

# Defining forward looking, judgement-based supervision

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**ABSTRACT** This brief article tries to cast some light on the understanding of the concept of judgement-based supervision, an approach favoured in the United Kingdom following the legislative reforms that have seen the dismantling of the Financial Services Authority and the establishment a Prudential Regulatory Authority as a subsidiary of the Bank of England, as well as a Financial Conduct Authority. The adoption of a 'more judgement-focused approach to regulation so that business models can be challenged, risks identified and action taken to preserve financial stability' is presented as a key feature of the new supervisory regime. However, what does it exactly mean? The article commences with a review of the notions of supervision (micro and macro) and regulation. It then assesses the domain of judgement or discretion in each supervisory stage, from the licensing or entry into the market to the sanctioning stage and crisis management. Back in 1942, in the context of the proposals that led to the establishment of the International Monetary Fund, John Maynard Keynes famously stated: 'Perhaps the most difficult question is how much to decide by rule and how much to leave to discretion'. This is the eternal challenge in administrative law, as it is in monetary policy. It is also the challenge the authorities face when trying to establish what exactly judgement-based supervision is. As regards the 'forward-looking' feature, it is worth recalling that though the law can be proactive, regulation after crisis (hence reactive, backward looking) is a constant in the history of finance.

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## DEFINITIONS

Regulation<sup>1</sup> refers to the establishment of rules, both acts of the legislator (Congress or Parliament) and statutory instruments or rules of the competent authorities. Rules may also be issued by self regulatory organisations or private associations of bankers, traders or other market

participants. Regulation also encompasses soft law rules (that is, standards that are not enforceable by the traditional means of 'hard law').

Supervision (micro-supervision) in a broad sense is a process with four stages or functions: licensing, supervision *stricto sensu*, sanctioning and crisis management (including lender of

last resort, deposit insurance and insolvency proceedings).

Supervision in a narrow sense (that is, supervision *stricto sensu*) refers to the oversight of individual financial firms' behaviour, in particular risk monitoring and risk control.

Although regulation and supervision are at times used interchangeably, they have different domains. Regulators set the rules (rulemaking) and supervisors implement and enforce such rules (monitoring and enforcement). However, because supervision monitors the degree to which the bank abides by the rules, there is a connection between the two terms. Most supervisory authorities are endowed with regulatory responsibilities.

The inter-action between supervision and regulation is evidenced in each supervisory stage. For instance, with regard to licensing, the law determines the requirements that a bank needs to fulfil in order to be granted a licence (minimum capital, management competence and integrity and so on). The adequacy of capital – a key element that supervisors assess to determine the health of the bank – is described in detailed rules. Penalties for wrong doing – civil or criminal – are clearly spelt out in the law. In the crisis management stage, most of the tools available to the supervisory authorities are governed by law; this is the case with deposit insurance and with the resolution and insolvency proceedings. Banking law extends beyond the supervisory process and deals with other issues, such as the legal form of the corporation and the bank–customer relationship.

In the aftermath of the global financial crisis, a consensus has emerged regarding the difference between macro- and micro-prudential supervision. According to the House of Lords Report on the Future of EU Supervision and Regulation, 'macro-prudential supervision is the analysis of trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy. The focus of macro-prudential supervision is the safety of the financial and economic system as a whole – the prevention

of the materialisation of systemic risk. Micro-prudential supervision is the day-to-day supervision of individual financial institutions. The focus of micro-prudential supervision is the safety and soundness of individual institutions and also consumer protection. The same or a separate supervisor can carry out these two functions. If different supervisors carry out these functions they must work together to provide mechanisms to counteract macro-prudential risks at a micro-prudential level'.<sup>2</sup>

Macro-prudential supervision is thus analogous to the oversight of the forest, while micro-prudential supervision is analogous to the oversight of individual trees. Macro-prudential supervision should target the causes of systemic risk.

## MACRO-PRUDENTIAL SUPERVISION AND SYSTEMIC RISK

From an institutional perspective, the exercise of macro-prudential supervision is given to either newly created councils for financial stability, such as the Financial Stability Oversight Council in the United States, or to the central bank, such as the Bank of England in the United Kingdom, where the Financial Policy Committee is in charge of this task.<sup>3</sup> In the EU, the European Systemic Risk Board (not a new institution) will share macro-prudential supervisory responsibilities with national authorities, and according to the Banking Union proposals, also with the European Central Bank for those Member States that become part of the Single Supervisory Mechanism (SSM).<sup>4</sup>

Ongoing discussions are trying to identify the powers and instruments macro-prudential authorities should have. Given the lack of a commonly accepted theoretical paradigm on the definition of systemic risk, this is no easy task.<sup>5</sup> Systemic risk refers to the risk or probability of breakdown of the entire financial system, as opposed to breakdowns in individual

parts or components. However, a widely accepted definition is still missing. All classes of financial intermediaries, markets and infrastructures can be systematically important in some level. Any risk (not only credit risk but liquidity risk, interest rate risk, exchange rate risk and so on) can grow into systemic proportions when its negative impact extends beyond an individual institution, affecting or threatening to affect by contagion other institutions (externalities), often creating a disruption in the monetary or financial system and that – depending on the severity of the downturn – will then mutate into economic paralysis (halt in production).

Systemic risks seldom occur alone; they usually spread to other risks like fire.<sup>6</sup>

Financial stability is a central banking objective, 'heir' to the objective of bank soundness. Recent events have proven that in times of crises, it also becomes a government objective, as governments cannot afford bank runs nor a collapse in the mortgage market. The ability of the financial system to withstand unforeseen shocks is recognised by many economists and central banks as the key indicator of financial stability.

In 'negative terms', financial stability is the absence of instability/crisis. In 'positive terms', the achievement of this objective encompasses a variety of elements such as good supervisory techniques, adequate capital and liquidity, competent and honest management, internal controls, early warning systems, effective regulation, transparency, accountability and an efficient payment system.

What makes a crisis of a systemic nature is not so much the trigger event (*causa proxima*), but the transmission mechanisms, domestically and internationally. If the linkages are strong, the potential for systemic instability increases. If the connections are weak, there is less of a threat of systemic risk. No chain is stronger than its weakest link.

The transmission mechanisms can be classified into at least four categories: (i) the inter-bank, inter-institution, inter-instrument channel; (ii) the payment systems channel; (iii) the information channel; and (iv) the psychological channel. The

loss of confidence in an institution or market (whether informer or uninformed, rational or irrational) will undermine the functioning of that institution or market.

Interestingly, the resolution of a crisis also presents a psychological component: the mere belief that the problem has been solved will bring investors back to the market. It is not so much the ability to lend but the willingness to do so that really counts in the resolution of a financial crisis.

Macro-prudential supervision<sup>7</sup> has different dimensions that aim to tackle different issues: interdependence and interconnectedness, criticality of certain institutions by size or by function (the problems of systemically important financial institutions (SIFIs) or systemically important financial institutions and the too-big-to-fail and its variations), economic and business cycles (boom-bust), overlaps and inconsistencies (including legal gaps or regulatory vacuums), pro-cyclicality and, of course, crisis prevention and resolution. The line of demarcation between micro and macro is not always clear. The simplicity of one goal (price stability) one instrument (monetary policy) entrusted to one authority (the central bank) that characterised the monetary architecture of the years preceding the crisis is not replicated when it comes to the design of the architecture of financial supervision. Here, the picture is more messy and complicated, with a variety of actors, instruments and multiple goals.

## WHAT IS JUDGEMENT-BASED SUPERVISION?

Judgement-based supervision is not substantially different from the notion of micro-supervision outlined above. Judgement-based supervision is presented as a new approach to the way financial institutions are supervised. As such it addresses the 'how' to supervise, rather than the 'what' or the 'who'.<sup>8</sup> It is not 'supervision-lite', it is strong supervision but with a change in emphasis. It has been defined as a reduction in

the reliance on rules and an increased focus on the spirit of regulation.<sup>9</sup> According to Hector Sants:

The essence of a judgement-based approach is a willingness to intervene when the regulator judges that the outcomes will, in future, be at variance to its mandate, even if the firm does not agree. Such proactive intervention needs to be proportionate and justified, but if we are to improve outcomes and meet the expectation of Parliament and society, such judgements will have to be made. The key to success in the new judgement-led approach is:

- the ability of supervisors to identify and focus on the big risks to their statutory objectives;
- the capability of supervisors to make the right judgement as to the course of action to reduce the probability of risks to their statutory objectives; and
- the decisiveness of supervisors to instruct the firm to execute these actions.

However, changes to the behaviour of supervisors alone will not be enough. If this approach is to work effectively firms will also need to change the way they think about regulation. Firms will be expected to:

- recognise the importance of aligning their goals with those of the supervisors and society as a whole;
- show a greater willingness to proactively comply with supervisory judgements. We are not asking firms to forgo their right to challenge their supervisor if their decisions have not been properly made. But we are suggesting that dragging their feet in complying with requests when it is obvious to all that the outcome is in the best interest of society as a whole, is not a behaviour which should survive in the new world; and
- recognise that this new approach will require greater resources and expertise

and thus costs more than the old reactive model which existed prior to the crisis.<sup>9</sup>

What are the conditions for successful judgement-based supervision? To begin, a clear goal, adequate supervisory tools and adequate resources. To be able to exercise judgement, one must have knowledge. This has implications in terms of adequate formation and pay. The latter in particular is fundamental if the supervisory authority wishes to attract the brightest minds. Second, the authorities should be aware that supervision and crisis management are part of a seamless process in which the supervision of healthy institutions turns into crisis management when they run into trouble. This requires a very close link with the resolution authorities; in the case of the Bank of England, the Bank itself hosts the Special Resolution Union, so this link is less problematic than in other jurisdictions (though the wisdom of combining supervision and resolution is contested on other grounds, notably that it might conflict with the central bank's role as lender of last resort, not to mention the potential reputational damage). Supervision, the authorities should remember, is a thankless task, where successes are hidden and failures trumpeted. The issue of immunity versus liability is also a cloud in the horizon for supervisors. There are few rules of thumb when it comes to good supervision, but one should surely be: beware of complexity! Of course, financial systems are increasingly complex, but then there are different types of complexity. The one complexity one should caution about is the conscious design of complex structures or products by financiers with the purpose of avoiding regulation or control.

There is a danger that the new approach may lead to the supervisor picking firms' business models, with the result that there is a loss of diversity in the financial system and an increase of systemic failure due to herding of firms into a model selected by the supervisor that turns out to be flawed. Second, there is a body of thought

that rules are inevitably more effective than human judgment, because judgment is affected by human tendencies to overconfidence and bias.<sup>10</sup> At the heart of the debate is the question whether rule-based limits on the size of financial institutions are necessary to protect against the inability of supervisors to guarantee that their judgment will provide sufficient protection to society. However, this is beyond the scope of this article.

From the perspective of organisational economics,<sup>11</sup> supervisors need to be allowed to think differently (group think was another cause of the crisis) and should not be penalised if they act as ‘whistle blowers’ or have contrarian views. After all, the goal of supervision should be a sound financial system, both for those that offer financial services and for those who demand them. The interests of bankers must be aligned with the interests of society.

In any case, judgement-based supervision should never be a substitute for good governance and sound risk management. Due diligence and internal risk controls remain the firm’s responsibility.

## THE SUPERVISORY PROCESS: RULES VERSUS DISCRETION/ JUDGEMENT

The balance between rules and discretion varies in each of the supervisory stages. This means that a ‘judgement-based approach’ is more suitable in some stages of the supervisory process than in some others.

By definition, the first stage, the entry into the business – via licensing, authorisation or chartering in the case of banks and simpler registration procedures in the case of other financial entities – must be rule-based. The issues at stake, the balance between competition and regulation and the function of this stage as catalyst or filter in the design of a sound banking market cannot be left to discretion. The law must consider the conditions to obtain a bank licence (typically minimum capital and suitable

management), the scope of permissible activities (which in turn will dictate the model of banking – universal or specialised – a given jurisdiction will have), the entry of foreign banks, the relationship between banks and corporations (either close ties or arms length), the legal form of the institution (company limited by shares, cooperative and so on), the forms of bank expansion (branches, subsidiaries, joint ventures, take-overs and mergers) and, finally, the authority to revoke a licence.

When it comes to the second stage, supervision *stricto sensu*, the ongoing monitoring and oversight of the health of the banks and the banking system, in particular asset quality, capital adequacy, liquidity, management, internal controls and earnings (the very definition of prudential supervision), are clearly a judgemental function, and hence the balance tilts towards discretion, albeit on the basis of clear and transparent rules. Risk monitoring and risk control entail a great deal of judgment. The various supervisory tools (reports and statistical requirements), internal ratings (CAMELS and others), on-site examinations, internal audits, off-site examinations, consultations with senior management and others (disclosure, fiduciary duties) require that supervisors exercise forward looking judgement. It is as much an art as a science. And then there are ‘pieces’ that are still missing in the ‘supervisory puzzle’ (and that hinder adequate cross-border assessments, valuations and comparisons), such as an adequate system of loan classification and rules regarding the reliance on external gatekeepers: independent external audits, credit ratings, legal counsel and others.

As regards, the third stage, ‘sanctioning’, the success of any regulatory and supervisory process depends upon its effective enforcement and must be, by definition, rule-based. Neither ‘institutional sanctions’ (which affect shareholders, such as fines, cease and desist orders, restrictions in activities, revocation of a licence or closure) nor ‘personal sanctions’ (which affect management, such as the temporary or permanent inability to be a banker, fines, loss of job or

imprisonment) can be subject to judgemental calls. The ladder of sanctions needs to be clearly known *ex ante*. The full force of the law is needed to afford adequate protection and guarantees.

The crisis management stage relies upon a mix of rules and discretion/judgement. While lender of last resort is clearly discretionary, explicit deposit insurance and resolution and insolvency proceedings should be rule-based. Again, no one would like to be deprived of any property rights by some sort of ‘judgement call’. A ‘hard law’-based approach (defined *ex ante*) is needed: debtors and creditors demand credibility and certainty. This is their protection and it is clearly rule-based. Early intervention (prompt corrective action (PCA), special resolution regime (SRR) and so on) and preventive measures, including living wills and others, rely upon a mix of rules and discretion (though they should be rule-based if early intervention implies closure or restriction in activities, that is, if early intervention has a ‘sanctioning’ component). As for government policies of implicit protection of depositors, banks (the ‘too-big-to-fail doctrine’) or the payment system, it is a murky terrain, often subject to judgement calls (sometimes terrible judgement calls). The discretionary nature of rescue packages does not contribute to certainty and predictability and it reinforces pernicious moral hazard incentives.

So far, we have only briefly discussed ‘official responses’. Regrettably, there are still few ‘private responses’ to internalise the costs of banking failures, and recent proposals (such as ‘bail in’) still need to be tested in practice, to ‘pass the market test’. However, surely the way forward lies in the privatisation of losses to accompany the privatisation of gains that has made banking such a lucrative business in recent decades.

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## REFERENCES AND NOTES

- 1 The Financial Services Act, which received Royal Assent on 19 December 2012, establishes a new supervisory structure that is due to become operational on 1 April 2013. See [http://www.hm-treasury.gov.uk/fin\\_financial\\_services\\_bill.htm](http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm). The Act creates a new Financial Policy Committee (FPC) within the Bank, which will look at the wider economic and financial risks to the stability of the system, a new Prudential Regulation Authority (PRA) that will be responsible for the day-to-day supervision of financial institutions that manage significant risk on their balance sheet. It will adopt a more judgement-focused approach to regulation so that business models can be challenged, risks identified and action taken to preserve financial stability and an independent conduct of business regulator, the Financial Conduct Authority (FCA), will take a tough approach to regulating how firms conduct their business. It will have a strong mandate for promoting confidence and transparency in financial services and to give greater protection for consumers of financial services. It will also have a strong role in promoting competition.
- 2 House of Lords’ European Union Committee on ‘The Future of EU financial regulation and supervision’ published on 17 June 2009, available at <http://www.publications.parliament.uk/pa/ld200809/ldselect/ldecom/106/106i.pdf>.
- 3 See <http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx>.
- 4 Some macro-prudential powers have actually been conferred to the ECB according to Article 4 (a) of the proposed SSM regulation, [http://ec.europa.eu/internal\\_market/finances/docs/committees/reform/20120912-com-2012-511\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-511_en.pdf), published in December 2012.
- 5 The power to adjust margins to influence the conduct of financial intermediation, such as loan to value ratios (LTV) is one of them. LTV ratios measure how much you are borrowing versus how much the house is worth. For example, a mortgage of £160 000 on a £200 000 house has a LTV ratio of 80 per cent.
- 6 See generally, Lastra ‘Systemic Risk, SIFIs and Financial Stability’ (2011). *Capital Markets Law Journal* 6(2): 197–213.
- 7 For an early study on macro-prudential supervision, see Claudio Borio, ‘Towards a Macro-Prudential Framework

for Financial Regulation and Supervision', BIS Working Papers no. 128, February 2003, <http://www.bis.org/publ/work128.pdf>.

- 8 As regards the PRA approach to the supervision of banks, see <http://www.fsa.gov.uk/static/pubs/other/pr-a-approach-banking.pdf>. As regards the PRA approach to the supervision of insurance companies, see <http://www.fsa.gov.uk/static/pubs/other/pr-a-approach-insurance.pdf>.
- 9 Hector Sants (2012) Update on the Regulatory Reform Programmes and European Issues. Speech at the Cityweek Conference, 7 February, <http://www.fsa.gov.uk/library/communication/speeches/2012/0207-hs.shtml>, accessed 20 March 2013.
- 10 See, for example, Miller, G. and Rosenfeld, G. Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Global Financial Crisis, p. 833 et seq,

available at <http://www.harvard-jlpp.com/33-2/807.pdf>; Chapter 21, Intuitions vs. Formulas in Daniel Kahneman's 'Thinking, fast and slow' (Allen Lane, 2011).

- 11 Garicano, L. and Lastra, R.M. (2010) Towards a new architecture for financial stability: Seven principles. *Journal of International Economic Law* 13(3): 597–621.

## CORRECTION

The guest editor's corrections to spelling and grammar have been made to the original Advanced Online Publication version of this paper.

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