Mr. de Swaan discusses the background, advantages and implementation of the core principles for effective banking supervision Speech by Mr. de Swaan, an Executive Director of the Netherlands Bank and Chairman of the Basle Committee on Banking Supervision, at the 14th Annual Meeting of the Latin American and Caribbean Banking Supervisory Organisations held in Santiago, Chile on 1/9/97.

The banking system is sometimes compared to traffic. This comparison is justified for at least two reasons: first, the causes of traffic accidents are essentially the same around the world, just like the causes of banking crises. It is therefore not surprising that almost all countries adopt the same type of rules, like speed limits in the case of traffic, or some kind of limitation of risk exposures in the case of banking. A second similarity between banking systems and traffic is that with the increase of cross-border activity, such as air traffic, the need for harmonisation of national regulations has grown. The minimum requirements for banking supervision which the Basle Committee has recently developed in conjunction with supervisors in emerging markets are an important step in this direction. Today, I would like to discuss with you the background, advantages and implementation of these core principles.

Background

l. Banking crises in countries are no new phenomena at all. In this part of the world a number of countries experienced severe banking problems in the early 1980s. In some western countries, notably in the Scandinavian, the banking community also faced substantial difficulties, albeit of a different nature. Since the Mexico crisis of 1995, awareness among policy-makers of the potential damage that can result from banking problems has grown significantly. In emerging markets, banking problems often result in much deeper recessions than in industrialised countries. Generally, these economies are more vulnerable to banking problems because almost all financial intermediation is carried out by banks. Most industrialised countries are less dependent on banks, because the function of financial intermediation is also performed by institutional investors and well-developed capital markets. Since the Mexico crisis, it has also been recognised that the frequency of banking problems is significantly higher in emerging markets. Recent research has shown that 85% of the severe banking crises which have occurred in the past fifteen years concerned developing and transition economies. My explanation for this striking fact is that the factors which cause banking crises are generally more prevalent, but not essentially different in emerging markets than in industrialised countries. This basic idea is the rationale behind the common set of core principles I would like to discuss with you today.

2. But before that a short word on the way the principles have been developed because it shows an important development in the cooperation between the members of the Basle Committee and other countries. The principles were first drafted by a joint working group consisting of a number of Basle Committee members and representatives from 15 other countries. Subsequently a very lively exchange of views took place in a meeting in Basle in March of this year in which representatives of approximately 40 countries, including the chairmen of all regional groups, participated. To my satisfaction the consultation period following that meeting produced a large number of reactions, nearly all of them favourable. These reactions will be incorporated in the core principles. To endorse the final text of the principles, a similar meeting to the one in March will take place on September 10th in Basle. Two weeks later, in conjunction with the annual meeting in Hong Kong, the IMF and the Basle Committee will co-sponsor a conference to introduce the principles to as wide as possible an audience of Ministries of Finance and central banks.

3. As I said, the main rational behind the core principles has been the increased awareness among policy-makers that banking crises can aggravate recessions. Another reason for the formulation of core principles is the increased globalisation of economic activity. With the strong growth of trade and financial flows between national economies, banking problems in one country have much more potential to spread to other parts of the world. A specific form of globalisation concerns the increasing international activities of large banks. Policy makers generally welcome cross-border banking, because of the beneficial effects on the efficiency, liquidity and depth of financial markets. However, the internationalisation of banking also increases the risk of contagion of banking problems. In order to reduce this risk, the core principles pay special attention to the supervision of cross-border banking. On this subject, the most important message from the core principles is that home country supervisors should practise consolidated supervision over their internationally-active banks. In order to enable home country supervisors to fulfil this task most effectively, host country supervisors must share information with them about the local operations of foreign banks. Finally, the core principles state that banking supervisors must require the local operations of foreign banks to meet the same high standards as are required of domestic institutions.

Advantages

4. You may wonder whether the core principles will really be able to reduce the severity and frequency of banking problems around the world. Let me try to answer this question by reviewing the main causes of banking crises and the way in which the core principles deal with these causes. One important cause of banking crises is macro-economic instability. High and variable inflation rates, booms and busts in economic activity and exchange rate volatility complicate credit assessments by banks. Moreover, during the expansion phase of a business cycle, there is often a tendency towards over-optimism and excessive lending by banks, which in turn can result in asset price bubbles. This factor can be regarded as the main cause of the current fragility of the Japanese financial sector. Thus, inadequate risk management by banks is frequently a crucial link between macro-economic instability and banking problems. Macro-economic instability is on average greater in emerging markets, reflecting less diversification and greater structural rigidities. Unsound fiscal and monetary policies can add further to this problem. As a consequence, the risks faced by banks in emerging markets tend to be higher.

5. The core principles formulate prudential regulations and requirements in order to promote a framework to control the risks inherent in banking. The application of this framework can limit the negative influence of macro-economic volatility on the soundness of the financial system. The requirements concerned cover capital adequacy, loan loss reserves, asset concentrations, liquidity, risk management and internal controls. Of this group of principles, I think those regarding risk management and internal controls deserve special attention. For example, core principles 12 and 13 state that banking supervisors must be satisfied that banks have in place risk management systems which accurately identify, measure, monitor and control market risks and all other material risks. Furthermore, banks are required to hold an adequate amount of capital against these risks. These principles reflect the growing recognition that banks bear the principal responsibility for adequate risk management themselves. The main task of supervisors is to set minimum standards and to monitor the policies and procedures through which banks control their risks.

6. I would like to emphasise that adequate risk management by banks can reduce but not eliminate the negative effects of macro-economic instability on the soundness of financial systems. But it is evident that a sound financial sector is an important precondition for

macroeconomic stability. For instance, when macro-economic stabilisation calls for monetary tightening, concerns about the effect of higher interest rates on the loan portfolios of weak banks may delay policy action. In Mexico, this delay contributed to a sudden reversal of capital flows and a deep recession in 1995. These so-called feedback effects from financial to macro-economic instability underscore the need for the application of the core principles.

7. The second main cause of financial fragility is premature financial liberalisation. It is widely recognised that financial liberalisation promotes competition among banks, thereby improving the efficient allocation of financial resources in the long run. However, during the transition, bank managers and supervisors often lack the expertise to deal with the higher risks associated with the new activities in which their institutions get involved. This lack of experience increases the probability of banking crises. Moreover, increased competition from foreign banks often encourages domestic banks to finance riskier investments in order to keep up their earnings. This chain of events has unfolded not only in emerging economies, but also in well-developed Nordic countries and the United States. Policy makers have drawn an important lesson from these banking crises, namely that financial liberalisation should be preceded by a strengthening of risk management systems by banks. The core principles regarding risk management and internal controls which I have just discussed can serve as a guide for the supervision of the risk management systems adopted by banks.

8. The third culprit is government involvement in banking. One way in which government policy can undermine the soundness of banks is by means of the tax treatment of financial institutions. For example, tax systems which do not allow the deduction of loan loss provisions from taxable earnings reduce the incentive of banks to recognise these losses on a timely basis. A perhaps more damaging way of government involvement is the use of state banks to finance government expenditures at below market rates. This channel has two apparent advantages to the government; for one thing, it is cheap, at least in the short run. In addition, bank financing does not show up in the official measurements of the budget deficit, which reduces the possibilities for public scrutiny. Although state-owned banks are most prone to this kind of political exploitation, privately-owned banks can also function as quasi-fiscal agents, for example when they are forced to lend to particular sectors or industries. Obviously, these financing practices reduce the viability of banks in the medium and long term.

9. I would point out that, while political involvement in banking tends to occur more frequently in developing countries, it is not restricted to them. In South Korea and France, for example, recent banking problems seem to be linked at least in part to government involvement. However, in less wealthy countries the pressure on government funds is usually larger, which increases the temptation to turn to state banks for funding. The risk of government influence on banks in emerging markets is also larger, because state banks tend to control a much bigger share of banking assets.

10. Core principle l contains a description of the preconditions for effective banking supervision. In the context of problems related to government involvement, the following elements of this first principle seem particularly relevant. First, the explanation of core principle 1 says that each supervisory agency should possess operational independence to pursue a sound banking system free from political pressure. A second important precondition is that each supervisory agency should have adequate resources to meet the objectives set. These resources should be provided on terms that do not undermine the autonomy and independence of the supervisory agency. The emphasis of the first core principle on the independence of supervisory agencies is important, first of all because independent supervisors are in a better position to prevent political exploitation of banks. And secondly because it can limit forbearance

in dealing with problems in individual banks. A number of banking crises could have been prevented or alleviated if the supervisory authorities would have had the independence and the instruments to intervene in a timely and adequate way.

In addition, the appendix of the core principles explicitly mentions the need for supervisors to apply their supervisory methods in the same manner to government-owned commercial banks as to other commercial banks. The implementation of this advice should also reduce the opportunities for governments to use state banks as a source of cheap funding.

ll. A related cause of banking problems is connected lending, which refers to loans extended to banks' managers, shareholders or to parties connected to them. Just like loans to governments, loans to connected parties are often granted on a non-arm's length basis and at below market rates. Another similarity with government involvement is that there is reason to believe that connected lending is a more serious problem in emerging than in advanced economies. The risks of connected lending encompass a lack of objectivity in credit assessment and undue concentration of credit risk. Core principle 10 explicitly addresses the problem of connected lending. This principle states that banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks. Moreover, core principle 9 calls for prudential limits to restrict bank exposures to single borrowers or groups of related borrowers. If these principles are implemented on a global scale, they will raise a significant barrier against connected lending.

12. I now turn to a fourth set of causes of banking problems, that can be labelled inadequate corporate governance. This term refers to an absence of the right incentive structure for bank owners, managers, depositors and supervisors to show prudent behaviour. Perhaps the best way to throw light on these types of problems is by means of a well-known example, namely the downfall of the US savings and loans institutions. In the early 1980s, the supervisory authorities in the US sought ways to enable savings and loans institutions, which were generally in bad shape, to continue in business. The range of activities in which these institutions were permitted to engage was expanded, capital standards were relaxed and the level of deposit insurance was increased. As a consequence, many savings and loans institutions tried to grow out of their problems by investing in high-risk assets, such as property and so-called 'junk bonds'. The point is that depositors were content to finance these risky investments, because of the generosity of the US deposit insurance at that time. Moreover, with low capital standards, equity holders or owners had little to lose. Finally, banking regulation in the US did not penalise bank managers for excessive risk-taking and allowed supervisors to delay corrective measures. When the property market started to collapse in the mid-eighties, many savings and loans institutions became insolvent, which eventually resulted in a loss of at least $150 billion for the US taxpayers. In order to prevent similar banking problems, bank regulation in advanced and emerging economies must incorporate the right incentives for all participants in the banking system.

13. If you look at the core principles you will find various sorts of incentives in this field. Firstly, principle 3 requires that the licensing process should consist of, among other things, an assessment of the bank's ownership structure as well as of its directors and senior management. The explanation of this principle makes clear that if the supervisory agency doubts the integrity and standing of a bank's owner or manager, it should have the authority to prevent a specific ownership structure or the appointment of a certain bank manager. In this way, past imprudent behaviour of bank owners and managers is penalised by excluding them from responsible functions in the banking sector.

14. Secondly, core principle 6 prescribes that capital requirements for banks should be no less than those established in the so-called Basle Capital Accord. The Basle Accord sets minimum capital requirements of 8% of the risk-adjusted assets of banks. Bank capital essentially serves three functions; it is a base for further growth, it provides a cushion against exceptional losses and it promotes better governance. The governance function relates to the fact that if shareholders have more money at stake, they have stronger incentives to ensure that banks are managed in a safe and sound manner. Regarding the loss-absorption function of capital, it must be stressed that the Basle capital requirements are considered a minimum standard. In emerging economies, higher minimum capital requirements seem appropriate, because banks there usually operate in a more volatile and therefore riskier environment. I therefore welcome the initiatives of the supervisory authorities in Argentina and Colombia, who have already raised their minimum capital requirements to 11.5 and 9% respectively.

15. As the example of the US thrift crisis showed, the design of deposit insurance deserves special attention. The second appendix of the core principles contains a balanced view on this delicate issue, which can be summarised as follows: On the one hand, deposit insurance is desirable because it limits the effect that problems at one bank might have on other banks. This obviously increases the stability of the financial system. However, deposit insurance can also increase the risk of imprudent behaviour by banks, because depositors will be less inclined to withdraw funds even if the bank pursues high-risk strategies. Therefore, governments should incorporate mechanisms in the system of depositor protection that prevent excessive risk-taking by banks. This can for example be achieved by a partial deposit insurance, so that depositors still have funds at risk. Another method is withholding deposit insurance from large, institutional investors. The precise form of such a program should be tailored to the specific circumstances of each country.

16. The last item on my list of crisis factors is a poor market infrastructure. It is widely accepted that imperfect accounting systems, limited disclosure practices and inadequate legal frameworks can hinder effective banking supervision and market discipline. Again, these deficiencies are more pronounced in developing countries, but deserve continuous efforts for improvement in developed countries as well. The first problem concerns the accuracy of accounting systems. In many countries, the accounting standards for classifying bank loans as non-performing are not tight enough to prevent banks from making bad loans look good. If non-performing loans are systematically understated and are not properly provided against, figures about profitability and bank capital become meaningless. On the disclosure side, the ability to distinguish healthy from unhealthy banks is often hampered by the absence of financial statements on a consolidated basis. Differences in accounting standards across countries and the absence of serious penalties for publishing inaccurate information can also obstruct a meaningful assessment of banks. Finally, the legal system sometimes impedes prudent banking, for example when it hinders banks to seize collateral behind delinquent loans.

17. Core principle 21 relates to the information requirements of bank organisations, which is an important part of the market infrastructure. This principle states that banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices. This information should enable supervisors to obtain a true and fair view of the financial condition and profitability of banks. Banks should also publish financial statements that fairly reflect their condition on a regular basis. Moreover. the explanation of this principle prescribes that if a bank provides false or misleading information, supervisory action or criminal prosecution should be taken against the individuals involved and the institution.

18. Having elaborated on the contribution that the core principles can make towards alleviating the main causes of banking problems, I think it is now time for an overall assessment. First of all, it would be an illusion to think that a global application of the core principles can by itself prevent financial crises occurring in the future. As I already mentioned with regard to capital standards, the core principles contain minimum requirements. Individual countries, particularly those in emerging areas, should therefore consider to what extent they need to supplement the core principles with requirements addressing particular risks of their financial systems. Moreover, banking supervision is a dynamic function that needs to respond to changes in the marketplace. Therefore, the principles will need periodic, but not necessarily frequent, refinement and readjustment. Finally, the core principles provide guidelines for bank regulation. I hope my description of the causes of financial crises has made clear that financial stability not only requires prudential behaviour by banks, but also macro-economic stability, a transparent government budget and an adequate legal framework. In these areas, which all have to do with government policy, the World Bank and the International Monetary Fund can make an important contribution to financial stability.

Implementation

19. In the near future, the implementation of the core principles should be a top priority. Of course the main burden of this lies with the governments of the individual countries. I don't underestimate the wide-ranging legal, infrastructural and educational changes the implementation of the principles call for in a large number of countries. Every country should put in place an ambitious program with clear time-frames for the implementation. It is obvious that the IMF and the World Bank should have a leading role with regard to monitoring the implementation of the core principles. The main argument for this structure is that the international financial institutions already send missions to almost all countries in the world. However, it is generally acknowledged that the Basle Committee possesses great expertise in bank regulation. I therefore plead for a model in which the Basle Committee, the IMF and the World Bank each and together assist countries in realising financial stability in their respective fields of competence. In this model, the IMF and the World Bank are primarily responsible for creating a sound environment for banking, which is highly dependent on viable government policies. As part of the assessment of government policies, these institutions will of course also pay attention to the quality of bank supervision.

20. The Basle Committee is primarily responsible for the amendment and interpretation of the principles and will review compliance with the principles at the International Conference of Banking Supervisors in October 1998 and bi-annually thereafter. The Basle Committee can furthermore make a major contribution towards the implementation of the principles by offering technical assistance and courses to supervisors in emerging countries. In this respect, banking and traffic again look alike. It is all a matter of knowing your responsibility; if you do not make a timely agreement about who drives home, you both end up drinking too much.