Comment on "Four Themes of Sound International Supervision," by Susan M. Phillips

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Risk Based Auditing

Principal responsibility for the success or failure of the firm rests with its directors and management. Comprehensive corporate governance is one element needed to achieve long-term stability and success. This includes development of the company's policies and procedures, particularly relating to risk management, an effective division of duties, internal and external audit, succession planning and other factors within the control of the firm. However, the supervisory audit by the regulator also should be a key element of overall corporate governance.

The supervisory audit must add value to contribute to effective corporate governance. While traditional tick and check audits may successfully identify frauds or defalcations, they are unlikely to get at core financial sector risk issues. The move toward risk-based auditing, in which the principal risks of the firm are identified and reviewed, promises to enhance the value of the supervisory audit. When this occurs, the supervisor adds depth to the corporate governance process, and as a result, to the credibility of their function.

Change precipitated by market liberalisation creates an environment of potentially increased instability. The importance of the supervisory role increases in recently-opened markets. Firms will seek to expand their operations to capitalise on the new opportunities. In these circumstances, the firm's own corporate governance practices may fall behind the increased market involvement. The result is increased risk, which can lead to liquidity or solvency issues for the firm. Widespread risk management shortfalls in the financial sector can lead to more generalised macroeconomic exposure. This in turn threatens not just the sector and its shareholders but the environment for economic development overall.

Capital Adequacy

The BIS capital adequacy guidelines are an important step in establishing standards by which financial institutions can be compared. Value will be

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added by upgrading these standards to distinguish between sub-categories of credit risk, and extending the guideline further to market risk and operations risk.

The leading edge of risk evaluation is likely to be centred in the risk management divisions of sophisticated financial institutions and their advisers. This leads them to development of risk analysis tools responsive to their needs. The US Federal Reserve has indicated that it is prepared to work with such institutions in the application of these models to the management of their risk. Depending on the portfolio mix, it is probable that this internal analysis will sometimes lead to capital requirements that are lower than those called for by the formula approach. Supervisors will need to exercise caution in accepting this proposition, as adverse changes can lead to erosion of the firm's ability to operate with lower capital requirements.

Moreover, the inevitable issue of precedent will lead to pressure from other firms for supervisors to apply such standards to them. Close liaison among supervisors from different jurisdictions will be needed to avoid regulatory arbitrage in these cases. It also erodes the ability to make comparisons among institutions based on common standards.

These comments are intended to be cautionary not limiting. Efficient allocation of capital contributes to a healthy market

Transparency

The importance of transparency cannot be overemphasised. Exposing transactions to the bright glare of sunlight greatly reduces the risk of undesirable behaviour. Transparency is an issue within the firm as well as between it and outsiders. A financial institution should have separate risk taking and risk review functions. Bank supervisors will wish to assure that the internal risk review function has sufficient access to information on the risk taker's deals to make a good assessment of risk. This is the first line of the defense.

Ensuring that an understanding of the risk is embedded throughout the firm is a key ingredient for ensuring that commercial institutions bear their share of the loss when events go off the rails. Failing this, a lack of transparency becomes a shield for the lender as well as a veil for the borrower. Neither accrues to the benefit of efficient or effective markets.

Coordinated Supervision

Regulators have long recognised the value of working together to deal with issues of fraud and corruption.

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There are new reasons to work together. Global trends in capital flows and technology are causing financial institutions to consolidate their operations. This applies to more than just the mega-mergers seen in recent months such as SBC and UBS. Institutions are merging across business lines like Salomon Brothers and Travellers Insurance. In addition, increased focus on risk means that most institutions are consolidating their risk management functions. The plain fact is that this coordinated approach can work to the disadvantage of regulators and supervisors unless they too work together.

Steps need to be taken to ensure a coordinated approach to financial sector supervision. The United Kingdom has drawn together its supervisory functions for banking, insurance and securities to achieve this. International institutions contribute to this trend. These include the Basle Committee of the BIS and regional and international meetings of financial sector supervisors. Recent initiatives include the Toronto Centre for Financial Sector Supervision sponsored by the World Bank and the Government of Canada in cooperation with the Schulich School of Business at York University. The Toronto Centre gives bank supervisors from emerging market countries direct contact with other bank supervisors in a programme directed to transferring know-how based on their own experience with bank failures and rescues.

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