REFORMING BANK SUPERVISION: DISCUSSION

Frederic S. Mishkin*

Ruth de Krivoy's paper is a valuable contribution to the literature on bank supervision. It provides a unique insight on this topic from an insider who witnessed the problems that bank supervisors can encounter in emerging market countries. During her tenure at the central bank in Venezuela, Krivoy saw firsthand what happens when bank supervision is inadequate. In 1994–95, Venezuela experienced a major banking crisis, which the World Bank estimated cost close to 20 percent of GDP to clean up (Caprio and Klingbiel 1996). To put this number into perspective, the estimated cost of the savings and loan crisis in the United States was on the order of 3 percent of GDP. Krivoy has seen what can go terribly wrong with bank supervision in an emerging market country, and we have much to learn from her experience.

I very much agree with the thrust of the recommendations in Krivoy's paper. Indeed, I was struck by how many of her recommendations paralleled ones I outlined in a recent paper (Mishkin 2000). In my comment I will highlight the recommendations in her paper that I think are particularly worth emphasizing and discuss one recommendation that I believe should receive more emphasis.

RECOMMENDATIONS IN KRIVOY'S PAPER

Krivoy's paper makes 10 recommendations for improving bank supervision in emerging market countries, which I paraphrase below.

1. Bank supervisors need to be independent and strong.

*Alfred Lerner Professor of Banking and Financial Institutions, Columbia University.

2. Supervisors need to be given substantial resources to do their job properly.
3. Supervision must be proactive and have features of prompt corrective action.
4. Supervision should make substantial use of market information.
5. Supervision should also focus on information about liquidity as an early warning signal of problems in the banking sector.
6. Supervision must ensure that bank capital is adequate.
7. Supervision should focus on asset quality and limit connected lending.
8. Consolidated supervision of banks' entire business is necessary for effective supervision.
9. Central banks should be engaged in bank supervision.
10. A central focus of bank supervision should be limiting moral hazard.

Economists, lawyers, and accountants can generally agree on what needs to be done to limit the moral hazard of excessive risk-taking by banks in order to promote a safe and sound banking system, and so most of them would agree with the list above. Yet we often see that these prescriptions are not followed in emerging market countries, with a high cost when their banking systems blow up. Why?

A key theme in Krivoy's paper is that "It's the politics, stupid": The failure of prudential supervision in emerging market countries to prevent banking crises is a political problem. If the political process does not support prudential supervision, then a banking crisis is likely to occur. Thus she emphasizes that it is critical that partisan politics or personal interests not be allowed to interfere with prudential supervision. This is of course important in industrialized countries as well. One aspect of the political problem that Krivoy did not mention is the fact that partisan battles are particularly apt to arise during crisis episodes in emerging market countries. These battles tend to be disastrous because political factions are less able to pull together, even when the country is falling apart.

The theme "It's the politics" explains why Krivoy rightfully starts with the first two recommendations for emerging market countries: the need to support strong and independent supervisors and give them the resources to do their job. In order to have strong and independent supervisors, the legal framework must support supervisors by giving them a legal mandate with the appropriate powers to enforce banking regulations. However, as Krivoy emphasizes, a legal mandate is not enough. Supervisors must be free from political pressure so they can avoid engaging in regulatory forbearance, in which enforcement of the regulatory rules is relaxed. Indeed, insulating supervisors from political pressure to engage in regulatory forbearance provides an important argument for having bank supervision housed inside the central bank, as Krivoy advocates. I agree with her on this point, as Mishkin (1992) indicates. Another argument for locating supervision in the central bank is the fact that the central bank is always going to be the lender of last resort, and to perform this role properly, it needs information about the condition of the banks it may need to lend to. Indeed, while I advocate this in the U.S. context, it may be even more important in emerging market countries.

Although supervisors need to be independent, they still must be accountable to the public in order to carry out their mandate of promoting a sound and safe financial system. How can this be done if the supervisors are given independence? The answer lies in transparency of the supervisory process, which discourages regulatory forbearance. For example, as pointed out in Mishkin (1997), an important but very often overlooked part of FDICIA that has helped make prudential supervision more effective in the United States provides for a mandatory report by the supervisory agencies if a bank failure imposes costs on the Federal Deposit Insurance Corporation (FDIC). The resulting report is made available to any member of Congress and to the general public upon request, and the General Accounting Office must do an annual review of these reports. Opening up the actions of bank supervisors to public scrutiny makes regulatory forbearance less attractive to them. In addition, subjecting the actions of bank supervisors to public scrutiny reduces the incentives of politicians to lean on supervisors to relax their supervision of banks.

Krivoy also emphasizes that not only must supervisors be independent, but they also must be provided with the resources to do their job properly. The supervisory agency should not be a small department in the ministry of finance, and supervisors must receive decent pay. It is crucial that supervisors be provided with good information technology so that they can monitor financial institutions adequately. They also need to be given the legal framework to support prompt corrective action, so they can alter banks' behavior before they reach terminal condition and close institutions quickly when they have lost most of their capital. The legal framework must also avoid saddling supervisors with personal liability for doing their jobs. Overarching all of these recommendations is Krivoy's view that supervisors must be given "respect." Their contribution to the society must be valued, and this should be reflected in the resources they are given to do their jobs.

Foreign Bank Entry

Although I am in almost complete agreement with Ruth Krivoy's analysis, one recommendation that she does not emphasize I believe is also very important for emerging market countries, the entry of foreign banks. This is a very tough political issue because it is uncomfortable seeing foreigners own some of your banks. As a result, many emerging market countries have restrictions on the entry of foreign banks. Rather than a threat, however, their entry should be seen as an opportunity to strengthen the banking system; emerging market countries need to encourage foreign bank entry. In all but a few large countries, domestic banks are unable to diversify because their lending is concentrated in the home country. (This also was a problem in the United States when “foreign” banks were not allowed entry in states like Texas, which saw its banks collapse when they were faced by adverse state-specific shocks they were not diversified against.) In contrast, foreign banks have more diversified portfolios, and they usually also have access to sources of funds from all over the world through their parent company. This diversification means that these foreign banks are exposed to less risk and are less affected by negative shocks to the home country’s economy. Many emerging market economies are more volatile than those of industrialized countries, and having a large foreign component to the banking sector is especially valuable because it helps insulate the banking system from domestic shocks. Encouraging entry of foreign banks is likely to lead to a banking and financial system that is substantially less fragile and far less prone to crisis.

Another reason for encouraging entry of foreign banks is that risk management is becoming more important in prudential supervision. The traditional approach to bank supervision has focused on the quality of the bank’s balance sheet at a point in time and on whether the bank complies with capital requirements. Although the traditional focus is important for reducing excessive risk-taking by banks, it is no longer adequate. First, capital may be extremely hard to measure. Furthermore, in today’s world, financial innovation has produced new markets and instruments that make it easy for banks and their employees to make huge bets quickly. In this new financial environment, a bank that is quite healthy at a particular time can be driven into insolvency extremely rapidly from trading losses, as was forcefully demonstrated by the failure of Barings in 1995. Although initially well capitalized, Barings was brought down by a rogue trader in a matter of months. An examination that focuses only on a bank’s position at a particular time may not be effective in indicating whether a bank will in fact be taking on excessive risk in the near future. Bank examiners now need to see what best practice for risk management is like in the banks they examine, and then make sure that best practice spreads throughout the banking industry by giving poor rankings to banks that are not up to speed.

Entry of foreign banks provides tremendous benefits in helping bank supervisors in emerging market countries focus on risk management, because foreign banks come with expertise in this area. When bank examiners in a country see better practices in risk management at foreign banks, they can spread these practices throughout their country's banking system by downgrading banks that do not adopt these practices. Having foreign banks to demonstrate the latest risk management techniques can lead to improved control of risk in the home country's banking system. Clearly, benefits also result from increased competition that foreign bank entry brings to the banking industry in the home country. Entry of foreign banks should be encouraged, because it will lead to improved risk management techniques and a more efficient banking system.

Conclusion

In conclusion, let me reiterate that the emphasis in Krivoy's paper is right on the money. Creating a better political environment for prudential supervision of the financial system is key to limiting the moral hazard problem of excessive risk-taking in emerging market countries, thereby promoting a safe and sound financial system. However, encouraging the entry of foreign banks should not be overlooked, because the increasing need to focus on risk management in prudential supervision is made substantially easier by the presence of foreign banks.

References

Caprio, Gerard, Jr., and Daniela Klingbiel. 1996. "Bank Insolvency: Bad Luck, Bad Policy, or Bad Banking?" *Annual World Bank Conference on Development Economics*, pp. 29–62.

Mishkin, Frederic S. 1992. "An Evaluation of the Treasury Plan for Banking Reform." *Journal of Economic Perspectives*, 6, No. 1 (Winter), pp. 133–53.

———. 1997. "Evaluating FDICIA." In George Kaufman, ed., *FDICIA: Bank Reform Five Years Later and Five Years Ahead*. Greenwich, CT: JAI Press, pp. 17–33.

———. 2000. "Financial Market Reform." In Anne Krueger, ed., *Economic Policy Reform: What We Know and What We Need to Know*. Chicago: University of Chicago Press, forthcoming.