FINANCIAL
STABILITY
BOARD

Increasing the Intensity and Effectiveness of SIFI Supervision

Progress Report to the G20 Ministers and Governors

1 November 2012

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Executive Summary

In the aftermath of the financial crisis, the Financial Stability Board (FSB) and the G20 Leaders identified as a priority the need for more intense and effective supervision particularly as it relates to systemically important financial institutions (SIFIs).[1] Increasing the intensity and effectiveness of supervision is a key pillar of the FSB's SIFI framework, along with requiring higher loss absorbency and facilitating the resolvability of failing financial institutions.[2]

In this third report, members of the FSB Supervisory Intensity and Effectiveness group (SIE) observe that weak risk controls at financial institutions are still being witnessed and there remains room for improvement in supervision to ensure that it is effective, proactive and outcomes-focused. The International Monetary Fund (IMF) and World Bank Financial Sector Assessment Program (FSAP) continue to identify problems in the fundamental requirements for effective supervision, such as the core principles for official mandates, resources, and independence. To some extent this underscores a point made in 2010: changes in supervisory intensity and effectiveness are challenging to implement quickly as it takes a change in the preconditions for supervision, as well as changes in culture and different types of skills and resource levels.

This report covers areas where supervisory practice is becoming more robust, while noting areas where supervisory practice still needs to be improved.

One major change in many countries is a move to more extensive and deeper engagement with systemically important firms. This is evidenced by more frequent interaction with Boards, and in some cases more proactive engagement with firms in relation to their process for filling critical roles. Such efforts require seasoned judgement by supervisors. For some, this will be seen as stepping into areas that typically reside within the remit of the firm's management; for supervisors it reflects the significant externalities that exist with SIFIs, thereby requiring more robust succession planning and appointment processes for key positions, particularly leaders of key control functions. In addition, this report discusses the need for supervisors to become more active in explicitly assessing risk culture at firms.

While light-touch supervision has been clearly rejected, supervisors are re-considering the range of approaches required to ensure effective supervision. For example, during the 1990s and early 2000s there was a move away from detailed assessments of profits and losses (P&L) and financial data (which were very time consuming) toward assessments of controls within financial institutions – a necessary move as financial institutions became more complex. However the pendulum may have swung too far away from analysis of the fundamental, strategic risks that underlie the sustainability of financial institutions' business models. The SIE will explore this issue further, with a view to identifying best practice approaches that could be adopted.

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1 The IAIS is currently in the process of developing its assessment methodology for identifying potential global systemically important insurers (G-SIIs) as well as the policy measures for G-SIIs. The final report is expected to be released early next year. After G-SIIs have been identified, the FSB, in collaboration with the IAIS, will monitor the implementation of the FSB's SIFI framework, including increasing the intensity and effectiveness of G-SII supervision.

2 See the 2010 FSB report *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions* which can be found at http://www.financialstabilityBoard.org/publications/r_101111a.pdf.

In order to remain effective, supervisory focus needs to change with changing risks and circumstances. As an example, this report highlights the importance of zeroing in on operational risk at G-SIFIs, which has been a key risk in recent loss events at financial institutions. This risk will continue to increase as financial institutions seek new ways to generate earnings, such as further expanding into wealth management and other revenue generating areas with low risk-weighted assets and required capital. To the extent that operational risk provides a broad, high level threat to the firm's business strategy, supervisors should satisfy themselves that Boards and senior management dedicate sufficient attention and resources to the management of operational risk with regard to prevention and control. Moreover, aspects of operational risk, such as business continuity and information security, cannot be addressed by adding capital.

No supervisory system can catch everything. The main responsibility for identifying and managing risk rests with each firm's management, whose risk managers, compliance and internal audit personnel will always greatly outnumber the resources available to supervisors. The more – and more sophisticated – activity of financial institutions has increased the array and intensity of the risks to which institutions are exposed. Risk-based supervision seeks to address this through deploying limited supervisory resources to the riskiest institutions and areas, prioritised based on an assessment of the risks therein. Other institutions and areas will, however, continue to present risks and supervisory authorities will lack the resources to examine everything. As such, supervisory approaches and areas of focus need to be periodically reviewed to confirm that, for instance, institutions and areas previously classified as "low or moderate risk" still warrant this assessment.

Effective supervision requires finding the right balance between focusing on areas of higher risk while also ensuring some periodic coverage of all aspects, including, for example, those that might prove risky *ex post*. Striking the right balance is an ongoing challenge; however, regulatory developments since the global financial crisis should allow supervisors to explore and leverage off deeper information sets and analysis. This may include the information that can be made available from central repositories and other centralised sources of financial data to track anomalies in the market, and information from implementation of recovery and resolution plans which provide supervisors with new insights.

The financial system is composed of institutions of many forms and shapes. While supervisory approaches to second-tier institutions in some countries might still rely on more traditional, risk-based approaches that call for a lesser degree of (or no) supervisory intensity, both the events during the crisis (e.g. Northern Rock) and recent events (e.g. the Spanish crisis) clearly demonstrate that small institutions can pose their own challenges to stability as a result of geographic and product concentration. The overall supervisory strategy needs to be mindful of such vulnerabilities.

Finally, supervisors need to be equipped with the mandate, independence and resources to reduce the likelihood of SIFI failures. Resource constraints at supervisory authorities was an area identified in the 2011 FSB report as hampering progress toward improving the intensity and effectiveness of supervision. To get at the crux of this issue, SIE members completed a survey aimed at assessing the resource constraints at supervisory authorities, particularly in the oversight of SIFIs and G-SIFIs. In addition, the IMF reviewed nine recent FSAP assessments regarding the adequacy of supervisory resources. Collectively, they describe some of the challenges supervisory agencies face in building the capacity required for the supervision of financial institutions, in particular of G-SIFIs. An immediate challenge is determining the supervisory staff required, not only in regard to numbers but also seniority and skill mix.

In summary, while the intensity of supervision has increased since the crisis, much remains to be done to support continuous improvement in SIFI supervision, in particular of G-SIFIs. When done well, however, effective and high quality supervision leads to more robust discussions with institutions and early responses to inadequately controlled risk-taking, from which both sides gain. To support continuous improvement, the report draws some recommendations that flow from the discussions among members of the SIE group.

List of recommendations:

More intense SIFI supervision

The following recommendations are aimed at intensifying SIFI supervision but they are also applicable for the supervision of financial institutions more generally.

1. Supervisors should adopt proactive approaches to assess succession planning and set performance expectations for key positions within SIFIs (e.g. CEOs, CROs, Internal Auditors), elements that should no longer be regarded as only internal matters for financial institutions. At a minimum, supervisors should require that firms have robust processes in place to ensure effective talent management and succession planning for leaders of control functions and other key positions. They also should be informed of the rationale for appointments to such positions in advance of the appointments being made.

2. Supervisory interactions with Boards and senior management should be stepped up, in terms of frequency and level of seniority, as should the assessment of the effectiveness of Boards and senior management. Supervisors should satisfy themselves that SIFIs have a robust process in place to assess applicants for Board-level or senior management positions and should be informed of the rationale for Board appointments in advance of such announcements.

3. Supervisory authorities should continually re-assess their resource needs; for example, interacting with and assessing Boards require particular skills, experience and adequate level of seniority. Multi-year resource plans, supervisory training programs, long-term career paths and development of "soft" skills, such as leadership and communication skills, are essential. The SIE will review supervisory approaches to and emphasis on training programs in the coming year.

4. Supervisors of G-SIFIs need to ensure that the stress testing undertaken for G-SIFIs is comprehensive and commensurate with the risks and complexities of these institutions and should advance further with the implementation of the BCBS *Principles for Sound Stress Testing Practices*.

5. Supervisors should further explore ways to formally assess risk culture, particularly at G-SIFIs. Establishing a strong risk culture at financial institutions is an essential element of good governance. Metrics such as audit findings not being closed and

employee survey results could allow conclusions about culture to be reached on an ongoing basis and before major issues arise due to weak risk cultures. Supervisors should also expect financial institutions to be proactive in this regard. The SIE will discuss supervisory practices and approaches toward assessing risk culture.

6. Supervisors need to evaluate whether their approach to and methods of supervision remain effective or have, for example, moved too far toward focusing on adequacy of capital and control systems, and away from detailed assessments of sources of profits and financial data. The SIE will explore this further, including resource implications relative to the benefits of increasing focus in the latter areas.

7. Supervisors need to consider putting in place additional data management and analysis processes for the information available from a range of sources, such as that collected by trade repositories and other centralised sources of financial data, so that key players in markets and market anomalies are identified. Supervisors should explore how this new information could be useful in the supervision of SIFIs.

8. By the end of 2013, the FSB SIE group should report on progress toward addressing these issues and set out best practices or recommendations for how to enhance the effectiveness of supervision in each of the above areas.

Assessment of effective supervision

9. The FSB's initiative on promoting adherence to regulatory and supervisory standards focuses on banking supervision, insurance supervision and securities regulation and views the IMF-World Bank FSAPs and ROSCs as central mechanisms for promoting implementation of the BCBS, IAIS and IOSCO core principles. However, there are differences in the assessment methodology and ratings nomenclature in regard to the: (i) use of discretion in the assessments to take account of proportionality and materiality; (ii) degree to which standards are aspirational versus minimum requirements; and (iii) messages communicated given the different terminology for ratings, particularly when applied to core principles that address similar areas. As the FSB places increased reliance on FSAPs and ROSCs and focuses on SIFIs (which can be from any sector), the FSB, in collaboration with the IMF, World Bank and standard setters, should examine the pros and cons of harmonising the assessment methodology and ratings nomenclature.

10. Emphasis must continue to be placed on the fundamental requirements for effective supervision, particularly in regard to official mandates, resources, and independence as FSAPs and ROSCs continue to indicate problems in these areas. The BCBS, IAIS, and IOSCO core principles provide a clear benchmark for what is needed to achieve effective supervision, and the enhanced BCBS and IAIS core principles raise the bar by placing greater emphasis on these issues. Governments should commit to implementing the BCBS, IAIS and IOSCO core principles for effective supervision and the IMF/World Bank should actively monitor progress toward full implementation through FSAPs and ROSCs. In addition, the FSB should enhance its monitoring of these areas, leveraging for example on the FSB Implementation Monitoring Network exercise, to ensure that adherence to these core principles becomes a matter of ongoing attention and public disclosure.

11. The IAIS should follow-up on its findings from the self-assessment exercise against ICP 23 on group-wide supervision, including the challenges and prerequisites for effective group-wide supervision and ensuring supervisors have the powers to act at the level of the holding company. The IAIS should report to the SIE by end 2013 on the progress made toward achieving group-wide supervision and equipping supervisors with the appropriate powers to act at the level of the holding company.

Operational risk

12. The recent spate of high-profile, and potentially solvency-threatening, operational risk events and failures have added some urgency to fundamentally reviewing the BCBS approach toward capital for operational risk. The BCBS should update its capital requirements for operational risk by the end of 2014.

13. The BCBS should conduct a peer review on implementation of its *Principles for the Sound Management of Operational Risk* by June 2014. The BCBS should supplement the review with an assessment of the additional guidance needed on operational controls within capital markets and trading businesses.

14. The BCBS should conduct a study of its *Supervisory Guidelines for the Advanced Measurement Approaches* by end 2015 to assess whether any changes are necessary to enhance their effective implementation and to bring more consistency to supervisory approaches in this area.

15. The IAIS should maintain its timeline for launching a peer review in 2014 to assess effective implementation of ICP 16 on enterprise risk management for solvency purposes and ICP 17 on capital adequacy, as both principles cover operational risk.

Supervisory colleges

16. The FSB, in collaboration with the standard setters, should intensify efforts to increase the effectiveness of supervisory colleges, particularly for G-SIFIs. Given the strong interest and expectation of colleges expressed through the G20 process, it is critical that the FSB further consider ways to ensure adequate exchange of information and cooperation within core supervisory colleges, as well as avenues to promote joint decision making processes in the future. The FSB should submit a report to the September 2013 G20 Summit which sets out policy recommendations to address the issues identified as hindering the effectiveness of core supervisory colleges.

17. The BCBS and IOSCO should monitor the establishment and composition of core (and universal) colleges as well as assess the activity of new colleges and frequency of existing colleges (as the IAIS does) and report progress to the FSB on an annual basis.

I. Introduction

The 2010 FSB report on enhancing supervision set out 32 recommendations for making the supervision of financial institutions more intense, effective and reliable.[3] The report noted that supervisory work was often not geared toward outcomes but more focused on process and that supervisory expectations for SIFIs in particular needed to increase. The 2011 FSB progress report noted that supervisors are making headway in addressing many of the issues identified.[4] Members of the FSB Supervisory Intensity and Effectiveness group (SIE), which is comprised of senior supervisors, continued to meet and discuss examples of supervisory practices that get to the essence of the firm's risk and how it is being managed as well as actions being taken to strengthen controls at SIFIs. The SIE's discussions represent an ongoing forum for unearthing issues early and this report covers other areas that emerged from those discussions with particular focus on financial institutions that are clearly systemic in a global context (G-SIFIs).

Supervision operates on a continuum; supervisory approaches and the types and volumes of resources dedicated to the supervision of SIFIs evolve depending on the complexity of the financial system and the financial institutions that comprise it. Self-regulation and light-touch supervision have clearly been rejected and supervisors are re-considering approaches for ensuring the resilience of the financial system. As such, supervisory methods are increasingly becoming more direct and more intense, particularly in areas previously considered the firm's entrepreneurial autonomy. The challenge for supervisors is to strike the right balance between taking a more intensive, proactive approach and shaping strategic decisions of firms' management. Section II discusses several areas where supervisory oversight has become more intense and more intrusive such as supervision of G-SIFIs and various risk dimensions including corporate governance, risk culture, and operational risk, as well as evolving supervisory methods to enhance effectiveness (e.g. "follow the money", stress testing).

Supervisory authorities are generally complementing a rules-based approach with an approach that provides a more comprehensive understanding of the business of the SIFI or G-SIFI, and rests on the ability and willingness of experienced supervisors to engage in credible and sceptical conversation with senior management and directors. This approach embeds a deeper understanding of the financial institution's business model, strategy and culture which collectively determine how firms make money and the kinds of risks they are willing to undertake. In some respects, a "follow the money" approach entails a return to more traditional diagnostic tools, such as financial statement analysis, to help identify emerging risks.

Adopting a forward looking and strategic approach to supervision requires an elevation of supervisory skills and increased depth of experience along with an increase in the volume of resources. The ability to attract and retain resources was an area identified in the 2011 FSB report as hampering progress toward improving the intensity and effectiveness of supervision. The SIE followed up on this finding and assessed in more detail the resource constraints at

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[3] See the 2010 FSB report *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* which can be found at http://www.financialstabilityboard.org/publications/r_101101.pdf.

[4] See the 2011 FSB *Progress Report on Implementing the Recommendations on Enhanced Supervision* which can be found at http://www.financialstabilityboard.org/publications/r_111104ee.pdf.

supervisory agencies, including the kinds of resources that are needed to "follow the money" and enhance oversight of operational risk management. See Section III.

To enhance effectiveness, supervisors discussed how to better leverage (core) supervisory colleges (see Section IV). While core colleges have been established for all G-SIFIs that are banks with relevant global operations, these colleges are yet to undertake joint work among their member supervisors as a matter of course. Information exchange and supervisory cooperation need to be made more effective, which could help to identify emerging risks and facilitate better use of available resources through enhanced coordination and reduced duplication of activities.

Assessing effectiveness of supervision remains a challenge. At the core of supervision are the global standards against which supervisors are assessed as part of the IMF and World Bank FSAP and Reports on the Observance of Standards and Codes (ROSCs). Indeed, the recently issued enhanced principles for effective supervision issued by the Basel Committee on Banking Supervision (BCBS) in 2012 [5] and the International Association of Insurance Supervisors (IAIS) in 2011[6] have raised the bar for supervisors, including with respect to resources, independence and supervisory tools. Following up on the recommendation set out in the 2010 FSB report, FSB member jurisdictions completed a self-assessment against certain Insurance Core Principles (ICPs) which mirrored the exercise conducted in 2011 against similar BCBS core principles for banking supervision. Section V summarises the outcomes of the self-assessments and discusses how these core principles provide much needed guidance to jurisdictions to aid in the strengthening of supervisory regimes.

II. Notable areas of more intense and more intrusive supervision

1. G-SIFI supervision

Supervision operates on a continuum and supervisory approaches evolve depending on the type of institution, e.g. whether small- or medium-sized, a SIFI or a G-SIFI. Supervisory authorities generally adopt a "risk-based" approach in order to effectively prioritise the use of limited supervisory resources among different supervised institutions and different areas within a G-SIFI. This prioritisation of supervisory objectives and activities – that explicitly or implicitly has to be done in any case – must be undertaken within a rational strategy, and subject to periodic review and challenge. This is because it is not free of risk, it can overlook unperceived correlations among apparently low risk institutions or it can fail to perceive material risks in areas or institutions previously considered as low or moderate risk. Without this periodic, high-level review, risk-based supervision can be risky because areas not covered in-depth by supervisors could be a source of material weakness that is not evident. At the same time, risk-based supervision is a necessary approach. A G-SIFI can have close to 8,000 people in risk management, compliance and internal audit. Supervisory teams, on the other

[5] The Basel Committee *Core Principles for Effective Banking Supervision* can be found at http://www.bis.org/publ/bcbs230.pdf.

[6] The IAIS Insurance Core Principles, Standards, Guidance and Assessment Methodology can be found at http://www.iaisweb.org/db/content/1/13037.pdf.

hand, (which could be anywhere from 40-150 people for a specific G-SIFI) cannot replicate this coverage and must therefore zero in and focus on the areas that seem to present the highest risks in the foreseeable future.

Especially in the case of G-SIFIs, risk-based supervision is, by definition, risky as all areas cannot be covered and there is the potential to move resources and focus from areas of greater emerging risks to other areas. Striking the right balance between dedicating enough resources to the highest risks and also ensuring some periodic coverage of all aspects that might prove risky *ex post* will be an ongoing challenge. To enhance effectiveness, supervisors should be able to leverage off new and deeper information sets and analysis, such as the information that can be made available from central repositories and other centralised sources of financial data so as to track anomalies in the market, and information from recent initiatives such as implementation of recovery and resolution plans which provide supervisors with new insights.

Supervisors are experiencing a mind-set shift when dealing with G-SIFIs and are increasingly adopting an approach that rests on the ability to reach a comprehensive understanding of the financial institution's business model, its sustainability, the risks involved and the processes in place to protect against those risks. In some cases, this may imply a greater level of involvement in what previously would have been considered the financial institution's entrepreneurial autonomy. This shift has occurred to varying degrees and to the point where some supervisors act as stakeholders in the financial institution (e.g. interviewing senior management, rejecting nominations, and approving bonuses and dividend distributions). This not only involves supervisory judgement but also taking on some risks and responsibilities that typically reside within the remit of a firm's management. Importantly, supervisors need to strike the right balance between a more intensive and more intrusive approach to G-SIFIs and shaping strategic decisions of a firm's management. This more prominent role for supervisors requires the ability and willingness to make difficult decisions.

The shift toward an anticipatory and strategic approach to G-SIFI supervision requires a significant change in culture within the supervisory organisation. The approach rests on the ability and willingness of experienced supervisors to focus on the big picture; to come to judgements that are forward looking in an attempt to anticipate outcomes relative to the biggest, solvency-threatening risks; and to engage in credible and sceptical conversation with the Board and senior management on the firm's business strategy and effectiveness of the risk governance of the firm. Supervision of G-SIFIs is about the ability to make credible judgements and to act on them. This underscores the need for supervisory authorities to be equipped with high quality and experienced resources (see Section III).

This supervisory approach presents several challenges, in terms of availability of up-to-date information and quantitative frameworks to support data analysis; adaptability of supervisory cycles to the speed with which complex firms can change activities and business models; achieving a good balance and allocation of resources between "planned" forward looking supervisory work on a rolling basis and effective "responsive" supervisory work that acts promptly to address emerging risks.

2. Corporate governance

Effective governance is clearly in the interests of the financial institutions' shareholders, but it is increasingly recognised that supervisors might – and should – play an active role, particularly in conveying elevated expectations for strong risk governance and oversight.[7] Supervisors are engaging in various ways with SIFIs on the effectiveness of their governance framework. Some authorities are increasing their engagement with Board members, including more frequent meetings with non-executive directors, and some supervisors are directly involved in the approval of Board members and the C-Suite.[8] Meanwhile, other authorities have focused their actions on "getting to strong" at financial institution's second and third lines of defence, with an emphasis on the CRO and internal audit functions and requiring the chief risk and audit executives to have a seat at the table in the Board room. There is also an increased emphasis on the need for robust and effective succession planning by institutions and heightened supervisory attention to this important area.

2.1 Engagement with the Board

Supervisors are increasingly targeting their actions toward understanding and addressing governance effectiveness. While the definition of what constitutes effective governance is evolving, supervisory views seem to converge on the following key expectations: an effective Board (i) sets the "tone from the top" (a tone that conveys the financial institution's risk culture); (ii) ensures that a high-quality executive team is in place and monitors the ability of the executive team to execute the agreed strategy; (iii) understands the business model and is well informed and comfortable in discussing with management the potential threats to the viability of the financial institution; (iv) challenges management on the adherence to the agreed risk appetite framework; and (v) encourages dialogue and debate, which is supported by comprehensive, reliable and understandable information on the relevant issues for the financial institution and its business activities. In addition, the Board should have well-diversified membership in order to broaden the view on the business strategy and to foster an informed, open and thoughtful dialogue on the relevant issues.

Supervisors are increasingly engaging with the Board, in particular non-executive directors, to ensure that Boards are focused on the higher level strategic and risk issues. Regular engagement with directors and people in key roles, especially Board-level committee chairs or influential non-executive directors, can provide supervisors with a better understanding of the financial institution's governance and of the people involved. This should be supplemented with meetings with the full Board to ensure that supervisory concerns are conveyed appropriately to all directors. More intense and frequent engagement with the Board can happen in a continuum, via more formal supervisory actions (such as horizontal reviews of Board effectiveness), through regular supervisory discussions with the Chair and other key directors (such as the Chairs of relevant Board committees), or periodically attending Board meetings. The latter can be particularly valuable in conveying that concerns exist over the

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[7] The FSB launched a thematic review on risk governance in April 2012 and the report is expected to be published in early 2013. The questionnaire that was completed by FSB member jurisdictions can be found at http://www.financialstabilityboard.org/publications/r_120404.pdf.

[8] The C-Suite refers to the Chief Executive Officer (CEO), Chief Risk Officer (CRO) and Chief Financial Officer (CFO).

Board's effectiveness. Some supervisors also note the importance of seeing first-hand the behavioural dynamics between Board members to assess their effectiveness. To help establish a relationship with directors and facilitate the exchange of information, supervisory teams should be stable, underscoring the need to ensure authorities continue to recruit and retain quality talent in the supervisory ranks.

2.2 Assessing firms' senior management

Approval of top people in charge (e.g. Board members, the C-Suite, Treasurer) is a practice among a few supervisors amid recognition that individuals in key management positions can play a critical role in establishing the "tone at the top" and shaping the culture of their organisation. A few supervisors share the view that more proactive and intense involvement with key functions should be adopted, particularly for large complex institutions with several thousand people and operations that extend across several borders. These actions could go as far as rejecting nominations for top management positions.[9]

While the degree of engagement in the appointment process for directors and senior management varies, it is essential for supervisors to regularly engage with the top people in charge either *ex ante* or *ex post* in order to monitor the performance of the Board and senior management.

At a minimum, supervisors should satisfy themselves that financial institutions have processes in place to robustly assess applicants for a Board position or a role in senior management at a SIFI and that recruitment standards ensure that applicants are qualified and competent in a manner that is proportional to their prospective role. Supervisors should also be given the institution's rationale for the nomination, including how the individual will add value to the existing Board or to senior management. Financial institutions should expect supervisors to intervene early in cases of poor management performance or Board ineffectiveness.

2.3 The CRO and Internal Audit functions

Strong, independent and competent CRO and internal audit functions are especially important for SIFIs. As such, some authorities have heightened supervisory expectations for SIFIs by setting a plan for "getting (from satisfactory) to strong" CRO and internal audit functions.[10] "Getting to strong" for these functions rests on an upgrade of the leadership – both stature and expectations need to be elevated to the level of the top executives. The CRO and Chief Audit Executive should have a "seat at the table" and have the personal capacity and authority to be

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[9] Notably, in recent years, the UK FSA enhanced its supervisory approach toward the approval and supervision of significant influence functions (SIF), with the purpose of ensuring a balanced and effective Board and senior executive team, comprised of individuals having the risk skills set. A significant influence function refers to roles that can exercise material influence over the running of a firm. See the UK Financial Services Authority Policy Statement on *Effective Corporate Governance* which can be found at http://www.fsa.gov.uk/pubs/policy/ps10_15.pdf.

[10] In the US, the OCC has directed audit and risk management committees at large banks to perform gap analysis relative to the authority's standards and industry practices and to take appropriate actions to improve their audit and risk management functions. SIFIs that are considered less than strong have to submit remediation plans to close any gaps. The examiners evaluate the state of the key oversight functions as part of their on-going supervisory review and identify key areas that require strengthening. See the June 19 2012 testimony of Thomas J. Curry, Comptroller of the Currency, before the US House of Representatives Financial Services Committee, which can be found at http://www.occ.treas.gov/news-issuances/congressional-testimony/2012/pub-test-2012-91-written.pdf.

able to challenge senior management and line managers on the business strategy in light of the risk appetite framework that has been set for the financial institution. They should be supported by strong underlying functions, including the ability to influence the budget, as well as quality resources (i.e. the best risk people should not all reside within the business units).

The Board and CEO need and depend on quality oversight functions to ascertain that the stated risk appetite is being followed, as well as embedded into the culture of the financial institution, and that the firm's policies and procedures are effective in supporting the risk appetite framework. The role of the CRO is critical for establishing an effective link between the Board and the business units on the financial institution's risk-taking strategy. A *strong* CRO should be able to present risks in a thematic way to the Board, be able to identify similar risks and control needs across an organisation, and when risks in one area surface, will probe to see if similar risks exist in other areas of the firm.

At the same time, the financial crisis, and more importantly recent events, demonstrates that internal audit functions should be empowered to constitute an effective third line of defence, which takes an active oversight approach on the appropriateness and effectiveness of firms' policies and processes. The recent Basel Committee guidance on internal audit encourages banks to build on the three lines of defence model to develop a robust relationship between the internal audit, compliance and risk management functions.[11] A *strong* internal audit function has equal stature as the CRO function and reports directly to the Board-level audit committee, is independent from business units and has the organisational support that ensures identified weaknesses are remediated in a timely manner.

2.4 Succession planning

Succession planning for senior management positions is of critical importance and helps to lessen the influence of dominant personalities and behaviours. Given the critical importance of experienced and highly qualified leaders to the financial institution's safety and soundness, it is essential to have effective and actionable succession plans for senior management, particularly those in the control functions. Financial institutions, in particular SIFIs, should have personnel management processes that ensure not only appropriate quality of staffing at senior levels but also provide for the proactive identification of staffing gaps and orderly succession in key positions. A pool of talent should be developed with enough experience and sufficient exposure to the top management throughout their career.

Supervisors should require financial institutions, particularly G-SIFIs, to have an active succession planning process and to prepare persons for leadership. More regular and focused review of succession planning at financial institutions should include consideration of both the process and the identified candidates. Supervisors should also engage with the Board-level

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[11] The Basel Committee on Banking Supervision issued in June 2012 a revised supervisory guidance for assessing the effectiveness of the internal audit function in banks. This guidance is applicable to all banks but is particularly relevant for systemically important ones. Beyond developing supervisory expectations relevant to the internal audit function, it recommends to have an internal audit function with sufficient authority, stature, independence, resources and access to the Board. Further, the document makes recommendations with regard to the relationship of the supervisory authority with the internal audit function, and the supervisory assessment of the internal audit function. The document can be found at http://www.bis.org/publ/bcbs223.pdf.

human resources committee to better understand the process. Knowledge of the identified successors provides an opportunity for supervisors to engage with these individuals in their current roles and will help to inform their views around the quality of these individuals especially in regard to management of risks at G-SIFIs.

3. Risk appetite and culture

Financial institutions have a long history of establishing risk limits for business activities, business units or legal entities, and these limits are sometimes generically referred to as the financial institution's stated risk appetite. Financial institutions, however, are more complex today as reflected in some SIFIs having several hundred risk metrics, which often lack comparability across business units and risk categories. The breadth of risk metrics, coupled with inadequate information technology (IT) systems to aggregate and identify risk exposures, are challenging financial institutions' ability to implement a risk appetite framework that is actionable and measurable.[12] This has hindered the ability for senior management to instil a strong risk culture across the spectrum of staff as the articulation of the financial institution's risk appetite and risk culture are mutually re-enforcing.

Indeed, risk appetite has become a common topic among Boards and senior management as it is a key element in the articulation of the strategic direction of the firm in terms of risk taking. However, much more evidence of risk appetite being translated down into the firm's culture and manifested in operational practices is needed, particularly in remuneration practices. While culture is difficult to measure, financial institutions should pay more explicit attention to this, as should supervisors. Important signals of a sound risk culture and control environment are that problems are recognised and escalated as appropriate, the financial institution's risk tolerance is clearly communicated, and controls and incentives exist for the financial institution's risk profile to remain within desired boundaries. A combination of discrete metrics, such as the number of risk limits breached and the cause; the manner in which problems identified in internal audit reports are addressed; and the pre-existing awareness of the problems (i.e. was management surprised by the findings) can help to assess a financial institution's risk culture. Supervisors should assess whether Boards have devoted sufficient discussion and time to ensure that the stated risk appetite aligns with the risk culture of the financial institution and have established a process for conveying and assessing the firm's culture, such as workshops, presentations, employee surveys or on-line tutorials.

To get at this issue, over the past year SIE members reviewed risk appetite statements at financial institutions and discussed some elements they would like to see contained within a financial institution's risk appetite statement to ensure a sound risk culture. Supervisors expect an effective risk appetite statement to:

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[12] The 2011 FSB report set out a recommendation for the FSB, in collaboration with the standard setters, to develop a set of supervisory expectations to move firms', particularly SIFIs, risk 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. The BCBS principles for effective risk data aggregation and risk reporting are expected to be finalised at the end of 2013.

- be a catalyst for discussion and strategic decision-making at the Board and senior management levels (e.g. whether to expand into a business line or area, whether an acquisition aligns with risk appetite);
- have strong linkages with the corporate strategy, capital and budget;
- set the tone for the desired operational behaviours (e.g. linked to performance review and compensation);
- include qualitative statements and a reasonable number of appropriately selected risk metrics (i.e. the number of metrics should not be overwhelming);
- have risk metrics that are linked to the financial institution's risk exposures, are measurable, frequency-based, understandable, comparable (e.g. capital, earnings, risk-weighted assets) at the Board and business unit levels, and relevant over time;
- allow a forward-looking view of the financial institution's desired risk profile under a variety of scenarios;
- be owned by the Board and developed by senior management, with active involvement across all key areas of the institution including the CEO, CRO, CFO and Treasurer;
- be supported by appropriate controls and stress tests as these are needed for financial institutions to articulate and stay within a stated risk appetite; and
- be supported by a strong culture (i.e. the business should understand that compliance with a set risk appetite is essential, but the culture needs to constantly ask whether risks have been identified, whether limits are still appropriate, etc.).

4. Operational risk

Operational risk is the common link between several headline events in the past several months (e.g. UBS rogue trader, MF Global, Global Payments, LIBOR manipulation, HSBC AML events, JP Morgan synthetic credit transaction losses, Standard Chartered AML events, and Knight Capital). These events underscore the need for supervisors to increase focus on operational risk management, in particular for G-SIFIs, to improve the resilience of the financial system and overall confidence. The capital regime for operational risk is far less advanced compared to the regime for market risk and credit risk. More importantly, certain risks such as business continuity cannot be addressed by capital; if a SIFI cannot resume operations following an event, capital cannot restore operations. Consequently, firms and supervisors should focus more on the prevention and detection of operational risk as a complement for appropriate capital underpinning operational risk.

Operational risk covers a myriad of risks across the enterprise, including people risk, outsourcing risk, internal and external fraud, money laundering, technology risk, etc. Risk culture is also related to operational risk in part because operational risk includes people risk: i) inadequate training; ii) insufficient personnel needed to adequately perform required tasks; iii) dependency on a limited number of qualified persons (e.g. key person dependency); iv) misalignment of business objectives and compensation programs; and v) inadequate mind set of control teams. However, financial institutions with a strong culture of operational risk management and ethical business practices are less likely to experience potentially damaging operational risk events and are better placed to deal effectively with those events that do occur. A strong culture of operational risk management means, among others, that:

- remuneration practices are aligned with the firm's overall risk-taking, including operational risk;
- the operational risk framework should be implemented so as to be appropriately integrated into the risk management processes of the financial institution;
- as part of internal controls and reporting systems, the financial institution is proactive in dealing with actions which are considered fraudulent or suspicious in key business activities (such as trading).

The BCBS *Principles for the Sound Management of Operational Risk* ('Sound Practices') set forth key principles and tools that assist financial institutions in identifying, measuring, monitoring and mitigating operational risk if implemented effectively.[13] The 2011 Sound Practices document uses a three line of defence concept.[14] Considering the broad scope of operational risk and the three lines of defence, many financial institutions are moving toward a model whereby second line of defence responsibilities are formally assigned to other independent groups with sufficient expertise in these areas, such as Information Security, Privacy, Technology Risk Management, Corporate Security, Business Continuity, Compliance, etc. These other groups then become actively involved in challenging the risk and control assessments that are developed by the first line of defence, such as new initiatives (e.g. outsourcing, acquisitions, system changes), new products and other tools outlined in the Sound Practices.

Supervisors discussed expectations for all G-SIFIs to move to a model whereby second line of defence responsibilities are assigned to independent groups with appropriate staffing and expertise and for supervisors to verify firms' progress. Supervisors should also assess the extent to which the Board and senior management play a role in establishing a strong operational risk management culture and are adequately involved in overseeing operational risk management practices. The IAIS core principle for enterprise wide risk management for solvency purposes (ICP 16) sets out guidance for supervision of operational risk management, which includes supervisory requirements for the insurer's Board and senior management to be responsible for the firm's own risk and solvency assessment. The IAIS is expected to launch a peer review against ICP 16 in 2014.

4.1 Capital

For many types of operational risk, regulatory capital acts as an additional prudential mitigant

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[13] The June 2011 BCBS Principles for the Sound Management of Operation Risk can be found at http://www.bis.org/publ/bcbs195.pdf and the June 2011 Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches can be found at http://www.bis.org/publ/bcbs196.pdf.

[14] The first line of defence is business/operational management (i.e. the business unit manages the business on a day-to-day basis, they own the risks and are the ones first and foremost responsible for identifying and managing the risks of their business). The second line of defence is the independent group that applies challenge to the risk assessment and control activities performed by the first line of defence. The third line of defence is an independent review and challenge of the financial institution's operational risk management controls, processes and systems.

should a financial institution not effectively identify or reduce the risk, and should an event materialise into a large loss. In the case of JP Morgan, the loss on synthetic credit transactions was large but the financial institution's solvency was not threatened due to its strong underpinnings (e.g. capital, reserves, and liquidity).

Recently, however, concerns have been raised regarding the capital approaches to operational risk as they were originally established during a period of limited operational risk data to support the various underlying components. Supervisors have found real weaknesses in the assessment of capital for operational risk and in the models used and their assumptions, leading to the need for material increases in capital.

The recent spate of high-profile, and potentially solvency-threatening, operational risk events and failures have added urgency to fundamentally reviewing these capital approaches.

The IAIS core principle on capital adequacy (ICP 17) includes guidance on the treatment of risks that are difficult to quantify such as operational risk and the IAIS will launch a peer review against this principle in 2014. In addition, the draft ComFrame paper for the supervision of internationally active insurance groups (IAIGs), which is currently in its development phase to be followed by a field testing phase, builds on and complements the ICPs for IAIGs. The current draft paper includes elements about an IAIG's enterprise risk management framework and an IAIG's calculation of its group regulatory capital, taking into account the relevant and material categories of risk, which include operational risk.

4.2 Capital markets trading

Members of the SIE discussed operational risk with respect to trading as well as trade confirmation controls, trader supervision controls, and information security and logical access controls. Supervisors discussed the fact that there is not a lot of guidance available for supervisors on what controls to expect, or how frequently supervisors should verify the effectiveness of controls at financial institutions.[15]

While the BCBS has published guidance on Sound Practices it has not published guidance related to operational controls within capital markets and trading operations. It is recommended that BCBS establish minimum control standards for managing operational risk within capital markets and trading operations. Further, some supervisors recommend that on-site reviews of areas like trading operations of SIFIs only be done with joint teams of market risk and operational risk specialists so as to ensure full coverage of the risks of trading operations.

5. "Follow the money"

Analysing strategic and tactical business plans as well as *pro forma* financial statements is a

[15] Following the UBS rogue trading event in the late summer of 2011, the Swiss Financial market Supervisory Authority, FINMA, issued guidance on unauthorised trading, which can be found at http://www.finma.ch/e/finma/publikationen/Documents/finma-mitteilung-31-2011-e.pdf. In October 2010, the European Banking Authority issued Guidelines on Management of Operational Risks in Market Related Activities which can be found at http://www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Management-of-op-risk/CEBS-2010-216-(Guidelines-on-the-management-of-op-.aspx.

time honoured component to supervision. Given the complexity of financial institutions, supervision has gradually moved away from analysing revenue flows and variability to placing more emphasis on risks and controls. More recently, however, supervisors have been trying to gain a better understanding of the firm's business as a precondition to better understanding its risks. The underlying analysis to "follow the money" allows supervisors to disentangle the revenue streams and lines of business returns, and put supervisors in a much better position to discuss revenues and corresponding risks in light of the communicated strategy, adequacy of capital, liquidity, and the various lines of defence. Further, recent evolutions in business models that are occurring among major financial institutions, and especially the move toward fee-based businesses, render the computation of risk-weighted assets and related prudential measures less informative on the overall potential risks of the institution. It is becoming therefore increasingly important to focus again on the source of, and change in, revenues within firms and across the financial sector. Financial analysis activities are important complements to the foundational supervisory role of understanding a financial institution's business objectives, the risks taken related to those objectives, and the controls that should be in place to mitigate those risks.

Discussions among supervisors, however, reveal that more intense focus and elevated skills are needed to deliver quality and timely anticipatory analyses. The current needs are elevated due to the size and breadth of business activities in the largest financial institutions, coupled with the uncertain operating environment and high frequency of changes to business models. Some supervisors have started to build resources with specific additional financial analysis skills, either by hiring personnel with previous expertise or by developing expertise through secondments of staff for short periods, for instance, to equity analysis groups at financial institutions. The benefits of focusing supervisory work more on "follow the money" are seen in: i) the ability to uncover issues early, which allows proactive and timely interventions; ii) a better understanding of the underlying sources of risk and thus an improved ability to continuously challenge management and benchmark the firm's performance, for example during capital planning reviews or strategy discussions; and iii) better informed decisions for risk-based supervision, as this approach supports the identification of potential hot spots. How best to achieve this outcome, in terms of the necessary supervisory tools and the needs of supervisory resources and skill sets, is something that supervisors deem as worth exploring further.

A challenging aspect, however, is what to do about the results of such in-depth analysis. It is a shared view among supervisors that the primary responsibility to deconstruct income statements and earning flows rests with the financial institution, and supervisors should not – as in other areas too – substitute their judgement for that of management in taking strategic decisions on the viability of the business. Ultimately, "follow the money" is seen as an important tool for increasing the intensity and level of engagement of supervisors with Boards and management to the extent that it facilitates a robust discussion of management's proposed strategy, while supporting the effectiveness of traditional supervisory intervention tools.

Finally, because the ultimate responsibility needs to rest with the financial institution, CFOs have a key role in this area since they are responsible for the accuracy of revenue statements, and should be capable of deconstructing and illustrating the revenue flows to the Board, which approves the business plan.

6. Stress testing

The Basel Committee recently published the results of a peer review of supervisory authorities' implementation of the BCBS stress testing principles issued in 2009.[16] The review finds that countries are at varying stages of maturity in the implementation of the principles, with nearly half of the countries at an early stage. The general outcome is that more detailed comprehensive reviews of firms' enterprise-wide stress testing governance and modelling as envisaged in the 2009 BCBS principles require expert skills and resources at both financial institutions and supervisory authorities, and as a result, they have not become standard practice in many countries.

The peer review highlighted that there are different supervisory approaches and it is difficult to state which is most effective. A small number of countries indicated that stress testing has become a tool for actually setting capital requirements. In other countries, even those with fairly advanced stress testing programs, stress testing was seen as one of several tools in assessing capital adequacy and there was a reluctance to place primary reliance on stress test scenario outcomes.

As more experience is gained, an important lesson from these exercises is that the focus of supervisory action should be on the effectiveness of firms' processes in place – for planning, managing, and allocating capital – and for assessing whether capital is adequate to withstand a stressful economic environment. Excessive attention on the part of supervisors to the outcomes of stress tests rather than on the effectiveness of firms' stress testing processes might create a false sense of security. In particular, in the case of SIFIs, interaction with financial institutions should avoid turning the exercise into a tick-the-box compliance exercise, and should instead be used to test and strengthen the effectiveness of firms' own stress testing capabilities as dynamic, forward looking risk management tools.

Stress tests can be extremely useful to support informed discussions with the firms about prospective risks, risk management strategies, and sustainability of capital plans in light of those risks and activities. At the same time, the technicalities of the exercise, the dependency of the results on the initial assumptions, including the severity / credibility of the scenarios, and the communication challenges, require a note of caution. Supervisors should be mindful of an excessive reliance on the results of the stress test and should ensure that the exercise is complemented by important elements of good practice: use of judgement to mitigate the technical shortcomings; strong governance processes; full buy-in from all parties involved; a clear follow-up plan tailored to the specific objective of the exercise; and a clear communication strategy.

III. Resource constraints

Adequate supervisory resources (quantity, quality and expertise) remain an issue in many FSB jurisdictions, particularly at the most senior levels. While resources at most supervisory

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[16] See BCBS Peer review of supervisory authorities' implementation of stress testing principles, April 2012 at http://www.bis.org/publ/bcbs218.pdf.

authorities have increased since the financial crisis, the increase has not corresponded with the growth in the amount of new regulation supervisors must oversee and other supervisory initiatives. These initiatives include Basel III, crisis management groups and stress testing, as well as implementation of the FSB policy measures for G-SIBs, including more intense and more effective supervision, resolution and recovery plans, crisis management groups, and data gaps initiative. International cooperation, be it in the form of supervisory colleges or participation on cross-border supervisory and regulatory initiatives, both at the international and regional level, require a higher number of resources. Further, new supervisory approaches, such as "follow the money" analyses and increased focus on operational risk management, are likely to require a set of resources with different skills than those that were traditionally employed.

Operational risk creates some unique supervisory issues in the area of resourcing and building supervisory teams which can greatly affect supervisory intensity and effectiveness. In the area of operational risk, many supervisors note a lack of development of technical and analytical knowledge and hence bench strength. Some supervisors view operational risk specialists as focused on ensuring compliance with capital requirements (for example assessing advanced measurement approach operational risk models used by some global financial institutions) versus being focused equally on day-to-day on-site supervision; others have operational risk supervisors focus on whether financial institutions are implementing the three lines of defence and other operational risk oversight matters.

Supervisors are indeed taking on more responsibilities, and consequently face increasing likelihood of not being able to spend sufficient time on risk issues. As such, the need for remedial action to address supervisory resource constraints needs to be taken seriously.

To get at the crux of resource constraints, SIE members completed a questionnaire aimed at assessing the resource constraints at supervisory authorities, particularly in the oversight of SIFIs and G-SIFIs (see Annex A). In addition, the IMF reviewed nine recent FSAP assessments regarding the adequacy of supervisory resources.[17] Collectively, they describe some of the challenges supervisory agencies face in building the capacity required for the supervision of financial institutions, particularly of G-SIFIs.

1. ***An immediate challenge is determining the supervisory staff required, not only in regard to numbers but also seniority and skill mix***. The number of required full-time supervisors per regulated institution is difficult to estimate given the wide variations in how supervisory agencies are organised and operate, and the evolution of supervisory approaches. For instance, one jurisdiction, which is an outlier, dedicates almost three times as many supervisors to each G-SIFI as any other jurisdiction represented in the SIE. Moreover, some supervisory authorities have a broader mandate than solely prudential supervision of financial institutions (e.g. market conduct) or may draw on expertise from areas outside the supervisory function such as research, or supplement internal resources by making use of third parties.

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[17] The countries included in the sample analysis are: China (2010), US (2010), South Africa (2010), Netherlands (2010), Luxembourg (2010), Germany (2011), UK (2011), Sweden (2011), and Mexico (2011). Supervisory standards of the BCBS, IOSCO, and IAIS have been considered; all information comes from documents that have been published.

The “will to act”, however, is a more important precondition for supervisory effectiveness than the sheer size of the team. Promoting a “will to act” requires supervisors to have independence, a clear mandate that drives “will to act”, and the capacity to attract and retain experienced senior staff with the ability to exercise supervisory judgement and effectively challenge SIFI management.

2. ***Attracting and retaining quality supervisory staff remains a challenge***. Some FSB jurisdictions observe that their budgets have been regularly cut back, influenced in part by public and government expectations for budgetary restraint. Many SIE members reported it was difficult in the current environment to keep their “heads above water.” Government austerity policies have led to a freeze on travel budgets and salaries at some supervisory agencies. While the salaries of supervisors are generally above the average level for other government agencies, in most cases they are well below industry levels, which make it difficult to attract skilled and experienced experts from the industry. A few jurisdictions noted conflict of interest rules (e.g. in some countries supervisors cannot work for the financial sector for three years after leaving the supervisory authority), which, if not properly designed, can act as a disincentive for attracting high-quality staff. Even if such skills can be obtained, retaining specialised staff is a challenge for most supervisory agencies particularly during periods when the financial sector is expanding and hiring, and when risk is being put on the books of financial institutions.

3. ***High staff turnover makes it very difficult to build a cadre of experienced supervisors***. While expertise in certain risk dimensions may be obtained from the private sector, deep supervisory experience can only be acquired on the job (i.e. supervisors are “home grown”). Hindering the ability for supervisory authorities to meet their staffing needs is the lengthy hiring and training process required to produce suitably qualified supervisors, which can be a deterrent for hiring when resources are already constrained. Turnover in several FSB jurisdictions among senior and specialised supervisory staff, which is particularly harmful to effective supervision, was explained by the lack of alignment of compensation to the level of responsibility, seniority and performance. In some cases where supervision is under the central bank, internal rules requiring mandatory rotation of staff across different departments within the central bank preclude the building of deep expertise in the supervisory area.

4. ***In addition to building a cadre of experienced and senior supervisors, there is a need for a change in supervisory culture and mind-set***. Supervisors need to strengthen their “soft” skills. The evolution of supervisory approaches is increasingly requiring senior supervisors to be more intrusive, with more judgment-based evaluations and a better understanding of the risk profiles and business lines of supervised financial institutions. While supervisors need to ask probing questions, they need to be careful to avoid assuming the role of management. Independence of mind is essential, as are judgement, maturity and critical thinking; these skills are difficult to develop and will require a change in culture and mind-set for many supervisors.

The IMF-World Bank FSAPs are an important factor in catalysing discussion and change among national authorities. The revisions to the Basel Core Principles bring notable improvements in the area of assessing supervisory resources as well as other areas of fundamental requirements such as enforcement powers, independence and risk management. FSAPs continue to indicate problems in these areas (see Annex B). Strengthening supervisory resources requires authorities to: (i) develop more forward-looking evaluations of supervisory resources in the context of their strategic and operational mandates; (ii) develop long-term career paths for supervisors (e.g. accreditation programs) and foster a work environment conducive to staff choosing to make supervision their career; and (iii) develop "soft" skills and promote cultural change so that supervisors become more challenging, sceptical and ready to act. These efforts need to be complemented by increased independence, authority and flexibility for supervisors to prevent a shortfall in resources from becoming detrimental to the effectiveness of supervisory processes, particularly for G-SIFIs. As noted in the 2011 FSB report, independence issues as well as effectiveness of supervisory process may arise as supervisory agencies are subjected to various budgetary constraints 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. The SIE will explore the implications and issues of budgetary constraints taking into account the different funding models for supervisory agencies and will report on this issue in the next progress report.

IV. Supervisory colleges

Supervisory colleges have been established for all G-SIFIs that are banks with relevant global operations. The BCBS survey has revealed that bank supervisors have obtained, through college arrangements, the sharing of tasks and the delegation of work to host supervisors in such specific projects as the Pillar 1 model approval. Bank supervisors have also shared their Pillar 2 methodologies and in some cases have undertaken joint on-site inspections of banking group economic capital models.

In the insurance sector, at present there are in excess of 30 global and 90 regional colleges run by insurance supervisors. In a recent survey it was identified that these numbers will double in the coming years. This continues to reflect an accelerating trend since the first survey on colleges undertaken in 2008. It was also identified that almost two-thirds of supervisors responding to the survey confirmed the implementation of a work plan for the 2011/12 period covering themes such as meeting schedule and coordination requirements, supervisory activities and assessment programmes and topics which include group structure and strategy, and risk management/internal control. The findings also identified that over 50 per cent of colleges involve joint visit/inspection programmes. Insurance supervisors have created some joint working groups focusing on specific issues related to the insurance company and joint on-site inspections have been conducted, planned or discussed in some cases.

While these initiatives are welcomed, supervisory colleges do not yet undertake joint work among their member supervisors as a matter of course, nor do they necessarily come to a joint decision-making process.[18] Hence there is scope to consider how further collaboration can take place through college arrangements in the context of an effective group-wide overview of risk. While too much prescription regarding joint work should be avoided, it would be helpful to develop guidelines that cover the ways in which college members should aim to undertake joint work where circumstances warrant. In that respect, the IAIS is developing an Application Paper on the operation of Supervisory Colleges to improve the establishment and functioning of supervisory colleges, building on the IAIS guidance published in 2009.[19] Ultimately, the successful operation of a college should bring national supervisors to have, at the very least, a better common understanding of the risk profile of the financial institution and avoid duplication of efforts.

The effective functioning of colleges requires as a necessary precondition the ability to share confidential supervisory information among college participants. The BCBS and IAIS surveys reveal that best practices have not yet been established on how home supervisors can ensure effective information exchange with host authorities that are not the members of core colleges. Many authorities have bilateral Memorandums of Understanding (MoUs) or other less formal cooperation agreements with other supervisors in the college.

In the insurance sector, 32 jurisdictions representing around 50 percent of global premiums are signatories to the IAIS Multilateral MoU (MMoU). The thorough scrutiny of applicants to the IAIS MMoU provides assurance to the signatories that the required provisions on exchange of information and confidentiality are in place, hence creating an effective network of cooperation. Moreover, the IAIS is developing an Application Paper on the effective exchange of information to provide guidance to insurance supervisors on effective information exchange and confidentiality. In addition, the IAIS established in 2011 its Repository of Supervisory Colleges (IROSC) to serve as a central repository for insurance supervisors to obtain information on insurance colleges. This database is being developed further and allows the IAIS to assess the activity of new colleges and frequency of meetings of existing colleges, and it is being used to promote signing of the MMoU with the goal of increasing the number of signatories by a further 7 jurisdictions each year.

MoUs, however, generally do not exist between all supervisory members of all colleges, and even when MoUs exist, they are not sufficient by themselves and must be underpinned by mutual trust and a network of relationships among college member supervisors. The FSB should consider how the information exchange through college arrangements could be made more effective. Although the range of information to be shared varies according to the needs and decisions of a particular college structure, one way would be to develop guidance on the types of information that are useful to share at different levels of the college structure and decisions, setting out core information and optional menus of information. Given the strong interest and expectation on colleges expressed through the G20 process, it is critical that the

[18] An exception and a relatively new initiative in this space is the one of the European Banking Authority (EBA), which has established guidelines for a joint risk assessment decision in European supervisory colleges. The first outcomes were expected at the end of 2011. See http://www.eba.europa.eu/Supervisory-Colleges/Publications/CEBS-s-Guidelines-for-the-joint-assessment-and-joi.aspx.

[19] The 2009 IAIS guidance paper on the use of supervisory colleges in group-wide supervision can be found at http://www.iaisweb.org/__temp/Guidance_paper_No__3_8_on_the_use_of_supervisory_colleges_in_group-wide_supervision.pdf.

FSB further consider ways to ensure an adequate exchange of information also with host supervisors outside the core membership, while avoiding unnecessary burdens.

In addition to the information sharing arrangements and possible guidance on the types of information to be shared among college members, establishment of communication channels is similarly important in ensuring effective information flow within colleges.[20] Although good practice communication depends on the needs of a particular college structure, innovative channels such as secure internet data rooms merit further consideration by authorities.

V. Assessments of effective regulation and supervision

Following up on the recommendation set out in the 2010 FSB report, FSB member jurisdictions completed a self-assessment against certain ICPs which mirrored the exercise conducted in 2011 against similar BCBS core principles for banking supervision.[21] The IAIS lead this exercise and, in summary, the self-assessments show that national authorities are making progress in strengthening their supervisory frameworks but much more work is needed in particular to achieve group-wide supervision. The key findings include:

- ***Transparency***: While most FSB member jurisdictions have procedures for the appointment of the head of the supervisory authority or member of its governing body, where relevant, many jurisdictions lack a transparent process for dismissal.
- ***Independence***: Several supervisory authorities are not independent from undue political, governmental and industry interference in the performance of supervisory responsibilities. In addition, some authorities do not have the discretion to allocate resources in accordance with their mandate and objectives.
- ***Group-wide supervision***: The recent adoption of this core principle posed many challenges for supervisory authorities to assess compliance. Nonetheless, some jurisdictions indicated that implementation of a formal group-wide supervisory framework is work in progress. A few jurisdictions have already introduced legislative bills and/or are revising their supervisory framework.

The IAIS will be collecting information on experiences from such assessments and reviews to help determine how best to respond to deficiencies or inconsistencies identified and draw "feedback loop" lessons for its standard setting or standard implementation activities.

Indeed, the supervisory community has benefited greatly from the development of core principles for effective supervision by the BCBS, the IAIS and International Organisation of Securities Commissions (IOSCO). These principles have provided much needed guidance to jurisdictions to aid in the strengthening of their supervisory regimes and countries' adoption of the principles are routinely assessed as part of each ROSC. These principles are

[20] Existing colleges already use a range of communication channels: e-mails; letters; teleconferences; secure web communication tools; secure on-line data rooms; and bilateral or multilateral meetings with a portion of members. The range of communication channels is complementary and each channel should be used at different times.

[21] ICP 1: Objectives, powers and responsibilities of the supervisor.
ICP 2: Supervisory independence, powers, resources.
ICP 23: Group-wide supervision.

incorporated in the FSB Compendium of Standards (the “Compendium”),[22] which were first developed in 1999, and aim to provide a one-stop, easy-to-understand reference for the various economic and financial standards that are accepted by the international community as important for sound financial systems. In 2011, the FSB revised the Compendium and noted that the assessment terminology used by different standard setting bodies for their key standards differs and can give rise to confusion or misunderstandings by national authorities and market participants.

The FSB encourages countries to publicise FSAP results and monitors the assessment ratings received by countries as an indication of the progress being made to strengthen financial supervisory and regulatory regimes. While publicising the results of assessments has had the beneficial effect of highlighting the importance of jurisdictions’ compliance with the core principles, it has also facilitated the comparison of the relative rankings of assessments of the different supervisory agencies over time, across sectors (e.g., insurance versus banking), and across countries. Such comparisons may not be meaningful because the principles and assessment methodologies are constantly evolving and assessments reflect the unique characteristics of each country’s financial system and the principles in place at the particular time of the assessment. Even so, comparisons are likely inevitable so long as the assessment results are published. Moreover, in the context of cross-sectoral supervision and the emergence of integrated supervisory agencies, assessments of similar features of supervisory agencies and their policies applied to the different financial sectors may increase.

This suggests that over time, there would be a benefit to greater harmonisation, to the extent feasible, in the principles and the methodologies of the three core principles, including the nomenclature used as part of the ratings process. Such convergence, which would require greater coordination going forward among the BCBS, IAIS, and IOSCO, might minimise the risk of confusion when similar vulnerabilities are assigned different ratings and would reduce the opportunity for regulatory arbitrage across the financial sectors. This was one of the outcomes of the 2001 Joint Forum report on cross-sectoral comparisons of core principles.[23]

[22] The FSB Compendium of Standards can be found at http://www.financialstabilityboard.org/cos/index.htm.

[23] The 2001 Joint Forum report *Core Principles: cross-sectoral comparison* can be found at http://www.bis.org/publ/joint03.pdf.

Annex A

SUPERVISORY INTENSITY AND EFFECTIVENESS GROUP

5 March 2012

SIE/2012/23

Questionnaire on resources at supervisory authorities

At the 1-2 February meeting of the Supervisory Intensity and Effectiveness (SIE) group, members discussed how constraints on resources (e.g. ability to hire, qualifications) are hindering supervisors' ability to intensify their oversight of firms, particularly systemically important financial institutions (SIFIs). This questionnaire aims to help assess the resource constraints of supervisory authorities and to obtain a better understanding of changes in the supervisory intensity and effectiveness of systemically important banks (SIBs). Members are asked to identify a G-SIB or a national SIB within their jurisdiction and complete this template for that firm (some questions are however designed more for the agency as whole or SIBs as a whole).

1. What is the funding model for your agency?

Table 1		
Funding model	**Yes/No**	**Description of funding model**
Government appropriation		
Industry funded		
Other		

2. Please describe the compensation philosophy of your agency.

Table 2		
Compensation philosophy	**Yes/No**	**Description of compensation philosophy**
Compensation is:		
– Aligned with industry salaries		
– Targeted to a proportion of industry salaries		e.g. 75% of industry salaries (excludes bonuses paid in private sector)
– Based on civil servant pay scale		
Is your agency able to pay a premium for certain skills (e.g. specialists)?		e.g. up to 15% above base pay
Have you been successful at attracting the skilled resources sought (e.g. specialists)?		

3. **What is the average turnover rate at your agency in the area of supervision/regulation (not central bank turnover)? If the historical data (e.g. for the year 2007) is not available, please provide a qualitative comment on the trend that has been experienced since the financial crisis.**

Table 3			
% turnover	**2007**	**2011**	**If historical data or a breakdown of information for front-line and specialists are not available, please provide a qualitative statement on the trend that has been experienced since the crisis**
Front-line supervisors			
< 10%			
10% – 30%			
30% – 50%			
> 50%			
Specialists			
< 10%			
10% – 30%			
30% – 50%			
> 50%			

4. Please describe the approval process for increasing full-time employees (FTEs) at your agency, including how any resource constraints are determined and addressed.

Table 4		
Approval process	**Yes/No**	**Description of approval process**
Agency head has final authority to decide		
Government must approve resource request		
Another authority (like an outside board with industry representation) must approve before resources can be increased		
Occurs annually along with the budget review process		
Occurs annually as well as outside annual cycle as needed		
Takes approximately:		
< 3 months		
> 3 – 6 months		
> 6 months		
Please describe the process for determining resource constraints and how they are addressed:		

5. **Please list stand-alone specialist groups in your agency (i.e. dedicated teams that focus on certain types of risk). [Please amend the table accordingly to reflect the names of specialist groups relevant to your agency in the spaces at the end of the table]. In addition, please describe any change in perspective on the types of skills or expertise your jurisdiction has undergone to intensify your supervisory oversight.**

Table 5		
Stand-alone specialist groups	**Yes/No**	**Please explain how this area of risk is covered within your jurisdiction and discuss any change in perspective on the types of skills or expertise sought**
Liquidity risk		
Market risk		
Consumer credit risk (e.g. mortgage loans, credit cards)		
Other types of credit risk (e.g. non-consumer credit)		
Operational risk		
Compensation		
Corporate governance		
[Other stand-alone groups]		
[Other stand-alone groups]		
[Other stand-alone groups]		

6. **Please complete the table by providing the number of FTEs dedicated to each of the areas of risk management. [Please amend the table accordingly to reflect the names of risk areas relevant to your agency in the spaces at the end of the table]. Please provide a qualitative statement on the recent trend (e.g. were resources shifted from one area to focus on another emerging risk area.**

Table 6					
Area of risk management	**FTEs**				**Please describe whether resources shifted from one area of risk to another emerging risk area**
	2007	**2011**	**Estimated supervisory needs**	**Planned increases**	
Credit risk					
Market risk					
Liquidity risk					
Operational risk					
Compliance					
Supervisory colleges					
Crisis management					
Living wills					
Compensation practices					
Corporate governance					
Asset management					
Stress testing					
Capital planning					
Business models					
Implementation of Basel, including model validation					
Other:					
[List area]					
[List area]					

7. For G-SIBs, please complete the table by providing the number of FTEs for each of the areas. If the historical data (e.g. for 2007) is not available, please provide a qualitative statement on the recent trend. Countries without a G-SIB may wish to complete for the largest most important national bank (or SIB in some jurisdictions).

Name of bank:	
Asset size:	
Business model:	

Table 7

	FTEs		**Please explain whether these resources are sufficient to meet your supervisory plans**
	2007	**2011**	
"Pure" supervision (e.g. dedicated teams)			
– Biggest G-SIB			
– If no G-SIB, biggest national bank			
Horizontal reviews (e.g. remuneration practices)			
Specialist functions (e.g. modellers/quantitative specialists, accountants)			
Third parties (e.g. external auditors, consultants) to assist with supervisory oversight			
Administrative staff			
Regulation (e.g. licensing, enforcement)			

8. Please note any areas where resources have declined in favour of dedicating staff to SIBs (e.g. in order to increase staff at SIBs)?

Table 8		
Areas where resources were reduced:	**FTEs**	**Comments**
Small financial institutions		
Other financial institutions		
Insurance		
[Other area]		
[Other area]		
[Other area]		

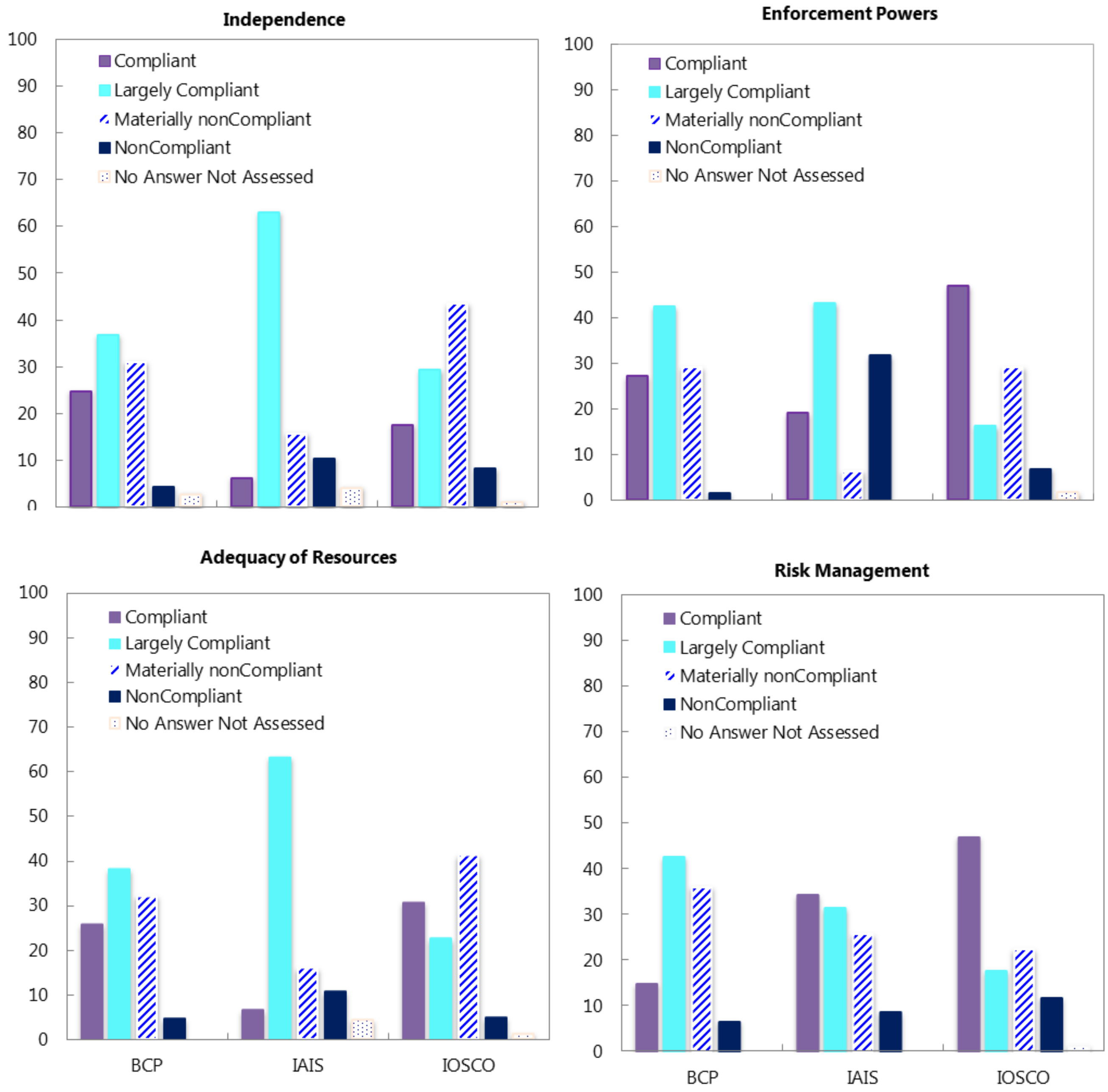
9. For countries with recent FSAPs, assuming your agency is able, please provide the assessment received on resources.

10. As noted in the 2010 SIE report, some supervisory agencies reported difficulties in accessing and analyzing data due to weak internal IT systems. Please discuss at a high level whether such difficulties remain.

Annex B

Compliance with Selected Principles across BCP, IAIS and IOSCO Standards (All assessments, in percent of countries by grades)

Source: Standards and Codes Database, IMF



Note: The following principles were used for the categories below:
Independence: CP1.2 for BCP 2006; CP3 for IAIS 2003 and CP1 IAIS 1999; CP2 for IOSCO.
Enforcement powers: CP23 for BCP 2006 and CP22 for BCP1997; CP15 for IAIS 2003 and CP14 for IAIS 1999; CP8, CP9, CP10 for IOSCO.
Adequacy of resources: CP 1.2 for BCP 2006; CP3 for IAIS 2003 and IAIS 1999; CP3 for IOSCO.
Risk management: CP7 for BCP 2006; CP18 for IAIS 2003; CP23 for IOSCO.