Jaime Caruana: Savings banks - efficiency and an ongoing commitment to society. Efficiency of financial institutions

Speech by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of The Basel Committee on Banking Supervision, at the 20th World Congress of Savings Banks, Madrid, 23 May 2003.

*   *   *

It is a great honour to participate today in this World Congress of Savings Banks. It is also a pleasure to be sharing the panel with two individuals for whom I have the deepest respect. Although I am sure they are very well known to you, allow me a few words about these two friends.

Andrew Crocket has been the General Manager of the Bank for International Settlements (“the BIS”) in Basel for a number of years until last month. This institution, traditionally the global forum for central bankers, underwent an important transformation in the mid-nineties.

Under Mr. Crockett’s masterful leadership, the BIS was able to evolve and adapt itself to the new environment. His insightful decisions, first, to broaden BIS membership to emerging markets, and second, to pay special attention to financial stability issues, placed the BIS in an excellent position to make an outstanding contribution to the debates on financial matters and, in particular, on financial crises in recent years. Partly in acknowledgment of this, Andrew Crockett was appointed as first Chairman of the Financial Stability Forum, in a personal capacity, when it was created in 1999.

I want to emphasise that in all these key positions Andrew has shown a remarkable capacity to generate new ideas, foster consensus, fuse different views and encourage dialogue, and all this with a subtle sense of humour and extraordinary attention for the human touch.

Let me add that during his term at the helm of both the BIS and the Financial Stability Forum, his steady hand has been behind the international financial system’s success in confronting the serious shocks arising in recent years.

In the case of Otmar Issing, I have the pleasure of meeting him regularly in the Governing Council of the European Central Bank, where his illuminating presentations on economic developments in the euro area are pivotal in guiding our monetary policy decisions. You should know that Otmar, an academic of outstanding personal and professional integrity, is a truly remarkable and experienced central banker.

For many years as Chief Economist of the Bundesbank and a Member of its Board, he contributed to enhancing the reputation of this institution as one of the most successful central banks in the world. When the European Central Bank was created in June 1998 he became its Chief Economist and a member of the Executive Board. Over what has been nearly five years he has been deeply involved in the fascinating tasks of putting in place and managing the single monetary policy. Otmar Issing’s contribution to these tasks has, in my view, been outstanding. Bearing in mind the structure of the European System of Central Banks, the merit of endowing the euro zone monetary policy with a single voice and, more important, a single soul in such a short time has been immense.

It is thus a privilege for me today to be accompanied by two very distinguished economists and policymakers, from whose experience and expertise I am sure we will all benefit greatly.

Introduction: The concept of efficiency

The analysis of efficiency is a matter that has required the attention of a sizable number of papers in the literature. Both the approaches adopted and the results obtained differ. Of what there is no doubt is how important the idea of efficiency has been and continues to be. It is a pleasure for me today to share some thoughts with you on the dimension this concept acquires for the financial system as a whole and for savings banks. I would wish these thoughts to be of a general nature; but they will inevitably be influenced by the Spanish savings-bank experience.

Efficiency relates the cost incurred to the product obtained. In general terms, the idea of efficiency broadly refers to the fact of using limited resources in the best possible way. In other words, an economic system is efficient if it does not waste its resources, in such a way that it maximises individuals’ well-being.

I would add two further thoughts on applying the idea of efficiency to credit institutions. First, the efficiency of a credit institution introduces an additional condition; the issue is not only to maximise output by minimising costs, but also not to alter the institution's risk profile. Here, then we have three elements output, costs and risk.

This idea factors in significant constraints and makes it necessary to focus on improved efficiency as a balanced process in which attention must be paid to a series of management elements that cannot be run down in cost-cutting drives. For example, no clear efficiency gain is achieved if it is done at the expense of increasing operational risk.

Second, in the financial sector efficiency can be analysed from a dual perspective: from that of the system as a whole, a macro perspective, and from that of the individual institutions, a micro perspective.

The financial system and intermediation

I shall refer firstly to the financial system as a whole, which enables saving to be channelled from agents wishing to lend funds, because they have a surplus of them, to others who wish to borrow funds, since they are lacking financing. Adding to this important function performed by the financial system is that of allowing the transmission of risks to those who have a greater wish or capacity to assume it. This is especially important in an environment of uncertainty.

An efficient financial system will enable a greater volume of funds to be channeled towards productive investment and therefore will help to boost economic growth and to achieve greater levels of well-being.

But the role of an efficient financial system is not confined solely to the important task of channeling savings, liquidity and risks. An efficient financial system should also contribute to improving financial stability and reducing procyclicality, i.e. the amplification of business cycles resulting from the interplay of the real economy and the financial system. An efficient financial system allows the impact of various shocks to be absorbed, distributing them over a lengthier period of time. Conversely, an inefficient financial system overreacts at a later juncture, ultimately impacting the real economy considerably. While we know from recent experience that the interaction between the real and the financial economy is increasingly important and intense, we also know that it is likewise very complex.

This is not only because of the progressive increase in the relative size of financial markets, but also because of the growing weight of financial channels in the international transmission of shocks and economic conditions: uncertainty and instability on financial markets and the fall in stock market prices affect households' financial wealth; the cost for companies of resorting to the stock markets to obtain financing to undertake new projects rises substantially; financial institutions readjust their strategies in step with the new risk context, etc.

Progress in market participants' practices and standards supported by financial regulation and supervision that provide incentives for forward-looking strategies are necessary elements of such macro efficiency. In this way, it is possible to gain robustness and room for manoeuvre in good times, and at the same time encourage good risk management.

Efficiency in individual financial institutions

As regards individual efficiency, deposits institutions have the capacity to pursue selection processes among potential borrowers and, at the same time, on the basis of the relative risk, to set different prices. Moreover, they undertake monitoring, seeking to minimise the risk of borrowers not meeting their obligations. In sum, deposit institutions help reduce both adverse selection and moral hazard problems, while their ability to transform maturities allows them to provide liquidity. The enabling mechanism for the proper functioning of this system is depositors' confidence in deposit institutions.

Efficiency in savings banks

Among overall deposit institutions, savings banks undoubtedly play a significant role, contributing as they do to the distribution of market share among a bigger number of institutions, thereby fostering

competition. Likewise, in a sector whose cornerstone is depositors' confidence, properly run savings banks contribute to reinforcing the stability of the financial system.

Savings banks are an old and peculiar form of financial institutions, and display a set of particularities relating both to the significant social content of their action and to their strong regional roots. I shall address these two aspects.

First, savings banks have, since the outset, been characterised by their contribution to preventing financial exclusion. That is to say, central to their objectives is a concern to ensure that the more disadvantaged segments of the population may have access to financial services. In this respect, savings banks have always paid particular attention to the financial needs of households and companies integrated into the social fabric. Thus, by granting access to financial services to a large segment of society, they have made a considerable contribution to the increased efficiency of the financial sector and the economy.

Secondly, we should not forget that savings banks allocate a high percentage of the profits they generate each year to financing social projects.

Last but not least, the close relationship savings banks have with the region in which they are established is another of their differentiating and defining features. Throughout their history, they have been clearly committed to strengthening the social and economic fabric of their heartland, thus becoming key players in regional development. This, in turn, provides them with greater retail customer loyalty, which no doubt offers a higher degree of stability for their business model.

Yet while all the foregoing is acknowledged and given the broad consensus that savings banks should retain their social commitments, I believe it should not be forgotten that, above all other considerations, they are deposit institutions. As such, and so as to promote the sound working of the financial system risk management, profitability and solvency should be at the heart of their concerns. Indeed, it is precisely through controlling risks, maintaining acceptable profitability and a level of solvency appropriate to their risk profile that savings banks will be able to survive and prosper over time. It is only through operating properly as business concerns, basing their management on professional criteria relating to economic and financial rationale, that savings banks can continue creating value for society and for their regions.

Let me turn now for a moment to the Spanish experience. Our "cajas de ahorros" are also very old financial institutions and our story has been a successful one. When I explain the characteristics of the Spanish financial system, and in particular the prominent role of savings banks, some of my foreign counterparts ask about potential problems of fragility and inefficiency and my answer is always the same. Not only are they neither fragile nor inefficient, but they are also as profitable as their banking counterparts, and they are increasing their market share year after year. They are a major contributor to making the Spanish banking sector an efficient and competitive one.

I earlier drew a distinction between macro and micro efficiency. Savings banks in Spain have made significant contributions to the macroeconomic efficiency of our system. In bolstering efficiency at firm level, certain factors, which I shall now refer to, should be given particular consideration by savings banks. Any management action geared to cost-rationalisation should pass a careful and thorough cost/benefit analysis so that certain elements of their long-term strategy or their risk profile should not deteriorate. Let me mention a few of these elements.

Investment in new technologies

Efforts to improve efficiency must be compatible with the challenges posed by new technologies. In fact, investment in technology, in which process savings banks have played a notable part, is an additional and important mechanism for attaining greater efficiency. This is because technological development allows processes to be undertaken more easily, simultaneously eliminating certain time- and labour-intensive tasks so that operating cost cuts are achieved. In addition the capacity to process massive amounts of data efficiently in real time allows for better risk management and also for services better tailored to client needs.

In line with the foregoing, appropriate human resources management will also be conducive to achieving greater efficiency. The importance of the role of human capital is beyond all doubt, and all the more so in the sector we are discussing today.

Business risk

In terms of not changing the risk profile while trying to gain efficiency, business and operational risks deserve some attention.

I have signalled before some of the specific features associated with savings banks. Ensuring the objective of efficiency also involves moderation to some extent in those activities and risks furthest removed from their nature and character.

A latent danger arising when cutting costs to improve efficiency, is an increase in the level of operational risk. As I mentioned, efficiency improvements may only be understood as such when the risk profile remains unchanged.

As you know, operational risk is increasingly under the scrutiny not only of supervisors but also of institutions. It is not easy to grasp the concept of operational risk, although the Basel Committee's definition is a good start: "risk of losses resulting from inadequate or failed internal processes, people and systems, or external events". Although public opinion associates operational risk with dire consequences for specific institutions, you and I know that it is present in all banks' daily operations, and in all their areas, from the most traditional to the most complex.

Given the relevance of operational risk, it is not surprising that both supervisors and the leading banks are making an increasing effort to measure its impact. Only if progress is made in such measurement will it be possible first, to conduct analyses of the impact that strategic decisions (expansion in new areas or regions, rationalisation of expenses, outsourcing, etc.) may have on the operational risk profile and, therefore, on the possibility of introducing corrective measures aimed at improving this risk profile. As things stand we are still far from achieving - in technical terms- a satisfactorily broad and deep measurement of operational risk.

This is why the Basel Committee, by setting for the first time an explicit capital charge for operational risk at banks, has done so avoiding, in the most advanced alternatives, mechanistic formulas that may curb operational risk management developments in the coming years. This is what lies behind the AMA (Advanced Measurement Approach) proposal: on one hand, recognition of the growing importance of operational risk but, on the other, to allow unrestricted development, without regulatory constraints, of their management techniques. It is difficult to find another area where a regulator is willing to grant such a broad degree of flexibility as the Basel Committee is prepared to do. In turn, its inclusion as a defined regulatory capital heading ensures that institutions will have a strong incentive to measure and control such risks.

Risk management and the New Capital Accord

To be sure, running risks is an integral part of banking. However, the leveraged nature of banking business, the risks of systemic contagion, the particular weakness of the depositor as a creditor, and the interaction between the real and the financial economy all mean that it does not suffice to expect banks to manage their risks well.

There are three additional factors overarching this management of risks. The first is capital: banks should have sufficient capital of good quality to withstand not only expected losses from activity (which should be covered by provisions), but also unexpected losses, so that the continuity of banks may be ensured in normal times and in crises alike. This factor was already of vital importance at the outset of the financial system as such, when there were no additional safeguards, nor any regulation of economic capital.

The second and third factors are common ones, as they involve extra surveillance of a bank's management of risks. The first check stems from public supervisory powers: a characteristic common to all financial systems is the existence of prudential supervision. The second stems from minor shareholders and bank creditors (either holders of ordinary or subordinated debt, or mere depositors), who exert scrutiny in what we know as market discipline.

I am sure that these arrangements sound familiar to you: they are the three pillars of the New Capital Accord, or Basel II. But the great worth of Basel II is precisely the acknowledgement that these three levels are part of the structure which, since the very inception of financial systems, has promoted sound banking systems.

The three Pillars reflect well-known aspects of the workings of financial and banking systems over many years. And there lies the merit of Basel II. It has been able to identify these three elements and

to integrate them so as to achieve regulation which is more closely aligned to the management of banks and which, therefore, is more efficient.

Let me conclude my remarks by raising the issue of corporate governance and transparency in deposit institutions, including savings banks. One could argue against paying much attention to corporate governance in savings banks, based on the lack of a shareholder structure. I do not agree.

First, we should never forget that the issue of corporate governance is related not just to the minority shareholder issue, but also to that of companies raising resources from capital markets. Second, saving banks may well need a sound corporate governance scheme precisely because of the special ownership and control structure. Third, corporate governance that reinforces transparency is always an important contribution to increased efficiency. Fourth, we supervisors see corporate governance as a way not just to safeguard minority shareholders, but also depositors, arguably the weakest part of the banking framework.

As regards the efficiency of institutions, we all know that the application of appropriate corporate governance rules improves the quality of their management, their reputation, their stability and, by extension, their risk profile. This is why the Banco de España is and has always been in favour of strengthening corporate governance and transparency in savings banks and will assign more resources to analysing both corporate governance requirements and the practical application of these requirements at each institution.

Conclusions

To conclude, let me add that the process of improving efficiency levels should not be viewed as a solution for times when the revenue arising on ordinary activity is adversely affected. Rather, it should be tackled as a process to be pursued over the medium and long term, in parallel to the improvement in risk management systems.