The Global Financial Crisis: Lessons for Bank Supervisors

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I. Introduction

With the tumultuous global events of the past two years still fresh in our minds, the often repeated questions are, what went wrong and whose fault was it? These are weighty questions indeed and there is obviously more than enough blame to go around! More importantly though, and definitely more challenging, is the question as to how we can mitigate against any future occurrence. A significant number of ideas have been proffered as possible solutions and the discussion and debate continues. Many of these require considerable analysis, and honest discussion with a touch of humility with respect to our true capabilities. As we can all appreciate, most of these ideas sound good in theory. The challenge, of course, is always in the implementation. The realities of Nigeria, exacerbated by the recent dramatic events in the financial sector, certainly do not lessen this challenge. It is imperative that we at the Central Bank of Nigeria (CBN) learn the lessons well, as they have particular relevance and applicability for us.

Recognizing the importance of cross-border issues for the CBN, I will like to expand the discussion further to touch on some of the broader lessons that we are learning as a consequence of the global financial crisis, provide some high level discussion about some of the many international initiatives from standard setters and others and conclude with a discussion on risk-based supervision and whether, after the financial crisis, it is still an appropriate supervision model for the CBN.

II. Debates on the Global Financial Crises

The global financial crisis has triggered significant reforms and a number of important debates that will have long lasting implications for banks and the way they are supervised. There is general agreement that supervision must be made more robust, proactive and

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inclusive. We are being told that we need to broaden the focus of prudential supervision, focusing less on single entities and more on how the components of the financial system interact. We are learning about the need to deal with the concept of pro-cyclicality in relation to regulatory capital. There are many advocates of closer linkages to macroeconomic indicators including tying a portion of capital requirements to macroeconomic indicators such as asset and credit growth and asset prices in the economy. Such, if adopted, would have important consequences for Nigeria given the explosive growth of the sector since consolidation. There is unanimous agreement that for there to be any meaningful reform, we must have an appropriate internationally-accepted regulatory framework.

There is also wide agreement that a priority area for regulatory reform is the need to develop policies to re-assert market discipline – the need to end the continuation of deep-rooted expectations of implicit or explicit support of financial institutions by governments. Debate also continues as to the merits of declaring some institutions as systemic, with the argument against, being that such categorization may actually reduce market discipline and increase the risk of moral hazard. Whatever regulatory changes we put in place, it is important to remember that the rules or regulations can create incentives to do one action, and not another. Therefore, we must be vigilant to push for incentives that lead to outcomes we want, and not incentives that lead to unintended consequences – consequences which we will all subsequently have to deal with, and which could have an unforeseen, yet dramatic impact.

III. International Perspectives

A significant number of international initiatives are underway, with numerous recommendations and suggestions to mitigate any reoccurrence of crisis. Principal amongst these initiatives has been the work of the G20 which has been a driving force in formulating and coordinating a global response to the financial crisis. The first G20 summit was held in Washington DC in November 2008, followed by two summits so far, in 2009 - London (April) and Pittsburgh (September). These summits are typically preceded by meetings of G20 Finance Ministers and Central Bank Governors, which group met most recently on November 7, 2009. The G20 established the Financial Stability Board (FSB) to coordinate and monitor progress in strengthening national and international financial regulation.

Flowing from the G20 Pittsburgh Summit in September 2009 were 107 commitments. Of that total, 24 fell under the rubric *Strengthening the International Financial Regulatory System.* For most part, these commitments reflect the cross-border theme of your conference with terminology such as "global standards", "internally agreed rules", "international framework of reform", etc. interspersed throughout. The G20 issued a challenge to all supervisory authorities to improve their supervisory standards and called for specific reforms to improve such areas as the quantity and quality of bank capital, compensation practices, the over-the-counter derivatives market and cross-border resolutions and systemically important financial institutions. The FSB subsequently held a plenary meeting to tackle these issues in more detail.

In April 2009, the FSB issued its *Principles for Cross-border Cooperation on Crisis Management. These Principles, which are particularly relevant to the CBN, require regulators to:*

- meet at regular intervals to discuss issues related to cross-border operations;
- set up supervisory colleges for systemically important cross-border banks;
- share relevant information on group structures and legal, financial and operational intra-group dependencies;
- identify linkages with the financial system and various financial markets;
- develop common support tools such as key data lists/common language for assessing systemic implications to manage cross-border financial impacts; and
- consider practical barriers to achieving coordinated action in the event of a crisis event and consider how such barriers could be overcome or removed.

The G-20 has also agreed that financial authorities should be able to identify and take account of macro-prudential risks. A macro-prudential approach takes a system-wide view of how government regulation, policies and other interventions in the financial sector affect business cycles and the broader economy. In Nigeria for example, a "P" government policy decision has been made to grow and develop the financial sector which has serious implications for ensuring safety and soundness. Much of the growth has taken place cross-border. Was the CBN well positioned to monitor the safety and soundness of such cross-border activities? In all of this, it is important to note that this system-wide view is a supplement to sound micro-prudential regulation and not a replacement.

Concurrent with the FSB's plenary meeting was the release of The Basel Committee on Banking Supervision's *Report and Recommendations of the Cross-border Bank Resolution Group.* The Report recommended:

- *strengthening national resolution powers and their cross-border implementation:*
- *encouraging ex-ante action and institution specific contingency planning which involves themselves and critical home/host supervisors; and*
- *reducing contagion and limiting the impact on the market of the future.*

Some experts are now also questioning whether certain financial institutions have grown too big and too complex for their management to run. We know that it is definitely more challenging to supervise a financial institution as it grows. Cross-border growth introduces a further dimension of complexity. As we have seen recently, it is perhaps no longer "too big to fail", but rather, "too big to run". It has been suggested that far from expertly manipulating their firm's books, many CEOs could not understand them. The Chair of the UK's FSA has called for systemically important banks to draw up "living wills" as a forcing device for the clarification and simplification of legal structures. There is a question as to whether authorities have been too tolerant of the proliferation of complex legal structures which often extend beyond national borders, designed to maximize regulatory and tax arbitrage.

In October 2009, the Senior Supervisors Group (SSG) issued Risk Management Lessons from the Global Banking Crisis of 2008 which identified deficiencies in the governance, firm management, risk management and internal control programs that contributed to, or were revealed by, the crisis. In addition to liquidity risk management issues, the SSG highlighted:

- the failure of some boards of directors and senior managers to establish, measure, and adhere to a level of risk acceptable to the firm;
- compensation programs that conflicted with the control objectives of the firm;
- inadequate and often fragmented technological infrastructures that hindered effective risk identification and measurement; and
- institutional arrangements that conferred status and influence on risk takers at the

expense of independent risk managers and control personnel.

Early in 2009, Prime Minister Gordon Brown asked David Walker to review corporate governance in UK banks. The terms of reference were:
"To examine corporate governance in the UK banking industry and make recommendations, including in the following areas: the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively; the balance of skills, experience and independence required on the boards of UK banking institutions; the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees; the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.

In September 2009, A Review of Corporate Governance in UK Banks and other Financial Industry Entities was released for consultation with 39 recommendations covering:

- board size, composition, qualifications;
- functioning of the board & evaluation of performance;
- role of institutional shareholders;
- communication & engagement;
- governance of risk; and
- remuneration.

IV. Lessons for Bank Supervisors

It is interesting to note that the Walker Commission also questioned whether bank shareholders would be better served by "a less complex product array, a more manageable business model and more limited geographic reach." Are there lessons for us here?

The financial crisis has also resulted in a significant degree of introspection by regulators, central banks and "experts" around the world about the most appropriate model of supervision. Many regulators are being criticized for poor performance and are under fire for inaction. The question at hand is whether it was the risk-based supervisory model that so many supervisors are now using, or was it the implementation of the model that failed us in some cases?

A look at the evidence is instructive. Although a sub-based supervisory approach is used by many of the world's financial sector supervisors, their results and performances have been uneven. In October 2009, the World Economic Forum rated Canada as having the most "sound" banking system for the second year in succession. The United States of America was rated #108 (out of 133). Both are sub-based supervisors, however, each uses a different supervisory approach. Was one more successful than another? It would appear so! Supervisory approaches range from "light touch", which the UK's FSA has been accused of, to intrusive which is typically what we think about the United States' model. Canada would fall somewhere in the middle of these two approaches, with "intrusiveness" escalating as concerns about an institution increase. Canada is also a conservative, principles based supervisor as compared to the more rules based approach to regulation of the United States, and focuses more on process and policy testing than it does on transaction testing. To determine the optimum approach is a difficult challenge.

Nigeria has largely followed the United States' model of supervision, a system that is under intense scrutiny due to the current financial crisis. By October 24, 2009, 106 banks had failed in the US with many more being deemed weak. Were it not for the Federal Deposit Insurance Corporation's (FDIC's) mandate of promoting confidence in the financial system, the speculation is that many more banks would have been closed. Bank failures have cost the FDIC US$25 billion in 2009 and the FDIC wants banks to pay in advance US$45 billion in premiums that would have been due over the next three years. The situation is extremely serious and necessary changes and improvements to the supervisory system in the United States are being debated.

As the United States is currently doing, we are re-evaluating our existing supervisory structures and processes here in Banking Supervision Department (BSD) and Other Financial Institutions Department (OFID). We need to answer the question - what can we do better, both structurally and procedurally?

The United Kingdom is also proposing changes and improvements to its supervisory system. Lord Adair Turner, the Chairman of the UK's FSA has opined in his March 2009, *The Turner Review:*

> *"It is noticeable, however, that this distinction between supervisory styles is not clearly correlated with relative success. The US system of resource intensive bank examination has been no more successful than the UK's approach in preventing bank failure. Conversely both Canada and Spain, with*

different supervisory approaches, have so far been less affected by the banking crisis......... The determinants of Spain's and Canada's relative success seem more likely to lie in other factors than in a particular choice of supervisory style".

The evidence is clear that sub-based supervision is only one element to achieving a sound regulatory system and ensuring financial stability. Others include adherence to the Basle Committee's 25 *Core Principles for Effective Bank Supervision* and the so called "pre-conditions" which include accounting rules, robust laws, a knowledgeable judiciary, etc. This must be a key priority focus for the CBN and much need to be done. The quality of supervisory staff and processes is extremely important, a reality that the CBN appreciates and is working manfully to improve. The financial crisis has magnified the need for supervisors to have an in-depth understanding of interactions among banks and banks and other financial sectors, not only domestically but internationally as well. Equally important is the identification of regulatory gaps and as always, continued enhancements to corporate governance and transparency are absolutely critical.

V. Conclusion

In conclusion, the debate on solutions and best practices continues. There is agreement on some issues, but less so on others. National considerations are sometimes in conflict with international considerations. What is clear, however, is that we have (should have) learned many lessons and that the great majority of these lessons have relevance for us at the CBN. As regards risk-based supervision, the general tenets are sound. The success factors are tied to implementation. The CBN is dedicated to improving the way supervision is conducted in Nigeria and to protecting the safety and soundness of our financial sector. The risk-based and consolidated *Supervisory Framework for Banks and Other Financial Institutions in Nigeria* is the tool that the CBN will be using to achieve these goals in assessing the risk of individual institutions and the financial system. In 2010, we will be working to implement some of the "lessons" and focusing on implementation of the risk-based *Supervisory Framework*.