Act early or pay later: the role of qualitative measures in effective supervisory frameworks[1]

Executive summary

The March 2023 banking turmoil, the most significant banking sector stress since the Great Financial Crisis (GFC), highlighted deficiencies in the quality of bank governance practices and the effectiveness of supervision. While the ensuing bank failures were triggered by liquidity runs, the root causes were poor board oversight, flawed risk management and/or unsustainable business models in banks ("qualitative weaknesses"). The subsequent post-mortem reports also pointed to failures in supervision and, in particular, delays in taking timely actions, which allowed lax risk management and unsustainable business models to continue until they eventually manifested in a liquidity crisis.

The turmoil also served as a powerful reminder that no amount of quantitative requirements can compensate for banks' qualitative weaknesses. It demonstrated that banks can comply with capital and liquidity requirements and still face a crisis of confidence. This underscores the critical importance of supervisors identifying and addressing the nature and severity of qualitative weaknesses in banks in a timely manner.

Yet, taking timely qualitative measures poses challenges for supervisors due to various institutional, legal and supervisory constraints. While some obstacles – like institutional and legislative issues – are beyond their control, many relate to aspects within their purview. These include the adequacy of supervisory tools and techniques that underpin risk assessments, communication of findings, internal processes like monitoring and escalation, and staff expertise.

In all jurisdictions, the effective use of qualitative measures depends on the robust application of a chain of related yet distinct supervisory activities that comprise the supervisory process. These include risk scoping, risk assessment, supervisory actions, communication, and monitoring and escalation. How each step is implemented significantly influences the decision to impose qualitative measures, as well as their type and severity. Implementation of each step is guided by: (i) jurisdiction-specific tools, rating systems, methodologies, guidance and processes; and (ii) the expertise and gravitas of supervisory teams, including their ability to exercise judgment on complex qualitative issues.

While the supervisory process aims to address banks' risks and vulnerabilities, methodologies and approaches differ across sampled jurisdictions. Risk assessment methodologies differ in design, covering various risk areas and using different scoring systems with varying degrees of prescription. These differences can affect the application of qualitative measures. Surveyed authorities have access to most – but not the full range of – qualitative measures, using informal and formal instruments, with moral suasion frequently used to address qualitative weaknesses at an early stage. Some authorities differentiate the severity of actions using a single instrument with variations in tone and signatory, while others employ multiple instruments. Written communication tools vary, with many shifting to streamlined approaches that highlight key risk areas. For escalation, some rely heavily on supervisory team judgments, while others have documented procedures to foster consistency.

To future-proof supervision, a range of initiatives focused on enhancing the use and effectiveness of qualitative measures can be considered. The initiatives noted below (and detailed in Section 7) address each element of the supervisory process, drawing from specific features in sampled

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jurisdictions' supervisory frameworks and the authors' own analysis. There is no "quick fix" in enhancing supervision; depending on jurisdiction-specific circumstances, actions may be required on multiple fronts to address the factors that influence supervisors' ability and will to act.

- **Risk scoping:** Risk scoping defines areas to allocate resources, influencing the depth and focus of supervisory assessments and shaping the scope and severity of findings. Authorities may benefit from defining their own risk appetite framework in order to clarify the level of risk they are willing to assume when supervisors make risk-based decisions in the risk scoping process. Using top-down and bottom-up approaches in risk scoping – with appropriate safeguards for the latter – can enhance the risk scoping process.
- **Risk assessment and rating system design**: Risk assessments, including the use of qualitative measures, are framed by jurisdictional choices on the design of risk rating systems. Authorities may consider evaluating and, if needed, enhancing certain features of their rating systems to facilitate the prompt identification of qualitative weaknesses in banks. Key areas to consider include placing greater emphasis on qualitative elements in order to influence the overall rating assigned to a firm by: (i) adopting a "weakest link" approach, under which a poor rating in any component drives the overall rating, ensuring that qualitative weaknesses are not overshadowed by stronger scores in other areas; (ii) elevating the importance of the governance rating such that the rating assigned for this component guides the overall composite rating assigned to a firm; and (iii) introducing an explicit stand-alone rating for business model viability.
- **Risk assessment of governance and business models:** Tools for governance and business model assessments are critical in helping to detect qualitative weaknesses before they surface in banks' financial metrics. Developing "red flags" or other indicators can help supervisors identify shortcomings at an early stage. Additionally, individual accountability regimes (IARs) can make it easier for supervisors to hold senior officials accountable for failings that occur under their watch.
- **Supervisory actions:** Supervisors have latitude in selecting actions to resolve deficiencies, though some authorities may need legislative action to access the full suite of qualitative measures. Successful qualitative provisions identified in several jurisdictions include: (i) assigning responsibility for overseeing corrective actions to senior-level individuals or board subcommittees to foster accountability; and (ii) replacing key senior officials and imposing business restrictions to drive cultural and strategic change where needed. Differentiating the severity of qualitative findings, such as by providing two-way links between ratings and actions, enhances effectiveness. Additionally, developing guidance on a menu of options for identifying and addressing business model weaknesses and clarifying when to use moral suasion versus other informal actions can further aid supervisors.
- **Supervisory communication, monitoring and escalation:** Communication bridges the gap between identifying weaknesses and implementing corrective measures. Authorities could consider issuing a consolidated letter at the end of the supervisory cycle that integrates findings from various supervisory engagements, prioritises key concerns and outlines remediation steps and timelines that provide clear guidance to firms. Disclosing supervisory risk ratings to banks, including the definitions of each rating level, provides greater clarity on the steps needed for banks to improve their risk ratings and helps firms benchmark their performance against regulatory expectations. Robust IT systems are essential to support supervisory monitoring of corrective actions, while structured escalation procedures that increase the severity of actions when banks fail to address identified deficiencies can provide consistency in decision-making.

Above all, supervisory judgment is the "glue" that binds the entire supervisory process. All authorities face the age-old tension between rules and discretion in supervision, and they need to find the right mix between fostering judgment and providing sufficient guidance to support supervisory decisions that align with their risk appetite framework and jurisdiction-specific needs.