Reforming National Bank Supervision: Discussion

John G. Heimann*

As many of you know, Ruth de Krivoy is the Senior Advisor to the Financial Stability Institute, of which I am Chairman. The issues involved in reforming national banking supervision that she describes are those that we have discussed and dissected many times over the past year. Before I go on to discuss the Krivoy paper, I have been asked to say something about the Financial Stability Institute. Many of you may not know about our work, all of which has to do with the areas of activity being discussed at this conference.

The Financial Stability Institute

After the East Asian crisis, it was broadly recognized that if a country's macroeconomic policies were poor and its financial system weak, you had the makings of a disaster. Even if macroeconomic policies were reasonably decent and the financial sector was weak, you could expect a disaster. And it was also recognized that when macroeconomic policies were not particularly good but you had a robust and viable financial sector, you might have a big problem, but you did not have a disaster. Hence, all of the official statements would include in their prescriptions ". . . and, of course, a strong financial system."

In fact, like so much that has to do with banking supervision and regulation, the principles are delivered at ten thousand feet, and that is where they remain. We need to get down to ground level, and that is where the Financial Stability Institute operates. Everyone can (and does) tell the financial systems in the emerging countries what to do. Precious

*Chairman, Financial Stability Institute, Bank for International Settlements.

few organizations are trying to show them how to do it. We must deal with implementation and enforcement, and that is the role of the Institute, created by the Bank for International Settlements and the Basle Supervisory Committee as a joint venture.

The Institute is one year old, and its first year was devoted to experimentation. We began by sending out a survey, asking the countries about their problems and needs. Within 35 days we got 223 answers from 125 countries, demonstrating the great demand out there for help and assistance.

Our methodology consists of seminars and workshops at regional meetings around the globe. Our mandate is to improve the financial system, the financial sector, and financial institutions in the developing and transitional economies. That includes banking, insurance, and securities. Our start was in banking, the primary form of intermediation in most of these countries. We held our first insurance and securities activities just last weekend, in Basle.

The FSI has been enormously productive in its first year. We have held more than 20 seminars, 10 in Basle and the rest in various regions. If the course content is purely supervisory, we use supervisors; everything else is taught by people from the private sector. Over 100 countries have participated, over 600 people have attended. We teach about credit risk, market risk, and corporate governance, but basically core principles methodology. We concentrate on implementation and enforcement. In many of these countries, the core principles cannot be implemented, for the reason that both Krivoy and Mishkin have described here: lack of resources.

Simultaneously, the FSI is becoming the voice of "everybody else," meaning the non-G-10 countries, in the councils in Basle and elsewhere, because these countries feel that they can talk to us. We are not measuring them, as the IMF does. The IMF does a great job, but these countries can tell us things that they just do not want to say before those who make assessments of them.

The Krivoy Paper

Not surprisingly, I have the highest praise for Ruth Krivoy's excellent paper, which is thoughtful, perceptive and timely, and correct. I agree with her analysis of the problems and her view as to solutions. Therefore, I shall take this opportunity to comment on some of the points in her paper, not as criticism, but rather for emphasis.

Strong and Independent Supervisors

This is the number one priority. In too many countries, the supervisor is under the political thumb of masters from the ministry of finance or those central banks that claim independence but are, in fact, politicized. The reasons should be obvious. By granting banking licenses, the supervisor is awarding economic benefits. Conversely, by taking over banks, the supervisor is destroying what at least is presumed to be economic value. If the supervisor makes judgments, not just on the merits but influenced by political considerations, then the public rightfully questions the validity of the supervisory role.

Independence means that the head of the agency is appointed for a term and cannot be removed by whim; likewise for the agency's boards of directors, if applicable; the agency is funded not through the political process but by fees paid by the supervised institutions; and the supervisors are not subject to personal liability suits.

To be strong, the agency must be independent.

Connected Lending

We all know connected lending when we see it, to borrow Justice Holmes's description of pornography. In the G-10 countries, the problems of this practice are well understood and the supervisory agencies are vigilant in their exposure of them. The supervisors in the non-G-10 countries also know the dramatic costs connected with this troublesome practice. But they have a unique problem.

Let us take a hypothetical situation: a country in which seven families control the leading businesses, directly or indirectly, and they also control the four leading banks. What is the supervisor to do? If he establishes rules that directly cut across long-established and self-serving practice, he is immediately in trouble. Those seven families undoubtedly have strong relationships with the ruling political structure, through long-established practice, funding, and often marriage. If the supervisor can be fired, he or she will be. And, I may add, in such countries, if you are fired by the political system, it is virtually impossible to find other employment. Not easy for a man or woman with a family to support and educate.

What needs to be done is to create a definition of connected lending that the supervisor can wave under the nose of his boss. He then does not become the evil party. Rather, the supervisor is merely carrying out the internationally accepted standard. The supervisor can blame "them," thereby doing the right thing without damaging his career. If we want to strengthen the financial system and institutions in developing and transitional economies, we must provide their national supervisor with the protection of defined international standards.

Where Should Supervision Be?

Since supervision must be independent, it belongs in an independent agency or a truly independent central bank. There can be no compromise with this principle. Implicit in this question is where supervision should lie for banking, securities, and insurance. Consolidated or not, the answer would be the same: Supervision must be independent.

In this increasingly globalized and consolidated world, considerable logic lies behind the movement to bring all of these agencies under the same roof, in a manner similar to that accomplished in the United Kingdom with the establishment of the Financial Services Authority. Of course, this form of amalgamation is and will continue to be fought in many countries where the self-interests of industries and regulatory bureaucracies prevent this step forward. In the United States, recent legislation has attempted to solve the concept of "consolidation" by creating an umbrella regulator to consolidate the functional regulators' observations within a financial conglomerate. This is better than nothing, but it still is a rather cumbersome and, as yet, untested solution.

Coping with Moral Hazard

Once again I find myself in total agreement with Krivoy's comments. This discussion did, however, raise another issue that has not been touched upon. Historically, financial supervision has been based upon quantitative analysis. Off-site supervision, peer group reviews, the annual inspection or examination have all been heavily reliant upon the numbers and the ratios derived from them. Leaving aside the pressing problems of accounting standards, which are very important but not the subject of this comment, the current trend is toward qualitative analysis. To put it another way, in the future, financial supervision will increasingly rely upon the judgment of the supervisor. This represents a huge leap forward in supervisory practice, and it is based upon the realization that periodic snapshots of a bank are inadequate. Technology has speeded up the entire process, and financial institutions can change their balance sheets in seconds.

Quantitative analysis is surely helpful and provides the foundation for trend analysis. But, in the final analysis, supervisors will need to rely increasingly upon their judgment. And judgment is subjective, challengeable in court or in the political arena. When a bank is insolvent, the supervisor has little problem proving the need for seizure. But when a supervisor is trying to prevent insolvency, he or she does not have proof positive but judgment, based upon experience and comparison with other like institutions. This change is not easy within the G-10, although increasingly it is becoming accepted practice. But in the non-G-10 countries, it will be much more difficult and, if combined with personal legal liability, virtually impossible.

In the final analysis, Krivoy is dealing with the nuts and bolts of financial supervision. And a good thing too! Over the past two years many trees have been destroyed and much ink wasted in the debate over financial architecture, a timely political subject used by the U. S. Treasury to assuage an antagonistic Congress and by others for its headline-grabbing appeal. Not nearly enough emphasis has been placed on the practicalities of the international financial system, that is, the payments system or financial supervision. Krivoy has presented a pragmatic and real-world view of what needs to be done, shorn of meaningless, broad-brush solutions that may tickle the press and the politicians, but do little to solve the problem. If the G-10 governments did nothing else but seek to implement her suggestions, the international financial system would be a far safer place.