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External Governance: Regulation and Supervision

The previous chapters have described how the primary responsibility for the oversight of banks lies with their owners and managers; there is no substitute for adequate internal governance. External forces provide additional discipline through financial markets, forcing the exit of poor owners and managers or of the entire bank. There are limits, however, to the efficacy of market forces. To complement internal governance and market discipline, most countries institute some form of official regulatory and supervisory oversight. Particularly in developing and transition economies, where financial market participants are ill-equipped to monitor banks and where the alternatives to domestic banks for payments, savings, or finance are limited or nonexistent, discipline in the form of official supervisory oversight is critical to compensate for failures in internal governance and market discipline.

Banking Regulation

The failures in internal governance and market discipline described above suggest that the standard corporate legal framework is insufficient to ensure that the banking system operates soundly and that any disruptions are handled smoothly. Risk is inherent in banking. Prudential policies, while not panaceas, can attempt to limit risk and make sure that it is managed properly. Many countries therefore have adopted a separate regulatory framework to govern the entry, operation, and exit of banks.[81]

[81] In this discussion, the term "regulation" is used to encompass laws, decrees, regulations, and administrative rules that are intended to regulate (control) bank behavior. Countries' practices with respect to what is established by statute and what is delegated to administrative regulation differ substantially. In general, features considered either fundamental or controversial are established in the law, while rules covering technical and relatively noncontroversial aspects are issued as needed and changed as circumstances require.

Such regulations establish the authority of supervisors to regulate banks and set such detailed requirements as may be necessary to oversee and control bank behavior. They should be structured so as to foster cooperation between regulators of banks and of nonbank financial intermediaries and limit the potential for regulatory arbitrage. Although specific regulatory practices will vary across countries, several broad categories are used to reinforce banks' operating environment, internal governance, and market discipline.

Regulations Reinforcing the Operating Environment

Prudential regulations typically control entry into the banking industry and the scope of banking. Rules governing entry into the industry are needed because some forms of competition from new entrants can be destructive. While liberal entry rules may increase competition and result in lower costs to customers, new banks that are inadequately capitalized, or poorly governed or managed, often offer above-market deposit rates to attract resources and then cover their higher costs with riskier loans. Examples include Spain in the 1970s, Malaysia in the 1980s, and Estonia, Kazakstan, Latvia, Lithuania, and Russia in the 1990s.

At the same time, excessively restrictive entry rules may also result in unsound banks. While concentrated banking systems might be expected to generate significant economic rents, restricting competition rarely improves soundness, as poor corporate governance and management thrive in protected environments. Protected banks become vulnerable to loss and insolvency when faced with unexpected financial developments or when introduced to competition. The appropriate goal of entry regulations is not to protect individual banks by providing them with monopoly rents but to bring about a banking system that efficiently serves the economy and the public interest.

Well-designed licensing procedures ensure that banks entering the system are sound and are operated in a safe and prudent manner, by requiring that a business plan be in place and that owners, directors, and managers be "fit and proper."[82] The ownership structure of a bank as well as its ties to financial or industrial groups must be carefully defined. Furthermore, the bank must have sufficient capital to finance start-up expenses, conduct its intended business on a profitable scale, and safeguard it against unanticipated developments. If the licensing conditions are not met initially or subsequently, the supervisors must have the authority to reject the application or revoke the license.

[82] In this context, "fit" refers to technical expertise while "proper" refers to the character and integrity of the individuals.

Regulations also define the industrial structure of banking and the scope of activities that banks may conduct. Rules regarding entry and scope of activities will determine the competitive structure of the banking industry. These will legitimately vary across countries, depending on economic factors, such as the size and diversity of the economy, and institutional factors, such as prevailing industrial structures and attitudes toward antitrust regulation.

Inappropriate restrictions on banking may reduce the soundness and efficiency of the banking system. The more concentrated are bank portfolios, either by client base or region, the more exposed is the banking system to cyclical fluctuations at the sectoral or regional level. For example, the U.S. ban on interstate branching exposed its banks to periodic regional recessions. Agricultural banks failed in the earlier 1980s when commodity prices fell; banks in Texas, Oklahoma, and other states failed when oil prices plummeted; and banks in New England and California became insolvent when the recessions occurred in these regions (in the late 1980s and early 1990s) and property prices fell sharply. Canada, on the other hand, with a more diversified banking sector, survived both the Great Depression and the oil price decline in the mid- to late 1980s without widespread trauma.

Permissible banking activities need to be defined so as to allow adequate diversification of credit risk and the conduct of appropriate related businesses. At the same time, banks' ability to assume excessive risk, for example, through potentially damaging involvement in nonbanking businesses, should be limited. Banks that are permitted to hold large equity positions may become more vulnerable to asset price shocks and exposure to concentrated enterprise risk. There is no basis, however, for an a priori assumption that systems of universal banks are more or less prone to unsoundness.[83]

Regulations Reinforcing Internal Governance

Prudential regulations can provide assurance that owners and managers are fit and proper, that owners share the risks to which they expose their depositors, and that bank portfolio quality and risk-management standards are high. Not only do such regulations provide a formal control over bank behavior, but they also provide a basis for the production of additional information that can be used by owners, supervisors, and the market in disciplining banks.

Because sound banking begins with sound bankers, countries have increasingly adopted regulations designed to assure fit-and-proper

[83] The arguments for and against universal banking are beyond the scope of this book. Saunders (1994b) discusses the issues and provides references.

bankers and to improve corporate governance structures. Such regulations require that the roles and responsibilities of boards of directors and senior managers be clearly specified and that the persons appointed be competent to carry out those responsibilities. In this regard, regulators should be authorized to approve shareholders with a controlling interest, directors, and top management of a bank before the bank is licensed and, subsequently, whenever there is a change in significant ownership stakes or in key officers.

The corporate governance of banks is improved, and the potential conflict of interest with depositors is ameliorated, when regulations require that owners put their own capital at risk. Capital adequacy regulations ensure that, as a bank becomes less sound, its owners are required to recapitalize it and that, as the bank becomes undercapitalized, owners lose both their control of the bank and their investment in it. Capital standards must ensure that bank capital is sufficiently great, so that owners have an incentive to do their best to protect their stake and avoid a potential loss. Regulators normally require a certain minimum level of capital for a bank. Supervisors must verify that the capital is real, does not consist of borrowed funds, and is actually paid up in liquid form. Owners should also have incentives to limit the risks they assume. Accordingly, capital adequacy is established increasingly in relation to a risk-weighted asset portfolio, with more capital required against riskier assets.

In 1988, the Basle Committee on Banking Supervision (Basle Committee)[84] agreed to require large internationally active banks to hold capital equal to at least 8 percent of risk-weighted assets, thus preventing banks from unduly increasing credit risk through greater leverage; many countries other than those of the Group of Ten have also adopted the Basle standard. For each bank, owners and managers remain responsible for maintaining adequate capital and reserves and for structuring the bank's portfolio so as to withstand the adverse shocks inherent in the banking business. Most well-managed international banks hold capital substantially in excess of the 8 percent minimum.[85] Comparable resilience in countries where economic volatility is higher than in the Group of Ten countries would require capital considerably higher than 8 percent of risk-weighted assets.

Critical in implementing capital standards is the parallel implementation of appropriate loan-valuation and classification practices and supporting accounting standards. Effective capital standards require proper

[84] The Basle Committee members represent the central banks of Group of Ten countries, as well as Luxembourg and Switzerland. The Committee works under the auspices of, but is distinct from, the Bank for International Settlements (BIS).

[85] See "World's 100 Largest Banks," August 1995.

evaluation of a bank's asset quality, which implies that its loan portfolio, contingent commitments, and other off-balance-sheet activities are correctly valued. There are numerous instances of banks being insolvent, despite reporting adequate levels of capital "verified" by external audits, and of banks reporting positive accounting earnings, despite extensive economic losses. Inadequate loan classification and provisioning were factors in at least 11 of the countries in the sample. For example, the audited accounts of the Tanzanian National Bank of Commerce showed positive earnings and capital until 1993/94, despite massive losses that accumulated over seven years, but were only recorded as of the end of 1993/94 (National Bank of Commerce, 1995). Failures of external audit related to the U.S. savings and loan crisis have resulted in lawsuits and judgments against accounting firms that had conducted the external audits of institutions that later failed. Thus, capital standards must be combined with proper valuation standards and requirements that banks classify their loan portfolios and make adequate provisions for nonperforming loans. Whenever such basics are not in place, nominal adherence to international capital adequacy standards will not be meaningful.[86]

Policies restricting insider lending, foreign exchange exposure, and maturity mismatch help check bank management's ability to assume excessive credit, exchange rate, liquidity, and interest rate risk; these policies are described in more detail in Appendix II. Regulations may set specific levels for key indicators (such as credit exposure to insiders and single borrowers, liquidity mismatches, or foreign exchange open positions).

Alternatively, regulations may explicitly permit banks' internal risk-management systems to set the appropriate level of exposure, where such systems are in place. For example, in late 1995, the Basle Committee introduced an amendment to its 1988 Capital Accord, recommending that banks be required to hold additional capital according to their exposure to market risk. Market risk may be measured using either a standard model or banks' own risk-assessment models. This approach, along with new disclosure standards, recognizes that financial innovation has made it increasingly easy for banks to radically alter their risk profiles with a few transactions and that new techniques are needed for the official oversight of risk management. Rather than focus on limitations on each type of risk or on the use of each financial instrument, the trend is toward a more comprehensive approach to risk management, stressing the importance of internal governance and the role of market discipline.

The role of prudential policy in supporting internal governance is to ensure that banks institute appropriate internal control procedures, and that managers are knowledgeable about and involved in the risk-

[86] See Dziobek, Frécaut, and Nieto (1995) and Kane (1995).

assessment process. Regulations may set specific standards for internal control, or may allow banks to organize their control systems as they see fit, provided such a system is in place. It is typically required that there be clearly defined internal audit functions and that annual accounts be subjected to external audit. Accounting and audit standards are critical to the ability of managers and owners (as well as the market and supervisors) to detect and correct weaknesses. Certain internal control principles, such as the need for at least two managers (the "four-eyes" principle) or the separation of dealing and back-office functions, may also be regulated. Most details of internal control, however, are usually left to banks' own discretion.

Regulations Reinforcing Market Discipline

Banking laws and regulations can enhance the soundness of, and confidence in, the banking system by ensuring that market participants have as much information as possible to judge the soundness of banks, and that the sanctions imposed by the market can take effect.

Prudential policy can support market discipline by fostering enhanced public disclosure of bank financial information. Adequate disclosure rules can decrease systemic risk by helping to distinguish good from bad banks. Even where corporate laws already require the publication of audited accounts for both financial and nonfinancial enterprises, banking regulations may need to make further specifications as to the standard and form of these accounts, and the specific rules for disclosure. The balance sheets of bank subsidiaries and other related entities should be consolidated so as to make bank activities more transparent; such consolidation should include both international affiliates and domestic groups and companies. With a view to encouraging improvements in reporting on off-balance-sheet activities, the Basle Committee recently has issued recommendations regarding public disclosure of banks' trading and derivatives activities.

A country's legal framework for banks and other companies defines the rights of bank owners, the obligations of banks as debtors, and the rights of banks' creditors. These laws facilitate market discipline by allowing creditors to apply credible pressure and by allowing a market for corporate control to drive out owners and managers who are not maintaining a bank's value. Clear definitions of creditors' rights also facilitate exit of unsound banks; transparency allows bank customers and other creditors to protect their interests during the resolution process. The banking law should establish rules governing the distribution of losses of a failed bank, so as to reduce conflict and speed the liquidation. For example, laws in some countries provide that all creditors share pro rata in the assets of a

failed bank. Others establish a hierarchy of priorities for different classes of creditors, in which collateralized claims and depositors' claims usually must be satisfied before those of other creditors.

There is a public policy concern to foster the smooth exit of individual banks to protect the payments system, enhance systemic stability, and avoid negative externalities exerted by the continued functioning of weak banks. Where closure policies are weak and unsound banks are permitted to compete against sound banks, the former often have incentives to survive in the short term by undercutting competitors in an unsustainable way, which can ultimately weaken currently sound banks and increase resolution costs. Therefore, the banking law should also authorize the supervisor to monitor, intervene in, close, and possibly liquidate unsound banks, as discussed below. To carry out their roles and responsibilities successfully, supervisors need to operate in an institutional framework that provides them with access to the information they require to monitor bank condition.

Supervision

Bank supervisors ensure that regulations are enforced, that markets have information at their disposal, and that there is a backstop to internal governance and market discipline. As discussed in Appendix II, supervision is conducted both off-site, by monitoring reports that banks submit to the supervisory authority, and on-site, by actually verifying the adequacy of asset valuations, the accuracy of prudential reports, and the quality of internal controls. Supervisors strive to analyze the financial condition of banks, evaluate management, restrain unsound practices, and force the exit of insolvent banks.[87]

Supervision to Reinforce Internal Governance

Supervision confirms that bank managers are complying with regulations, provides information that owners can use to monitor managers, helps ensure that bank owners and managers are fit and proper, and provides a means for enforcing compliance with banking regulations.

A principal task of on-site supervision is to evaluate the accuracy of a bank's reports and the quality of the bank's asset-valuation systems and ensure that the balance sheet accurately reflects the bank's net worth. On-site inspection should also address the quality of a bank's earnings,

[87] Some supervisors use formalized rating systems such as CAMEL (capital, assets, management, earnings, liquidity) or ROCA (risk management, operations, capital, assets) as a summary for this process; see Appendix II.

which are a source of cash flow and liquidity and an indicator of the bank's viability. As mentioned above, profitability and capital provide a reliable picture of total earnings only when adequate provisioning for nonperforming assets has been made and the improper accrual of interest on past-due loans has been removed. While off-site analysis can provide some indications in these areas, only on-site analysis can provide the verification.

Similarly, bank compliance with prudential regulations is monitored by the supervisors through off-site analysis and on-site inspection. The accuracy of reported capital adequacy can only be verified on-site. Exposure to credit, liquidity, interest rate, foreign exchange, and off-balance-sheet risks and adherence to insider lending limits may be revealed by prudential reporting, but it also needs to be verified by audit or inspection. Such supervisory oversight ensures that bank managers and owners have incentives to comply with regulations, and to accurately value assets and off-balance-sheet exposures.

It is increasingly recognized that evaluation of the quality of management and the adequacy of internal controls and internal audit requires on-site inspection, since the market usually cannot adequately assess these aspects of bank operations. Supervisors provide an independent outside assessment. On-site inspection provides supervisors with a view of how management monitors credit, liquidity, market, and foreign exchange risk. Where deficiencies exist, supervisors may require that adequate systems be established to monitor and manage risk and will advise bank managers and owners. In this way, internal governance is supplemented by providing additional monitoring of staff on behalf of managers and of managers on behalf of owners.

Given banks' increasing ability to rapidly change the composition of their portfolios and their risk exposure, it is virtually impossible for any single person within a bank, let alone anyone outside the bank, to accurately value a bank's asset portfolio. Oversight by management, owners, and the market is becoming increasingly dependent on a bank's own internal control systems. The supervisors' contribution to this process is to assess both the quality of management and the adequacy of the policies, procedures, and systems that are used internally to assess, limit, and report on risk. In addition, supervisors are well placed to take a systemic view, and to notice where behavior that may appear rational to each individual bank, such as rapidly growing credit to a particular "hot" sector or credit expansion due to capital inflows, may have heightened systemic risk. In such cases, the supervisor can question banks' asset allocations, call for increased collateral, and encourage managers to take a more careful look at investment decisions. The Hong Kong Monetary Authority (1994) and the U.S. Comptroller of the Currency (Ludwig, 1995), for

example, each recently issued a general warning to their banks that bank quality was declining.

Bank owners and managers have a responsibility to ensure that bank operations are consistent with all relevant laws and regulations. However, the law must establish the enforcement authority of supervisors for cases in which bank owners and managers are not in compliance. The law must provide supervisors with the authority they need, including the ability to act without political approval to impose a range of enforcement actions, which might include cease-and-desist orders, fines, removal orders of senior management and directors, and placement of the bank in conservatorship or liquidation. Their authority should enable supervisors to encourage voluntary compliance, punish noncompliance, and compel corrective action.

Supervision to Reinforce Market Discipline

Supervision strengthens market discipline by helping to ensure that accurate information is disclosed to market participants and that weak banks are forced to exit the market. Supervisors may disclose information directly to the market, by releasing aggregate data on the condition of the banking system or on individual banks, or indirectly by verifying the information provided to the market by the bank and its external auditors.

External audits can complement the supervisory process, but they cannot substitute for it. External auditors can evaluate the consistency of accounting methods, the accuracy of financial reports, and the adequacy of internal risk-management systems. This information enhances the ability of the market to judge the soundness of the bank. External auditors, however, are usually hired by, and in some senses beholden to, the bank itself. They may be reluctant to make strong negative statements about an asset or a procedure. Moreover, bank management may not heed the auditors' warnings. For example, Barings's external auditors notified management of deficiencies in internal controls relating to derivatives activities during the 1992 audit.[88] In addition, auditors may not be permitted to report unsafe and unsound practices to the supervisory agency, much less to the markets. In this regard, the International Accounting Standards Committee recommends giving auditors responsibilities to convey adverse information to supervisors, and in recent years, many authorities, including those of the EU, have increased the responsibilities of external auditors.[89] In some cases, supervisors may hire external auditors to provide an independent assessment of a bank.

[88] See the United Kingdom (1995), paragraphs 10.33.

[89] See International Accounting Standards Committee (1995) and the European Union (1995), Article 5.

The type of evaluation done by auditors tends to be backward looking; it assesses whether procedures were followed and repayment schedules met. Few external auditors can be counted upon to have the information or skills to do the forward-looking asset valuation, including projections for particular businesses and the economy as a whole, which is necessary to assess a loan portfolio and evaluate the future prospects of the bank (see Appendix I). On-site supervision can monitor the quality of external auditing and its consistency with the supervisors' assessment of the value of the bank and its assets; however, since supervisory reports are not published, the market can only infer broad supervisory concurrence from the fact that revisions to published audit reports have not been required.

Ideally, a system of prompt corrective actions will prevent banks from becoming insolvent. For example, in 1991, the United States introduced legislation (FDIC Improvement Act) that required supervisors to take prompt corrective action once a bank reaches certain levels of undercapitalization. Regulation and supervision, however, will not prevent banking problems from occurring, and, as explained above, the market will not always respond quickly enough to incipient insolvency.

Supervisory arrangements then must focus on preventing individual bank failures from becoming systemic problems. The continued operation of weak but solvent banks presents systemic dangers, including the potential for destructive competition that could weaken other banks. If a bank does become insolvent, it should be quickly closed and resolved; when this occurs without systemic disruptions, the process of prudential oversight can be deemed to be functioning properly in support of market discipline. As noted earlier, market-led exit involves a first-come, first-served distribution of assets, which may run counter to desired liquidation priorities. Furthermore, a precipitous withdrawal of resources from a single bank could incite a crisis of confidence, which might spread throughout the banking and payments systems.

Thus it is particularly important for supervisory action to be taken to initiate or at least control closure. Closure should certainly occur when a bank becomes insolvent; preferably it would occur earlier, when the bank becomes seriously undercapitalized. Supervisory data often provide the basis for such action. If closure has been initiated by market forces, supervisors should be empowered and prepared to oversee and smooth the process, for example, by closing a bank that is experiencing a run, so as to put in place an orderly liquidation process.

Rapid closure and liquidation usually requires the ability to act outside the standard corporate bankruptcy procedures and without political approval. The banking law should provide the supervisors with the authority to close a bank and to liquidate it. A system of limited deposit insurance can assist the authorities in maintaining some stability and in

disposing of insolvent banks, promoting consolidation of creditors by replacing dispersed depositors with the insurance fund as the principal creditor. It can also provide political cover for closure decisions.

The desirability of prompt action to enforce corrective measures or initiate the conservatorship, restructuring, or liquidation of troubled banks on strictly technical grounds without political interference reinforces the need for adequate supervisory capacity, authority, and independence, discussed below. Orderly bank failures should be viewed as powerful reminders to other banks that the market system works and that they need to remain sound. Implementing strong exit policies, including intervention before a bank is formally insolvent, would require a change in attitude in many countries. Often the authorities consider bank failures to be evidence of a political or supervisory failure and go to considerable lengths to avoid closure; however, the closure of individual banks without systemic repercussions can be viewed in most cases as evidence that supervision is indeed functioning.

Supervisory Authority and Independence

To function properly, the supervisory agency must have sufficient capacity, authority, and independence. Supervision covers a range of activities and requires adequate human and financial resources. The supervisory agency must have the capacity to provide inputs into legislation, design regulations, evaluate owners and business plans of banks applying for licenses, assess existing banks' net worth and loan-valuation procedures, and analyze the management functions and internal controls of banks. To accomplish these and related tasks, the supervisory agency must be able to attract and retain high-caliber employees and to provide them with the necessary facilities, equipment, and training.

Beyond this basic capacity, the supervisory agency must have sufficient authority, established by law, to carry out its duties. Necessary powers include the authority to request data from banks, to conduct on-site examinations at the supervisor's discretion, and to enforce corrective actions ranging from informal agreements, to cease-and-desist orders, to closure. Supervisors must be able to act against banks without the delays and subversions that result from a need for political approval; their authority to this end must be firmly established, along with legal protection for supervisors who are properly discharging their duties. In cases where the judicial system does not allow a speedy or impartial response, administrative summary procedures may be required.

The efficiency and integrity of the oversight process is hampered when the supervisory agency is not independent. Supervisory actions are often unpopular. The supervisory agency should be institutionally structured to

have sufficient independence to carry out its day-to-day operations without interference. In many countries, this also means that the supervisory agency should have its own source of funding so that it cannot be held hostage to politically motivated budget battles; such funding may come from levies on banks being supervised. To ensure institutional independence, provide adequate information flows between the supervisory agency and the lender of last resort, and assure proper consideration of banking system soundness objectives in the broader policy mix, the supervisory agency is most commonly located within the central bank.

Alternative arrangements that constitute the supervisory agency as a separate administrative unit of government can also be appropriate; to a great extent, the location of the supervisory agency in different countries depends on historical, social, and political factors. Countries with different institutional structures have been able to construct effective supervisory systems. It should be noted, though, that supervisory agencies subordinated to a government ministry have often lost their ability to act independently, particularly when the government stands to bear the costs of bank closures or other supervisory actions. Supervision generally has greater independence of action if it is not a part of the government.[90]

Regardless of its institutional location, it is clear that the supervisory agency must develop a close working relationship with the central bank. This is necessary because the central bank requires supervisory information to back its decisions as lender of last resort and because the central bank should provide the supervisor with information on macroeconomic policy and overall conditions in the banking system.

The concept of supervisory independence should encompass prudential regulations, the application of which should be independent of monetary management. Prudential regulations are not monetary instruments to be varied over the business cycle in an effort to control domestic liquidity or to promote recovery from a general or sectoral economic slowdown. Using them in such a way could result in conflicts between supervisory and monetary authorities, reduce the long-term safety of the banking system, and create the mistaken impression that flexibility in the compliance with prudential regulations is acceptable. Rather, minimum regulatory standards should be established so as to keep banks sound regardless of the phase of the business cycle.[91]

Should a decline in general economic conditions cause a particular bank to have difficulty in complying with regulatory standards, the authorities may deem it appropriate to agree on a compliance program with that

[90] See Tuya and Zamalloa (1994).

[91] The initial implementation of prudential regulations may have short-term macroeconomic effects; the need for phasing in such regulations is discussed below.

bank; in so doing, they would closely supervise the bank's operations and monitor its progress toward meeting the regulatory standards. This need not imply a generalized relaxation of such standards. On the other hand, in periods of rapid growth in bank assets, increased monitoring of lending to high-risk sectors is in order. This may result in calls to stabilize or reduce exposure to such sectors, or in stricter collateralization rules. Such a tightening of prudential oversight is fully consistent with the supervisor's responsibility to take an overall view of banking sector developments and to act to maintain soundness when necessary.