

The Role of the Supervisory Authorities in Organizing and Securing the Safety of the Banking Business

When I first agreed to speak on this subject, the title seemed self-explanatory. However, as I thought more about the phrase “supervisory authorities”, it occurred to me that it means different things in different countries, because these authorities are not necessarily restricted to central banks, which are responsible for supervising the banking and financial system. The USA, for example, has the Federal Reserve System (FRS), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). Coordination among these supervisory authorities limits the redundancies among their activities. In Britain and Kuwait, supervision and monetary policy are both carried out by the same institution, i.e. the central bank, as is the case in most countries.

As discussion of the role of supervisory authorities in organizing and securing the safety of the banking business cannot ignore the role of monetary policy and its reflections on this business. Furthermore, since supervision is relevant to the health of banks both on an individual or micro basis and also on a macro level, monetary policy participates in providing the proper environment for the banking industry to operate in. The supervisor must therefore not adopt too narrow a view of his work.

This point can be developed by outlining the role of the supervisory authorities from both the supervisory and the monetary policy perspectives.

The supervisory perspective can be clarified by outlining the six basic requirements for banks; capital, assets, management,

earnings, liquidity and systems, known as the CAMELS approach:

First: Banks should be adequately capitalized for the operations and risks they run.

Second: Banks should have high asset quality, not only in terms of repayment and creditworthiness, but also in terms of a well-diversified portfolio not overly concentrated in terms of economic sectors or investment instruments or individuals.

Third: Banks should have management and boards of high quality and skill.

Fourth: Banks should have a good earnings profile.

Fifth: Banks should be liquid, i.e., able to meet their obligations as they fall due.

Sixth: Banks should have internal systems and controls that adequately and prudently assess the risks they run.

The function of the supervisor is to take these six basic requirements, known as CAMELS, and formulate policies, rules and regulations to ensure that these requirements are met. In theory, this role sounds very simple, but in practice, banks continue to collapse and supervisors continue to be blamed when things go wrong. This is because the role of the supervisor is essentially simple in terms of its basic requirements however, in terms of execution, the role of the supervisor is often extremely complex and subject to all kinds of external factors - political, economic and pragmatic - which tend to compromise his ability to perform his role effectively.

Why does supervision sometimes go wrong? The difficulties of executing effective supervision in practice may become clearer with a brief consideration of each of the six points.

First, Capital. Until the publication of the Basle Capital Accord in 1988, there was no internationally agreed benchmark for measuring the capital adequacy of one bank against another in the same country or abroad. Even now, the Basle Committee is still discussing whether a third tier of capital might be included in the Accord and how certain risks that were not sufficiently covered by the original paper might be measured. These risks include market risk, interest rate risk and foreign exchange risk.

Bankers know what these risks are, but as the lack of consensus on the 1993 Basle paper concerning proposed revision to the Basle Capital Accord shows, the measurement of these risks is still a source of disagreement. The main problem is that these risks cannot easily be measured by formulas at fixed scales, and so the individual supervisor (or banker) ends up using his personal judgment about these risks and their measurement. This in itself is a risk and places the local supervisor in the following dilemma.

If there is no real international consensus on such issues, how is the local supervisor meant to regulate and measure capital and risk? If he takes no action beyond the absolute minimum, he may rightly be perceived as lax in his duties. Alternately, if he goes ahead alone and sets up a tough system of measurement and limits for specific items such as derivatives, he may be criticized for driving away business or making local banks uncompetitive by “over-regulation”.

Not finding the satisfactory regulatory balance between over-regulation and uncontrolled risk-taking can have harsh

consequences. On the one hand, banks may collapse due to laxity in supervision and internal controls. On the other, a fledgling market may be held back from expansion due to the weight of its regulatory baggage.

Second, Asset Quality. As recent years have shown, times and circumstances can change abruptly, and what was the “flavour of the month” yesterday can be tomorrow’s loan provision. Even “marking to market” can be of little use if the market ceases to exist. Thus, in 1995, both the market and the supervisors are still struggling with the measurement of asset quality from an objective standpoint.

Third and Fourth, Earnings and Liquidity are very much the areas where the supervisor should be the first to see that things are going wrong. Yet, as with asset quality, factors affecting liquidity change quickly and income recognition for items such as derivatives may cause significant problems where previously all was thought to be fine.

Finally, when it comes to effective appraisal of Management and Systems, these are the areas, which are subject to the highest degree of judgment by the supervisor. Here, instinct and experience play as much of a role as rules, regulations, and minimum standards.

Having reviewed the previous practical problems, it will now be appropriate to discuss how supervision is carried out by central banks through the following controls:

- 1- **Preventive Control**: this kind of supervision aims at reducing bank risks to the lowest limit possible. Ways to achieve this include the minimum capital adequacy ratio according to Basle Committee resolutions, maintaining reasonable liquidity ratios and avoiding risks caused by

fluctuations in interest rates, as maturity mismatching between assets and liabilities causes two kinds of risks, the first of which is related to liquidity, while the other is related to the cost of short-term borrowing. This is in addition to the instructions connected with rationalizing and organizing bank credit policy and credit concentration.

- 2- **Performance Control**: the task of central banks here is concentrated on the use of information and statistics that show banks' performance. This use is made feasible through monthly, quarterly and annual statements of information and statistics, as well as the regular meetings with bank authorities.
- 3- **Corrective Control**: this control is based upon reports prepared by central banks on banks' actual achievements and their financial statements, and is used to reveal any discrepancies among estimated budgets and assigned policies.

The question here is how can the supervisor achieve adequate supervision and regulations? It is known that supervision is based on objectives from which policies are drawn; an action plan is then adopted to ensure that banks adhere to these policies. Accordingly, it is important to mention here the following two kinds of supervision:

- a. **Off-Site Supervisions**, where banks provide the supervisors at the central bank with accurate and timely statistical information that can be used to find out how far banks are adhering to central bank instructions. These statistics should be clear, brief and informative. Supervisors frequently obtain the right quantity of information, but not set out in a way that enables them to

carry out their role satisfactorily. Equally, supervisors are reluctant to cancel statistical reports, even though they may no longer be entirely relevant. The danger here is that the supervisor will be swamped with information, and unable to give sufficient attention to the important statistical returns.

- b. **On-Site Supervision:** where the supervisor goes to the banks to assure the accuracy of figures and information given by these banks, the regularity of bookkeeping, the banks' adherence to central bank instructions and related legislations, the safety of internal control systems at the banks and all factors that affect bank safety and accomplishments, including the banks' capital adequacy and liquidity.

It is obvious that on-site supervision concentrates on bank appraisal, where the nature of this kind of inspection is fact finding. No doubt the availability of a highly efficient internal control system would facilitate the process of inspection, and save time in auditing certain operations intensively.

Moral suasion can come into play here, through which directives are implemented on occasion between high management in supervisory authorities and bank management.

After indicating how the supervisor performs his duties, it is proper to explain the difficulties or problems facing supervisory activities, such as:

- 1- The employment of highly qualified and well-trained supervisory staff involves significant training and salary expenses, which represent a financial burden in light of constraints on public expenditure, particularly as supervisors are usually a part of the Government sector.

This problem points to the fact that most central banks do not have adequate financial capabilities that can assure their independence, although it is generally agreed that central banks should be truly independent if they are to perform their role effectively without vested interests interfering with their work.

- 2- Although banking supervision and its systems try to acclimatize themselves to changing circumstances and developments in banking and finance, supervisory authorities are often blamed for bank crises, especially if the bank has passed a recent inspection. In these cases, attention is focused on detailed ratios, thus neglecting the “Art Of Managing Monetary Developments”.
- 3- The supervisor may simply confine his interest to the business that a bank carries out locally. Capital adequacy, asset quality and earnings, for example, can only be assessed on a group wide or consolidated basis. We have seen the dramatic consequences of problems in an overseas office of an international bank earlier this year, and the need for both supervisors and banks to supervise their organizations on a consolidated basis.

However, nothing can replace close contact with the banks themselves through regular meetings, inspection and contact with the external auditors. Furthermore, there is no substitute for understanding the business and the products of the banks under supervision. As the Financial Times put it recently, “...you can’t supervise, unless you know the business”. Also, understanding the business builds mutual confidence, respect and cooperation between the supervisor and the banks, leading to better cooperation.

- 4- The requirement for consolidated supervision leads to the fundamental necessity of contact and cooperation among international supervisors. The issues of contact and exchange of information have been covered in the Basle Concordat and the Basle 1992 Minimum Standards Paper. Nonetheless, they raise important issues of confidentiality and secrecy in many countries, which still need to be addressed.

Some may argue, but why supervise banks at all? Why not let market forces and consumer choice sort it all out? What makes banks special or deserving of extra attention? There are four basic reasons.

First, banks have what Mr. Peter Cooke, previously of the Bank of England, described as “a unique fiduciary responsibility, which they assume when they accept other people’s money for safekeeping”.

Second, they are unique because they are the main vehicle which grants loans and allocates funds for productive uses in the economy.

Third, as the Federal Reserve points out, despite the growth of other financial institutions as a result of global deregulation and the ever-continuing process of disintermediation, banks are still the main means by which the authorities implement monetary policies.

And finally, banks provide the mechanics of the payments system through which most business is transacted, internationally and locally. Quite simply, they are essential for the stability and efficiency of the financial system as a whole. If the general public loses confidence in the domestic banking system, then the domestic economy itself will be in danger of

collapse.

Given banks' special status, there is a twofold requirement for the supervisor to ensure, on the one hand, public confidence in the banks and the banking system through deposit protection or guarantee schemes and supervision policy. On the other, there is a requirement for systemic protection through policy tools such as lender of last resort and minimum requirements for new entrants to the banking market. But even in these basic areas, there are wide differences in approach among countries.

It is obvious that to maintain public confidence in the banking system, some form of basic deposit protection is needed, but this protection varies in amount from the equivalent of only 75% of the upper limit of the insurance value (£ 15,000) in the United Kingdom to a 100% guarantee by the Government on bank deposits of the private sector, excluding the financial institutions, in Kuwait. Lender of last resort, too, is a fundamental role of central banks; however, if overused, the commercial banks will become complacent, knowing that the authorities will bail them out.

In summary, overprotection of the depositors or the banks may lead to complacency, and risk of moral hazard, and that may ultimately restrict the development of the domestic banking system. "Moral hazard" is a phrase often used by supervisors, but basically it means that if one entity, which is supervised by another, becomes aware that it will also be protected from the consequences of its actions, it ceases to exercise such high levels of care and discretion in its activities.

"Moral hazard" is neither quantifiable nor legislatable against. In fact, because the supervisory authorities themselves have such a key role in creating a climate of moral hazard through overprotection or over leniency, the question sometimes arises

of who will supervise the supervisors? This is perhaps a question for another forum, but the points covered here lead to the so-called macro level of the banking business, where the supervisor has a degree of responsibility for the system as a whole.

The role of supervisory authorities may be considered from the monetary policy perspective as well. As is known, the basic role of any central bank is to draw up and implement monetary policy within the outline of the general economic objectives of the economy. This necessitates the central bank being fully aware of these objectives as well as the economic and monetary developments taking place domestically and abroad. This explains the attention given by the central bank to the supervision and strengthening of the banking and financial system in order to be able to achieve monetary policy objectives and other benefits of a safe banking system.

On one point there is general consensus: namely, that no modern economy is self-contained. This means that the Government and its monetary authorities in their role as managers of the economy must give considerable attention to trading and financial relationships with other countries. These transactions pass through the banking system, but there is no particular reason why, in the short-term, import and export receipts and expenses should balance.

However, unless short-term excesses or shortages are managed by the central bank, and unless there is a tendency to balance over the longer term, then harmful currency and price fluctuations will result.

Central banks attempt to contain these fluctuations through intervention in the foreign currency markets, the discounting of bills, and open market operations and other available monetary

policy instruments. Certain countries have resorted to exchange controls, price controls, and other rigid requirements when difficulties have arisen. Generally, over the longer term, such controls simply do not work in a modern economy, or more often, end up having the opposite effect to that intended. Moreover, such policies interfere with the market process, encouraging rigidity within the economy and reinforcing vested interests.

We have also seen an oversupply of money by central banks, hoping to alleviate systemic or other problems, lead to overexpansion of credit, to inflation, boom, and then slump. After decades of bitter experience, many countries now set growth targets for the domestic money supply and target zones for exchange rates. All of these policies, if pursued conservatively and without short-term political manipulation, lead to a more stable and predictable framework for the domestic banks to work in. Ideally, the supervisor should avoid using monetary policy tools for supervisory purposes and should not use supervisory policy to achieve social, monetary or other macro economic objectives; yet the supervisor cannot ignore the crossover effects of either monetary or supervisory policies.

In conclusion, the supervisor must be able to identify problems in banks swiftly and accurately, before they become so serious as to threaten solvency; and once serious problems have been identified, the supervisor must have the legal power and capacity to take prompt remedial action to prevent either capital loss to depositors or systemic disruption to the banking system as a whole.

Yet, “banking supervision” does not mean, “banking protection”, nor does it mean attempting to manage the banks. Banking regulation should encourage efficiency and

competition rather than protect the inefficient and stifle innovation. Promotion of a free market approach will allow banks to compete domestically and thus internationally, and give value for money to consumers.

In short, to quote Doctor Tommaso Padoa-Schioppa, current Chairman of the Basle Committee, “the supervisor’s role is not to supplant the role of directors and management in running banks, nor to limit the role of the market in exerting discipline and punishing bad business decisions. Rather, the supervisor has the role of strengthening the disciplinary factors already present in the banks and the market, and to complement them where they fail, or where their failure would entail undue social costs”.
