Reforming Bank Supervision in Developing Countries

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Financial regulation and supervision are progressing at an encouraging speed in many developing countries. Concerns about safe and sound banking are widely shared. Laws are changing, and efforts to step up prudential supervision are under way. This is the legacy from two decades of crises.

Economic reforms in the 1980s and early 1990s generally underestimated the potential risk of banking crises. Targets and deadlines set by governments and multilateral institutions in many structural adjustment programs for the financial sector were inconsequential, more of a ritual than a true attack on the core weaknesses, reflecting strong opposition by vested interests. Concerns about bank insolvencies therefore did not translate into effective and timely remedial action in many countries, even if problems were identified while there was still time to prevent most of the damage. The 1992 Basle Committee standards for the supervision of international banking groups and their cross-border establishments helped break some deadlocks, as leading bankers in developing countries perceived that their business would be at risk unless national banking supervision was upgraded. In the mid 1990s, thus, reforms speeded up.

Financial turbulence, individual bank failures, and systemic crises occurred in Latin America, Asia, and Eastern Europe, as well as bank failures and near-failures in developed countries. These breakdowns have triggered extensive work by regulators in both G-10 and non-G-10 countries in crafting new rules, setting international standards and guidelines, and searching for ways to successfully implement the needed changes, worldwide.

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The problem is that in any given country, financial sector reforms are at the core of the power play. Idiosyncratic factors and vested interests therefore have a powerful role in determining the pace and breadth of changes that governments undertake in the field of banking regulation and supervision. It is true that economic and financial constraints influence the speed at which countries can adopt international standards, and financial sector reforms must therefore be carefully phased in. But gradualism is a mixed blessing, and the risk of procrastination is huge if targets and deadlines do not tightly bind the implementation process. "We are different" is an expression used often to explain why regulations addressing the weak spots in a national banking system either cannot be enforced, must be watered down, or can only be implemented over too long a period of time. But after the fall, it is frustrating to realize that whatever was done was "too little, too late."

The current wave of reforms in national banking supervision is largely rooted in the internationalization of financial markets. The most important motive for maintaining the momentum also comes from the global arena. Incentives to upgrade banking supervision and comply with international standards can thus be expected to be higher, the more the country depends on access to international financial markets.

The greatest challenge when building stable financial systems in the developing world is effective implementation. It involves creating incentives for prudent risk-taking while adapting and adopting international standards; strengthening the institutions charged with the responsibility to regulate and supervise financial institutions; and getting rid of moral hazard through clear exit rules, limited and credible deposit insurance, and better contingency planning. The bottom line must be to get day-to-day politics out of banking supervision and prevent bad banking from translating into systemic risk.

Strong and Independent Supervisors

Effective financial supervision requires strong and independent supervisors, shielded from day-to-day political pressures by means of a clear mandate, legal protection, and political support to do their job. Operational independence, as set out in the Basle core banking principles, is a complex term, and the nuances that country-specific circumstances may bring to the subject are as varied as the historical, political, and cultural realities that come into play. When trying to assess whether a supervisor is independent, it is easy to identify the cases that merit a clear "Yes" or "No." Separating the "more independent" from the "not so independent" is a much more difficult task.

A suitable legal framework ranks first in the checklist. More and more, supervisors are called upon to exercise their judgment and to be proactive. A clear mandate to license financial institutions, exercise ongoing supervision, punish improper conduct, and implement prompt corrective action must be spelled out in the law, so as to make supervisors accountable, protect citizens from being abused by bureaucrats, and protect supervisors from being harassed by vested interests. But only real world facts will tell us if supervisors can truly enforce fair and timely decisions geared to ensure safe and sound banking. Supervisors can be expected to act, free from political pressures, only if they cannot be dismissed for doing their job, if they serve for predetermined terms and cannot be removed when a new administration takes office, and if their agency's budget is not subject to political approval. Supervisors should not be treated as cabinet members.

Why would politicians delegate the authority to supervise financial institutions to an independent agency? Today the most powerful incentive comes from the international context. First, in a world of global financial markets, market participants are free to choose, and they must assess counterparty risk in order to price transactions accordingly. Countries with more fragile financial systems pose greater risks and therefore end up having to pay a premium and, in extreme cases, may even be excluded from the international financial market. Second, international bodies have promulgated and endorsed a variety of standards, including those of the Basle Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissions (IOSCO), the International Monetary Fund (IMF), and the World Bank. These organizations are also developing detailed methodologies for assessing observance, and increasingly they will disclose their findings to the markets. Such efforts have strong political support in the developed countries, and finance ministers of emerging market countries are also encouraging their constituencies to participate in the process. Hence, the more dependent a country is on international financing, the more likely it is that the political leadership will be willing to allow independent financial sector supervision.

Independence must come hand in hand with accountability. Regulators should be accountable to both government and congress, as accountability is the basis for social checks and balances. How this really works out will largely depend on the strength of democratic institutions and the overall transparency of decision-making in the realm of public policies. Accountability needs to be carefully built up as part of democratic governance. It also makes clearly defined supervisory powers and rules protecting supervisors from improper political influence even more necessary; otherwise, supervisors will not be respected by the local banking community. Persuading bankers to follow the rules is very important for high-quality supervision, but unless the supervisor has the clout to enforce laws and levy fines and other punishments, supervision is ultimately ineffective.

Adequate Resources

Supervisors must be provided with appropriate resources to accomplish their goals. Supervisory agencies are often small departments within a ministry of finance, without sufficient funds, information technology, and skilled human resources to perform the job. Financial supervision must compete for public funds in an environment filled with social pressures, with society's demands for badly needed public services and social infrastructure, and even with pork barrel politics. Underfunded bank supervisory agencies are a powerful indicator of the political leadership's priorities!

Meanwhile, modern financial supervision tends to be costly, and countries must invest in upgrading their supervisory agency in order to have effective supervision. To begin with, supervisors must know as much as the bankers do about bank business, financial techniques, risk management, and market trends. Financial innovation is unleashing new risks, but it is often unclear what kind of regulations (if any) these new risks warrant. Regulators and supervisors must therefore be able to engage in significant discussions with financial institutions to craft the most appropriate prudential regulations, that is, regulations that effectively address the risk factors and can be enforced.

Supervisors must also be able to gather and analyze meaningful and timely information. Regular on-site supervision conducted by skilled people following rigorous procedures is especially important, as supervisors cannot tell if a bank is solvent simply by looking at paperwork. Bank reporting can be biased, and vested interests can disguise problems. Information system requirements are also expensive because supervisory agencies must catch up with the industry. Banks in developing countries usually have state-of-the-art information technology, while central banks and supervisory agencies tend to lag behind.

All of this can only happen if supervisory agencies are able to attract and retain well-trained professionals and have incentives to shield them from corruption. Assessing the availability of resources for banking supervision is a good way to test the politicians' commitment to effective supervision. Governments should allot funds to this end, but financial institutions must also be called on to fund the supervisory agency, either wholly or at least in a significant proportion. This makes banks stakeholders in the administration of resources, creating incentives for more cost-efficient supervision. It also reduces the influence of politics in approval of the supervisory agency's budget. Providing funding for upgrading national financial supervision must also be a priority for international financial institutions and regional development banks.

Proactive Supervisors

Having strong and independent supervisors is not enough; they also need to be proactive, willing to tackle problems head on. Banking problems will not go away on their own, but proactive supervision can limit their severity. In Venezuela we saw this dramatically demonstrated. Even as Venezuelan banks and their offshore operations failed in 1994, subsidiaries and related financial services companies prevented from incurring violations or imprudent practices in the United States, the United Kingdom, Switzerland, and Colombia remained solvent. Meanwhile, lenient supervision and late decisions allowed insolvency to build up in the Venezuelan banking system. The consequences were disastrous and made it difficult and costly to restore public confidence in the banks and in the currency. Many other countries have painfully learned that same lesson.

A central bank is in a position to compel action from both the banks and the supervisors, essentially because of its ability to restrict access to the rediscount window, and it can thereby force both parties to tackle the problems at hand. However, when faced with a systemic risk, the central bank might find itself constrained from taking drastic measures by the need to protect the payments system. And if a widespread crisis breaks out, simply shutting the rediscount window will not solve much.

Developing countries must overcome both legal and cultural barriers in order to move toward modern proactive prudential supervision, especially if they operate in the civil code system. In a banking context, the word "prudential" means creating rules and incentives that encourage banks to be prudent, and such rules are more effective, the earlier supervisors act. This is easier to institute in common law countries, as the common law framework provides basic principles and guidelines that are then enriched by jurisprudence and experience. Regulators operating in such a climate can more readily take preventive measures when they find that a bank is behaving imprudently, can craft more flexible regulations, and can seek formal commitments from banks to fill gaps in legislation, as long as the rule of law prevails.

By contrast, it is much more difficult to conduct nuanced negotiations in most of Latin America and Eastern Europe, where relatively rigid legal systems leave public officials and judges little room for discretion and societies are riddled with distrust. Legislation under such a system tends to be very detailed, spelling out precisely what can and cannot be done. Judges are seen as confirmers of the written legal code rather than interpreters of the law, and the powers of banking supervisors, like those of most public officials, are meticulously determined. This climate gives supervisors little opportunity to use their judgment or to negotiate with bankers in order to forestall unsound banking practices before they become serious. Rather, the emphasis is on punishment. This style of law encourages supervisors to act later rather than sooner, since measures that do not fall clearly into legally defined categories can easily be challenged in court and lead to protracted lawsuits.

Rules requiring prompt corrective action help make supervision more proactive; such rules compel supervisors to act, while providing them the indisputable justification for measures that politicians always tend to shy away from. But rules are not enough to assure that early action will be taken. Supervisors also need political support and resources to resolve or close insolvent banks in a timely fashion.

Supervisors must also be protected from personal liability for their official decisions. If supervisors are personally liable for decisions they must make as part of their duties, they are exposed to political pressures and their effectiveness is seriously impaired. The incentive is to look away rather than tackling problems up front, hoping that the bomb will explode in the hands of a successor. In addition, legislators and government must make sure that supervisors are fairly judged. Independent and skilled judges should review the lawfulness of the financial supervisor's actions. In many countries, this entails substantial efforts to train judges on regulatory and supervisory issues and on modern financial intermediation at all levels. Bank failures are always politically charged events and the supervisor, rather than the banker, usually ends up in the dock. The judiciary must therefore also be protected from improper political influences, in order to ensure due process to all the parties involved, supervisors and bankers alike.

The Location of Bank Supervision

Institutional frameworks are conducive to safe and sound banking only if they fulfill three basic requirements: independence from improper political influence, coordination between the monetary policy function and banking regulation and supervision, and effectiveness, enabling incumbents to anticipate systemic risk and creating the incentives for them to act promptly and efficiently.

To improve the prospects for lasting monetary stability, central banks must work to institutionalize safe and sound banking at all levels. My views are obviously influenced by my personal experience. I strongly believe that central banks are remiss if they limit themselves to macroeconomic policy issues and take it for granted that banking supervisors can and will solve banking problems by themselves.

This leads to the question of where to place responsibility for bank supervision, and there is no universal solution. Countries place the responsibility for banking supervision in the central bank or in a separate body, according to specific issues shaping the arrangement most appropriately at the time. Giving supervisory powers to an independent central bank is especially advantageous if public institutions are weak, skilled human resources are scarce, or coordination between public sector agencies is troublesome. Central banks are usually among a country's most prestigious and well-equipped institutions, and they are in a good position to hire, motivate, and keep skilled staff.

Furthermore, I strongly believe that the central bank must ensure that all critical factors converge on the goals of stable money and safe banking. As the Venezuelan case demonstrates, if bank supervision is weak, a strong case can be made in favor of an independent central bank vested with supervisory powers as part of an overall strategy to avoid a systemic crisis. If the central bank must cope with a crisis as lender of last resort, it must also be able to prevent the crisis from happening. Otherwise, the central bank's charter to pursue monetary stability and protect the payments system may be an impossible mission.

Interagency coordination issues are also relevant. A multiple-agency system works well when institutions are strong and stable, the political leadership is truly committed to monetary and financial stability, and anti-inflationary constituencies are strong enough to keep policies on track. A multi-agency system is less effective when politicians depend on constituencies with a strong pro-inflation bias, as was the case in Venezuela. Efforts and resources are diluted and conflicting views and responsibilities ultimately lead to poor results on all fronts. A single regulatory agency may also facilitate crisis resolution, as expeditious decision-making and a clear voice will cope with contagion effects and restore depositor confidence more effectively.

Markets as Indicators

Supervisors must be hypervigilant. The challenge is even more demanding when the banking system is fragile and the economy is volatile and shock-prone. In such cases, the risk that a sudden negative political or economic event could escalate into a full-fledged financial crisis is very high; and once a crisis begins, it can accelerate very rapidly. Aside from monitoring the health of the banks through financial indicators, regulators and supervisors should watch the financial markets for danger signs.

In countries with mature capital markets, prices of bank shares or bonds are reliable signals of investors' evaluations of the financial health of banks. In emerging market economies, where ownership of banks is usually concentrated and capital markets are small, the money market becomes a much more relevant indicator. If a bank consistently offers much higher deposit rates than its competitors, for example, probably more than aggressive pricing is going on. High deposit rates offered by weaker banks are almost always an obvious sign of approaching problems.

Volatility and segmentation in the interbank market provide another powerful signal. Banks that begin losing deposits tend to fund themselves with increasing frequency in the interbank market, and soon they have to pay exorbitant rates for overnight money. The interbank lending rate becomes more volatile as tensions build, leading to a widening gap between the best rate, offered to solvent banks, and the top-dollar rate that problem banks are forced to pay. Once the market begins to single out weaker banks in this way, supervisors should act swiftly. If such problems go unchecked, ailing banks will soon have no choice but to put up collateral for short-term interbank loans, by pledging specific assets or setting up ad hoc trusts. By that time, with their weakness so obvious, the danger of runs will be acute.

Liquidity as a Powerful Early Warning Sign

Liquidity is crucial to the ongoing viability of any banking organization. Managing liquidity is therefore one of the most important activities conducted by banks and ought to be closely watched by supervisors. Public disclosure of information about banks should include as relevant liquidity ratios, in order to strengthen the market's ability to monitor risks.

Liquidity management takes on a special dimension in emerging market economies, as liquidity is often a primary proof of solvency there. This is explained in part by the lack of transparency in their legal and accounting infrastructures.[1] Investors cannot rely on these infrastructures to aid in evaluating the solvency of borrowers. They therefore force borrowers to remain liquid by restricting their borrowing opportunities to short-term funds and by carefully monitoring their cash flow. Another explanation is related to macroeconomic uncertainties and volatility. Investment decisions have very short-term horizons when economic policy turnarounds and political turbulence raise long-term risks to high, almost unbearable levels. Banks in many emerging-market economies must operate under these constraints. A structural maturity mismatch emerges, as deposits tend to be very short term, while assets have long—sometimes too long—maturities.

Moral hazard may weaken the effectiveness of liquidity as an early warning sign, however. Implicit full deposit insurance coverage overshadowed problems in Mexico in the 1990s as depositors and banks pumped money into ailing banks, betting they would be bailed out by the government.[2] In contrast, illiquidity was a powerful sign of the problems banks were facing in Venezuela long before their collapse in 1994, despite

[1] Liliana Rojas-Suarez and Steven Weisbrod. "Achieving Stability in Latin American Financial Markets in the Presence of Volatile Capital Flows." Inter-American Development Bank Working Paper Series 304.

[2] I thank Patricia Armendáriz for bringing this to my attention.

moral hazard. Although an explicit deposit insurance system had been in place since 1985, one could argue that the market operated under the assumption of implicit full coverage. Venezuelan bankers and their clients had good reasons not to fear repercussions from imprudent lending or risky deposits; more than 30 years of bailouts demonstrated that the government would always step in and pay for losses and, if necessary, run failed banks for years. Banks' political clout further strengthened this perception. The tide began to change when ruling elites started losing power after two failed military coup attempts in 1992, President Pérez's impeachment in mid 1993, and a significant change in the political landscape after the December 1993 elections. The ailing banks' liquidity problems intensified as political turbulence rose. Weakening political ties help explain this, because implicit full coverage ceased being a sure bet in the mind of the more sophisticated depositors and creditors. In short, Venezuelan ailing banks suffered liquidity problems while implicit coverage dominated the scene, and the problems worsened when uncertainties regarding government backing surfaced. The depth and cost of the 1994 crisis could have been contained if supervisors had not been impervious to the signs of bank illiquidity.

The nature of bank lending in developing countries must also be taken into account when assessing bank liquidity. Bank loans are usually booked as short-term operations, but this is largely deceiving. In the virtual absence of long-term funding, short-term loans are frequently used to fund medium-term and long-term investments. Under those circumstances, it may be misleading to assume that the maturities of the loan portfolio are truly short-term in nature, even if the loans are current. The mismatch of maturities can sometimes reach extreme proportions. In Venezuela, 90-day loans have been normally used for medium- and long-term funding. As the economy became more volatile in the 1990s, the maturity profile of bank liabilities shortened dramatically while borrowers were being hurt by recessions and many investments undertaken by the banks went sour. At the time of the 1994 crisis, we found banks that funded 12- to 14-year projects with eight-day funds. Not surprisingly, these banks failed.

Liquidity problems may worsen in times of transition. Economic reforms put pressure on banks and also reshape the business of banking. Deregulation and more responsible fiscal and monetary policies usually bring about positive real interest rates, slower growth, and more competition. Devaluations may hit both banks and borrowers. Inflation ceases being the way out of financial problems. Volatile cross-border capital flows place banks under stress, and tighter monetary conditions lead to a deterioration in bank liquidity. Bank supervision must therefore be vigilant throughout the process.

Globalization and competition may bring additional pressures to the banks' liquidity management through changes in the payments system.

Many developing countries are moving from designated-time net settlement systems (DTNS) to real-time gross settlement systems (RTGS) because of globalization and international competition, even if the interbank money market is still small and underdeveloped. The central bank and the banking system may be compelled to move from DTNS to RTGS as a result of competitive pressures brought into the market by bank clients (usually large national or multinational corporations operating in key industries) and foreign banks entering the country. The effect on banks of unexpected fluctuations in the payment patterns of their customers is heightened, and the central bank may be slow in responding to the needs for intra-day funds. Liquidity risks in the banking system therefore rise. Regulators must monitor the impact of such developments and may be called to work with the central bank in setting up an appropriate intra-day loan facility with high-quality collateral and to monitor the banks' holdings of securities that can be pledged or repo'ed to the central bank if necessary.

Government regulations forcing banks to lend medium and long term to priority sectors (agriculture, industry, or low-income housing, for example) often accentuate the maturity mismatch between assets and liabilities. Governments must refrain from forcing banks to lengthen the maturities of their loans. No matter how important certain sectors may be to the long-term well-being of the country, their growth should not be pursued by means that weaken the banking system. Appropriate financial institutions (public and private) must be established in order to channel medium- and long-term funds to these sectors and take the pressure off commercial banks.

The picture of a bank's assets and liabilities must thus take into account the "true" maturities and thoroughly assess liquidity risks. Banks should be forced to put in place a structure for managing liquidity, measuring and monitoring net funding requirements under alternative scenarios, reviewing the liquid assets and short-term liabilities in order to properly reflect the impact of price volatility, and enhancing contingency planning. Liquidity monitoring must take into account the cash flow impact of off-balance-sheet liabilities, an area of particular significance to the banks' safety and soundness in emerging market economies.

Diversification of funding sources can be an unrealistic goal in small economies that depend on a few export products, however. Their banking systems tend to be uniformly hit by shocks, and it is the central bank's responsibility to make appropriate short-term funding available to such banks without hampering its monetary policy goals.

Capital Adequacy

Lack of capital is a frequent source of bank weakness in emerging market economies. The situation may result from low capital requirements and also from low-quality capital. Regulators must therefore ensure that banks are properly capitalized, with shareholders having real capital at stake. Consolidated supervision and specific regulations on bank holding companies are required, to avert the risk of conglomerates being used to channel low-quality capital into the banks.

Efforts to increase capital requirements can be successful only if they are implemented when the overall investment climate in the economy is favorable. If such a policy is not undertaken while investor confidence is high, it becomes an impossible mission once the economy enters into recession and a crisis emerges, as was the case in Venezuela. Timing is crucial.

If a country needs a bold recapitalization program to foster the health of its banks, it should focus on attracting new private capital, and this effort may benefit from reducing or eliminating restrictions that limit foreign investment in the financial sector or ownership concentration. In times of crisis, some extra sweeteners may be necessary to induce owners or new investors to put fresh money into banks, such as tax breaks, debt-equity conversions, or other measures. Ownership concentration, however, increases the risk of connected lending and must be accompanied by rules directly aimed at containing this problem, in order to avoid damaging asset quality. We will take up this topic below.

The 1988 Basle capital accord has played an important role in strengthening the banking systems in many emerging market economies. Most countries have adopted the risk-weighted capital adequacy rules, often after hard-fought battles with vested interest groups. The system is now being revamped, as it has become a source of distortions and contains an incentive to maximize risk-taking within each category of assets. However, the capital accord has great advantages: It is relatively simple and easy to monitor and it facilitates data comparability. These virtues should not be lost in revision.

The new capital adequacy framework submitted for worldwide consultation by the Basle Committee on Banking Supervision is intended to better align regulatory capital requirements with underlying banking risks and to recognize new risk management and control techniques. It brings along positive changes but it also poses important problems for developing countries. A phased-in approach is therefore recommended.

With regard to minimum regulatory capital requirements, the Committee proposes replacing the existing approach with a system that would rely substantially on the use of external credit ratings for determining risk weights. This is the so-called "standardized" approach, to be applied to the risk-weighting of sovereign debt, claims on banks, corporate debt, and securities. Independent credit ratings add value to the regulatory process, enhance transparency, and strengthen market incentives. However, in practice, serious problems may arise because many countries do not have the basic elements required to make this work.

More generally, using sovereign debt credit-risk ratings as a parameter for both sovereign debt holdings and claims on banks, and the possibility of allocating a risk weight in excess of 100 percent for poor risks, would substantially increase the cost of funds for poorly rated countries. Sharply downgrading the sovereign rating would also cause abrupt increases in the cost of funds to all borrowers.

For claims on banks, two options are presented for discussion by the BCBS. Both link the risk weight for claims on banks to the sovereign rating. Under the first option, claims on banks are weighted at one level less favorable than the country where the bank is incorporated. Under the second option, claims on banks are weighted corresponding to the rating of banks' debt, but no claim on a bank can receive a risk weighting below that applied to its sovereign. This hurts the banks of poorly rated countries, regardless of the bank's solvency, the quality of its assets, and the markets in which it operates. It places the banks of the poorly rated country at a competitive disadvantage vis-à-vis the banks from better-rated countries that operate in the market of the poorly rated country. The banks thus bear the cost for the government's underachievement without being able to significantly influence the process that this rule aims to unleash, that is, proper economic policies and adherence to the IMF's Special Data Dissemination Standard (SDDS).

Another aspect of the proposed risk weights on bank claims relates to their treatment of short-term and long-term claims. The first option would eliminate the current difference between short- and long-term claims; this option would have a favorable impact on financial flows' volatility, as it eliminates an incentive to shorten the term of claims on banks. Under the second option, short-term claims can be weighted at one level more favorable than longer-term claims, creating an incentive to shorten the term of claims on banks and adding to volatility.

Under either option, claims on a bank would receive a risk weighting of less than 100 percent only if the banking supervisor in that country has implemented, or has endorsed and is in the process of implementing, the Basle core principles for effective banking. Linking risk weights to the implementation of the core principles is a positive change, as it will most likely turn the banks into allies in this process. The challenge, then, is to properly assess the implementation process. New rules affecting claims on banks may disrupt thin and underdeveloped interbank money markets and increase payments system risk, a matter of concern to the central bank. Close coordination between supervisors and the central bank is called for, to mitigate such risks.

With respect to corporate debt, most borrowers in developing countries are not rated by independent rating agencies. The same applies to many developed countries as well, and the situation is not likely to change in the foreseeable future. External ratings are used only by a very limited number of large corporations that either tap the domestic capital market or fund themselves in the international financial markets. The cost of credit for non-rated clients would thus rise out of proportion to the risk they pose to the bank. The competitiveness of national companies also might be affected vis-à-vis multinationals operating in local markets and involving comparable risks, as the latter are more likely to be rated and will benefit further from the rating of the country where they are incorporated.

Greater reliance on external ratings also leads to a need to assess the quality of external rating services available in emerging market economies. In some countries, rating firms cannot be expected to be totally impartial, as no rules prevent them from being linked to banks or industry through common ownership or business relationships. Moreover, local affiliates of global rating agencies do not always live up to the global standards of the firms. National legislation might also have to be modified if it does not allow the credit rating agencies access to relevant information, thus hampering their effectiveness.

The alternative to the Basle Committee's "standardized" approach is to allow the more sophisticated banks to use their internal credit ratings to determine capital charges. This option may seriously distort competition in the banking sector in developing countries, because capital charges will be higher in banks with no internal ratings. The majority of domestic banks in developing countries do not have internal rating systems yet. They may thus abruptly find themselves at a competitive disadvantage vis-à-vis the branches or subsidiaries of large international banks operating in the country, which may immediately avail themselves of the internal rating systems of their parent companies.

Further along the line to flexibility and self-regulation, the Basle Committee on Banking Supervision debates the possibility of using portfolio credit models, analogous to those that some banks use for market risk. The use of credit-risk models by banks in developing countries usually confronts insurmountable problems because of the lack of appropriate information. Models may therefore be misleading, by being completely useless even when they look good.

Asset Quality

Adequate capital is important for the health of a bank, but asset quality deserves just as much attention, to say the least. Poor-quality assets can virtually wipe out the bank's capital even as formal financial indicators indicate full compliance with capital adequacy rules. The challenges come mainly from connected lending practices and asset valuation and provisioning rules.

Connected lending practices are deeply rooted in the banking business in many developing countries. Banks are often owned and controlled by small groups of individuals or families who have an iron grip on the boards of directors and on management. Corporate governance is therefore poor, internal controls are loose, and external auditing tends to be inconsequential. Furthermore, banks are often linked by common ownership to a variety of other commercial enterprises to which they are likely to grant loans on the basis of affiliation, whether or not the projects are financially sound, and then rescue them at the expense of the bank. Instead of relying on independent banks, the usual move for large industrial enterprises, farmers, and merchants has been to set up their own banks as a more secure way to expand their businesses, especially when credit is rationed as a result of negative real interest rate policies. In such an environment, industrial and commercial companies linked with banks enjoy the distinct advantage of having access to loans from their affiliates. Connected transactions are often obscured by complex arrangements involving third parties—often in offshore jurisdictions—because conventional wisdom is that such practices are unsound, and rules may limit loans to shareholders, management, and connected parties. If rules on single risk-exposure are loose, the problem gets even worse.

These micro problems tend to contaminate macroeconomic policies. Connected lending practices worsen the impact of credit rationing on non-connected borrowers. Monetary policy thus comes under pressure, as governments cater to the needs of the disenfranchised or vested interests. Directed lending rules forcing banks to grant loans to certain types of borrowers, often at below-market rates, are used as a means to provide small and mid-sized enterprises access to cheap bank loans. Interest rates may also be regulated in order to ensure that everyone gets a piece of the pie. Such restrictions only cause additional damage to the health of the banking system and make financial markets more fragile, while tying the hands of the central bank.

Connected lending can also be the starting place for systemic risk, when closely held banks account for high shares of total deposits in a weak regulatory environment. If the banking system is highly dependent on the fate of a few banks, which in turn depend on the decisions of a very small number of people besieged by conflicts of interest, insider lending easily translates into systemic banking crises. The Venezuelan case illustrates this case. Connected lending has been a source of problems in Venezuela throughout modern times and largely explains the banking crises of the 1960s and the 1990s, as well as many individual bank failures along the way. Supervisors were not aware of the true dimension of the problem at the time banks began to tumble in early 1994. Huge losses were uncovered after the fall and they significantly increased the cost of the crisis.

Several elements are needed to keep the risk of connected lending at bay. First, regulators must have the power to implement consolidated supervision and be tough on it. If Venezuela had had consolidated supervision before 1994, bells could at least have been rung at an earlier stage. Second, connected loans must be clearly defined. It is all too easy to bypass poorly crafted rules. Third, relevant information on ownership, loans, and investments must be disclosed to the market. Disclosure helps build trust in the banks, especially when bank ownership is concentrated and the bank is linked to commercial and industrial companies. Markets know too well the incentives, and the dangers, of weak banks' engagement in affiliated-party lending. Fourth, supervisors must push for the continuous strengthening of corporate governance by making controlling shareholders and management liable for a bank's failure. Bankers must realize that affiliated-party lending does not serve any bank's long-term (or even short-term) interests and that it is in their best interest to have good internal controls, strong and independent directors, and skilled managers. Too many banks run by yes-men have failed. Fifth, management incentives should reward compliance and prudent banking at least as handsomely as aggressive business development.

With respect to asset valuation and provisioning, accounting rules must be clear and applied uniformly to all banks. Decisions cannot be left up to management, as has been the case in some developing countries. No matter who sets the accounting rules, all government agencies involved in banking matters (ministry of finance, central bank, deposit insurance fund, and bank supervisors) must agree on accounting principles. This will smooth the decision-making process, strengthen prudential supervision, and facilitate early action if a bank runs into problems. Furthermore, rules should encourage prudent valuations and proper coverage for unforeseeable losses, especially when the macroeconomic environment is unstable and financial markets are underdeveloped. Safe and sound banking cannot simply rely on the banker's "prudence" or the bank supervisor's "feeling."

Market-value accounting is the way to measure the bank's tradable assets. However, some caveats must be heeded in a volatile environment precisely because asset values are unstable. Valuing assets to market, without a proper provisioning policy, increases the risk factor in the bank's balance sheet. In the boom phase, prices rise sharply and "marking to market" does not in itself prepare the bank to absorb the shock that a downturn might cause at any time. Specific accounting and valuation problems may also arise in small and underdeveloped financial markets in connection with assets that are "illiquid," either because of the nature of the individual assets or the small market size or because of exceptionally difficult market conditions in times of distress or crisis. Prudent asset valuation can be achieved by applying cost or market value, whichever is lower, and setting and enforcing clear and strict provisioning rules.

Consolidated Supervision

Implementing effective consolidated supervision deserves special efforts. It is key to prudent banking and financial stability, as it gives supervisors the ability to monitor a conglomerate's entire business, including its domestic financial and nonfinancial affiliates and its international operations. Conglomerates love complexity, for tax reasons or as a means of regulatory arbitrage.

Legislation in many countries imposes strict specialization by financial institutions, allowing banks to engage only in certain types of business and legally preventing them from participating in others. This leads financial institutions to group in conglomerates of legally independent financial entities controlled by common shareholders. The setup is analogous to universal banking in that it allows the group to diversify services to customers and provides options to diversify shareholder risk. The downside is that it may lead to artificial product differentiation that confuses bank clients, reduces the efficiency and transparency of financial intermediation, and makes supervision more difficult. More flexible legislation and clear authority to enforce consolidated supervision are the goals to be pursued.

As boundaries between different types of regulated financial intermediaries blur, closer cooperation between national regulatory authorities is also needed to assure the solvency of all the components of a financial conglomerate. In Venezuela, insurance companies, securities firms, and banks often collaborated in a variety of speculative ventures, taking advantage of regulatory loopholes. This spread insolvency throughout the financial system. Meanwhile, the regulatory framework was trailing far behind, treating the institutions as if they were unrelated to one another.

Moral Hazard and Crisis Management

Exit rules, deposit insurance, and crisis management are the usual sources of moral hazard. How to turn them into incentives for prudent risk-taking and minimize the risk of a crisis is a key challenge in developed and developing countries alike. The U.S. thrift crisis in the 1980s, and certainly the Venezuelan banking crisis, demonstrate how the cost to the taxpayer rises when regulators are unwilling to force institutions to reorganize, or to let them fail once their net worth is depleted.

First of all, sanctions must be meaningful and consistently enforced. Supervisors must be vested with the authority and obligation to impose sanctions on a bank if it fails to comply with regulatory requirements or engages in criminal activities. If sanctions are inconsequential or inconsistently enforced, they do not deter wrongdoing, and the bank supervisor is not respected. Regulators always try to make the most of persuasion. Persuasion, however, works only if requests are backed up by the power to act. Venezuela suffered because its crisis erupted in an atmosphere of arrogance, in which some bankers believed themselves to be above the law. They knew too well that the central bank had no power to enforce banking regulations and impose sanctions, and that the government was not keen on doing it either. Instead of capitalizing their banks, the bankers chose to gamble on being rescued.

Regulatory intervention should come as early as possible, in order to keep the banking system healthier and reduce the potential cost of a banking failure. But such powers require clear rules for the imposition of sanctions. The rules generally specify that a bank's capital may not decline below a specified percentage of total assets. Yet closing a bank while its net worth is still positive—that is, before it reaches the point of technical insolvency—is a tough decision that may make supervisors the target of political attacks and legal suits.

Preventive measures and sanctions should be graduated, beginning with cease and desist orders, fines, termination or suspension of deposit insurance; then moving to holding measures and civil or criminal penalties; and finally allowing government takeover and revocation of a bank's license. The power to promote early mergers should also be part of a regulator's arsenal of resolution instruments.

Rules for bank closure, resale, or government takeover in the event of bankruptcy should be clear and rigorous. If so-called "exit rules" are lax and ambiguous, governments tend to postpone tough measures until carrying them out is politically expedient. By then, the bank's capital is likely gone, and the public is forced to foot the bill. The Venezuelan experience demonstrates that, over decades, vague exit rules for problem banks left excessive room for political maneuvering, weakened the regulators, and contaminated banking supervision with politics.

Moral hazard thrives when information is in short supply. Supervisors must get meaningful, reliable, and timely information on the state of the banking system, especially on problem banks. In normal times, and much more so during a banking crisis, it is crucial to have useful information to avert disaster. Information cannot be expected to be absolutely accurate, but it must at least be coherent and manageable. The ability to design a crisis management strategy and persuade private banks to become partners in the resolution process is heavily dependent upon the quality of the information available to decision-makers. No sound bank asked to participate in a rescue will step into a problem of unknown dimensions, and no responsible authority should push it to do so. Eighteen months of trial and error in handling failing banks in Venezuela in 1994 and 1995, the failure to set up private-sector-led rescue plans for some of the banks, and the decision to expand the safety net to cover a wide array of liabilities that were noninsured at the time of the crisis, can be traced largely to the lack of proper information.

Contingency planning is a powerful tool to manage a crisis and avoid improvisation that in turn increases moral hazard problems. Conflicting policy objectives will have to be dealt with in mid-crisis, when tensions are at a maximum, and the trade-offs among objectives raise very sensitive issues. It is therefore better to be prepared. A crisis plan can help strike a balance between short-term and long-term goals, thus helping to minimize the cost to the government, restoring confidence in the banking system, and getting the banks lending again quickly, so as not to deepen the inevitable recession. Provision should also be made to identify and bring to justice those whose behavior was negligent or criminal (as opposed to those who simply made bad business decisions). This approach can trigger necessary changes in the structure and practices of the banking sector and preserve market discipline. Although a plan might not work perfectly in practice, it serves to lay out options and induce everyone involved to be more focused and effective. In fact, any plan is better than no plan at all.

Bankers are ultimately responsible for their banks and must be involved in the process. A timely injection of private sector money into ailing banks is essential, and bank owners should be the first to commit to it. Bankers will, however, be reluctant to put good money into their bad banks unless the inducements are powerful indeed. If they refuse to deposit capital, that is a bad sign; it suggests they do not believe in their own banks.

Handling a banking crisis is a difficult political exercise. Bank regulators must therefore make sure the message reaches government leaders, the executive branch and congress are involved, a strategy is developed, and appropriate legislation is passed as needed. If the government remains uninterested, the country will inevitably be run over by the crisis. The challenge lies in finding the way to convey such sensitive information to a wide enough audience of influential leaders without unleashing depositor panic and runs on the banks.

The depth of a banking crisis is a time for government leaders to build alliances, not to foment conflicts. Governments should not fall into the trap of pretending to handle a crisis on their own as a public relations exercise, or use it to win a political advantage. All key institutions in a country are needed and must be mobilized to rescue the financial system, rebuild national and international confidence, and ensure the well-being of the citizenry. A banking crisis threatens a country's social fabric; a united front should be presented. If partisan politics or personal battles are allowed to deepen societal rifts, crisis management is more difficult and costly, damage to the economy is worse, and wounds take much longer to heal. During the Venezuelan crisis, little attempt was made to forge a political consensus. Not only was there a lack of consensus on a strategy to handle the crisis, but no agreement on the key economic and financial issues, either. To make matters worse, many politicians were ideologically biased against the banking industry.

In a crisis, it is crucial to avoid suspending bank operations, especially if the public could lose confidence in other banks. Shutting the doors of a bank to its depositors can be extremely disruptive, especially if the banking system is weak and no plan is available for dealing with the financial and social consequences of closures. Deposits get frozen, banks are unable to settle their payments, and the chain reaction threatens the payments system. Democratic institutions come under pressure and politicians tend to overreact, extending the safety net in crisis times and building up moral hazard. It is much better to look for solutions that do not interfere with banks' relations with their customers.

That does not mean keeping bankrupt banks open, however, or avoiding liquidation if a bank deteriorates beyond rescue. The longer hopelessly bankrupt banks are kept alive, the greater the cost to taxpayers and deposit insurance funds and the bigger the benefit to uninsured depositors, other creditors, and shareholders. That is why it is so important for regulators to take early action, while a positive net worth still remains in a bank; the franchise at least has some value then, and the risk of contagion can be limited.

If a bank is deemed insolvent, its shareholders fail to pledge new funds at that critical stage, and other investors are nowhere in sight, the government should be ready to take over the bank. The legal framework to deal with such a delicate operation must be built very early on—preferably before the crisis breaks into the open. Solutions that allow the government to "close" the bank, wipe out the shareholders, replace the board and top management, and open the next morning to customers will end up being less costly for the government and society.

If a bank must close, the government must immediately tell depositors what to expect. Leaving them in suspense causes unnecessary suffering and inflames the inevitable social conflicts. That also weakens other banks, because depositors at other institutions may fear their own banks could suffer the same fate. Turbulence in the early stages of the Venezuelan banking crisis can be traced to the decision to close Banco Latino, the second largest bank in the country and the first to collapse. This action left depositors in limbo for more than two months. Other banks immediately came under great strain, and when banks being propped up by the government were closed six months later, again leaving depositors struggling with uncertainties, it spelled disaster for the entire system.

Burden sharing must not be improvised. It should be clearly determined at the outset who will bear the expense of a bank failure—bank shareholders, uninsured depositors, or taxpayers. Improvisation inevitably ends up placing most of the burden on taxpayers, as depositors press to get their money back and bank shareholders start lobbying for relief.

To prevent that from happening, the executive branch and the congress ought to state beforehand that shareholders will lose their money if the bank fails, and also lay out clearly who will be paid by deposit insurance, making sure all depositors are treated equitably. The government must also make it clear from the start that the cost of the banking crisis will be properly accounted for in fiscal accounts, and that taxpayer money will go only to depositors. Confusion and turmoil make such explanations much more difficult to convey, mid-crisis.

The Venezuelan experience also points to the need to keep the payments system running, even if it is a costly proposition. Central banks are primarily concerned with inflation. But if the operation of the payments system is endangered by the inability of one or several participants to settle, the central bank should be prepared to extend special credits to protect the payments system and help maintain confidence in the national financial system. Detrimental as such actions may be to the mission of containing inflation, the collapse of the payments system is considerably worse. Of course there can be no monetary policy if there are no banks.

The central bank can support the payments system in several ways. It can temporarily reduce reserve requirements, establish overdraft facilities, give banks access to discount window lending, use money market refinancing instruments such as repos and reverse repos, and support the banking system's liquidity through open market operations. The central bank can also provide financial support to a bank resolution agency, as we did in Venezuela when one-third of the banking system collapsed in a matter of weeks. Such credit facilities help troubled banks meet their obligations and weather a period of adversity until either they regain strength (and investors' confidence) or the authorities arrange a more permanent solution. The key issue is that the central bank's lender of last resort capability helps limit the contagion and thus soften the impact of the crisis.

But protecting the payments system cannot be left to the central bank alone. When heavy runs occur, depositors—insured and uninsured alike—are telling the government they have lost confidence in their banks. The government must thus come boldly into the picture to guarantee the central bank or bank resolution agency's bank loans, and assure depositors that the banks will be able to honor their commitments. The government must also quickly produce funds to back the banks. The crisis will be far more expensive if the public is left clamoring for answers, or if depositors are prevented from accessing their funds until after the bankrupt institutions have been liquidated.

Centralized decision-making is key to managing a crisis. As the Venezuelan experience demonstrates, without one clear voice and a single, accountable authority with a crisis management mandate, it is almost impossible to restore depositor confidence. The government and the central bank should establish an emergency body, to avoid the confusion of having several overlapping regulatory agencies pursuing independent crisis management strategies. This body could draft laws and interact with the congress and coordinate government support to ailing banks. As in the Swedish case, the emergency body should dissolve as soon as the acute phase of the crisis is over.

Deadlines are needed when stopgap measures are imposed. They serve to discipline everyone involved. Short-term fixes have a way of haunting their creators, lingering long past their usefulness. In Venezuela, the Fogade emergency support program started off in January 1994 as a short-term plan designed to help banks cope with runs. But over time, it locked ailing banks into dependence upon this aid, since the government crafted no substitute plan.

Limiting the official safety net, thus making depositors assume part of the risk, reinforces market discipline. Implicit protection of uninsured depositors is not advisable; governments fool themselves into believing that they are not liable to depositors and fail to allocate funds, only to find themselves unable to meet their commitments when a crisis arrives, as happened in Venezuela. A deposit insurance system without credibility made the crisis there even more expensive.

Shareholders should never be protected by deposit insurance schemes. Furthermore, if regulators make controlling owners liable for double or even triple the amount of capital they have invested in their banks, incentives for prudent management are that much stronger.

In a deposit insurance system, coverage should ideally be geared to the small and unsophisticated depositor earning a market or below-market interest rate. Sophisticated players out to profit from banks' distress should not be subsidized. Risk-adjusted premiums are advisable, as they establish fair burden-sharing between weaker, riskier banks and sounder, better-capitalized ones. Otherwise, undercapitalized banks end up being subsidized. As the Venezuelan experience also proves, deposit insurance funds should be made available to insured depositors as soon as a bank is taken over by the government. Making depositors wait until the bank is liquidated places the payments system under greater stress and deepens the cost of the crisis. Deposit insurance must be appropriately funded, as its resources must be safely invested. Otherwise, the deposit insurance program has no credibility and is useless. Lastly, depositors must be educated and made aware of the exact insurance coverage they can expect in the event that their banks should fail.