VIEWPOINT

Regulatory Philosophy

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Risk-based supervision sought to spur innovation and reward good behavior but helped bring about the global financial crisis

THE causes of the financial crisis are widely acknowledged, but what is less well understood in the public debate is how the philosophical approach to the regulation and supervision of the global financial system played an enabling role in the runup to the current financial crisis. This philosophical approach is often described as the "risk-based supervision" (RBS) framework. It has been adopted by the leading developed economies, as well as many other countries throughout the world. Although the RBS framework can be used to describe a general philosophical approach to regulation and supervision of the entire financial system, I will use the term more narrowly—as it applies to official oversight of the banking system.

At the core of the RBS philosophy lies the view that a banking organization can engage in virtually all forms of financial activity, as long as it has robust risk management systems and sufficient earnings and capital to support those underlying risks. In short, RBS seeks to liberalize the powers of well-managed banks, to spur innovation, and to reward good behavior.

The RBS framework also aims to promote proactive financial sector supervision by early identification and resolution of weak risk management practices, *before* their effects threaten the stability of both individual banks and the banking system as a whole. Virtually all countries that have adopted this approach have aligned their legal, regulatory, and supervisory approach to support this overarching philosophy.

Where risk-based supervision falters

Although the ideals of RBS are admirable and the framework has yielded tangible benefits, its shortcomings are rarely discussed, given the presumption that the RBS approach is the best way to oversee a nation's banking system. The unfolding of the current financial crisis has exposed fundamental cracks in this approach to banking system oversight.

First, ***the RBS philosophy outsources critical public policy matters***—such as whether certain financial activities are permissible and the implications for broader financial system stability—to individual bank supervisors. To take a recent notorious example, should banks be allowed to originate and/or purchase via securitization home mortgage loans that require a very small or no down payment and that do not require any documentation of customers' ability to repay? Should banks be allowed to sell complex structured products to their retail depositors?

On the one hand, proponents argue that creative financing and the availability of a wide range of financial products facilitate innovation and provide greater access to credit and choice of products to a broader range of consumers. On the other hand, critics—among them, Nobel Prize–winning economist Joseph Stiglitz—argue that it is necessary to differentiate between good and bad innovation.

Whatever the relative merits of these arguments, if we are to view the reasonableness of such activities solely through the lens of individual banks' risk management and financial capacity, we may be missing the larger public policy and systemic risk implications: whether

Matters

such activities are on balance good or bad for the financial system. Issues of such magnitude are best addressed at the institutional, rather than individual bank supervisor, level.

Judgment skills

Second, ***the RBS approach relies on the ability of both bank supervisors and risk managers at individual banks to make sound judgments.*** And because good risk management cannot be judged as black or white—but in shades of gray—it is often subject to intense debate between the regulator and the regulated. This judgment-based process has become more complex over time, as larger banks have developed increasingly sophisticated risk models that few people within central banks and regulatory authorities—and, as it turns out, within banking organizations themselves—fully understand.

The implications of the explicit links established under the RBS model—between a banking organization's risk management capacity with the scope of its permissible financial activities—must be considered against this backdrop. As such, the stakes for arriving at erroneous risk assessment are high, and, as the unfolding of the current financial crisis has shown, it could, on a collective basis, bring down the entire financial system.

Third, although a key aim of the RBS framework is to allow banking supervisors to identify and resolve problems in the banking system at an early stage, ***it is difficult to constrain the risk-taking activities of banks when their earnings and capital positions still appear strong.*** Early regulatory intervention is more prominent under the RBS philosophy, particularly because it also liberalizes a banking organization's scope of permissible financial activities. In practice, problems are encountered on two fronts, at both the firm level and the political level.

At the firm, or micro, level, for example, if regulators were to identify a significant relaxation of banks' loan origination standards as an area of concern, the bank's management could point to the bank's superior earnings and capital position as "evidence" of its ability to manage risk. Thus, to the extent that bank supervisors identify these shortcomings, they typically make "soft recommendations" as opposed to issuing "mandatory directives." These challenges are compounded by the procyclical nature of bank capital requirements, which allow banks to hold less capital during good times, precisely when heightened competition and rapid credit growth lead inevitably to an overall increase in risk appetite and an erosion of risk-assessment standards. The current financial crisis has revealed that risks both at individual banks and in the banking system as a whole were building to unsustainable levels, at a time when the global banking industry was reporting record profits and seemingly healthy capital levels.

At the political level, there may also be pressure to keep the credit flowing. After all, what politician wants to be blamed for taking away the punchbowl when the party is just getting started? As a result, weak risk management practices can continue to persist in the banking system, until bank regulators step in with a too-little-too-late response—after the cumulative effects of weak risk management practices have penetrated the bank's balance sheet and adversely affected reported earnings and capital.

Policy implications

Because of these shortcomings, any meaningful reform of official banking system oversight must take a critical look at, and attempt to mitigate, the enabling role the RBS philosophy played in the current financial crisis.

- First, banking supervisors must be willing and able to constrain banks' risk-taking activities—as needed—at an early stage, even when their financial condition is strong on paper. That is easier said than done, because it would require bank supervisors to ignore conventional wisdom and say "no" to powerful banking organizations, which—if they happen to be systemically important banks—are likely to have strong political backing at the highest levels of government. As such, early regulatory intervention can succeed only if it is backed by a credible bank regulatory authority that has the institutional wherewithal to carry out effectively its "safety and soundness" mandate.
- Second, banking authorities must find a better balance between the use of "regulatory" and "supervisory" tools to oversee the safety and soundness of individual banks and the banking system. The implementation of risk-based supervision has led to a greater—and perhaps excessive—reliance on discretionary methods to ensure a healthy banking system. In short, this philosophical approach has been used as the basis to liberalize banking activities and to delegate critical decisions to individual bank supervisors, based on their assessment of banks' risk management and financial capacity.

While this system of supervision is here to stay, we must attempt to formulate more explicit regulatory backstops to mitigate its unintended consequences and to provide a more tangible means to curb excessive risk in the banking system.

Among those new regulations should be the establishment of countercyclical capital and loan loss provisioning requirements during economic upswings. It will no doubt be a challenge to strike an appropriate balance between drawing a line in the sand regarding a banking organization's risk-taking activities and continuing to encourage innovation in the global financial system. Authorities must be willing to confront this challenge and—critically—get the balance right. Given the scale and severity of the current financial turmoil, we simply cannot afford to be so wrong again. ■

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