

Coordinated Supervision: Suggestions for the Way Forward

I plan to share some thoughts with you on the way that supervision is developing between the Arab World and our friends outside it. The word central bank governors like to hear is “stability” the word “crisis” is not one we like to use. I suspect that “risk” falls somewhere between the two. Nevertheless, the question of risk rightly concerns the world’s supervisors as new concepts develop, such as “derivatives”, “hedge funds” or even “Islamic banking”. There is no doubt that the rapid technological development of the world’s financial system has increased the risk of contagion (i. e., the risk of one bank’s problems spreading through the system).

Previously, the prime concern of a central bank governor would have been to stop a crisis in one of his country’s banks spreading to other domestic banks. Now we are more concerned that the crisis might spread not from bank to bank, but from country to country, as we saw with BCCI, and with the recent falls in the US equity markets. For me, this makes it even more important that we all give each other full cooperation, and wherever possible, coordinate our activities. Perhaps, therefore, I should start with the areas where we have achieved success, although in some cases there is still work to be done.

In the last two years, several Arab countries, including my own, have adopted international accounting standards to achieve transparency of balance sheets, and to enable comparison of banks’ results from one country with another. In the Arabian Gulf area, some of this work has been done through contact between the GCC Committee of Banking

Supervisors and the Basle Committee; other work has been harmonized locally through the GCC Governor's Committee.

Money laundering, too, has been accorded critical attention by supervisors. In Kuwait, the Central Bank introduced guidelines to banks and financial institutions in 1993 based on the so-called "forty recommendations for combating money laundering", following the work of the Basle Committee in the 1980's. But many countries maintain different standards, guidelines and laws relating to money laundering. In consequence, both in Europe and the Arab World, activities which are perfectly legal in one country are against the law in another. There is an obvious need for an international body, such as the Basle Committee, to continue the work so far achieved, and establish a set of consistent international minimum standards, rather than the existing guidelines.

The need for a consistent supervisory approach has been well recognized by the Basle Committee, and its work has been invaluable in establishing the Capital Accord, the Basle Concordat, and in bringing together the general approach of the OECD countries in the first phase. The present highly competitive environment encourages new initiatives, which in turn create considerable problems for the supervisor, who now has not only to keep up with new ideas but, at the same time, provide a quick reaction to them consistent with his colleagues in other countries. It is essential, therefore, that supervisors be in touch with new developments, not just to fulfill their own responsibilities, but also to help their banking system to remain competitive.

One new development which has attracted a significant amount of attention in recent years is Islamic Banking. Initially this was a concept subject to suspicion and criticism outside the Arab World, but now, western banks are increasingly offering

Islamic banking products. Islamic banking is not some strange and mysterious beast from legend or fable. It should be regarded as simply another type of financial services, and supervisors have a duty to understand its product risks and terminology, just like other specialized products. Ten years ago, I wonder how many of us would have felt comfortable with basic terms relating to options trading such as “delta”, or “put” or “call”. It was the suspicion and fear felt by supervisors for new derivative instruments, and the contemplation of draconian laws to quash and regulate these products from their beginning, that led many banks in the 80’s to educate supervisors on these products through seminars, secondments and other means. I believe that banks offering Islamic products must respond in a similar manner now, as they too have a duty to “sell” their products to supervisors. Equally we, as supervisors, should contemplate seriously first how the deposits or hands which finance these lending products should be treated by domestic deposit protection legislation, and secondly how to integrate such lending products into the Basle capital adequacy framework.

This seems a good point to refer to the work of the Basle Committee. As our friends in Basle have understandably concentrated on the major countries, the second tier have effectively been left to decide amongst themselves the extent to which to follow Basle’s recommendations. Some Arab countries, including my own, have formally adopted the Basle Capital Accord. Other Arab countries have partially adopted, or are working towards full adoption of, the principles of the Accord. This all represents encouraging progress, but at the same time it highlights the one issue in the Basle Capital Accord which continues to cause division between participating supervisors. This is the two-tier differentiation in risk weighting attached to the cross-border claims of banks on public sector borrowers. Under this system, lending by an

international bank to the government of a Zone “A” country in the OECD, or a participant country in the General Agreement to borrow with the IMF, is given a capital weighting of zero. But lending to governments of all countries outside this group is given a minimum 100% weighting, unless denominated and funded in the national currency.

Most international banks have come to regard this system as a kind of capital tax, and therefore set a two-tier system of interest rate margins accordingly. Kuwait, for example, felt the interest rate burden of this system when it raised its jumbo loan at the end of 1992 to finance the rebuilding of domestic infrastructure after the brutal Iraqi occupation of the country in 1990 and 1991.

The political reasons for adopting this two-tier system are well known, and to have used the OECD definition as a short-term solution to establish the Capital Accord was understandable. But as early as 1988, the Governors of the G10 countries were aware of the concern being voiced by various parties over this two-tier principle. Now, for obvious reasons of GNP per capita, balance of payments and public sector borrowing in relation to national income, this system has become outdated as a measurement of risk, and is now perceived by many to be increasingly archaic. It is surprising therefore, that in the six years since its introduction; the Basle Committee has been unable to improve on this arbitrary and intellectually indefensible basis of differentiating between countries.

The lack of logic in this two-tier approach has meant that certain countries have gone their own way in interpreting it. For example, the GCC Governors Committee has decided to add all GCC countries to the so-called Zone “A” list. This may be just a small and understandable exception to the Capital Accord, but it is one of many variations, which are appearing,

not only in the Arab World. These differences may prove impossible to reverse if they continue unchecked.

An example of this is the divergence on the subject of credit concentration or large exposures. In certain cases, some Arab countries have adopted tighter limits than the internationally recognized benchmark of 25% of capital. In Kuwait, we have a 10% limit on borrowings to an individual customer (or group), but this limit ranges between 7%-40% in other countries. In the UK it is 25% and so on. In Kuwait, we do not allow any collateral to be offset against exposures, but in the UK, there is limited collateral (cash, Zone "A" government securities and certain Zone bank or government guarantees). In other countries, real estate, assignment of rights, and many other types of collateral are allowed. Supervisors also differ as to what products and entities they exempt from credit concentration reporting. I could go on, but I am sure you will agree that there must be considerable value in the Basle Committee attempting to coordinate the more detailed application of credit concentration regulations and other matters.

There are also certain other areas where there is work to be done. In 1988, the Basle Capital Accord mentioned that the subject of market risk still had to be covered. In 1993, we saw a consultative paper emerging on this subject from the Basle Committee. I must confess the complexity of some of the measurement systems surprised me in the Basle proposals. I feel the transparency of the original system of the measurement of capital adequacy is in danger of being lost in complex mathematical procedures, and the resulting figures are not easily quantifiable back to a particular position. One of the great attributes of the original Basle Capital Accord was its simplicity, and the fact that it could be policed quickly and

effectively by the supervisors. I would ask that at least some of the original simplicity be retained in any future proposals.

Of course, there is a view put forward by certain influential parties and publications that the business of derivatives and non-banking should be taken outside the supervision of banks, and left to specialist regulators. But more regulators do not necessarily mean better regulation. Sometimes a large number of regulators has meant that no single supervisor has been able to get a proper picture of the soundness of a banking group on a consolidated basis. I would therefore prefer to see the supervision of banking institutions remaining as far as possible with a single supervisor. I feel that the plethora of supervisors was one reason why we also saw different proposals emerging from some countries and regulations from the EU on market risk. This means that we in the Arab World currently have the option of choosing from three models on the subject of market risk. This lack of consistency plainly must not be allowed to continue.

Lack of international consistency is also a problem with interest rates and liquidity risk. These are subject to hugely different degrees of regulation, and yet possibly are the most frequently observed factors when banks are faced with difficulties. I note the work of the Basle Committee towards the mismatch approach, but now specific time periods and ratios need to be considered to encourage some consistency in measurement and definitions.

I am sure that Basle does not underestimate the importance of the issues I have mentioned. There is an urgent need for the same consensus that resulted in the Basle Capital Accord to be found again on the subject of market risk in particular. Otherwise, if differences in supervision continue to multiply, the supervisory playing fields may become so uneven that

banks might begin to indulge in that awful sounding, but nonetheless real practice of regulatory arbitrage. We do not want to reach the stage where international banks book facilities in the most tolerant regulatory environment. Such a practice would play havoc with the implementation of the 1992 minimum standards for the supervision of international banking groups set by the Basle Committee. But if there is no internationally accepted set of guidelines to follow on the subject of market risk in particular, then I foresee some form of banking crisis in the next few years where regulatory arbitrage plays a key role. This crisis could start with anything from fraudulent use of repo transactions, to program selling, or difficulties in enforcing netting arrangements. The possibilities for a crisis caused by regulatory arbitrage are, unfortunately, too numerous to mention. My wish is that we shall build on the common regulatory ground we already have, and move towards greater international consistency in our approach towards the supervisory issues I have mentioned.

There is no doubt that recent banking crises, some of them cross-border, have caused supervisors to improve their contacts and information flow with their colleagues in other countries. However, much more needs to be done, especially in widening the exchange of information concerning foreign branches and subsidiaries. To achieve this, we need to improve the level of trust among each country's supervisors, so that information is freely exchanged with confidence.

An essential ingredient in developing this trust is the introduction of some uniform standard, which can be established concerning confidentiality in the exchange of information. Such a standard would be invaluable in the avoidance of misunderstanding, divergences, and inconsistencies. For those countries which have confidentiality laws to be overcome, to have an internationally agreed standard

would be particularly helpful as a lever to obtain the approval of their parliaments. Whether Basle is happy with the idea or not, they do provide the only body at present capable of establishing consistency between both OECD and other supervisors. It is important that they grasp the initiative and undertake this role before regional groups go their own way. They will need more resources, and this will not be a problem if they are prepared to make a genuine effort to widen their range of consultation.

In the short term, the first logical step would be for some stronger presence from the Arab and other regions on the Basle Committee. The second step would be for the Basle Committee to continue the work started with the Capital Accord and the Concordat, and set minimum standards and regulations in the areas I have mentioned, so greater consistency is achieved. This implies greater regional representation on the Basle Committee. If the IMF is able to cope with individual countries such as mine, I am sure that Basle could be ambitious enough to allow regional representation. Perhaps such a move would be somewhat revolutionary. But we may be able to make a helpful contribution on such matters as Islamic banking and other regional issues.

My main point is that the world is moving on, and supervisors must move with it if we are to avoid the word “crisis” appearing too often. After all, banking is about confidence and confidence requires trust. We all need to look beyond our own borders in supervising our financial sectors these days, and this means that countries big and small need to work together and coordinate their activities on a consistent basis. It is a huge task, but one that, if dealt with in a positive and structured manner, will lead us to that much admired word, stability.
