WHAT EFFECTIVE SUPERVISION IS ABOUT

A WALK THROUGH BANKING SUPERVISION AND ITS SUPERVISED INDUSTRY

Antonio Pancorbo
Financial Supervision and Regulation Division (MCM Department)
October 20, 2015

VIEWS EXPRESSED DO NOT NECESSARILY REPRESENT THOSE OF THE FUND
PLEASE CHECK AGAINST DELIVERY
The supervised industry

“The best way to rob a bank is to own one”

Title of a book written by William K. Black in 2005
What banks do

“LOANS AND DEPOSITS BANK Corp.”

<table>
<thead>
<tr>
<th>FIXED ASSETS</th>
<th>CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH</td>
<td>DEMAND DEPOSITS</td>
</tr>
<tr>
<td>LOANS (funded with savings)*</td>
<td>TERM DEPOSITS (savings)*</td>
</tr>
</tbody>
</table>

* In a balanced financial structure

Deposits bank

Loans bank

From a purely economic and socially useful standpoint:

Two distinctive brands of activity:

I. Provide money custody and treasury services— “deposit bank”

II. Channel savings into credit operations— “loans bank”
What else banks do

Credit and money creation
through a simple accounting entry

Debit
Credit

Loan to whomever pleases
the bank,.........................1,000

against a newly created
current account as good
as central bank money...........1,000
Bank money creation

«Who gets the money first?»
Limits to banks’ credit creation

Legal and regulatory limits
• Need to meet capital requirements
• Need to meet reserve and liquidity requirements

Actual limits
• Need to “present” a positive bottom line
  – Cost of finance
  – Other recognition of costs
# Bank credit expansion

<table>
<thead>
<tr>
<th>FIXED ASSETS</th>
<th>CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH</td>
<td>DEPOSITS</td>
</tr>
<tr>
<td>LOANS (funded with real savings)</td>
<td>“I promise to pay CASH on demand”</td>
</tr>
<tr>
<td></td>
<td>TERM DEPOSITS</td>
</tr>
<tr>
<td></td>
<td>(real savings)</td>
</tr>
</tbody>
</table>

Credit fueled BOOM!
## Bank credit contraction

<table>
<thead>
<tr>
<th>FIXED ASSETS</th>
<th>CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH</td>
<td>DEPOSITS</td>
</tr>
<tr>
<td>LOANS</td>
<td>UNCONVENTIONAL CENTRAL BANK GOVERNMENT SUPPORT MEASURES</td>
</tr>
</tbody>
</table>

Credit Crunch

- LOANS (funded with real savings)

Deleverage

- TERM DEPOSITS (real savings)

Reckoning day BUST!
Justification for “fractional reserve banking”

• Social function of banks in maturity and liquidity transformation

• The law of large numbers also applies (not all depositors come for the money at the same time)

• A 100% reserve would keep money idle, which fractional reserve banking puts at good use. Fractional reserve banking is needed for growth
The path for a socially accepted model
“Banks are different”

• Banking: the most leveraged industry in the economy by far (including hedge funds)
• Banking: the only industry where a huge negative working capital is accepted and seen as “virtue.”
• Too-big-to-fail. The biggest corporations in the economy are banks—and getting bigger.
• Too complex to be managed, even to be understood by their managers themselves.
• ...eventually, the failure of a big bank group is not a workable option...
Bank business model main drivers

• Achieve the highest leverage possible
• Reduce “reserve requirements” to the technical minimum
• All but equity!
• All but balanced financial structures!
• Remove any personal liability
• Gain “too-big-to-fail” status—and then get bigger
• Don’t interfere with the market dynamics of regulatory capture
Banking supervision
Why is banking supervision necessary?

• Because governments guarantee the banks
  – Fiscal contingency.
  – Ensure bank discipline.

• Because banks run critical activities for the society
  • For its **survival**: central role in payment systems
  • For its **growth**: credit intermediation and capital formation
What is the objective of banking supervision?

“The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system” (CP1, EC2)

Supervisory Discipline as a proxy for what is missing

Pruning the system

- Flawed laws and regulations
- Poor judiciary
- Industry and political interests
- Lack of accountability
- Concentration of power

Government Support
Can supervisors identify vulnerabilities?

Do supervisors escalate findings to the right Decision making body?

Are decisions made on a timely manner?

SUPervisory DISCIPLINE!
Preventive actions
Corrective actions
Contribution to resolution processes
How to assess effective supervision in normal times?

• Prevention
  – Verification
  – Risk analyse

...and in particular, supervisors...
  – avoid the massaging of the accounts, refinancing
  – remove non-viable institutions which are not generating funds
  – restrict reckless risk assumption – risks which are not controlled
    • They assess institutions’ risk profiles and operations and issue prudent rules and regulations
  – have a clear prudential bias!
How to assess effective supervision in times of stress?

• Resolution

– Diagnosis of the situation:
– Act without delay or obstruction
– The lowest fiscal cost
– Not say “the crisis is over” prematurely
Benchmarking resources: How much supervision is enough?

• A political question that needs a public policy answer.
  – There is no contrast.
  – It is a political decision about how much, how deep.

• Following the logic of public services provided under legal monopoly
  – Provision of a public service (supervisory discipline, a proxy to market discipline)
  – Provided under a legal monopoly (economic logic: more expensive, lower quality)
  – Supply driven (consumer do not decide how much supervision they can buy, but the authority decide how much supervision they will have)
Benchmarking against specific activities

• What supervisors are asked to do? (supervisory discipline).

• Once it is decided, it can be benchmarked against experiences from other supervisors, but always moving in the uncertainty.

• Dangers fixing the tasks:
Assess the resiliency of a banking group as a single economic unit by maintaining sufficient capital and liquidity.

Assess the effectiveness of the group-wide corporate governance, risk management, and recovery planning.

*The supervisory “risk perimeter” extends beyond accounting consolidation concepts.*
Cross-border consolidated supervision

• Cross-border supervision is a concern about how to deliver prudential outcomes when a bank or banking group operates in different jurisdictions.

• First, no foreign banking establishment should escape supervision.

• Second, the supervision of the foreign establishment should be adequate.

• Both **home and host** determine whether their counterparties practice effective consolidated or solo supervision over the foreign branches and subsidiaries of common interest.
Cross-border information requirements of home and host supervisors differ

• The home supervisor needs information on all the group subsidiaries in its capacity as supervisor on a consolidated level.

• The natural source of information for the home supervisor is the parent institution.
  – Information should flow appropriately and unrestrictedly from subsidiaries and branches to the parent (and vice versa)
  – If the parent does not receive adequate information from subsidiaries it can not manage adequately the group.
    • To carry out effective cross-border supervision, it is essential that first the parent bank is able to produce consolidated management information.
    – If the parent does not receive information, the home supervisor cannot perform its function of supervisor on a consolidated basis.

• The host supervisor must be able to ensure that the capital and risk management of the subsidiary is appropriate.
  – The host supervisor needs information on the group as far as that is relevant in this connection.
Marginal thoughts on banking regulation

• Justification: “market failures”
  – The missing analysis of “government failures”

• The effort to fight “moral hazard” with regulation
  – Regulation treats the symptoms of moral hazard: more capital, more liquidity, sounder risk management.
  – What about dealing with the root cause and eliminate moral hazard (mostly created by the State’s support and lack of boards and managers personal liability)

• “Regulatory competition”
Checklist of threats to supervisory effectiveness

- Lack of powers
  - To conduct on- and off-site supervision
  - To impose supervisory discipline

- Lack of resources and technical skills

- Lack of technical independence of supervisory actions

- Lack of focus on prevention 😊 and resolution 🙁

- Lack of credibility
  - Poor performance due to incompetence
  - Poor performance due to lack of independence
  - Capture of the supervisor -- “rent-seeking”
  - Perceived corruption
What are your main takeaways?