pose.*

6. Group-wide and Consolidated Supervision

***Recommendation**: All national authorities should prepare a detailed self-assessment against BCP 24 (all ten essential criteria and three additional criteria), develop action plans to fill any identified gaps and produce a letter to the FSB Chairman (to be shared with FSB peers) covering the shortcomings, plans to correct and timelines for completion by June 2011. As it relates to insurance supervisors, once the IAIS has issued their revised ICPs that will apply for supervision of insurers at the legal entity and group level, then a similar process should take place (see time lines in Section 1 of this report titled Mandates). Given the legislative aspect of this issue, national authorities other than supervisors may need to take the lead on this effort.*

***Recommendation**: Consideration should be given to elevating additional criteria 1,2 and 3 in BCP 24 covering consolidated supervision, to essential criteria given the importance of these issues for SIFIs These criteria address group-wide supervision, assessing the quality of host jurisdiction supervision, and the supervision of foreign locations.*

7. Continuous and Comprehensive Supervision

***Recommendation**: All supervisory authorities should develop and codify a comprehensive communication regime which calls for frequent communication between senior levels of supervisory authorities and firms to ensure that information flows between industry and regulators on a continuous basis. In addition, a less formal but equally important regime must be developed and maintained between the authority and the firm in the areas of specialised expertise including credit, market and operations risk. (It is expected that such frequent communication is already in place between line functions in a firm and the generalist supervisory teams.) The supervisor's internal communication regime should express the need for escalation of issues vertically and horizontally, and the need to aggregate the outcomes of these interactions into thematic conclusions for senior level consideration.*

***Recommendation**: The organisational structure of supervisory authorities should reflect the importance of SIFI institutions, allowing SIFI supervisory team leads direct access to the most senior personnel in the supervisory authority.*

8. Supervisory Colleges, Home/Host

***Recommendation**: The work of the standard setters should continue in the area of Supervisory Colleges and Home/Host information sharing. In addition to this, the FSB recommends that by end 2012, the BCBS Standards Implementation Group and the IAIS individually engage in efforts to study the effectiveness of the improvements made to supervisory colleges which may include feedback from the home supervisors who conduct the sessions, as well as host supervisors and members of the supervised firm who participated.*

9. Macro-prudential surveillance, Multi-disciplinary approach (forward looking)

***Recommendation**: Supervisory authorities must have a well developed macro-prudential surveillance approach which is designed to identify trends and developments that might negatively impact the risk profile of its firms. It should be endorsed by all government stakeholders, provide for consultation and coordination with those stakeholders, identify the key sources of market and industry information, articulate a regular communication regime* *with those sources and take into account the expertise of all of its various disciplines (credit, market, operations risk) when assessing that information. This approach must regularly inform the senior management team within the supervisory authority and where appropriate should generate senior level communication between firms and the supervisor.*

Recommendation*: Consideration should be given to BCP 19 on supervisory approach; in particular whether additional criteria 1 outlining that the supervisory approach should be forward-looking, should be elevated to essential criteria and possibly expanded given the importance of this issue for SIFIs.*

10. Use of Third Parties

Recommendation*: Consideration should be given to altering BCP 20 related to supervisory techniques. Specifically, the principle might be read to imply that the complete outsourcing of onsite work to third parties is an acceptable substitute for work performed by a supervisors own resources. In the case of SIFIs, this presumption would be met by a great deal of discomfort in supervisory circles.*

Recommendation*: Use of third parties for specially commissioned examinations should be supported by a supervisory assessment of whether the output can be relied upon to the degree intended. These assessments should take into consideration the biases that influence third parties.*

Recommendation*: Consideration should be given to BCP 22 on accounting and disclosure; in particular whether additional criteria 2 outlining the duty of external auditors to report matters of material significance to supervisors, should be elevated to an essential criteria for all firms.*

Recommendation*: The heads of national authorities should prepare a letter to the heads of SIFI external auditors reminding them of the expectations outlined in BCP 22. In addition, national authorities should have regular contact with the regulators of auditing firms to exchange experiences and concerns.*

11. Concluding Recommendations

Recommendation*: For jurisdictions with global SIFIs, the assessment of additional criteria during FSAPs should be mandatory as it relates to the supervision of those SIFIs. Furthermore, failure to comply with those additional criteria should be considered in the final assessment of the subject jurisdiction.*

Recommendation*: The FSB should continue to discuss the special needs and challenges of SIFI supervision. This group should before year-end 2011 prepare a status report for members on whether further steps should be taken to implement or complement the recommendations set out in "Intensity and Effectiveness of SIFI Supervision".*

Recommendation*: Between FSAP reviews (approximately 2-3 years after a review), supervisory authorities should prepare a formal self assessment against the standard setters' core principles, which may in turn be peer reviewed on a global basis. The head of the supervisory authority should prepare a letter to the FSB Chairman outlining the results of these self assessments and the measures planned to correct any gaps. In the spirit of transparency, that letter should be made available to their FSB peers.*

Annex B: BCBS-SIG questionnaire

Standards Implementation Group 31 March 2011

Questionnaire for national supervisors on Intensity and Effectiveness of SIB supervision

Objective of the questionnaire

At its March 2011 meeting, the Basel Committee agreed that working on the supervision of systemically important banks (SIBs) should be a priority for the Standards Implementation Group (SIG) for 2011, not just given the Financial Stability Board (FSB) recommendations, but also because most of the Basel III implementation issues are likely to impact SIBs.

As a first step, the SIG will contribute to the work of the FSB's Supervisory Intensity and Effectiveness (SIE) group by coordinating the sharing of national plans to implement the nine recommendations addressed to national supervisors for improvement to supervisory processes, mentioned in the 2 November 2010 FSB report on intensity and effectiveness of SIFI supervision. In addition, the SIG network, following a suggestion from the SIE FSB group, has decided to include some additional questions regarding the area of "improved techniques", aiming at gathering information on some aspects of how supervisors are coping with horizontal reviews, assessment of boards, financial statement analysis, product analysis and quantitative models outside Pillar 1. The SIG will also contribute to the debate about whether further steps should be taken to implement or complement all these recommendations.

For this purpose, the following questionnaire has been developed. Conclusions and findings will be shared with the FSB before the summer to inform its work on SIE.

Instructions

Organisation of the questionnaire

For each of the recommendations of the SIE report included in this questionnaire, specific questions have been developed to capture relevant and needed information. Where possible, tables are used. In order to facilitate the analysis, it is important to complete in all cases the "comments" column of these tables. In addition to answering the specific questions, for the nine recommendations addressed to them, supervisors should also explain what additional actions they plan to undertake in the future to improve their implementation.

Scope

For the purpose of this questionnaire, supervisors should provide information about their supervisory practices for the firms they consider to be important in their jurisdiction and that should accordingly be subject to a more intense and effective supervision. Supervisors should not necessarily limit their answers to practices related to global or domestic SIBs.

Although the SIE recommendations refer to the general term SIFI, for practical reasons and to be consistent with other BCBS work related to these institutions, the term SIB is used in this questionnaire to qualify the firms for which information about supervisory practices should be provided.

Deadline

Each supervisory authority should submit answers to the Secretariat by Monday, 25 April 2011 COB at the latest.

Questionnaire

Name of Supervisory Authority:

Country:

General questions

(a) In order to better analyse the relevant information to be collected in this questionnaire, please attach a brief (one page) description of the main characteristics of your supervisory model for systemically important banks (SIBs).

(b) In order to better understand how your processes and framework are tailored to SIBs' supervision, please describe how many banks are considered as SIBs in your jurisdiction, and what they collectively represent in terms of assets.

1. Resources – Recommendation 3(b)

Recommendation 3(b): As part of their annual resource planning exercise, supervisors should regularly (at least annually; on a rolling basis) take stock of existing skills and projected requirements over the short to medium term and review and implement measures that could be taken to bridge any gaps in numbers and/or skill-sets. Such measures could include more flexible hiring policies, schemes for secondment of staff to industry, or other supervisory national/international agencies. This effort would be aimed at providing access to specialist skills on a temporary basis as well as provide opportunities for supervisory staff to better understand industry practices.

1.1. Using the table below, please provide a short description of the resources dedicated to SIB supervision in your supervisory authority.

	Short-form responses	**Comments**
How many people are dedicated to the supervision of SIBs?	#	
Do you have dedicated supervisory teams for each SIB?	Y/N	
Are these staff dedicated exclusively to the supervision of SIBs or are they involved in other activities?	Dedicated vs. mixed	

	Short-form responses	**Comments**
How do you select the staff for these supervisory teams?	Selection criteria: internal vs. external; years of experiences, etc.	
What is on average the level of experience and seniority of SIB supervisory teams?	# Years of experience? Seniority – level?	
What is the average of permanence of this staff in the supervisory authority?	# Length of service?	

1.2. Please complete the table below in regards to supervision of the largest SIB in your country. Try to limit the response to people covering prudential work only.

	Short-form responses (# of days)	**Comments**
Approximately how many resources (expressed in staff days) did you spend on the largest SIB last year?		
Please try to provide a breakdown of time spent by specialists :		
Capital markets		
Credit		
Operational		
Liquidity		

1.3. How do you define the skills requirements for your staff? How do you monitor the skills of your SIB staff and address any skill gaps against requirements? Are there any constraints on your ability to hire staff with appropriate skills (e.g. salary constraints, experience constraints, knowledge constraints)?

1.4 Do you have a permanent training program? How many hours of training does each specialist receive per year? How do you assure that courses provided are in line with new products and innovation on the financial markets?)

1.5. Please complete the table below.

	Short-form response (yes/no)	Pros and Cons
Do you hire specialists from the banking industry/market?		
Do you hire career supervisors?		
Do you have a target mix of private and public sector expertise?		

Actions planned

1.6. What additional actions are you undertaking/do you plan to undertake to improve resourcing and address skill gaps? Please complete the table below.

	Short-form response (yes/no)	Comments
External recruitment		
Remuneration review		
Training and development		
Secondments / exchanges		
Internal reorganisation (e.g. the creation of specialist groups)		
Other		

2. Focus on outcomes – Recommendation 5(a)

Recommendation 5(a): Supervisory authorities should determine whether their frameworks for risk assessment focus enough on the risk outcomes that result from the processes which are being evaluated. This would include both looking at trends in the quality of outcomes and checking and aligning risk assessments against stress test outcomes (i.e. do business lines rated as low risk show outcomes that support this assessment in stress tests?).

2.1 How do you assess risk/reward decisions made by SIBs? How do you challenge businesses when stress tests or other analysis provide evidences of risk/reward combinations that may not be aligned with plans?

2.2 How do you assess trends in new, complex, high-growth or high profit portfolio/businesses? How do you challenge them against the embedded risk profile (e.g. growth due to relaxation of underwriting standards; inconsistency between expected profitability and risk levels)? Do you check for the potential use of arbitrage by new products, portfolios or business fields, e.g. by testing whether the new product/portfolio replaces an existing one and whether this leads to a quantifiable capital relief?

Actions planned

2.3 What additional actions are you undertaking/do you plan to undertake to measure or assess risk outcomes?

3. Data aggregation – Recommendation 5(i)

Recommendation 5(i): Supervisors should study their data needs and data processing capabilities in the context of the higher requirements for SIFI supervision. Where there are deficiencies in any or all of i) the type of data collected, ii) the authority's ability to process the data in a timely and fulsome way, or iii) their ability to collect ad-hoc data in a timely manner, these should be addressed as soon as possible.

3.1 Using the table below, please describe the different sources of information in the SIB that you use/have access to when supervising SIBs.

	Short-form response (yes/no)	**Comments**
Internal management information		
Databases		
Management board minutes		
Prudential reports		
Ad-hoc information		
Other		

3.2 If you subject SIBs to stricter data requirements than other institutions, please describe the main differences in your data collection processes for SIBs.

	Short-form response (yes/no)	Comments
Volume of data		
Granularity of data		
Frequency		
Remittance lag		
Others (please specify)		

3.3 Have you enhanced your data collection from SIBs in the past 18 months? Have you faced any obstacles in terms of getting the data you need?

3.4 Have you made any investments in your IT systems to improve your regular data collection from SIBs?

3.5 How quickly can you collect ad hoc data from your SIBs if needed? Do you have direct access to SIBs' information system? Have you identified any deficiencies or gaps in ad hoc data collection processes?

3.6 Have you made any investments in your IT systems so as to be able to query financial institution data collected? Please describe the type of queries you can do or plan to be able to do under your systems.

3.7 Do you consider your IT systems to be flexible or robust enough to query data collected from firms? If not, do you have a program underway to address these weaknesses?

3.8 How do you ensure the quality of this collected data? Does your authority check it, or do you use third parties for this purpose?

Actions planned

3.9 What additional actions are you undertaking/do you plan to undertake to improve the implementation of this recommendation in your supervisory authority?

4. State of the art controls – Recommendation 5(j)

Recommendation 5(j): National supervisors should consider how their supervisory frameworks set internal control expectations for SIFIs, and they should be confident that the assessment criteria for the control environment at SIFIs set a "higher bar" for these firms to achieve in the areas of internal controls given the potential systemic impact that they pose.

4.1 Please describe your methodology for assessing internal controls for SIBs. Has this methodology changed over recent years?

4.2 Have you set internal control expectations for SIBs in the areas for risk appetite, data aggregation, data integrity and complexity (operations, business lines, group structure) that are higher than those for other institutions? What areas do you think are more sensitive and deserve a tougher internal control structure?

4.3 As a result of the crisis, many institutions and supervisors began elevating the importance of the chief risk officer (CRO), and a leading practice has become for CROs to report directly to boards and for strong independent risk management functions to be in place. Please describe the extent to which this is the case in your jurisdiction. Has this been an area of supervisory emphasis, and if so, have you encountered any difficulties?

Actions planned

4.4 What additional actions are you undertaking/do you plan to undertake to improve the implementation of this recommendation in your supervisory authority?

5. Continuous and comprehensive supervision – Recommendation 7(a)

Recommendation 7(a): All supervisory authorities should develop and codify a comprehensive communication regime which calls for frequent communication between senior levels of supervisory authorities and firms to ensure that information flows between industry and regulators on a continuous basis. In addition, a less formal but equally important regime must be developed and maintained between the authority and the firm in the areas of specialized expertise including credit, market and operations risk. (It is expected that such frequent communication is already in place between line functions in a firm and the generalist supervisory teams.) The supervisor's internal communication regime should express the need for escalation of issues vertically and horizontally, and the need to aggregate the outcomes of these interactions into thematic conclusions for senior level consideration.

5.1 Please describe your communication processes with the SIBs. Is it continuous? Do you have contacts with all different seniority levels of the firms? Do you have access to any member of the firm's staff or do you usually have a single contact in each firm at each level?

5.2 What level is the supervisor who has day-to-day responsibility for overseeing a particular SIB? Describe in terms of how many levels below the head of the authority.

5.3 How often would meetings occur with SIB staff? Are there periodic meetings focused on specific subjects or risks? Are themes explored such as strategies for the future, new businesses, annual budget and others that contribute to a better evaluation of trends and potential risks?

5.4 Who would be the most senior person at the supervisory authority to meet with the chief executive officer (CEO) or senior management of a SIB when discussing routine supervisory findings? Where would that person rank relative to the head of the authority (e.g. one level down from the top, two levels down, three levels down, or a combination of people including the authority head)? Would the person be different if the findings raised significant supervisory concerns?

Actions planned

5.5 What additional actions are you undertaking/do you plan to undertake to improve the implementation of this recommendation in your supervisory authority?

6. Organizational structure – Recommendation 7(b)

Recommendation 7(b): The organizational structure of supervisory authorities should reflect the importance of SIFI institutions, allowing SIFI supervisory team leads direct access to the most senior personnel in the supervisory authority.

6.1 How does the organizational structure of your supervisory authority reflect the importance of SIBs?

6.2 Are there regular/frequent meetings of SIB supervisory teams with the most senior personnel in your authority? How often do these occur? What is the process for scheduling a meeting with senior personnel (e.g. a direct request of the supervisor or approval is required by a higher level)? How are critical issues/concerns regarding individual SIBs normally escalated within your authority?

6.3 Have you made any changes to employ more continuous and comprehensive supervision, such as organizational changes to effect the SIE recommendations? Are any proving to be challenging? Have any changes been tried and discarded?

Actions planned

6.4 What additional actions are you undertaking/do you plan to undertake to ensure the implementation of this recommendation in your supervisory authority?

7. Macroprudential surveillance – Recommendation 9(a)

Recommendation 9(a): Supervisory authorities must have a well developed macro-prudential surveillance approach which is designed to identify trends and developments that might negatively impact the risk profile of its firms. It should be endorsed by all government stakeholders, provide for consultation and coordination with those stakeholders, identify the key sources of market and industry information, articulate a regular communication regime with those sources and take into account the expertise of all of its various disciplines (credit, market, operations risk) when assessing that information. This approach must regularly inform the senior management team within the supervisory authority and where appropriate should generate senior level communication between firms and the supervisor.

7.1 Please describe the main characteristics of your macroprudential surveillance approach and explain how micro-prudential supervision and macroprudential supervision relate to each other in your country.

7.2 What kind of analysis do you use? Do you have formal structures (committees, working groups…) that bring together microprudential and macroprudential supervisors in your country (frequency of the meetings)?

7.3 Have you made any changes in your systems to incorporate macroprudential information in order to obtain enough information to be better able to detect trends and developments that might negatively affect the risk profile of SIBs?

Actions planned

7.4 What additional actions are you undertaking/do you plan to undertake to ensure the implementation of this recommendation in your supervisory authority?

8. Use of third parties – Recommendation 10(b)

Recommendation 10(b): Use of third parties for specially commissioned examinations should be supported by a supervisory assessment of whether the output can be relied upon to the degree intended. These assessments should take into consideration the biases that influence third parties.

8.1 Do you usually use third parties in your supervisory work? Please describe in what areas and give recent examples. If the answer is yes, go to question 8.2 below; if the answer is no, go directly to section 9.

8.2 How do you assess to what extent third parties' input is reliable and in line with your supervisory standards for SIBs?

8.3 During the last months have you made any changes in the way that you use these third parties? For example, have you used them less or more than before? Have you made any changes when dealing with third parties to increase the quality of their work?

8.4 Have supervisors made any changes to increase contact with external auditors so as to exchange experiences and concerns? If so, have these interactions proven to be useful? Why?

Actions planned

8.5 What additional actions are you undertaking/do you plan to undertake to promote the implementation of this recommendation in your supervisory authority?

9. Use of third parties – Recommendation 10(d)

Recommendation 10(d): The heads of national authorities should prepare a letter to the heads of SIFI external auditors reminding them of the expectations outlined in BCP 22. In addition, national authorities should have regular contact with the regulators of auditing firms to exchange experiences and concerns.

9.1 Please describe the nature of contacts that you have with regulators of auditing firms. Please elaborate.

9.2 Have you prepared a letter to the heads of SIB external auditors reminding them of the expectations outlined in BCP 22 or otherwise formally communicated this expectation?

9.3 Do you have routine or ad hoc contacts with auditing firms? Have you made any changes to increase contact with external auditors so as to exchange experiences and concerns? If so, have these interactions proven to be useful? Why?

9.4 Have you had any problems/ concerns during these contacts with auditing firms and regulators in the last two years? If so, what measures have you adopted to solve them?

Actions planned

9.5 What additional actions are you undertaking/do you plan to undertake to promote the implementation of this recommendation in your supervisory authority?

10. Additional questions on "improved techniques"

Horizontal reviews – Recommendation 5(b)

Recommendation 5(b): Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. In particular, there should be greater discussion of the use of horizontal reviews and good practice around the use of this valuable supervisory tool.

10.1 Have you made more use of horizontal reviews in the past year? Please describe the number of horizontal reviews done, the topics, and the number of SIBs that were reviewed per review. Can you provide an estimate of the amount of time and resources devoted to each so as to provide some context as to how deep the reviews were?

Assessment of boards - recommendation 5(d)

Recommendation 5(d): Consideration should be given to developing expanded BCBS guidance to supervisors on how to assess a board with the goal of being better armed with tools and techniques which enable better determination of board effectiveness.

10.2 In order to improve board effectiveness; do you meet with boards to discuss the most recent supervisory findings? How frequently? Who from the supervisory agency usually attends? Would the head or the deputy (e.g. number 2 person) at the supervisory agency attend? Do you meet with the whole board and committees? Which committees?

Financial statement analysis - recommendation 5(e)

Recommendation 5 e): Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. In particular, there should be greater discussion of the use of financial analysis and the enhancement of supervisory practices around the type and depth of financial analysis that can help inform supervisory risk assessments.

10.3 Describe your financial statement analysis function, including its main outputs and how they are used by supervisors. Have you made any changes to this function at your agency in the last year? Please describe why the changes were made and what the changes were intended to achieve.

Product analysis - recommendation 5(f)

Recommendation 5 f): Consideration should be given to expanding BCP 19 and BCP 20 on supervisory approach and supervisory techniques respectively. The BCPs should consider covering the area of business model assessment and product oriented risk analysis, such that supervisors are guided to better understand the risk embedded in the business models of the banks as well as in the design of their product offerings. In addition, the BCPs should reflect the need for supervisors to ensure that firms have processes to monitor post-approval alterations made to new products which may alter their risk profile. In such cases, the firm's new product approval process should be re-applied.

10.4 Have you taken any steps so that supervisors are more on top of risks embedded in new products? Please describe. Are there examples of new products that have been analysed recently? How did you pick these products (e.g. were they part of new product approval processes, randomly selected, or targeted based on other factors)?

Quantitative models outside Pillar 1 - recommendation 5(g)

Recommendation 5 g): There are no BCBS standards for approving quantitative models outside of pillar 1. Given the pervasiveness of their use, consideration should be given to addressing quantitative models more fully in international guidance

10.5 Do you have any processes for becoming aware of model usage outside of Pillar 1? Do you assess these models?

Annex C: Summary of self assessments against certain BCPs

1. Principle 1: Objectives, independence, powers, transparency and cooperation

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 1 is divided into six component parts, each of which is commented on separately in this report.

Principle 1(1): Responsibilities and objectives

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

All jurisdictions report they have laws in place for banking and for the authority or authorities involved in banking supervision. The self assessments show that most jurisdictions have only one authority responsible for regulation and supervision of banks and a few (e.g. Germany, United States) have more than one. There is a range of practice with respect to the extent to which authorities across G20 jurisdictions are integrated supervisors responsible for supervision of both bank and non-bank entities (such as insurers and securities firms), or to the extent their mandate combines responsibilities for conduct of business as well as prudential regulation and supervision.

How responsibilities and objectives for various authorities are expressed appears to differ considerably across G20 jurisdictions. Some jurisdictions did not report on their explicit mandate, noting only in their self assessment that their mandate and objectives are clearly set out in relevant legislation, as required by the BCP. Virtually all jurisdictions consider their mandate to be clearly defined and all report it is publically disclosed. In only a very few jurisdictions have there been recent changes in prudential mandate made or proposed for individual supervisory authorities (e.g. United Kingdom as part of a larger institutional reform, or the United States as part of the crisis response). Some jurisdictions do not have an explicit concise mandate statement in legislation, but the supervisory authority has drawn its mandate from the more specific longstanding legislative powers and grants of authority it has (e.g. the United States agencies). Some mandates indicate that the authority is responsible for the regulation and supervision of banks or credit institutions, without much indication of the results desired (e.g. Brazil, Saudi Arabia). Others make reference to protection of depositors or to concepts such as safety and soundness or prudent operation of banks.

There are also differences in the treatment of system stability in mandates. Some supervisor's legislative mandate explicitly refers to contributing to or promoting the stability of the financial system (e.g. Australia, Italy, Japan, Netherlands, Turkey, United Kingdom), but in others it is more implicit. This issue may come to the fore when the division of macroprudential responsibilities is considered in the period ahead.

Considerable differences are reported in the degree to which industry competitiveness or competition concepts are included in legislative mandates. Some jurisdictions (e.g. Australia, Canada, China and Italy) are to consider these but it appears to be understood that the prudential mandate is primary. In jurisdictions such as Switzerland the formulation of the mandate makes clear that achieving prudential objectives is the way of contributing to reputation and competitiveness. In a few cases (e.g. Korea, Saudi Arabia, Singapore, United Kingdom,) the legislative mandate goes even farther and refers to promotion of the advancement of the financial industry, or promotion of the jurisdiction as a financial centre. It is unclear how these authorities balance these objectives with their prudential mandate and whether there are potential conflicts that may hinder effective supervision.

Very few jurisdictions report any element in their legislative mandate that suggests the need for early intervention or explicitly recognise that banks can fail; exceptions include Canada and the proposed United Kingdom mandate for the new prudential authority. However, a number of jurisdictions report they do have prompt corrective action regimes, or are introducing them. In addition, several note that they have general powers to intervene and effect remedial action where necessary (not just tied to more specific breaches of rules) and as a result they feel accountable if they did not act early to deal with problems at individual banks and this has contributed to them having an early intervention culture (e.g. Australia, Hong Kong, Singapore). As the self assessment did not cover actual experience in these areas, it is not possible to comment on the range of early intervention practice, or whether it is changing.

All jurisdictions report their laws and regulations provide a framework of minimum prudential standards that banks must meet. These set standards in such areas as capital adequacy, liquidity, large exposures, sound risk management, related party lending, governance and internal control, and fit and proper standards for management and those with controlling interests. In most jurisdictions the supervisor also issues extensive guidance, which may or may not have the force of law but are used to further clarify supervisory expectations. These tiered arrangements for setting rules allows for flexibility in adapting more quickly to changing circumstances, and many jurisdictions reported significant changes in guidance/circulars/ regulations recently in response to the financial crisis and new BCBS and FSB initiatives, with some jurisdictions also reporting changed legislation. Only a few report that legislation contains specific higher prudential standards being imposed on specified, systemically important banks (e.g. United States). As noted elsewhere, others report higher supervisory expectations for these banks as a result of application of their supervisory approach.

BCP 1(1) also requires that the supervisor confirm that information on the financial strength and performance of the industry under its jurisdiction is publically available. All jurisdictions report that the supervisor and/or the central bank where the bank is not the supervisor publish regular aggregate analysis of the banking sector. Practice with respect to publication of the financial condition of individual banks differs considerably. In some jurisdictions (e.g. Australia, Canada, United States) the supervisor makes available extracts of supervisory returns, including balance sheet and income statement data. In other jurisdictions this is left entirely to banks themselves under requirements set by the supervisor (e.g. as in Pillar 3 of Basel II) or through accounting disclosure rules. It is not always clear from the self assessments the extent to which supervisors periodically and selectively verify accuracy of this information or cause other independent parties (e.g. auditors) to do so. Having individual bank information reported only by each bank separately can make access to this information by markets and analysts more difficult.

Many jurisdictions report that in determining supervisory programs and allocating resources they take into account risks posed by individual banks/banking groups. Often this is based on supervisory ratings at least in part, with some using a combination of a rating of risks, risk mitigants and importance/impact of individual banks, and others using the CAMELS system or multiple systems. A few jurisdictions (e.g. India) report they do not use a risk-based approach. Some jurisdictions (e.g. United States) have statutory requirements for banks to be subject to full scope examination within set time periods, while for others this is set by supervisory methodology. It is not possible to determine, on the basis of the self assessments provided, the extent of similarities or differences in risk-based supervisory approaches. Nor is it possible to document the enhancements that have been or are being put in place as a follow up to lessons learned in the crisis and new international guidance.

Principle 1(2): Independence, accountability and transparency

Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.

Some nine jurisdictions self assessed other than compliant on this BCP, more than on any other of the BCPs. There were various reasons, including issues related to resourcing and the appointment and removal process for the head of the supervisory authority. No jurisdiction reported that these matters meant it was unable currently to carry out its core regulatory and supervisory mandate.

Many jurisdictions reported that the operational independence of their body for regulatory or supervisory decisions was either specifically covered in legislation or was part of the authority for exercise of their various powers. There are a number of cases where other bodies (such as Finance Ministries) have been provided with decision-making powers (for example with regard to the granting and revocation of bank licenses in Saudi Arabia), can direct the supervisor about policies it should pursue or priorities it should follow (Australia), or can otherwise be involved (Argentina, Netherlands). In some cases (e.g. Mexico, Spain) the supervisor must obtain the agreement of the central bank or Ministry before taking certain supervisory actions. The self assessments generally indicated that the prudential analysis of relevant decisions is the responsibility of the supervisor and that operational independence had in practice been preserved.

However, several jurisdictions reported themselves other than compliant due to deficiencies with regard to the removal of board members of supervisory authorities, though that had not arisen in practice. In particular, some jurisdictions report that the law does not set out the reasons for removal of the head of the supervisory authority and/or does not require public disclosure of the reasons of a dismissal (Brazil, India, Mexico, and United Kingdom). Several of these jurisdictions, as well as Japan, also reported that the head of the supervisory authority was not appointed for a fixed term. No jurisdiction reported that removal has actually occurred in practice.

Supervisors generally report that their staffs have credibility based on their professionalism and integrity. Often, extensive training programs and secondments are mentioned as instruments to ensure that staff's professional skills and knowledge are maintained. Some supervisors are making use of stakeholder consultations to assess the knowledge and effectiveness of staff. Some supervisors reported on codes of conduct applicable to their staff.

Self assessments of resource matters illustrated the diversity of situations in the G20 group, and some jurisdictions raise issues, similar to those identified in the SIE report. Most supervisors fund themselves through levies on industry if they are not funded out of central bank operations. A number report that attracting and retaining specialised staff can be a challenge, but they have adopted various strategies to attempt to deal with this issue. Use of outside experts where necessary is possible to assist in supervisory tasks. Several supervisors reported material increases in staff as a result of new demand in the post-crisis environment, though not all self assessments reported on trends in resource levels, so it is not possible to make general observations.

Several supervisors reported that there was government involvement in their budget process, either because they could be and/or recently were subject to government-wide fiscal restraint measures, or selective approval processes or controls on salaries and/or headcount (e.g. Australia, Brazil, Canada, China, Switzerland, and Turkey). Some (e.g. Netherlands) reported that much of their costs were borne by industry levies and partly by the general budget, resulting in Ministerial approval of their budget. In a few cases (e.g. China, Mexico) the fees collected by supervisors went to treasuries and the amount made available to supervisors out of that was determined by government budget processes. Countries generally did not report in practice that core prudential work had been compromised by these arrangements. Some jurisdictions noted increased demand for quality staff that was hard to meet due to salary limitations. While these various arrangements were not reported currently to raise independence-related concerns in practice, some jurisdictions pointed out the potential for such issues to arise. Sometimes the authorities involved saw a need for more flexibility with regard to budget and salary limitations. As a result of such factors, a number of jurisdictions assessed themselves as less than fully compliant with this principle.

Principle 1(3): Legal framework

A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.

All jurisdictions report compliance with this principle. Their laws identify authority(s) responsible for granting or withdrawing licenses. In a number of cases this is a combination of the supervisory authority and the minister of finance or other ministerial group. Laws empower supervisors to set various prudential rules and jurisdictions follow various consultation mechanisms with differing practices.

All supervisors report they have adequate statutory powers to obtain information from banks in the form and frequency deemed necessary. All report they use these powers extensively, both in supervisory reporting from banks and in getting bank-specific information as well as access to bank staff as part of the supervisory process.

Principle 1(4): Legal powers

A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.

Supervisors generally report adequate broad legal powers to address compliance and to deal with safety and soundness concerns. However, as noted in other BCPs (e.g. BCP 23) there are certain jurisdictions that report deficiencies in specific tools. No jurisdiction reports issues of not having legal authority for full access to banks boards, management and records. However, a few jurisdictions (e.g. Brazil, South Africa, Russia) report that their laws do not have full or adequate room for supervisors to use judgment in determining compliance with rules or determining whether unsafe or unsound conditions exist, or that operational issues exist because of extensive appeal processes. In addition, in some jurisdictions (e.g. Spain, South Africa) some or all of the powers to require banks to take remedial action or impose a range of sanctions (including revoking a bank's license) is exercisable by the minister (or the courts), not by the supervisor, and some of these jurisdictions faces other limitations.

Principle 1(5): Legal protection

A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.

For all but a few jurisdictions the law provides protection to the supervisory authority and its staff against acts taken (or omissions made) while discharging their duties in good faith. Exceptions occur in a few jurisdictions where clear protection does not exist (e.g. Russia) or exists but may be narrower than the principle requires (e.g. Brazil, Indonesia, Korea) or where protection exists but further regulations are necessary in order to clarify implementation or interpretation (e.g. Mexico). In a few cases (e.g. Saudi Arabia) protection may be in the general law not in the banking law but regardless is reported to work effectively.

All jurisdictions, including those few which do not report adequate legal protection, have arrangements for defending the supervisory authority and its staff. As a result they do not face the costs of defending their actions taken in good faith (though in Italy the reimbursement is ex post).

Principle 1(6): Cooperation

Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Countries virtually universally reported that necessary arrangements (formal or informal) were in place to share information with domestic authorities with responsibility for the soundness of the financial system. In jurisdictions where the central bank is also the supervisor or where an integrated supervisor also regulates and supervises banking and/or securities firms fewer formal arrangements are needed. In other jurisdictions the typical arrangements covered the central bank, other financial sector regulators, the deposit insurer, and the finance ministry.

Countries generally have a network of memoranda of understandings (MOUs) and/or other informal arrangements for information sharing with foreign banking supervisors of material interest to the jurisdiction as a home or host supervisor. Many jurisdictions reported evolution of these arrangements through such mechanisms as regular visits or discussions, participation in supervisory work with the foreign supervisor (either abroad or as host), and participation in colleges of supervisors.

Arrangements generally allow sharing of confidential information with appropriate protection of the confidential status of that information by the receiving party and requirements that it be used only for supervisory purposes. A few jurisdictions noted limitations in these arrangements (e.g. Russia and Indonesia). Self assessments varied in indicating actual practice under the arrangements so it is not possible to reach general conclusions in that area.

2. Principle 23: Corrective and remedial powers of supervisors

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

All jurisdictions' supervisory process includes raising supervisory concerns and recommendations with management or the board and using various tools to require that the concerns are addressed in a timely manner. Follow ups occur through some combination of special monitoring and reporting and through the supervisory process and follow-up examination. There is also the possibility and practice of escalation of the formality and severity of intervention depending on the circumstances. Initial recommendations to banks coming out of the supervisory process are backed up by the possibility of use of sanction authorities. Both oral and written communications are typically used. Many jurisdictions share their supervisory rating with bank boards and management.

The trigger for imposing supervisory actions appears to differ among jurisdictions. This is related to the issue of the degree to which the legislation and rules permit use of supervisory judgment, which also appears to differ considerably among jurisdictions, and could hinder early intervention. In some cases the trigger is related to actual breaches of rules (e.g. capital requirements). In other cases deterioration of financial condition and the reasonably certain anticipation of a future breach of rules, or materially adverse development that may affect bank's safety and soundness, as determined by the supervisor, are sufficient for triggering of supervisory action. While the BCP speaks of supervisory action being 'at an early stage', and most jurisdictions rate themselves as fully compliant, most self assessment are not detailed enough to determine the extent of early intervention that is actually occurring.

Supervisors also appear to differ in the extent to which they can raise concerns with management or the board if based on more general supervisory concerns (such as actual or potential unsafe or unsound practices) as opposed to breaches of specific rules or guidance requirements.

Many supervisors report that they participate in deciding when and how to effect the orderly resolution of a problem bank situation. The self assessments suggest that in a number of jurisdictions, the involvement of supervisory authorities in the orderly resolution is evolving as resolution frameworks are enhanced post-crisis. A few jurisdictions (e.g. Netherlands, Saudi Arabia) rate themselves as less than fully compliant, as resolution frameworks are being augmented and new resolution tools are put in place in their jurisdiction. Other jurisdictions report recent revisions of resolution frameworks and accompanying supervisory powers (e.g. Germany, Switzerland, and United States). Typically supervisory determinations are a trigger for various resolution actions by the supervisor and by other financial stability authorities. In a number of cases the applicable tools and processes followed for resolution depend on whether the bank is deemed to be systemically important. Understandably, few if any authorities can require a merger but some (e.g. HK, Indonesia) report their practice is to be quite active in attempting to encourage or facilitate these forms of resolution.

Nearly all jurisdictions report an adequate range of supervisory powers. Typically, supervisory authorities have the ability to restrict or suspend a business, withhold approvals of acquisitions/new activities, issue formal orders to rectify deficiencies, limit or revoke banking licenses, and appoint special administrators. They also report that they generally have the ability to impose various penalties, including removing individuals from banks' senior management or boards, imposing increased capital and liquidity requirements to reflect risks and/or until deficiencies are rectified, as well as imposing monetary fines and penalties. There appear to be some differences in the extent and grounds that banks can use to appeal supervisory decisions (e.g. all aspects or only issues of due process) and whether appeals stay various supervisory decisions. A few jurisdictions report less than full compliance because of their experience of material delays (Brazil), or because they do not have authority to take final decision on serious disciplinary matters, rather they have to be referred to the government (Spain).

Notwithstanding, the self assessment does not always evidence that supervisors have the power to take all the measures discussed in the FSB recommendation on supervisory powers (e.g. increase liquidity requirements, impose large exposure limits, impose dividend cuts, and require additional capital). A few jurisdictions report a need to enhance their supervisory powers, particularly for seeking specific regulatory capital increases or imposing higher liquidity requirements in line with the new Basel III rules. Others report that they do not have targeted powers, but consider themselves to be compliant as they can (and in practice do) employ their general supervisory intervention powers to achieve the results if the situation warrants (e.g. Hong Kong with respect to dividend restrictions, or the United States as a result of rules such as prompt corrective action and availability of formal enforcement action powers related to unsafe or unsound practices). In some cases, jurisdictions did not report specifically on each of the specific powers mentioned in the FSB recommendation.

There appears to be differences in the use of these powers, for example with respect to capital and liquidity. Some jurisdictions have across-the-board minimum requirements that are higher than the Basel minimums. Others report that they have supervisory triggers/expectations/guidance that in essence amount to setting less formal targets – for most if not all banks – higher than the regulatory minimum. Others appear to exercise their authority to set higher-than-minimum levels on a more case-by-case basis and less frequently. In some areas, such as liquidity, practice is understandably evolving as new standards and practice comes into effect. Some jurisdictions (e.g. Brazil, Germany) report that availability of certain of these powers such as requiring capital above minimums is relatively new. So experience may be limited in practice.

Compliance with BCP 23 does not require that a jurisdiction have a 'prompt corrective action' regime though a number of jurisdictions report that they have such a regime in place. These differ in the degree of formality, whether they are tied to specific triggers such as capital thresholds or to more judgmental assessments by the supervisor. A few jurisdictions reported that there may be limitations on periods for interventions, or there may be no laws or regulations explicitly guarding against undue delays of intervention, but these issues are not reported as material enough to affect compliance with the overall principle.

Countries generally report that they can apply penalties and sanctions not only to the bank but also to management and/or the board. This includes powers to remove board members and members of management either generally, or those in specified key roles. In a few cases (e.g. Russia) this power exists only for formally intervened banks. In Italy, the supervisor can put replacement of board members on the shareholders meeting agenda, but the decision is up to shareholders (this is proposed to be altered). A few jurisdictions such as Switzerland report they cannot impose direct financial penalties but can use other tools to bring about appropriate remedial action.

Countries generally report compliance with criteria related to ability to ring fence the bank from actions of parent companies, subsidiaries, and other related or parallel-owned banking structures. Often the reports indicate that jurisdictions would use a combination of their general remedial powers to effect this result, if necessary.

Countries also generally report that they have the authority and often have MOUs or other arrangements in place with regulators of related non-bank financial entities. As a result, these other regulators can be aware of the bank supervisors' actions and coordinate as necessary. For integrated regulators this communication is within the same organisation. As the self assessments usually did not speak to actual practice, it is not possible to conclude the extent to which these arrangements are working in practice.

3. Principle 24: Consolidated supervision

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide

Countries generally report familiarity with the structure of banking groups (domestic and cross-border) as a result of their supervisory activity. This is supported by requirements for banks and banking groups to report regularly on their corporate structure and from the notification/approval process with respect to acquisitions and changes in ownership of banks and banking groups. Powers to review overall activities of a banking group (domestic and/or cross-border) generally derive from specific laws and regulations and or occasionally from arrangements entered into with banking groups with respect to their non-financial activities as a condition of approval for these acquisitions. This can include explicit information gathering powers from non-financial or non-operating holding companies (and their affiliates) in corporate groups that control a bank (e.g. Germany, Hong Kong, United States, United Kingdom)

Some supervisors reported that they have explicit powers to require changes in corporate structure to facilitate consolidated supervision. A few jurisdictions (e.g. Mexico, Russia, Turkey) report that they lack, or are in process of putting in place, a legislatively-defined structure for consolidated regulation and supervision of banking groups (as opposed to banks and their direct subsidiaries and branches). A few (e.g. Argentina, India) report limits on information they get on entities in the conglomerate group that they do not regulate, or lack of supervisory powers over associated companies in these groups. On the other hand, several jurisdictions have explicit supervisory and authorisation powers over non-operating bank or financial holding companies in financial groups (e.g. Australia, Canada, Korea, and United States).

Supervisory frameworks generally take account of risks to the bank or banking group from non-banking activities conducted by the group. The degree to which these assessments are formalised in supervisory methodologies and rating systems appears to differ across jurisdictions. A few jurisdictions (e.g. Singapore) reported that they generally restrict the non-financial activities of banking groups.

The issue of applying prudential standards, such as capital adequacy, large exposures, on a consolidated basis is complex and not all jurisdictions report specific corrective or remedial powers at the holding company or group-wide level. All jurisdictions report applying such prudential standards to the bank and its subsidiaries on a solo and consolidated basis. Countries that have explicit power over bank holding companies generally also apply these rules on a consolidated basis at that level and have the authority to enforce them at that level.

A number of jurisdictions observe that they do not have formal enforcement authority or ability to impose certain prudential requirements such as for capital or liquidity on holding companies. Nonetheless, most report that they are able to require consolidated reporting of capital adequacy at the group level and that they can take action at the individual bank level with respect to group-wide issues (e.g. Germany, Hong Kong, United Kingdom). Some, but not all, self assessed themselves as largely compliant as a result of this type of arrangements. Lack of authority at the holding company level may also prevent such jurisdictions from being able to fully review acquisitions that are effected through holding companies, as opposed to their power to review acquisitions by banks directly. Certain jurisdictions (e.g. Hong Kong, Italy) report that ongoing fit and proper standards do not apply to individuals in controlling entities.

Countries report a high level of compliance with the parts of BCP 24 that deal with the supervisor's powers and practices vis-à-vis foreign operations of banks. Supervisory processes typically include the on-site examination of foreign operations, as well as the assessment that management is maintaining proper oversight of the foreign operations, that information on foreign operation is adequate, and that there are no host-jurisdiction restrictions on passage of information to the bank's head office and/or home jurisdiction supervisory authority. In general, jurisdictions report they have the power to close foreign offices or impose activity restrictions, if supervisory authorities determine that oversight by the parent bank is not adequate relative to risks, or if information constraints about foreign operations hinder or prevent consolidated supervision. Switzerland reports it is in process of enhancing management of cross-border operations related to legal and reputational risks. Brazil, Germany and Mexico report they are not explicitly able to close foreign offices and/or limit activities. Russia reports that limits on information sharing within banking groups regarding client transactions, and limits on information sharing relating to parent bank holding companies are being addressed by a law now in process.

Annex D: Self assessment ratings[18]

SELF ASSESSMENTS	AR	AU	BR	CA	CN	FR	DE	HK	IN	ID	IT	JP	KR	MX	NL	RU	SA	SG	ZA	ES	CH	TR	UK	US
BCP 1 Objectives, Independence, Powers, Transparency and Cooperation																								
1.1 Responsibilities and objectives	C	C	C	C	C	C	C	C	C	C	C	C	C	LC	C	LC	LC	C	C	LC	C	No ratings provided	MNC	C
1.2 Independence, accountability and transparency	C	LC	LC	LC	LC	C	LC	C	LC	C	C	C	C	NC	C	LC	LC	C	C	C	LC		LC	C
1.3 Legal framework	C	C	C	C	C	C	C	C	C	C	C	C	C	C	C	LC	C	C	C	C	C		C	C
1.4 Legal powers	C	C	LC	C	C	C	C	C	C	C	C	C	C	C	C	LC	C	C	C	LC	C		C	C
1.5 Legal protection	C	C	LC	C	C	C	C	C	C	MNC	C	C	LC	LC	C	LC	LC	C	C	C	C		C	C
1.6 Cooperation	LC	C	C	C	C	C	C	C	C	LC	C	C	C	C	C	LC	C	C	C	C	C		C	C
BCP 23 Corrective and remedial powers of supervisors	C	C	LC	C	C	C	C	C	C	LC	C	C	C	LC	LC	LC	LC	C	C	C	LC		C	C
BCP 24 Consolidated supervision	LC	C	LC	C	C	C	C	C	LC	LC	C	C	C	LC	C	MNC	C	C	C	C	LC		LC	C

Legend: LC – Largely Compliant; C – Compliant; NC– Non Compliant; MNC – Materially Non Compliant

Acronyms: AR – Argentina; AU – Australia; BR – Brazil; Ca – Canada; CN – China; FR – France; DE – Germany; HK – Hong Kong; IN – India; ID – Indonesia; IT – Italy; JP – Japan; KR – Korea; MX – Mexico; NL – Netherlands; RU – Russia; SA – Saudi Arabia; SG – Singapore; ZA – South Africa; ES – Spain; CH – Switzerland; TR –Turkey; UK – United Kingdom; US – United States.

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18 At the time of finalisation of this report, one country had not submitted its self assessment and two countries had submitted self assessments without ratings.

Annex E: IAIS progress report for enhanced supervision

International Association of Insurance Supervisors

Note from the IAIS Secretariat **12 September 2011**

Report from the IAIS on implementation of recommendations for enhanced supervision

Introduction

This report covers a broader range of recommendations from the SIE Report than those specifically allocated to the IAIS, as many of the other recommendations were regarded as relevant to insurance supervision from a broader perspective.

1. Mandates

The 2011 work plan of the Standards Observance Subcommittee is directly linked to the recommendations emanating from the SIE Report. The Subcommittee was tasked to conduct self-assessments against the ICPs within 6 months of their date of issue (expected to be October 2011). Deficiencies and corrective action plans are to be outlined in a letter to the FSB chair and shared with FSB peers by end of March. The following topics were recommended for this year:

- Mandates
- Supervisory Powers
- Group-wide and Consolidated Supervision

It was also agreed that the new ICP1 and ICP2 would be tackled jointly in one self-assessment questionnaire and that ICP23 would be the subject of a separate self-assessment.

The timetable includes:

- 3 October: Issue questionnaires on Mandate, Supervisory powers and Group-wide and Consolidated Supervision to all IAIS Members, including FSB Members.
- 30 October: Last date for responses from IAIS Members.
- 25 March: Report to FSB as indicated in the SIE Report

ICP 1 Objectives, powers and responsibilities of the supervisor, standard 1.3 states that the principal objectives of supervision is to “promote the maintenance of fair, safe and stable insurance sectors for the benefit and protection of policyholders", while standard 1.4 deals with possible conflicts between legislation and supervisory objectives.

A requirement has been added to ICP 10 Preventive and corrective measures, standard 10.2:

"The supervisor has sufficient authority and ability, including the availability of adequate instruments to take timely preventive and corrective measures if the insurer fails to operate in a manner that is consistent with sound business practices or regulatory requirements. There is a range of actions or remedial measures which include allowing for early intervention when necessary. Preventive and corrective measures are applied commensurate with the severity of the insurer's problems."

A requirement has been moved from guidance to standard in ICP 1 Objectives, powers and responsibilities of the supervisor, standard 1.2:

"Primary legislation clearly defines the objectives of insurance supervision and the mandate and responsibilities of the supervisor …"

2. Independence

The IAIS material covers independence under ICP 2 (Supervisor), which covers notably:

- accountability (2.1.1)
- relationships with executive and judicial (2.3 and 2.3.1)
- independence from government and industry and budgetary autonomy (2.4 and 2.4.2)
- access to needed skilled staff and other resources (2.11)

Additional guidance has been added to ICP 2 Supervisor as 2.4.2: "In the ordinary course of business, the supervisor should not manage or otherwise run the insurers it supervises. A member of the governing body of the supervisor should exclude him/herself from decisions where he/she is in a conflict of interest position."

3. Resources

Guidance has been added to ICP 9 Supervisory review and reporting as 9.1.1: "Supervisors should ensure that there are adequate resources allocated to on-site inspection and off-site monitoring to ensure a comprehensive assessment of risk is undertaken taking into account the nature, scale and complexity of the insurer."

A requirement has been added to ICP 24 Macroprudential Surveillance and Insurance Supervision under standard 24.6: "The supervisor has an established process to assess the potential systemic importance of insurers, including policies they underwrite and instruments they issue in traditional and non-traditional lines of business" and guidance has been added in 24.6.1: "In assessing the systemic importance of insurers, the supervisor should deploy processes with adequate depth and quality to support effective supervision given the nature, scale and complexity of the supervised entities and taking into account the results of market analysis and Macroprudential surveillance."

Guidance has been added to ICP 2 Supervisor under 2.11.1:

"As part of their annual resource planning exercise, supervisors should take stock of existing skills, experience and projected requirements over the short to medium term and review and implement measures that could be taken to bridge any gaps in numbers and/or skill-sets. Such measures could include more flexible hiring policies, schemes for secondment of staff to industry, or other supervisory authorities within the jurisdiction or internationally. This effort would be aimed at providing access to specialist skills on a temporary basis as well as provide opportunities for supervisory staff to better understand industry practices."

4. Supervisory Powers

The IAIS Solvency Subcommittee is reviewing the BCBS liquidity rules and considering any implications for insurance. Listing specific tools as requirements could be problematic because as markets evolve the tools can change. The important consideration is whether the supervisor has a full range of powers.

See the change to ICP 10 Preventive and corrective measures under 10.2 under Mandates.

Guidance has been added to ICP 10 Preventive and corrective measures under 10.2.2:

"The supervisor has adequate tools to supervise insurers according to the nature, scale and complexity of their activities, including activities that could pose systemic risk. These could include restrictions on the insurer's business activities, directions to reinforce the insurer's financial position, introduction of liquidity requirements or large exposure limits."

5. Improved Techniques

a) Focus on Outcomes

Guidance has been added under ICP 9 Supervisory review and reporting under 9.1.3:

"The supervisory framework for risk assessment should analyse trends and compare risk assessments against stress tests outcomes. Supervisors should assess the quality of outcomes of insurer's enterprise risk management framework for the identification and quantification of risks (refer to ICP 16 Enterprise Risk Management for Solvency Purposes) and evaluate whether business lines rated as low risk show outcomes that support this assessment."

The subject matter of stress testing is covered under ICP 16 Enterprise Risk Management for Solvency Purposes under 16.16 (paragraphs 16.16.6 through 16.16.8). Paragraph 16.16.8 amended as follows: "…Such testing informs the discussion between supervisors and insurers on appropriate planning, comparing risk assessments against stress test outcomes, risk management and management actions and enables supervisors to consider the dynamic position of insurers and form a high-level assessment of whether the insurer is adequately capitalised to withstand a range of standardised and bespoke stresses."

b) Horizontal Reviews

A requirement has been added to ICP 9 Supervisory review and reporting standard 9.1: "…The system uses the inputs from on-site inspections and off-site monitoring, including market analyses, horizontal reviews and other sources of information to assess risks."

A new standard has been added to ICP 24 Macroprudential Surveillance and Insurance Supervision under 24.3 as follows: "The supervisor performs both quantitative and qualitative analysis and makes use of both public and other sources of information, including horizontal reviews of insurers and relevant data aggregation."

In addition, guidance has been added on horizontal reviews under 24.3.1 – 24.3.3

c) Assessment of Boards

A requirement has been added to the principle statement for ICP 9 Supervisory review and reporting: "The supervisor has an integrated, risk-based system of supervision that uses both off-site monitoring and on-site inspections to examine the business of each insurer, evaluate its condition, the quality and effectiveness of its board and management and compliance with legislation and supervisory requirements…"

A requirement has been added to ICP 24 Macroprudential Surveillance and Insurance Supervision enhanced under 24.7:

"If the supervisor identifies an insurer as systemically important, it develops an appropriate supervisory response, which is commensurate with the nature and degree of the risk."

d) Financial Statement Analysis

Guidance has been added to ICP 9 Supervisory review and reporting under 9.1.2:

"The supervisor should promptly analyse financial information received from insurers. Financial analysis by the supervisor helps to provide a deeper understanding of developing trends affecting an insurer, its risk appetite and the effectiveness of its strategy. Analysis by business lines helps to provide insights into the insurer's risk/return profile."

e) Business Models and Product Analysis

No further changes are considered necessary. ICP 16 Enterprise Risk Management for Solvency Purposes and ICP 17 Capital Adequacy address assessing risk by understanding the business model and the embedded risks with that business model. ICP 16.3.2 states: "An insurer's risk management policy should clearly address the relationship between pricing, product development and investment management …"

f) Quantitative Models outside Pillar 1

ICP 17 addresses business models used for capital adequacy requirements for solvency purposes. The subject matter of internal models and own risk and solvency assessments (ORSAs) will be further discussed within the ComFrame project. Further substantive guidance on the use of internal models for either regulatory purposes or insurer risk and solvency assessment purposes may be provided under ComFrame.

g) Stress tests

ICP 16 Enterprise Risk Management for Solvency Purposes covers the issue of stress testing as part of ERM and the role of supervisors in using/ prescribing stress testing. No additional changes are required at this time.

h) Data Aggregation

A requirement has been added to ICP 9 Supervisory review and reporting, 4th bullet of standard 9.2: "requires more frequent detailed additional information on a timely basis whenever there is a need."

A requirement has been added to ICP 9 Supervisory review and reporting under standard 9.5: “The supervisor periodically reviews its reporting requirements, including consideration of higher requirements for certain insurers based on their nature, scale and complexity …”

Additional guidance has been added in ICP 9 Supervisory review and reporting under 9.2.8: “The supervisor should be able to process data in a timely and comprehensive way. For efficiency, the supervisor should have processes and procedures to collect and store financial and statistical data in electronic form.”

A requirement has been added to ICP 24 Macroprudential Surveillance and Insurance Supervision under 24.7 as follows: “If the supervisor identifies an insurer as systemically important, it develops an appropriate supervisory response, which is commensurate with the nature and degree of the risk.”

i) State of the Art Controls including risk management

A requirement has been added to ICP 24 Macroprudential Surveillance and Insurance Supervision under 24.7: “If the supervisor identifies an insurer as systemically important, it develops an appropriate supervisory response, which is commensurate with the nature and degree of the risk.”

6. Group-wide and Consolidated Supervision

The IAIS 2011-2012 roadmap includes a self assessment exercise on the ICPs related to group-wide supervision with a completion date of spring 2012. The work will be undertaken by the Standards Observance Subcommittee with subject matter expertise provided by the relevant working parties responsible for developing the ICPs. Please refer to the comments above under Mandates.

The IAIS 2011-2012 roadmap also includes an exercise to develop specific mechanisms that facilitate the exchange of solvency information. Work will be undertaken by the Solvency and Actuarial Issues Subcommittee and supported by the Insurance Groups and Cross Sectoral Subcommittee. The development phase will run through to September 2012 with facilitation due for completion by October 2013.

7. Continuous and Comprehensive Supervision

A requirement has been added to *ICP 9 Supervisory review and reporting* under standard 9.2:

“The supervisor:

- maintains a framework for continuous monitoring and supervision of insurers based on on-going communication with the insurer, financial and statistical reporting and market analysis as well as other information acquired …”

Guidance has been added in *ICP 9 Supervisory review and reporting* under 9.2.1: “The supervisor should develop a comprehensive communication regime to ensure continuous information flow between the supervisor and insurers. The communication regime should include the role of senior levels and specialised areas within both the supervisor and the insurer.”

A requirement has been added to *ICP 2 Supervisor* under standard 2.1: "… There is effective communication and prompt escalation of significant issues to appropriate levels within the supervisor."

Organisational structure that reflects the importance of SIFIs is not addressed directly in ICPs. However, it is indirectly addressed by enhancement to ICP 2.1 (noted above) requiring escalation of significant issues to the appropriate levels within the supervisor and guidance 9.1.1 calling for adequate supervisory resources to ensure comprehensive assessment of risk taking into account the nature, scale and complexity of the insurer.

8. Supervisory Colleges, Home/Host

The IAIS 2011-2012 roadmap includes a review and update of the Supervisory College Guidance paper, providing additional guidance for a range of situations involving large, complex institutions which would also be applied to potential SIFIs.

The IAIS has conducted an impact assessment survey of the guidance paper on the use of supervisory colleges in group-wide supervision. The IAIS is organising regional roundtables with group-wide and host supervisors as well as the relevant insurance groups; preparing a questionnaire on colleges and organising presentations from members with experience in colleges. The information collected will be used to assess the need to review and update the Supervisory College Guidance paper. A report will be completed by end-2012.

The IAIS repository of supervisory colleges (IROSC) is currently being set up under a joint project between the Insurance Groups and Cross Sectoral Subcommittee and the Supervisory Cooperation Subcommittee.

9. Macro-prudential surveillance, Multi-disciplinary approach (forward looking)

ICP 24 Macroprudential Surveillance and Insurance Supervision states:

"The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that may impact insurers and insurance markets and uses this information in the supervision of individual insurers. Such tasks should, where appropriate, utilise information from, and insights gained by, other national authorities."

A standard has been added to ICP 24 Macroprudential Surveillance and Insurance Supervision as follows (24.2): "The supervisor, in performing market analysis, considers not only past developments and the present situation, but also trends, potential risks and plausible unfavourable future scenarios with the objective and capacity to take action at an early stage, if required."

In addition guidance 24.2.1 has been added as follows:

"Macroprudential surveillance is defined as a set of systems and processes that monitors the vulnerability of the financial system with respect to economic and financial shocks. One of the aims of Macroprudential surveillance and regulation is to: i) Identify systemic risk (including shocks, interconnectedness and feedback effects), ii) Reduce the likelihood of systemic risk, and iii) Mitigate spillover effects within the financial system and into the real economy."

Guidance has been added to ICP 9 Supervisory review and reporting under 9.2.2: “It is essential for the supervisor to be pro-active and forward looking in requesting information necessary to conduct effective off-site monitoring …”

10. Use of third parties

Guidance has been added to *ICP 2 Supervisor* under 2.13.1:

“Outsourcing of some supervisory functions to third parties can complement the supervisor’s resources with valuable expertise. However, the oversight and control of supervisory functions is the primary responsibility of the supervisor and the complete outsourcing of supervisory responsibility to third parties is not an acceptable substitute for that performed by supervisors.”

A requirement has been added to *ICP 2 Supervisor* under standard 2.13:

“Where the supervisor outsources supervisory functions to third parties, the supervisor sets expectations, assesses their competence and experience, monitors their performance, and ensures their independence from the insurer or any other related party. Outside experts hired by the supervisor are subject to the same confidentiality rules and professional standards as the staff of the supervisor.”

11. Concluding Recommendations

The revised ICPs will be assessed based on standards and there will be no additional criteria. The introduction to the ICPs includes the following statement in paragraph 8:

“It is recognised that supervisors need to tailor certain supervisory requirements and actions in accordance with the nature, scale and complexity of individual insurers. In this regard, supervisors should have the flexibility to tailor supervisory requirements and actions so that they are commensurate with the risks posed by individual insurers as well as the potential risks posed by insurers to the insurance sector or the financial system as a whole. This is provided for in the ICPs and standards where relevant.”

The Standards Observance Subcommittee is developing self assessment questionnaires in the areas of supervisory mandate, supervisory powers and group-wide supervision. The Standards Observance Subcommittee’s workplan includes the development of self assessment questionnaires for other ICP material over the next two years. See comments above under Mandates. A draft IAIS Peer Review Process is currently being prepared for review by the Implementation Committee and others at the Seoul meetings in September.