Philip H Penn: Enhancing and strengthening banking supervisory capabilities in Pacific countries

Opening remarks by Mr Philip H Penn, Acting Governor of the Central Bank of Samoa, at the Pacific Regional Banking Supervision Seminar, Apia, Samoa, 23-25 October 2007.

*   *   *

Mr Andrew Milford, Banking Supervision Advisor from the Pacific Financial Technical Assistance Centre;
Distinguished Resource Persons;
Ms Elizabeth Roberts, Director of the Financial Stability Institute (FSI);
Messrs Graham Johnson and Chris Gaskell from the Australian Prudential Regulatory Authority (APRA);
Mr Kim Norris, Director, International Advisory Group, OSFI, Canada;
Deputy Governors;
Participants;
Ladies and Gentlemen.

As the host for this year's Regional Seminar and the Annual Meeting of the Association of Financial Supervisors of Pacific Countries (AFSPC), I am very pleased and honored, on behalf of the Governor and Staff of the Central Bank of Samoa, to extend to you all a very warm welcome.

We are very happy to see and meet again some familiar faces.

And for those of you who are here on your first visit, a special warm welcome to Samoa and we hope you have time to spare to enjoy the Paradise of the Pacific.

You have certainly arrived at the time when the streets of Apia are back to normal as compared to a few weeks ago when we experienced unusual busy traffic due to the influx of tourists and overseas sports people, who came to enjoy and participate at the 10th South Pacific Games which we hosted last month. With due respect to our friends from the Pacific, I am very pleased to mention that these Games was a great success and an extraordinary achievement for our country and for all those who attended. I understand that some of you were very keen to hold this Seminar to coincide with the Games. **But I guess the potential risk from a prudential supervisor's view of losing participants during the two weeks of the Games may be considered critical and detrimental to achieving the objectives of our Seminar.**

That aside, the Central Bank of Samoa is very grateful for the opportunity to be co-hosting this years' event with the Financial Stability Institute in Basel, Switzerland; the Pacific Financial Technical Assistance Centre in Suva; and the Association of Financial Supervisors of Pacific Countries. This Seminar is part of a continuing series of trainings which could only contribute towards enhancing and strengthening our capability as supervisors in the development of our economic and financial systems. This is indeed a great opportunity to learn and share issues of common interest, in particular, the potential risks and threats that could adversely affect the confidence in our banking and financial systems.

As you all know, banks and non-bank financial institutions play a vital role in the economic development of any country. Therefore, there is strong public interest in maintaining the stability and financial soundness of these institutions. And recognizing such importance, central banks have been entrusted with the responsibility of not only licensing but supervising them as well.

The financial system is built on a **fundamental (and ever-present) mismatch**. Savers want access to their money instantly, if necessary. But borrowers are usually unable to give it to them anything like as quickly.

The banks have traditionally bridged that gap. But the only way they can do so is to borrow short and lend long. This mismatch makes them vulnerable. That is why governments have imposed regulations on the banks, requiring them to hold reserves against emergency. But if there is a complete loss of confidence among depositors, there is really not much an individual bank can do. The central bank is usually obliged to help.

Modern innovations in the financial system have seen banks, rather than holding on to the loans that they have made, parcelled them up and sold them on. The aim was to disperse risk; in the case of default, it was better for a lot of investors to lose a little than for a few banks to lose a lot. However, all the clever types of "securitization and structured products" have not eliminated the **fundamental mismatch**. Someone still has to borrow short and lend long. Northern Rock, the stricken British bank in recent weeks, is a case in point.

In relation to this case, I just want to paraphrase an interesting article in the latest publication of The Economist headed ***"A generation has prospered from the wholesale transfer of risk through securitization. Now it is paying the price".***

[The chief executive of Northern Rock, Mr Adam Applegarth, in unveiling his bank's first-half results last July, announced that "the medium-term outlook for the company is very positive," He spoke of a credit book that was "robust". But, who would have guessed that less than two months later, Britain's fifth-largest mortgage lender would be fighting for its life, its branches besieged by customers demanding their savings back?

The run on Northern Rock is the most dramatic symptom of the contagion gripping the financial markets. Here was a bank that had grown rich from the innovations of recent years, using abundantly stocked wholesale markets to fund its lively growth, using those same markets to offload bits of it loan book as and when they became unattractive.

But the very innovations on which Northern Rock thrived have savaged its business. The company does no lending overseas. Nevertheless, its fate was determined by the distant turmoil in America's mortgage market. When that spilled over into the securities markets, the money markets that Northern Rock had depended on for years, dried up in a single day at the start of last August.

The brave new world that enabled banks like Northern Rock to grow so fast is founded on "securitization" – the process that transform mortgages, credit-card receivables and other financial assets into marketable securities – and the innovation it spawned in "structured" products. This was a revolution that brought huge gains. But across the financial world, investors and regulators are ***asking themselves*** *whether it also brought costs that are only now becoming clear."*

The way oversight of the financial system is split between the FSA, the Treasury and the Bank of England is in doubt. Gordon Brown's reform of a decade ago means that those responsible for monitoring the banking system are separate from those who make the decision to intervene.]

In understanding the factors that impinge on this particular case about Northern Rock, one will learn that the roles and tasks faced by the supervisors and the regulators are enormous. Supervisors need to keep a step ahead of financial market developments and innovations.

We must not be oblivious or ignorant to the fact that, despite all the strength of legal framework, regulatory and supervisory arrangements we can have, we always learn that banks still fail, even those too big to fail collapsed at their own demise – some due to reasons other than risks. In other words, the supervision of banks cannot provide full or complete guarantee against banking failures.

However, **supervision can assist** the banks in managing their risks by taking appropriate measures and precautions. After all, banks are vulnerable to errors in human judgment and the fragile confidence of depositors. ***Therefore, regulation and supervision is not a substitute for good management.*** That is the lesson we have to learn from many bank failures even in countries with the best regulatory systems. Finally, it is the responsibility of the management of the banks themselves to introduce proper checks and balances to ensure that the risks are managed efficiently and effectively.

As we know, the whole approach to bank supervision in particular and financial supervision in general is still in its early evolutionary stage. With the fast changes in financial markets and information technology, the methods of ensuring the safety of banks will also need to change. Already, the rules relating to bank operations are changing in many parts of the world. This means that the ways banks are supervised also need to be changed. The responses to these rapid changes may be slow, but there is concerted and dynamic effort by the international supervisory authorities to ensure the safety of banks.

Thus, banking supervision is conducted in the interest of everyone because the cost of a banking crisis can be enormous. When banks fail, we all fail. And certainly, the cost of a banking crisis will be unbearable especially for our relatively small economies in the Pacific Region.

I note that you have a full agenda ahead of you. At the same time, I have no doubt that the choice of topics is to provide discussions, which should add value to your work not only in your own countries but also for the Pacific region. **The case study that will provide the experience of Palau** regarding the failure of one of its biggest bank, will not only remind us of the reality and the crucial role of bank supervisors, but it should bring us together to learn from it and be better prepared for the possibility of such crisis occurring in our own respective countries.

I also note with interest that you will be covering **the Basel *Revised* Core Principles** which, as I mentioned earlier, reflect the ever changing environment in which banks operate, that international standards continue to change as the environment of risks also changes. And as part of the global financial system, we all need, to some extent, to adapt to such changes. Although some of these changes may not directly affect us due to our narrow market base, others can impact on our financial system indirectly. One of these changes would be the **Basel II new capital adequacy framework** that has already been advanced for some years for adoption.

From experience, the **new Capital Accord** will have significant impact on our limited resources and our capacity to administer and properly implement. In this connection, I am pleased to acknowledge the presence of resource experts, Ms Elizabeth Roberts, Director of the Financial Stability Institute (FSI) at the Bank for International Settlements, Basel; Messrs Graham Johnson and Chris Gaskell from the Australian Prudential Regulatory Authority (APRA); Mr Kim Norris, Director, International Advisory Group, OSFI, Canada; and experts from the IFC. I am confident that their knowledge and experience would be immensely helpful to the participants in understanding and appreciating the practical implications behind these changes both from a supervisor's perspective as well as from the standpoint of the supervised institutions.

To conclude, let me say that we all face enormous resource and capacity constraints in coping with existing responsibilities, let alone undertaking these new challenges. Hence, the value of coming together to share our experiences and plan regional training programs for our member countries is very important. Through these meetings, we can learn and maintain strong networking relationship which should enhance our efforts in capacity building in this innovative and challenging area of financial supervision.

Ladies and gentlemen, it gives me much pleasure to declare this Regional Seminar for Financial Supervisors open and I wish you all an enjoyable and fruitful week of discussions.

Thank you for your attention and may God Bless you all.

Soifua.