Strengthening the banking system: issues and exposures

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It is a privilege to be able to present in Beijing the Basel Committee's recent work, and especially the Basel Core Principles for Effective Banking Supervision. In front of such an audience, which has taken a strong stance on financial stability, there is no need for me to stress their importance. Let me start with a few general considerations concerning the Basel Committee and its recent work.

The Basel Committee was created in 1974 by the Committee of G10 central bank Governors and it meets four times a year. It comprises banking supervisory authorities of the G10 countries, and cooperates with regional groups of supervisors (for example SEANZA and EMEAP, of which China is a member). The Committee has an international Secretariat at the BIS (with a representative from the People's Bank of China), and is supported by several working groups. It is also a forum for international cooperation among the G10 countries and between G10 and non-G10 supervisors.

The Committee has produced binding minimum standards, best supervisory practices papers and, more recently, the "Core Principles for Effective Banking Supervision". It maintains contacts and cooperates with fellow supervisory groups such as IOSCO and the IAIS and it played a significant role in the creation of the Joint Forum (1996) addressing the supervision of financial conglomerates.

What are the Core Principles for effective banking supervision? In what way can they be helpful to China?

The Core Principles are a set of supervisory guidelines aimed at providing a general framework for effective banking supervision in all countries. They are a reference document to be used by national supervisors and international institutions to strengthen supervisory standards in emerging and developing countries.

The Principles represent for the Basel Committee a very radical change in its relationship with non-G10 countries. But they are at the same time only one step in a continuous process that the Committee has been engaged in for over twenty years to strengthen banking supervisory standards around the world.

This has been from the outset a product developed at the global level. The Basel Committee has driven and supported the process, but it could not have moved forward at the speed it has without the positive and active cooperation of supervisory authorities around the world. We can all be satisfied with the outcome and the speed with which a worldwide consensus was reached.

The Core Principles are in at least three ways a "first" for the supervisory community. As I have mentioned, a mixed drafting group in which non-G10 countries were in the majority developed them. The extent of consultation with supervisors in all countries was such that the document can truly be regarded as a consensus document of the world supervisory community, the first of its kind but by no means the last.

The second innovation is that the Core Principles are comprehensive in their coverage. They are sometimes called the supervisors' "bible". The Principles are not developed in any great detail but instead represent a checklist of the principal features of a well-designed supervisory system. The much longer Compendium, of course, supports them. While the documents in the Compendium were not designed for the purpose of providing comprehensive supervisory guidance, we now have a framework to build upon.

What is the Compendium?

The Compendium is a collection of most of the Basel Committee's "live" policy papers. It consists of three volumes dealing with basic supervisory methods, advanced supervisory methods and International supervisory issues. The most recent version was recently published in February 1999.

In a more subtle way, however, and this is the third "first", the Principles represent a significant initiative by the supervisory community to make a political statement, albeit clothed in technical language: financial stability is a public good that must be achieved everywhere because we now live in a "global village". Sound banking systems and efficient banking supervision are key points in this process. Similarly, in

the "Preconditions for effective banking supervision" we lay it on the line by stating that it will not be possible to ensure the effectiveness of a country's supervisory arrangements unless certain conditions are in place. This, too, I will come back to later.

Let me mention two other preliminary points. First, the IMF and World Bank were closely associated with the development of the Core Principles. Both institutions saw and commented on the Principles during the drafting process and have expressed their intention of using the Principles as a basis for developing technical assistance in their missions and surveillance work. The current preparation of a methodology for assessing compliance with the Core Principles will be very helpful in this respect. Second, the Core Principles are deliberately designed to apply equally to industrialised countries, emerging markets, economies in transition and even countries that do not yet aspire to any of these categories.

An important aspect of the Core Principles is the philosophy that underpins them. Conceptual approaches to banking supervision have developed radically over the past 20 years or so, both as a result of the work of the Basel Committee and in response to the rapid evolution of the financial markets. In the major markets, at least, the old technique of ticking boxes, analysing ratios and monitoring compliance with numerical standards has become totally inadequate as a means of monitoring the performance of a bank. Supervision has become far more qualitative than quantitative – more an art than a science. In today's fast-moving environment, the focus of supervision at the sharp end is on the quality of corporate governance, risk management and internal controls. The key point to grasp is that bank management must manage – supervisors can be advisers, unpaid consultants if you like, but not those who take the decisions. That is the responsibility of bankers and ultimately the reason why they earn more money than we do.

As far as the content of the Core Principles document is concerned, I mentioned that it is general but comprehensive and addresses a wide range of supervisory issues.

There are four main aspects to which I would like to draw your attention.

1. The first of these concerns a section I have already mentioned, "Preconditions for effective banking supervision". This section makes some fairly obvious, but nonetheless important, statements about the

circumstances in which banking supervision can operate. The conditions include:

- First, sound macroeconomic policies – in their absence, supervisors are faced with an almost impossible task.
- Second, a well-developed public infrastructure in order to protect financial system stability. The infrastructure one would look for includes such basic features as; business laws sufficient to establish solid contract and property rights; well-defined accounting standards; a system of independent audits to validate financial statements; adequate supervision of non-bank financial markets and their participants; and a secure clearing system for settling financial transactions. If these are not in place the ability to supervise effectively is severely constrained. None of these features of the financial system fall within the competence of bank supervisors and, if they are lacking, it is essential that they be addressed expeditiously.
- Third, a system of effective market discipline based on good standards of corporate governance and adequate transparency in respect of financial activities. That, too, is something that goes beyond bank supervisors' responsibility and that cannot be achieved overnight.
- Fourth, sufficient flexibility to enable problems arising in banks to be resolved in an efficient manner, including, where necessary, the orderly exit of problem institutions. This is important, because forbearance and continued feather-bedding of inefficient market participants damages the ability of strong competitors to expand their business and improve efficiency in the sector.
- Fifth, an appropriate level of systemic protection, or some kind of safety net, in order to guard against crises of confidence. I personally believe that a soundly structured deposit insurance scheme is of considerable help to supervisors in addressing problem banks.

2. The second, which is also the longest of the Core Principles, deals with the characteristics of an effective supervisory body. I am sure that this Principle is one you can all readily support. Five main components are established:

- First, a consistent framework of responsibilities, with operational independence to pursue them. Such operational independence means that supervisors should not be subject to political pressure concerning operational judgements they may be called upon to make. But it can also mean independence in setting supervisory rules.

  Whereas bank supervisors would be wise to consult the industry and other supervisory bodies, etc. about regulatory changes, the final decision must remain with the supervisor.
- Second, adequate resources to train, pay and provide adequate technology for the agency's staff. Too often, either the supervisory body is not able to recruit the kind and number of staff it needs or it suffers a steady "brain drain" over the years. No supervisory agency can be expected to perform to the highest international standards if it does not have adequate, properly trained human resources.
- Third, a framework of banking law that enables supervisors to set prudential rules in a flexible manner, gather information and apply penalties for non-compliance.
- Fourth, protection from personal and institutional liability for supervisory actions taken in good faith.
- Fifth, the ability to share information with other regulators and to protect the confidentiality of information received. This is a difficult issue, particularly in a cross-border context, because of the need to preserve customer confidentiality without giving criminals undue protection. But without adequate information channels, supervision will be handicapped.

3. The third section of the document, on which I would like to put particular emphasis, deals with credit risk management. This is critical because, whatever you hear about trading and operational risks, the problems that have led to the vast majority of bank failures have had their origins in credit risk. Credits should be granted only when the money will generate an additional return that can be used to service and repay the debt, and not because the national plan determines that certain industries or projects need financing. Otherwise, bad loans will pile up in the balance sheet of the banks and sooner rather than later the banking system will have to be restructured and supported/bailed out by public money. Sound credit practices involve standards for banks' policies in the following five areas:

- First, policies for making credit assessments as a basis for granting loans.
- Second, policies for evaluating the quality of assets, which also means establishing provisions against impaired assets.
- Third, management of concentrations (this includes consideration of supervisory limits on concentrations).

- Fourth, guarding against connected lending abuses.
- Fifth, management of country risks.

More fundamentally, however, the establishment of a prudent approach to credit risk management at the national level involves the development of skills in a number of different professions:

- Bank credit officers need the skills to evaluate a loan application.
- Bank supervisors need the skills to assess whether the bank has an adequate method of evaluating loan applications and, later on, monitoring the performance of the borrower.
- Bank auditors need to be properly trained and qualified to pass a judgement on whether the accounts present a "true and fair" view.
- The borrowers themselves need the skill to assess a project, arrange the financing and carry out the expenditure in an efficient manner.

This may involve in some countries a significant change in attitudes to the role of banks in financing economic development, and such cultural and educational advances/changes are not likely to take place rapidly.

4. The fourth and final section I would like to spend a few moments on is Principle 22, which deals with supervisors' powers. What is most important here is that supervisors have the authority to bring about what is called "prompt corrective action", i.e. to enforce changes when they detect incipient problems in a bank. This can include additional reporting requirements, special audits or examinations, constraints on a bank's ability to operate or, if necessary, the suspension of dividends or other financial constraints. It is essential that the supervisor have the power to address management weaknesses, including the ability to replace poor-performing managers, or, in extremis, impose conservatorship. Most bank supervisors have the "nuclear option" of withdrawing a licence, but in a deteriorating situation it should be possible to take remedial action before the patient becomes terminally ill.

Among the other tools: capital adequacy. The Basel Committee believes that capital is an important defence and discipline and the Principles state that supervisors should establish appropriate minimum capital requirements. The big question concerning capital, however, is what to do when losses overwhelm the available capital. Very often, this occurs at a time when the markets are not receptive to new equity issues. The resolution of such problems is one of the main skills of the supervisor; often mergers or takeovers by stronger partners are the most practical solution.

So what happens next? The challenge for supervisors now is "Quality implementation of the Core Principles".

The Core Principles for banking supervision provide the foundation necessary to achieve a sound supervisory system. Local characteristics need to be taken into account in the specific way in which these standards are implemented, as they are necessary but may not be sufficient, on their own, in all situations. Each country should therefore consider to what extent it needs to supplement these Core Principles with additional requirements to address particular risks and general conditions prevailing in its own market.

No two countries are starting from the same point – some have nearly all the Principles in place in their supervisory arrangements, while others have a way to go. In many countries, significant changes in the legislative framework are required. Some, for example, are lacking in basic infrastructure, such as the framework for effective contract law, property rights, or insolvency procedures. There is no "quick fix" in such a country. Years will be needed to establish the skills to develop the necessary legal framework and credit culture. We need to be careful not to create unrealistic expectations as to how fast improvements can be made.

Quality implementation of the Core Principles will be a long process to build, as it requires a competent and motivated body of professional supervisors, a banking regulatory framework that supports sound banking practices, a credit culture that supports sound lending practices, and adequate accounting, reporting and disclosure requirements that support financial transparency. The first step is always an assessment exercise: identify the areas where changes are necessary and establish a timetable.

The first step is to make an honest assessment of the situation: identify where changes are needed and determine what the impediments may be.

The survey prepared for the Sydney ICBS, to which we received over 120 responses, identified four common difficulties.

1. The most acute problem is the shortage of skilled human resources. We are all aware of the need to strengthen banking supervisory skills, but several survey results also pointed out the need for improvements in the banks themselves, where the Core Principles require skills in several areas such as credit assessment, risk management, internal audit

and back-office controls. The Core Principles also have human resource implications for some non-banking professions such as lawyers and accountants.

2. A related issue raised in the document is the financial strength of the supervisor and his ability to retain his skilled staff. Although most agencies have control over their budgets, these are rarely sufficient to protect themselves against a "brain drain" to the private sector.

3. The autonomy of supervisory agencies is clearly not adequate in many countries. A very practical test of the autonomy of the supervisor is the licensing process. As the Core Principles make clear, this goes far beyond the issue of initial licences and needs to protect against structures and cross-ownerships that may impede effective supervision.

4. A fourth theme that is common to many responses is the need for greater understanding and use of modern risk management techniques, both in banks and in supervisory agencies.

One issue that is being discussed is the extent to which we need to impose some form of time limit for the implementation of the Principles.

Part of the problem is that the timing of implementation of the Core Principles is not something that supervisors can necessarily control. They can advise and "lobby for action", but where legislative changes are required they are at the mercy of the national political process. So I believe that we should readily welcome the outside pressure that is coming from a number of quarters, notably the G7, the G10 and the Willard Group (the G7 plus 16 emerging markets). In addition, the IMF and IBRD are playing an important role in advising on and encouraging implementation. Already in their surveillance work, the two Washington institutions are placing great emphasis on stronger supervisory standards and the Basel Committee's Chairman and Secretariat are in regular contact with IMF and World Bank staff. In addition, we expect the rating agencies and other private sector agencies to play a role in demanding that countries adhere to the Principles.

To help assess compliance with the Core Principles in an efficient and consistent manner, the Basel Committee, with the support of the Core Principles Liaison Group (of which China is an active member), is preparing a methodology. For each principle (or sub-principle) this methodology distinguishes what constitutes minimum standards and best practices.

All these pressures are very likely to make life difficult for those countries that do not apply due diligence to implementation, although monitoring compliance is not going to be a simple procedure.

Also, sooner or later, there will be a demand for transparency and accountability, which will be difficult to resist.

Of course, the Basel Committee has taken a number of initiatives to support the implementation process. The Core Principles Liaison Group already referred to consists of about 18 countries (including China) and meets three or four times a year. The World Bank and the Fund are members of the Liaison Group.

Meanwhile, the Basel Committee has revised its 500-page Compendium of detailed documents that back up the Core Principles and issued a second edition. Even more important, though, the Basel Committee is working to elaborate on certain features of the Core Principles, namely credit risk management, corporate governance and loan valuation and provisioning issues.

As supervisors, we are well aware of the practical realities. High-quality banking supervision can, over time:

- strengthen national banking systems;
- contribute to greater stability in the financial sector; and
- reduce vulnerability to external shocks.

But, at the same time, it cannot solve all the financial problems countries are faced with:

- it cannot, on its own, create macro-economic stability;
- it cannot immunise a country to external shocks;
- and, importantly, it cannot guarantee that no bank will ever fail. If that is to be the prime objective of bank supervisors, it is likely that they will impose conditions that obstruct dynamic growth in their banking sector.

So, we need to take care that expectations of what the Core Principles can achieve are set at a realistic level. First, implementation of the Principles in spirit and not only in letter is critical. Second, this is going to be a long process. For those starting from scratch, the first challenge is to build a competent and motivated body of professional supervisors. This takes time: sending someone on a couple of training courses, even to Basel, does not make a supervisor. Years of on-the-job experience are necessary.

Even with the right people in place, supervisors need the appropriate tools to do the job. What are the main necessary arrangements for ongoing banking supervision? Sixteen of the 25 principles cover the essence of ongoing supervision under three main chapters: prudential regulation and requirements (Principles 6 to 15); methods of ongoing banking supervision (Principles 16 to 20); and information requirements (Principle 21).

Let us focus on methods of ongoing banking supervision. Main prudential regulations should address at least: capital adequacy (regulatory capital should cover credit risk, market risk and operational risk); risk management; internal controls; and accounting, reporting and disclosure requirements.

Methods of ongoing banking supervision comprise: on-site and off-site supervision; regular contact with bank management; procedures for collecting, reviewing and analysing prudential reports and statistical returns on a solo and consolidated basis; methods of independent validation; and the ability of supervisors to supervise consolidated entities.

Let me conclude with what I regard as the three critical elements of infrastructure:

- a legal framework that supports sound banking practices;
- a credit culture that supports sound lending practices; and
- an accounting framework that supports financial transparency.

For each of these elements, too, it is necessary to train the necessary people, including lawyers, judges, bank credit officers, auditors, accountants, etc, and develop the necessary body of experience and case law to enable the system to operate effectively. This, as I have said, will inevitably be a long process, but it is one which we need to support and work towards if we are to be able to exercise our functions to the best of our abilities.