

Tarisa Watanagase: Aspects of optimal supervisory arrangements

Remarks by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the SEACEN Governors' Conference, Kuala Lumpur, 6 February 2009.

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Bank Negara Malaysia's background paper provides a good summary of issues related to the choice of optimal supervisory arrangements. It is generally accepted that integrated model of supervision may have inherent synergies, economy of scale and scope, very little or no regulatory arbitrage and the ability to identify problems sooner. However, its possible weaknesses are the blurring of focuses and a tendency to compromise multiple objectives. On the other hand, separate supervisors have been credited with being more focused on their mandates, but of course the biggest concern is about supervisory coordination, the lack of which can lead to regulatory arbitrage, making supervision ineffective.

It is also generally accepted that no one model is better or more optimal than the other. It all depends on the context of each country, including its supervisory capacity and resources, and details in operational arrangements.

Thailand can certainly agree to such a conclusion. In our case, the Bank of Thailand (BOT) supervises the banking sector, which is the core of the financial sector. The Securities and Exchange Commission (SEC) supervises market conduct, the Insurance Commission supervises the insurance companies. This model has worked well so far. By law, the BOT chairs the Financial Institutions Policy Committee, whose members include the Secretary General of the SEC and the Insurance Commissioner, that meets on a monthly basis. The forum provides the opportunities for policy dialogues, exchange of views and concerns, and information updates, among other things. This is the major operational arrangement that we have put in place to make the separate authorities model work for us. No doubt other operational arrangements can be put in place to make the integrated model work as well.

Having said that, let me add another dimension to the issue of supervisory arrangement – one that is related to central bank's other key function, namely, monetary policy. I believe that supervisory policy and monetary policy can be arranged in such a way that they are complementary and supportive to each other. I also believe that the often-cited conflicts of interest between the two roles, if performed by the same institution, may have been overstated somewhat. If there are policy conflicts, these conflicts will have to be resolved regardless of who is in charge of supervision. Then, would it not be more efficient if the conflicts could be internalized and resolved within an institution? In fact, many possible mechanisms exist to help ensure full accountability for each role, thereby minimizing potential conflicts while getting synergies from having the two roles under one roof. The arrangement we use in Thailand, as I alluded to earlier, is the establishment of two separate policy boards that include outside experts. The linking pin is membership in both policy boards by central bank's senior management, which makes it possible for information and knowledge in one area to be usefully employed in performing the other, without compromising the mandate of each policy board.

For example, detailed supervisory information about banks' changing risk appetite and exposure to different economic sectors and markets – as well as how these risks are being managed – can provide useful early warnings about the health of the economy and potential systemic problems down the road. This can be a very important input for monetary policy board. On the other hand, central bank's oversight of monetary policy and economic stability can strengthen and provide context to its supervisory responsibilities, for example, in identifying potential macro factors that may affect the health of financial institutions. Decisions about the stance and timing of prudential and supervisory policies in general can

also be more appropriately made with the full knowledge of macroeconomic conditions and monetary policy.

As can be seen, the two policies are essential to each other and hence it is useful or even desirable, in my opinion, for central banks to supervise at least the core financial sector, whether under a separate or integrated supervision model. This is most evident in times of systemic crisis where central banks' last-resort lending is likely to be called upon and prompt decision is vital. Central banks that also supervise core financial institutions would have the clear benefits of immediate access to vital information and expert assessment from supervisory staff about the health of individual institutions and their systemic implications. This could greatly help reduce the likelihood of any unnecessary delay or even misinformed decision that might hamper efforts to stem a financial crisis.

For emerging market economies, the case for central banks to supervise the core financial institutions may be even stronger. This is because, financial markets in these countries are typically not well developed enough to serve as an efficient channel for the transmission of monetary policy. Market interest rates and even commercial banks' prime rates react only sluggishly to changes in central bank's policy rate, and often with a long time lag. In these circumstances, the traditional tool of monetary policy alone is unlikely to be enough to maintain economic and financial stability. Since in most emerging market economies, commercial banks are by far the most dominant players in the financial system, central banks with supervisory responsibilities could and should make use of targeted prudential policy to tackle financial imbalances and excessive asset price movements, both of which lie at the heart of all financial crises.

This was what we did in 2003 to successfully contain incipient speculative bubbles in the property sector by imposing a ceiling on banks' loan-to-value ratio of high-end housing loans. In the same vein, in order to contain household debt at prudent levels to prevent financial imbalances, a maximum credit-to-income ratio was imposed on credit card and personal loans.

Let me now turn to the current financial crisis and discuss some lessons that are relevant to the issue of supervisory arrangement. If we look at the wide range of countries afflicted by the current turmoil, we immediately notice that financial sector problems happened in countries with either supervisory model. Notably, the US is well-known for its multiple agencies, whereas the UK has an integrated one. Yet both countries are currently faced with similar financial sector problems. One cannot help but think that there must be certain common supervisory weaknesses that led to the crisis, regardless of the supervisory arrangements. So perhaps the key question is not about the institutional form but rather about how to strengthen the regulatory framework to ensure financial stability.

Of course, this is not an easy task, given the scale and the complexity of the problems that we are in right now. Several committees and working groups of various organizations, including the BIS, are working on a number of issues that have been identified as contributing to the crisis, such as the procyclical nature of supervisory and accounting rules and the inadequate focus on liquidity risk. I do not know whether there are efforts to try to identify common weaknesses of different institutional setup of supervision. But no doubt this is an area that more work will be needed.

To me, both types of institutional setup may have one important common weakness, that is, there does not seem to be the notion of a lead supervisor in either model. Allow me to elaborate on this point.

In the case of separate authorities, it would be normal for each authority to assume that every authority is doing its job according to its mandate. Therefore, one would tend to focus only on its own mandate. This can be a problem if some authorities fail to do a proper job, others may not be able to take note. Worse still, if there are supervisory gaps, the chance of any one authority identifying potential adverse impact from areas outside of one's own mandate is even smaller. Take the US as an example, the authorities and investors did not

realize that credit rating agencies were not doing an adequate job in their rating of complex structured products. If there were a lead supervisor, would the whistle have been blown earlier? I believe that there would have been a better chance if there were a lead supervisor with a clear mandate to take the lead responsibility and who is risk focused. There would have been more dialogues through which weaknesses may have been identified and corrected.

The idea of a lead supervisor has gained widespread support in the area of cross-border supervision, as it contributes to better coordination, which in turn could help to prevent or identify problems at an early stage. By the same token, such benefits could be gained in the domestic setting from having a lead supervisor under the separate authorities model. Of course, in the case of the integrated model, the notion becomes a lead department in the same agency, rather than an outside lead supervisor.

The next question is: who should be the lead supervisor? The obvious answer is it should be the one that supervises the core financial institutions of the country. And following my previous argument that a central bank should supervise the core financial sector, the central bank should be the lead supervisor. The financial landscape, role, and systemic importance of financial institutions evolve overtime, so must the scope of oversight and focus of lead supervisor. The lead supervisor must closely monitor this evolution and ensure no regulatory gap emerges. It can do so by expanding its scope of supervision either directly or indirectly through the relevant agencies and build coordination to ensure it can perform its lead role properly.