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Challenges Confronting Regulation and Supervision

The design and implementation of regulatory and supervisory policies for banks present a number of challenges, including the need to carefully direct policy toward legitimate and achievable objectives and the potential for conflicts of interest at a number of levels. All too often legislators, regulators, or supervisors fail to meet these challenges adequately. For example, politicians may be tempted to use the banking system to achieve social objectives they are unwilling to fund overtly in the budget, but which may prejudice bank soundness. Poorly designed incentive structures may encourage bank supervisors to pursue career interests that detract from bank soundness. Furthermore, bank regulations frequently have a macroeconomic impact. The authorities may legitimately phase in significant escalations of regulations to moderate their impact and give banks time to adjust to the new environment. It is not appropriate, however, to adjust prudential regulations in an attempt to use them as macroeconomic policy instruments.

Regulatory Failure

Regulations may fail by being too lax, too intrusive, poorly designed, or inadequately implemented. Regulatory failure in some form was a factor in all of the countries in our sample, with the possible exception of Kuwait (see Table 16). Where regulations are insufficiently strict or comprehensive, the solution is clear. Correcting a situation of regulatory capture, which occurs when regulators or legislators are allied with banking interests, is likely to be difficult, but here too the prescription is clear. On the other hand, banking regulations may also be too intrusive, raising the cost of compliance and reducing bank efficiency and the scope for innovation.

Bank behavior is often dictated by regulations that are more quasi-fiscal than prudential. For example, laws in some countries require banks to

Table 16. Deficiencies in Regulation and Supervision[1]

Argentina (1980–82): Changes in the regulatory framework lagged behind liberalization, and certain favored loans were excluded from capital requirements. Prudential regulations were fairly comprehensive, but the supervisory agency lacked resources to keep up with the growth in the financial sector. Supervisors checked compliance rather than credit quality, ceased conducting on-site inspections in the years before the crisis, and lacked strong exit powers.

(1989–90): Supervision remained weak and allowed banks to grow rapidly before the crisis. Reserve requirements were very high.

(1995): The system had too many smaller banks because entry was easy. Supervisors allowed banks to grow rapidly before the crisis.

Bangladesh (1980s–present): Prudential oversight needs many improvements; monitoring compliance with loan classification and provisioning rules is especially weak, as are exit policies.

Bolivia (1994–present): The supervisory agency has adequate information; however, the implementation and enforcement of regulations are inadequate, especially the requirements regarding liquidity and loan classification and provisioning.

Brazil (1994–present): The central bank's powers to remove management and apply corrective actions were limited until November 1995, when new legislation was enacted. Weaknesses in the regulatory and supervisory structure are being addressed by the authorities.

Chile (1981–86): Lax supervision allowed interlocking ownership patterns (with connected lending accounting for 21% of outstanding loans at the 5 largest banks in 1982) and facilitated excessive risk taking and unsound lending practices (including the fast accumulation of short-term debt and "distress borrowing"). Prudential regulations were also weak—loan classification and financial ratings were only introduced in 1980–82.

Czech Republic (1991–present): Following the transition from a monobank system, prudential regulations were put in place, but their implementation had to be tightened in 1994.

Egypt (1991–95): Banking supervision and regulation have improved substantially since 1991.

Estonia (1992–95): Licensing was weak—the capital requirements for new banks were inadequate and other prudential regulations were lacking. Supervision was inadequate and allowed fast growth, risky portfolios, insider lending, and inadequate loan classification and provisioning.

Finland (1991–94): Supervision under the Ministry of Finance lagged behind deregulation and, until 1991, lacked authority and resources. The supervisory agency checked compliance with rules rather than risk management and did not supervise savings or cooperative banks.

France (1991–95): Although the laws, regulations and enforcement powers were adequate, and although the supervisor (the Commission Bancaire) has the authority, skills, and resources it needs, its effectiveness is being questioned. The supervisor was aware of Crédit Lyonnais's problems in 1991 but did not disclose them until the first rescue in 1993 and then allowed them to continue so that a second rescue was needed

Table 16 *(continued)*

in 1995. For example, Crédit Lyonnais was allowed to grow rapidly and to assume risky exposures in real estate and to a few large borrowers. In general, however, there is no political interference in supervision.

Ghana (1983–89): There was an inadequate legal, regulatory, and supervisory framework that did not include capital adequacy, loan provisioning, and other key requirements. The insufficient supervisory capacity left most banks unexamined and allowed one bank to operate with an unclear legal status.

Hungary (1987–present): A prudential and regulatory system has been established but is hampered by weak accounting and fragmentation.

Indonesia (1992–present): Prudential regulations broadly conforming to Basle standards were introduced in 1991, but enforcement is uneven and a system for resolving failed banks has yet to be developed. For example, shareholders' consent is needed to close a bank.

Japan (1992–present): Foreclosures are difficult; the authorities lack the power to close failing banks without shareholders' consent or a court order. Credit cooperatives were supervised by the authorities in the prefectures, but supervision was inadequate. The Ministry of Finance applied forbearance between 1993 and 1995 to insolvent credit cooperatives.

Kazakstan (1991–95): Too many new licenses have been issued. Bank closures are taking place, but supervision is understaffed, loan classification and provisioning is very recent, and provisions are not tax deductible. There is a lack of standards for risk diversification and connected lending.

Kuwait (1990–91): Bank supervision was strengthened following the banking collapse associated with problems in the informal stock market in 1982 and was further strengthened in 1993–95.

Latvia (1995–present): Liberal licensing requirements and lax supervision allowed a proliferation of unsound banks. Enforcement of prudential regulations and exit policy was inadequate.

Lithuania (1995–present): There is insufficient implementation of all prudential regulations, particularly capital adequacy. Enforcement of exit policies has been difficult.

Malaysia (1985–88): Supervision was slow in dealing with the problems that developed, partly because responsibility was split between the Ministry of Finance and the central bank. There was a lack of regulations dealing with loans to single and connected borrowers, suspension of interest, loan classification and provisioning, reporting consolidated positions and authority to effect exit and take enforcement actions. Supervision was much weaker for nonbank financial institutions and illegal deposit-taking institutions were allowed to operate.

Mexico (1994–present): Supervisory and regulatory standards were weak. There were no limits on credits to related parties, until they were introduced in 1992 and 1994.

Norway (1987–93): Capital regulations were weak. Supervision lacked resources and lagged behind deregulation; it monitored compliance with reserve requirements rather than credit quality and avoided closing banks. The situation worsened when the supervisory agency was merged with the insurance regulator in 1986, in a process that preoccupied the staff and diverted them from on-site inspections, which almost ceased. There were also problems with staffing because of low salaries.

Table 16 *(continued)*

Pakistan (1980–present): Supervision, which has staffing problems, focuses on formal compliance with legal and administrative issues. Prudential analysis remains embryonic.

Paraguay (1995–present): Rules for loan classification and provisioning have been partially implemented but they were long delayed. The supervisor has inadequate exit powers, and there is political interference in the supervision process.

Philippines (1981–87): Prudential regulations regarding capital adequacy, connected lending, and relations between a bank and its subsidiaries were relaxed and, even then, were not enforced in the years before the crisis. Reforms were delayed and regulations were not enforced because of the political climate. Fast loan growth and heavy insider lending resulted. Accounting standards, loan classification and provisioning rules, and exit policies were inadequate.

Poland (1991–present): Too many new licenses were issued. Improved laws and regulations have been introduced, but they are not yet fully effective. There is now both off- and on-site supervision.

Russia (1992–present): An adequate supervisory framework exists although improved coordination between on-site and off-site supervision is needed and some further modification in prudential regulations is necessary. For example, restrictions on insider lending, correspondent banking, and foreign exchange exposure are inadequate. Enforcement of supervisory regulations is lax and exit legislation is inadequate.

Spain (1977–85): Licensing was relaxed. Supervision was antiquated and had not kept up with deregulation; it checked compliance with regulations rather than credit quality. Prudential regulations were inadequate and yet were eased before the crisis. Those that remained were not enforced.

Sweden (1990–93): The large exposure regulations on loans to one borrower were insufficient and there were no regulations to restrain foreign borrowing. Bank closure was subject to the general corporate bankruptcy code. Bank supervision lagged deregulation and it allowed fast growth and risky asset portfolios.

Tanzania (1988–present): Prudential regulations were weak; supervision was lax and concentrated on compliance with credit allocation plans rather than financial condition. There was inadequate loan classification and provisioning.

Thailand (1983–87): The regulatory system was inflexible and subject to political influence. Inadequate licensing practices allowed concentrated ownership with conflicts of interest and undiversified portfolio composition. Supervisory responsibility was split between the central bank and the Ministry of Finance. The Ministry of Finance lacked strong exit and enforcement powers. There was lax oversight of capital adequacy and loan classification and provisioning. Unpaid interest was capitalized. Bank regulations were relaxed before the crisis and, even then, they were not enforced. There were no on-site inspections and no consolidated oversight.

Turkey (1994): Problems of coordination between the Ministry of Finance and the central bank impeded effective prudential oversight. Regulations on open foreign exchange positions and accounting standards were inadequate. The supervisory system needed improved instruments for dealing with problem banks and was unable to enforce rules on connected lending, which was often hidden in subsidiaries.

Table 16 ***(concluded)***

United States (1980–92): Regulation and supervision were adequate for banks for the most part although prompt corrective action requirements were lacking until 1991. Prudential regulation and supervision lagged deregulation in the thrift industry and were seriously deficient, encouraging savings and loans to hide their insolvency and continue operating in the hopes that they would "grow" out of their problems by taking more deposits and undertaking newly provided activities. There was political interference in the supervision of the thrift industry.

Venezuela (1994–present): Laws, regulations, and enforcement, especially regarding capital, loan classification, and provisioning were weak. Supervision lacked resources and basic tools, checked compliance rather than solvency, and did not conduct consolidated oversight, with the result that financial groups were able to hide problems. Under the 1995 Financial Emergency Law, most key supervisory decisions, such as revocation of licenses and requiring recapitalization, must be approved by the Financial Emergency Board, which is outside the supervisory agency.

Zambia (1994–present): An inadequate prudential framework was improved in 1994. Licensing requirements, however, continued to be deficient. Supervisors lack authority to discipline or close problem banks.

[1] Years in parentheses denote the period of banking problems.

extend loans that would otherwise not be extended, by designating priority sectors or mandating "community reinvestment" requirements.[92] Liquid asset ratios and similar portfolio regulations may require banks to lend to the government or other entities that issue eligible assets, often at below-market yields. Sectoral lending priorities or creating a particular type of banking system (e.g., a system composed of small local banks) is usually politically dictated, with the intent of achieving some social objectives. Interest rate controls may also be imposed in pursuit of certain resource allocation goals. These objectives may be achieved, but often at the expense of distorted prices, impeded market development, and increased bank fragility. Government development and social welfare policies are better handled transparently through budgetary allocations rather than by imposing regulations that could impair bank soundness.

The pursuit of economic efficiency along with banking system stability requires careful review of regulatory and supervisory policies to see that they are in line with the environment and enhance, rather than reduce, bank soundness and market discipline.[93] The international trend toward deregulation and financial liberalization reflects the experience that macroeconomic and allocative controls on bank behavior tend to be inef-

[92] Priority sectors may be favored domestic industries, or classes of citizens (as in Malaysia); for a discussion of community reinvestment requirements in the United States, see Benston (1986).

[93] This has been referred to as "market-friendly supervision" (Padoa-Schioppa, 1995).

fective and inefficient.[94] However, microeconomic efficiency (and private profit) may at times usefully be traded for stability (and public benefit) through prudential or consumer protection regulation; such stability enhances overall market efficiency. At the same time, these regulations should not remove the market's incentive to monitor bank behavior, by creating excessive deposit guarantees or by interfering so strongly in banking activities that the public infers an implicit government backing for the banks. Similarly, regulations must not shelter banks from healthy competition or from the market for corporate control. For example, Prowse (1995) presents evidence that the effectiveness of board intervention and of hostile takeovers as disciplinary mechanisms was reduced for U.S. banks relative to manufacturing companies and attributes this in part to banking regulation.

In many jurisdictions, different parts of domestic financial conglomerates are supervised by different authorities. Which institutions and activities are subject to banking laws needs to be carefully defined, so that the possibility for regulatory arbitrage among domestic regulators of banks and other financial institutions is limited.

Supervisory Failure

Supervisory failure usually takes the form of forbearance—an adjustment in the interpretation of rules to accommodate problem banks or a failure to act in a timely manner to prevent or address unsound banking. This can occur for a number of reasons. Supervisors may not have the ability to act independently, because of inadequate organizational structure or direct political interference. Where the political will to enforce regulations and supervisory standards is missing, supervision is unlikely to succeed in keeping the banking system sound. Some form of supervisory failure was a factor in almost all of the sample countries (Table 16).

Supervisors in some countries develop longstanding relationships with the banks they oversee. Such supervisors are subject to regulatory capture, a process in which the supervisor identifies more closely with the banking industry than with the public interest, and may see his role as protecting, rather than disciplining, the banking industry.[95]

Because the public often perceives the supervisor's only role as preventing bank failures rather than as ensuring the exit of weak banks so as to maintain systemic soundness, supervisors may be reluctant to close banks.

[94] See Vittas (1992).

[95] In countries where supervisors routinely find employment in the banking sector after leaving the public sector, regulations must be in place to address potential conflicts of interest. Williams (1996) indicates that this was a problem in Japan.

Supervisory accountability may be lacking, particularly when supervision is part of a bureaucracy in which responsibility for taking tough decisions is not clearly allocated. In addition, political interference may prevent intervention in a bank.

A common reaction to the emergence of banking distress is for the authorities to adopt a "wait-and-see" attitude, hoping that the difficulties are temporary, that no serious threat to the financial system is posed, and that any problems will either resolve themselves or remain submerged until after someone else takes office. This can occur where supervisory systems are not sufficiently independent or are underfunded and lack qualified staff; consequently, authorities are wary of taking potentially controversial decisions. Forbearance, delay, or cover-up may be abetted by ambiguous assignment of responsibility and a lack of accountability. It can also occur in well-developed systems where authorities have become more concerned about their reputation for overseeing a system with no visible difficulties than about resolving banking problems. Deposit insurance may further exacerbate the problem by removing pressure from depositors as a potential spur to action.[96]

Delay in addressing unsound banks is rarely effective and usually detrimental. Unsound banks continue to operate, weakening initially sound competitors and increasing the likelihood of systemic difficulties. Furthermore, unsound banks tend to take on even more risk or may be looted by insiders, which ultimately increases resolution costs.

Supervisory failure may also result in weakened effectiveness of regulation. Supervisors, sometimes under political pressure, may try to keep a banking system afloat by lowering capital standards, by allowing continued unfettered operation with less-than-adequate capital, or by permitting increased risk exposure. This in turn may delay corrective actions until after a bank has become insolvent. Despite this, supervisors in several countries have relaxed or failed to strengthen valuation and accounting standards when banks were weak, ostensibly to give the banks time to grow out of their problems. For example, U.S. regulators adopted accounting standards that disguised insolvency during the savings and loan debacle (United States, General Accounting Office, 1985). Accounting procedures obscured the true condition of Japanese banks and thrifts; corrective measures were first promised by the Bankers' Association, rather than the supervisors ("Japan," November 1995). In these and other cases, delay exacerbated unsoundness.

Systems in which supervisors either do not promulgate regulations independently or enforce those regulations unfailingly often result in the

[96] *See Allen and Saunders (1993).*

continued operation of weak, undercapitalized banks. Banking laws can be written, however, so as to limit the possibility of supervisory failure. The law should be flexible enough to allow the supervisors to apply successively more stringent corrective measures, while being firm enough to limit supervisory forbearance. It should also protect supervisors acting professionally, and limit lawsuits or other actions against them. Rules governing prompt corrective actions to be taken against banks that are not complying with the laws and regulations should be established in the law. Even with such provisions in place, there are limits to what regulation and supervision can accomplish.

Market participants will always be changing and innovating, and testing the limits of legality and prudence. Regulators and supervisors will almost always be a few steps behind, trying to adapt rules and supervisory procedures to the latest financial products and developments in financial markets. Innovation and capital market liberalization have made it easier for banks to circumvent existing regulations on net foreign exchange positions and leverage. Liberalization also makes it possible for banks to blind supervisors to their risk taking by engaging in complex offshore activities especially when conducted through derivative instruments. For example, Mexican banks' use of structured notes and other offshore transactions to weaken the impact of domestic financial regulations is often cited as a factor contributing to the pressure on the peso in late 1994.

In general, supervisors will not be able to anticipate sufficiently to outengineer the financial engineers. At the same time, other market participants will often have insights that supervisors lack. Supervision and regulation must therefore work alongside, and encourage, dynamic market and internal forces. Thus prudential regulation and supervision should be viewed as just one part of a comprehensive system of guidance and incentives influencing bank behavior; the system must also include market discipline and strong internal governance.

Macroeconomic Effects of Prudential Regulations

As explained earlier, bank activities affect macroeconomic conditions, particularly in the monetary area. Prudential policies and regulations that delimit bank activities will therefore have macroeconomic implications. Much of the concern in this area has been over strengthening capital requirements, which, it has been argued, could reduce bank lending and slow economic growth. Other prudential regulations, however, may also have a macroeconomic impact. This does not represent a form of regulatory or supervisory failure and does not argue for suspension of such regulations. The macroeconomic impact of prudential policies can be anticipated, and implementation of such policies can be adjusted accordingly.

Capital Standards

A frequently cited example of the influence of prudential policies on monetary and macroeconomic conditions is the impact of the 1988 Basle capital standards on credit conditions in the major industrial countries. There was a slowdown in credit growth in a number of countries during 1988–91, which appears to have lengthened or worsened cyclical downturns. It is likely the case that this slowdown, referred to as a "credit crunch," was in part the result of the increase in capital that banks were required to hold against assets. Banks apparently responded to the new capital requirements by reducing the volume of credit extended or by increasing their interest margins to build up own capital.

It is difficult to fully substantiate whether capital constraints contributed to the credit slowdown, however, since the demand and supply schedules for loans are not directly observable.[97] While the contribution of capital adequacy requirements to the U.S. credit crunch of 1988–91 cannot be isolated,[98] some studies have found evidence that growth in lending by U.S. banks that were constrained by the new capital standards was slower than the growth of lending by better capitalized banks.[99] On the other hand, the Bank of England concluded that the U.K. credit slowdown resulted from decreased borrowing capacity and banks' concern to tighten standards and improve profitability, rather than from problems in meeting the international capital adequacy standard.[100] Japanese banks widened their margins and adopted a more restrictive lending stance from 1988 to 1991, but observers differ as to whether or not wider bank margins reduced the macroeconomic impact of looser monetary policy, and whether the reduction in credit was due to a capital constraint or was mainly demand driven.[101] Thus the evidence is mixed, but there is some theoretical and empirical support for a capital-induced credit crunch.

Capital adequacy requirements can affect credit expansion in two distinct ways: they compel banks to build up sufficient capital at the time when ratios are initially imposed, and they compel banks to reduce risk assets when the capital constraint becomes binding. To some extent, these rules reinforce what should occur naturally. Banks should maintain adequate capitalization to support the risks they assume. A credit crunch surrounding a rise in capital requirements should be transitory, and may reflect other distortions (such as a real estate bubble) that have resulted in overextension that is difficult to reverse to meet a higher capital-to-asset

[97] See Goldstein and others (1992), Chapter III.
[98] See for example, Cantor and Wenninger (1993).
[99] Brinkmann and Horvitz (1995).
[100] Bank of England (1991).
[101] See Fairlamb (1994) and Shinagawa (1993).

ratio. If default rates rise in an economic downturn, capital will be reduced. Total assets will also decline as loans are written off, but the loss in asset-carrying capacity will be greater owing to the leveraging of bank capital—if a loan of 100 is written off, minimum required capital would decline by 8 but actual capital would decline by the full 100.

The effects of an economic downturn on bank assets will result in reduced capital due to loan write-offs. Thus the effects of minimum capital ratios tend to be procyclical, binding during recessions and asset price depressions;[102] however, capital adequacy ratios will also dampen volatility in the longer term. Thus, discussion of the effects of the Basle Capital Accord needs also to take into account the timing of implementation. Had stricter capital standards been applied in the early 1980s, a larger capital cushion would have been available to absorb losses later in the decade, and capital might not have become a binding constraint on credit growth.[103]

Other Prudential Instruments

Concern for macroeconomic effects extends also to other regulatory and prudential instruments, including liquidity, interest exposure, foreign exchange exposure, loan limits, and other prudential standards. These may constrain banks' asset allocation, resulting in higher costs or reduced income, and increasing interest rate spreads. For example, a number of historical periods of tight money in the United States have been linked to regulatory action, in particular to actions regulating interest rates.[104] If prudential regulations require banks to hold more liquid assets, and these yield less than other assets the bank might have chosen, the reduced income will be reflected in wider spreads.[105] Loan-loss provisioning will similarly increase bank expenses and contribute to wider spreads.

Excessively stringent regulations may be cause for concern. However, to the extent that prudential regulations merely force a recognition of the true costs of doing business safely, the higher price paid by borrowers and the lower yield to depositors do not mean that regulation has created additional costs for banks. Rather, wider interest rate spreads reflect a shifting of costs from the deposit insurer or lender of last resort and to the consumers of banking services.

[102] See Goodhart (1995) and Blum and Hellwig (1995).

[103] In addition, the asset price inflation that resulted in those losses might not have occurred to the same degree; see Alexander and Caramazza (1994). Cantor and Wenninger (1993) present views that the regulatory failure lay in not containing the excesses of earlier years.

[104] Romer and Romer (1993).

[105] Reserve requirements may also have an impact on both banks and the macroeconomy (see, for example, Chari, Jones, and Manuelli (1995) and Spiegel (1995)); however, reserve requirements should be considered monetary rather than prudential instruments, even though they overlap liquidity rules to some extent.

Regulations may have spillover effects on other financial instruments. Prudential rules on liquidity management by commercial banks typically also affect the demand for, and yield of, liquid assets such as treasury bills and commercial paper. In addition to the possible impact of systemwide regulations on bank lending and interest rates, actions taken to limit the activities of certain banks may also have an impact. For example, supervisory intervention to limit deposit acquisition by weak banks may remove a source of upward interest rate pressure and reduce credit growth. The actual effects of prudential regulations will ultimately depend on the particular circumstances of the banking system and the economy as a whole.

Cyclical Adjustment of Prudential Regulations

Prudential policies should be devoted to creating a framework for sound banks rather than diverted to cyclical demand management. Therefore, prudential requirements should not be viewed as an additional monetary policy tool. While regulations could potentially be adjusted over time to produce procyclical or countercyclical effects on the economy, such an approach to prudential regulation is likely to introduce conflicts of interest within the central bank and weaken the banking system in the long run. For example, expansionary policy could be reinforced by reducing capital requirements.[106] This policy tool, however, could be difficult to reverse, with the result that over time the banking system could tend toward lower levels of capital and greater risk of insolvency.

It has been argued that in some circumstances prudential regulations could weaken the effectiveness of monetary policy instruments. For example, a stimulatory monetary policy may be less effective when capital adequacy regulations constrain bank credit expansion, since the central bank can control access to, or the cost of, borrowed funds, but does not control the supply of bank capital.[107] While that is true, there are many aspects of credit creation that the central bank cannot control, such as the supply of bankable projects and the credit-screening process. Central banks normally do not seek to control these aspects of credit creation, since it is not desirable to expand the supply of questionable credit.

Arguments against maintaining strict prudential standards on monetary management grounds focus excessively on short-term considerations. The central bank should not seek to expand the supply of credit based on an insecure capital foundation. During periods of economic stress, banks should be encouraged not only to maintain the minimum level of capital, but to build up additional capital if possible, for example, by refraining

[106] This is suggested by Goodhart (1995).
[107] See Brockelmann (1995).

from paying dividends. In the medium to long term, there is no inconsistency in striving for effective monetary control, strong banks, and sound prudential policies. In fact, an effective system of prudential regulations that fosters a sound banking system will increase the flexibility and effectiveness of monetary policy instruments, which should enhance monetary control in a reasonably stable economy.

Transitional Arrangements in Raising Prudential Standards

Understanding the potential short-run effects of raising prudential standards leads to a policy approach that recognizes that any changes in prudential regulations should be phased to take account of the capacity of the banking system to adjust and of broader macroeconomic trends. An increase or decrease in capital adequacy ratios can leave the banking system starved of or flush with capital. Either could cause problems, depending on current and prospective macroeconomic conditions. For this reason, the Basle Capital Accord was phased in over a period of four years. Similarly, the introduction of new or higher liquidity, interest exposure, loan limits, and other prudential standards needs to be undertaken with due regard for the short-term effects on the banking system and the monetary stance. Prudential policies should be tightened gradually. Any forbearance that may be required must be monitored and phased out under an enforceable compliance timetable.