The supervision of banks: the United Kingdom's experience and challenges in China

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Introduction

Every country faces its own unique challenges, heavily influenced by history and its own particular set of economic and social circumstances. Nonetheless, it should be possible to learn from others' experiences and in this spirit I propose to set out briefly some of the developments in UK financial regulation which may be of interest to you in China. I will cover the background to the creation of the UK Financial Services Authority, some observations from our own experience of what typically goes wrong in banks, the UK approach to supervision of banks (including risk based supervision) and finally some remarks on the relevance of all this for developments in your own banking system.

Creation of the UK Financial Services Authority

The concept of a single financial regulator is of course not unique to the UK – we also have the Japanese FSA and the Korean FSS and many others are considering this approach. In the United Kingdom's financial sector we had ten different regulatory bodies working under eight different pieces of legislation with around 15 different rule books. The regulatory bodies included government departments, the central bank and self regulatory organisations. The style of supervision ranged from relatively informal to highly rule-based and the objectives for each body were in many cases not set out clearly in legislation, or at best incomplete or vague. None of this is surprising since the regulatory framework had grown up over a long period of time in a piecemeal fashion often in response to a particular crisis or market development. Although there were no significant barriers between different types of

financial institutions they remained distinct, and it is only in recent years that we have seen moves to put together institutions dealing with all aspects of financial activity. Moreover, because the United Kingdom has such an open financial system we have benefited from virtually every financial innovation imaginable. Changes in our society's needs and expectations have also had a significant influence, particularly on the protection provided for retail consumers.

All of us involved in financial regulation were well aware of the potential risks and inefficiencies of these fragmented arrangements (which are not unique to the UK), and we had put in place cooperative arrangements designed to mitigate them. We had regular information exchanges between the different regulatory bodies both about particular institutions and on general policy matters; we worked together at all levels on common issues and problems, and we were making good progress. But there would always have been limitations on just how far we could go because of our differing (and sometimes unclear) objectives, our different legal and institutional arrangements and the resulting differences in styles and techniques of regulation. At the same time the increasing integration in our financial industry with conglomerates combining banking, insurance, securities business and investment management, and the repackaging of conventional products across several parts of the financial industry, was putting severe pressure on this regulatory structure.

The new Labour government decided to dismantle the current arrangements and replace them with a single regulator and a single piece of legislation with clear objectives and accountabilities designed to deliver greater effectiveness, efficiency and consistency within a more flexible overall framework. We are now in an interim phase where all the regulatory staff are employed by the Financial Services Authority but we are still operating under the old legislation. We hope that our new legislation, which will replace most of the existing laws, will be in place by mid-2000. In July 1998, the government published the new draft law (the Financial Services and Markets Bill) for consultation and it will shortly begin its passage through our parliamentary process.

So the complex arrangements I described earlier are largely still in place and we in the Financial Services Authority are now supplying services under contract to eight of the regulatory bodies mentioned earlier and are still operating under eight separate Acts of Parliament.

Banking Supervision has benefited from an early legislative change and is now fully the responsibility of the FSA, although our powers continue to derive from the Banking Act and the Board of Banking Supervision remains in place.

What our experience has demonstrated is the need for: legal and institutional arrangements which are flexible, adaptable and as simple as possible; clear objectives and accountabilities; a mechanism to ensure there are no gaps in the regulatory system, minimal overlaps and a consistency in approach; a set of rules or guidelines which minimises duplication of effort and thereby reduces inefficiencies and the opportunity for regulatory arbitrage; and institutional arrangements that facilitate the exchange of skills and knowledge at all levels, both among regulators and between regulators and the regulated institutions. The precise way of delivering this set of objectives will vary between countries, but the more integrated the financial system, and companies within it, the more difficult it will be to deliver effective and efficient regulation with numerous different regulators.

The new proposed legislation is a flexible framework which leaves the FSA to set the more detailed rules and guidelines. It sets out four clear objectives for the FSA:

- market confidence: maintaining market confidence in the financial system;
- public awareness: promoting public understanding of the financial system;
- consumer protection; securing the appropriate degree of protection for consumers;
- reduction of financial crime: reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime.

These are supported by a set of general duties which set out principles of good regulation to which we should have regard in achieving these objectives:

- using resources in the most economic and efficient manner;
- the responsibilities of those who manage the affairs of authorised persons;
- being proportionate in imposing burdens or restrictions on the industry;
- facilitating innovation;

- taking into account the international character of financial services and the UK's competitive position;
- not impeding or distorting competition unnecessarily.

The UK FSA is committed to an open and consultative approach and has issued numerous consultation papers and explanatory documents. They are all available on the FSA's website and we would be very happy to answer any questions you may have on them. The task of merging ten very different organisations and approaches is not easy and we have a long way to go yet, but we are on target with our plans so far and already beginning to see the benefits of all the staff belonging to just one organisation, now housed in a single building in London's Docklands financial district.

What goes wrong in banks

Continuing with my theme of learning from the experiences of others I will try to summarise what seem to be the most common causes of bank problems and failures. This brief outline is the result of some work carried out nearly six years ago when I returned to bank supervision after a lengthy spell on other central bank duties. It is based on a range of case studies covering both large and small banks that encountered problems. I have not had to change these key factors in the last six years and you may be tempted to conclude that the main message is that bankers are very slow indeed to learn from their own or others' mistakes.

We identified five main generic causes of bank problems and failures:

- misconceived *strategies*;
- failure to analyse and *understand the business* (e.g. the risks, costs, source of profit);
- inappropriate *organisational structure*;
- weak or irrelevant *controls*;
- lack of timely, reliable and relevant *information*.

Strategy

A common feature of any well-run organisation is a clear and properly resourced strategy which is understood at all levels in the organisation. The most frequent weaknesses in strategy that we found are:

- a fundamental misunderstanding of the economic, financial and – particularly – competitive environment;
- inadequate resources to support the strategy, for example insufficient capital, inadequate skills or experience, poor information technology, weak management;
- inability to recognise that a previously sound strategy is no longer viable due to changes in the economic, social or financial environment, and failure to adjust accordingly;
- failure to implement change effectively (this is a particularly high risk in large organisations where chief executives sometimes do not understand that it takes a huge amount of planning, effort and determination to achieve effective implementation throughout the organisation);
- poor communication. No matter how good a strategy, it will not work unless everyone in the organisation understands it and the role they have to play in delivering it.

But perhaps the biggest and most frequent cause of problems under this heading is the complete absence of any agreed or coherent strategy.

Understanding the business

In every case of failure or significant loss that I have observed, senior management has quite simply not understood the nature of the business they are in. For example, they have not understood:

- exactly how and where the profits have been made (there is a tendency to investigate thoroughly the source and cause of obvious losses – but not of profits);
- the risks taken to generate those profits (are boards able to review an analysis of risks alongside the profit figures on a regular basis?);
- the cost structure;
- potential changes/threats to the business (how often do banks conduct regular and effective scenario analysis to evaluate the future viability of their business under different sets of assumptions?).

Organisational structure

Clear responsibilities and accountabilities are essential. A common cause of bank failures and problems has been confusion over responsibilities. Overlapping responsibilities, where no one takes ownership of issues, are just as dangerous as outright gaps.

- The organisational structure needs to reflect business and control objectives.
- Responsibilities should be clear and written down with no overlaps or gaps.
- Care is needed in deciding how much decision-making should be delegated or centralised.

Controls

Controls are often much too narrowly interpreted. A key control is the whole culture and leadership of the organisation. This sets the tone for what is acceptable behaviour. Appointments, rewards and compensation and motivation systems as well as the quality of training are all key parts of a sound control system.

We should of course not overlook the more conventional control mechanisms:

- segregation of duties and dual control;
- independent risk management (which should cover operational risk as well as credit risk and market risk);
- high quality independent internal audit and compliance;
- high quality external audit;
- independent non-executive directors.

These types of controls are essential but they will not work properly unless the overall culture of the organisation promotes, respects and rewards strong controls and the organisation appoints people to senior positions who believe in these values.

And finally of course controls need to be relevant. In some of the banks that have experienced problems there were plenty of controls in place, but the nature of the business had changed and the controls had not been adjusted to meet that change.

Management information

In order to manage and control any organisation and measure its progress, management needs timely, reliable and relevant information. As with controls, many banks implement significant changes in their business without paying regard to the change in their information needs. Banks need management information that is:

- of a reliable quality and accuracy;

- up-to-date and timely, so that it can be used as a tool to steer and manage the business – not as a historical record;
- appropriately detailed (too much irrelevant detail is as bad as insufficient information).

  The information should enable management to assess:
- the bank's progress against its plan (with particular emphasis on areas of significant change);
- the bank's risk profile; and
- its profitability (with appropriate breakdowns of costs and profit sources).

It is also very important that information gets to the right level of management at the right time and is fully aligned with each person's responsibilities.

Supervisory approach

If these are some of the hazards to which banks are exposed, what is the proper role for bank supervisors? We have a very wide range of banks in the United Kingdom, from multi-billion dollar capitalised international banks to very small local banks offering a few simple products. All of these banks operate in a volatile and rapidly changing financial environment. We have also always been keen to ensure that we have a sound financial system in which innovation and competition can flourish. The key features of our supervisory approach are that it is *risk-based* and *flexible*. I will explain our risk-based approach to supervision (known as "RATE")[1] briefly below. The key outputs for each bank are a tailor-made and unique supervisory programme and a capital requirement, both of which reflect the supervisors' judgement of the risks of that bank. We set individual capital ratios for each of our banks, typically above – and for some banks significantly above – the Basel minimum.

Supervisory techniques

We use a range of techniques in our supervision:

Off-site analysis of formal FSA statistical returns, the bank's own management information, risk limits, risk manuals, general industry data and much more.

[1] Risk assessment, tools of supervision evaluation.

On-site analysis of systems and controls, focusing particularly on credit risk, market risk, operational risk, IT systems and internal audit. We also review the effectiveness of senior management, high level controls, strategy and so on. This work is conducted by supervisory staff and teams of technical experts.

Reports by accountants where the FSA determines the scope of the enquiry but the work is carried out by external accountants (usually, but not always, the bank's own external accountants).

Liaison with overseas regulators is also very important to discuss the operations of foreign banks in the United Kingdom and of UK banks operating in other countries.

Risk-based supervision[2]

The FSA undertakes a formal risk assessment of each bank, reviewing the bank's *business risk* and *control risk* separately, so that we may find that a bank has high inherent business risk (because for example its business is concentrated in volatile markets) but because the business is very well controlled the control risk may be low. Conversely, we may find a bank which has low business risk to have very weak controls and therefore represents a high control risk.

Under the *business risk* heading we evaluate capital, asset quality, market risk, earnings, liabilities and general business risk (which includes for example strategy and competitive position). Under *control risk* we evaluate internal controls, organisation and management.

I hope you will recognise here the issues I covered in our small study on things that go wrong in banks! The work involves an on-site risk assessment including interviews with senior management, analysis of key numerical data and consultations with other parties, particularly overseas supervisors (where relevant).

The output from this process is:
- a formal risk assessment with detailed numerical scores;
- a remedial action plan for the bank with deadlines;
- a supervisory programme for the supervisors and bank which will include:
  - "discovery": where the supervisors need more information;

[2] Described in more detail in "Risk-based approach to supervision of banks", FSA, June 1998.

– "correction": where the supervisor seeks to ensure that required corrective or remedial actions by the bank are implemented; and
– "monitoring": where the supervisor needs to receive regular information.

The work is reviewed by a committee of senior FSA staff to provide a check on quality and consistency.

The risk assessment, remedial action plan and supervisory programme are sent to the bank's board of directors along with a letter highlighting the key points. It is also sent to overseas supervisors and head offices in the cases of foreign banks. The risk assessment sent to banks does not include detailed scores (these are used internally) but the bank is told whether it has high, medium or low business and control risk and the reasons for the FSA's views are given very clearly. Most banks appreciate this frank and open approach. The FSA will also determine and communicate a "supervisory period", which is the length of time until the next formal risk assessment. This can be anything from six months for a high-risk bank to three years for a low-risk bank operating in a stable market.

We have found this to be a very effective process. It communicates clearly to banks our assessment and expectations of the bank within a consistent and transparent framework. It also provides a sound basis for us to allocate our own scarce resources to the areas of highest risk, leading we hope to a more efficient and cost-effective supervisory system. This has been a very brief summary of our risk-based approach and if you are interested in more information I urge you to read our explanatory paper on the process published in June 1998. As well as being a supervisory tool it is also a useful framework for banks to conduct self-analysis.

Sanctions against banks

We are frequently asked what sanctions we have if banks do not meet our requirements. The first thing I should say is that we have a very strong preference to agree voluntary remedial actions with banks. We believe this is the most effective way of securing our objectives but if that is not possible we have a range of powers and sanctions at our disposal.

- We may *increase the bank's capital requirement*. This is not a "punishment" – it simply recognises that the bank's risk has increased and many higher-risk banks have permanently high capital requirements; similarly we may *increase liquidity requirements*.
- We can place *informal agreed restrictions* on a bank's business, for example on credit exposures, types of business, management, shareholder controls, etc.
- We can invoke our *formal powers under the Banking Act*; this can range from formal restrictions to revocation of a bank's authorisation. The use of Banking Act powers is subject to formal procedures, and is subject to appeal.

Relevance to China

You in China are facing your own challenges, which in many ways are quite distinct, but I believe that there may be useful lessons from our experience in the UK that can be adapted to your particular needs. There are, of course, significant differences between our two countries: they are at different stages of economic development; their financial sectors differ in structure and composition; and there is a different balance in public and private sector involvement. Nevertheless, China is moving towards a market-based economy, with some of the most far-reaching reforms being in the financial sector. I believe, therefore, that some elements of our approach may be relevant to China in spite of the differences between us.

Single regulator

I have mentioned earlier the reasons why the UK has opted to have a single financial regulator, but we have never claimed it is a universal model. You in China have gone the other way – creating separate regulators for the banking, securities and insurance sectors. The decision to go with either model must be determined in large part by local circumstances. In China you have opted for a separation of banking, securities business and insurance, so there is logic in having separate regulators. The task of adapting regulation to the needs of a new and rapidly developing financial services industry is a difficult one and specialised regulators may be better able to focus on the unique problems that this brings up.

You may find that, further down the road, you will come under pressure from regulated firms to remove the restrictions that prevent them engaging in a full range of financial activities. Even at this stage, however, you may want to consider setting in place arrangements to ensure that there are no gaps or overlaps between the regulatory bodies and that there is sufficient consistency in approach between them to prevent any regulatory arbitrage or possible distortions to the financial system. If at a later time you do ever come to consider the merits of a single regulator, you will be in the happy position of being able to learn from our mistakes.

Reform in Chinese banking sector

But that is looking quite far into the future. For now, we are watching the reform of the Chinese banking sector with great interest. As we see it, the key elements of this reform are:
- the removal of policy lending from state-owned commercial banks;
- measures to deal with non-performing loans;
- strengthening the capital of the major state-owned banks;
- strengthening internal controls; and
- increased competition.

If I may, I would like to make a few remarks about each of these, from the perspective of a UK regulator.

Removal of policy lending from state-owned commercial banks

The removal of "policy lending" from the state banks is a key reform if these banks are to operate on a commercial basis. It marks a major change in the whole culture of Chinese banking: amongst management, employees and customers. The crucial ingredient is independence. If the process is to work, government – at both local and national levels – must allow management to make its own commercial decisions. Managers, in turn, will have to get used to being held accountable for the decisions they take and the performance of their staff. It is a significant strategic shift and will require a restructuring of incentive systems, controls and management information systems.

For this to work, it is important that a bank's organisational structure is clear and its levels of decision-making and responsibility well set out and understood. This is something which we look at under our RATE framework. As part of our risk assessment, we evaluate the effectiveness of a bank's organisational structure and whether the Board of Directors and management have the necessary skills, experience and integrity to manage the business. A bank which fails these "Corporate Governance" tests will have much greater difficulty controlling its business and will be more susceptible to fraud.

Non-performing loans

Dealing with the legacy of past policy lending is a major challenge. The quantity of non-performing loans in the major state-owned banks is unknown, at least outside China, but estimates range from 20% to 40% of the total. Whatever the exact figure, it will be difficult for the banks to make a genuine shift to a more commercial, risk-based approach so long as they retain relationships with such a large number of borrowers who cannot service their debts.

I therefore welcome the announcement that the legacy of non-performing loans will be tackled by the creation of Asset Management Corporations. This method has been used with success elsewhere, and I look forward to hearing details of the Chinese model. If you are to convince the outside world that you are serious in your resolve, it will be important to make the process as transparent as possible. Which bad loans are to be transferred? What discount will apply? Will the banks have to recognise losses at the point of transfer? How will the Asset Management Corporations be funded? There is a lot of interest outside China in what you are doing and, I am sure, a lot of support. But the benefits that you stand to gain from dealing effectively with the legacy of past policy lending could be compromised if the process is not seen to be clear and rigorous.

Dealing with the past is difficult enough. But it is equally important to avoid making the same mistakes again. A priority for the banks should be to develop sound credit assessment procedures to minimise the risk that new lending will turn bad. And of equal importance, they need to introduce prudent provisioning policies consistent with the new loan grading system that I understand is being gradually introduced throughout the banking sector. This will help to ensure that any deterioration in credit quality is picked up quickly, acted upon by lending officers and also accurately reflected in the balance sheet. I should emphasise, too, the importance of a clear bankruptcy code, which banks can invoke to recover some part at least of otherwise unrecoverable debts.

Strengthening the capital of the "Big Four" banks

Clearing non-performing loans from the banks' balance sheets will not by itself be a panacea for China's banking sector. There is a need for additional capital to support their business, particularly in view of their rapid expansion in recent years. Raising and maintaining adequate capital, and earning a decent return on it, are important disciplines for a bank. Under Chinese accounting standards, it has not been possible for outsiders to judge the quality of Chinese banks' assets, their profitability or the adequacy of their capital and provisions. The authorities have said that all the state-owned banks will meet the Basel minimum capital ratio of 8% within two years. No one would argue with the objective of strengthening the banks' capital, but it will not be enough merely to assert that the standard has been met. Much further disclosure will be required if you are to convince an often sceptical world that the published figures are true.

This is a fundamental point which applies more widely. A market-based economy relies on the availability of timely, accurate and comprehensive information on the financial status of companies operating within it. This is, of course, particularly important for banks, if they are to make a proper, objective assessment of a borrower's creditworthiness before extending a loan and then monitor credit quality during its life. Banks, indeed, should be at the forefront of those calling for greater disclosure. But they will not be the only beneficiaries. The economy as a whole will benefit from an improvement in accounting standards because it will, over time, lead to an increase in productivity by enabling savings and investment to be channelled to where it can earn the best return. Better disclosure could also help China in its objective of eliminating moral hazard. I completely agree that lenders and investors should rely on their own analysis and commercial judgement when dealing with Chinese counterparties, and not on an implicit state guarantee. Nevertheless, if they are to do that, they need more information than is available at present. It was clear from the closure of GITIC that there was a large gulf in understanding between foreign creditors and the

Chinese authorities about the degree of official support the investment and trust companies enjoyed. I do not want to comment on that particular case, save to say that it demonstrates how important it is that all players know and understand the rules of the game.

Strengthening internal controls

I know that the strengthening of banks' internal controls is one of the priorities of the People's Bank of China. We too set great store by this. As a starting point, a bank's internal control framework should be commensurate with the nature of its business and the amount of risk it is prepared to run. In the FSA, we assess this framework in each bank, together with its internal limits and guidelines, the adequacy of its IT systems, the quality of its financial and management reporting, the effectiveness of its audit and compliance functions and its money laundering controls.

As a minimum we expect to see: accurate accounting and other records so that management has the information it needs to make informed judgements about its business; adequate systems to identify, measure, monitor and control different types of risk; and staff and remuneration policies that ensure staff are properly qualified for the jobs they do, and adequately rewarded on the basis of their performance. As I mentioned earlier, in the UK we make extensive use of external accountants to report on the adequacy of the banks' systems and controls. We have also built up specialist teams to help our line supervisors assess the quality of controls in the banks. These include IT specialists who have been particularly busy of late analysing the adequacy of banks' Y2K preparations. A useful by-product of the work of our specialist teams has been their contribution to spreading best practice throughout the banking sector.

Increased competition

Judging by our own experience, increased competition will be a spur to the process of reform that is under way in China. Although the "Big Four" state-owned banks remain the dominant force in Chinese banking, a number of new commercial banks have been established in the past decade, bringing a new level of participation to the banking sector. Competition from foreign banks, however, has been slower to develop.

I understand the reasons behind this, and appreciate the need for gradual, controlled development. At the same time, I believe that China will reap great benefits from opening up its banking sector to outsiders, who will bring in new capital, technology and expertise. More generally, increased foreign competition, not just in banking but in fund management and insurance too, will over time help bring greater stability to China's financial markets.

Conclusion

Although the UK and China are at different stages of economic and financial development, we share at least one thing in common – the pace of change in our financial service industries is accelerating and, as regulators, we must do our best to keep up. I have spoken today about developments in the UK and tried to draw some lessons from our experience for China. I hope they are of some help. A lot, I know, is already under way in China, and the initiatives the People's Bank has already taken show that it is well aware of the key issues it faces and is taking steps to address them. We in the FSA should be delighted to help in any way we can. We have, I am pleased to say, a very good relationship with the People's Bank, with frequent visits in both directions. We were delighted to host, in conjunction with the Bank of England, a week-long programme for Deputy Governor Liu and his delegation last November. It was during that visit that a Memorandum of Understanding covering the exchange of information between the FSA and the People's Bank was signed.