Banking supervision in the transitional economy

Brian Quinn, Executive Director, Financial Stability at the Bank, considers[(1)] some of the challenges confronting banks and banking supervisors in countries making the transition from command to market economies. Among the general problems facing banks is the need to conduct their business in step with the changing pattern in the wider economy; more specifically, they have often inherited poorly-performing loans from the previous regime, and have to operate in money markets that are not yet well developed. A number of supervisory elements seem particularly important for countries in transition: including adequate assessment of the fitness and properness of a bank's owners, directors and managers—and of the links between a bank and its owners—and the assurance of adequate capital, given the uncertain operating environment.

A sound and efficient banking system is an absolutely fundamental element of a market economy. The balance sheets of commercial banks are virtually a mirror of the economic and commercial life of the country; their assets and liabilities represent the activities of all economic agents—consumers, savers, investors, companies, governments. Banks exist to facilitate the economic intercourse of the nation and to do so in a way that combines confidence in their own financial strengths with the provision of products and services that people want, and at a price that reflects the risks of intermediating between savers and borrowers. This is why banks are special.

Countries seeking to move from command to market systems, of course, know this well enough—at least instinctively. But instinct is not enough. What they are looking for is the path that takes them from where they are to where they want to be, and preferably with as few accidents and alarms as possible along the way. They may sometimes feel that the problem is not lack of advice, but a surfeit of it. It may seem to them that there are too many things that they are told need to be done.

For example, they are told that a banking system will not be able to function properly unless there is a properly established law of property, including bankruptcy arrangements; and that an infrastructure that includes reliable accounting laws and conventions is a vital precondition for a sound banking system. This is undoubtedly so: paradoxical as it may seem, the foundations of a sound banking system have to be securely based on contractual arrangements that encompass the possibility of failure. However, rather than repeat these points—which I am sure will be driven home more effectively by others—I thought it might be helpful to look at some of the challenges facing banks and banking supervisors during the transition process. If this does not necessarily chart a path from the command to the market economy, it may nevertheless mark out some of the more important milestones along the way.

The nature of the transition

Let me start by offering some observations at a general level. Perhaps the first—and maybe the most important—point is that the way in which banks conduct their own business cannot be out of step with what is going on in the wider economy. This is true, of course, regardless of the state of development of any country, but it presents particular problems to those converting to the market system.

The transition process is essentially one in which resources are *increasingly* allocated by relative prices—and by changes in relative prices—rather than by administrative decision. Banks have to move in step with their customers, on both sides of the balance sheet, if they are not to experience fundamental problems. If they fail to price their loan and deposit products in a way that reflects the appropriate ratio of risk and reward, they will, of course, pick losers rather than winners, with predictable effects on their performance and perhaps even their capacity to survive. The riskiness and profitability of their customers will, however, be significantly determined by the stage that the economy has reached in the transition process. Some sectors will be more open, more deregulated than others; and the degree of government involvement will also vary, sometimes sector by sector, sometimes firm by firm.

Price signals—which are the mechanism by which decisions are made—will be difficult to read, since profitability of the customer or sector will not always be the only or main force at work. The point is that this is a process, not a steady state; and so the banker has not only to be continuously alert to changes in the structure of the economy as the transition proceeds, but has to be quick to price his (or her) whole range of products and services accordingly. Now this is easier said that done.

This point may be worth elaborating since it is pretty basic. Bankers in developed market economies are in a position to price their loans in such a way as to take account of the

(1) In a speech at the European Bank for Reconstruction and Development's annual meeting in London on 9 April.

differential effect of changes in interest rates on their customers' business. For example, the real-estate sector is customarily more sensitive to changes in short-term interest rates than most other sectors. This observation is supported by experience over several cycles of economic activity. Changes in the structure of the economy may take place over this period in a way that affects the precise degree of sensitivity of the sector to interest rate changes, and bankers have to be conscious of those changes and reflect this in their loan rates. That they have not always done this successfully can be seen from the losses posted in many countries in recent years.

However, the challenges facing bankers in these cases are minor when compared with the effects of moving from a state-controlled to a market-orientated property sector in a piecemeal and sometimes unpredictable way. Assessing credit risk in a developed market system, where relative prices are constantly changing, is already very difficult; but at least one central assumption—what can I expect to happen if my counterparty is unable to meet his obligations—no longer necessarily applies.

How are bankers in transition to cope? There is, I am afraid, nothing more that they can do than try to keep fully informed of the changes going on in the economy, pressing continuously for more and better macroeconomic and microeconomic data and talking continuously to their customers. And—here is the hard part— they must price their products and services to allow for the higher uncertainty that attends their operations in this environment. Finally, they should warn their wives and families that they are unlikely to win many popularity contests.

Let me now move from general observations to some more specific matters in addressing the transition. Firstly, there are the problems that arise in the earliest stages of transition. These are, I am sure, familiar to most of you. The first and almost certainly least useful comment is that one is too often starting from the wrong position. The new banks too often inherit the problems of the past. Poorly-performing economies mean poorly-performing loans. But they do not go away, as if by magic, when the banking system is reformed. These loans represent a drag on earnings, and can seriously deflect managements' energies from the more productive and rewarding job of serving the needs of economic agents who are finding their own way in the evolving market economy. Managers of companies, whether they be in brand new firms or from converted state-owned companies, may have limited experience of financial planning or of business planning more generally. Both sets of managers have the job of learning about financial management and applying it at the same time. It is little wonder that mistakes are sometimes made. Indeed, it is perhaps not a great exaggeration to say that both the bankers and their customers proceed by learning from one another's mistakes.

In discussions of these matters, attention tends to focus on credit, for reasons that are easy to understand. However, in the early stages of transition, when money and interbank markets are not well developed, the management of liquidity may represent every bit as much of a problem. Bankers have to be more self-reliant in ensuring that they can engage in maturity transformation—and therefore make money—and nevertheless meet all of their obligations as they fall due. And here, as in credit, they cannot run far ahead or behind of what is happening in the market-place; otherwise they risk having a profitable business that cannot meet its need for cash and that, as we know, spells the end for a bank. In practice, this means that banks must take a close interest in the authorities' activities in the financial markets and encourage them to develop the necessary infrastructure in the form of money-market instruments and efficient payments systems; and the banks must stand ready to play their part in establishing this infrastructure.

Banking supervision

Let me now turn to the subject of banking supervision and the role it plays in the process of transition.

It is, I think, important to recognise that the stability of any banking system is determined by a package of factors the elements of which may vary to some extent in their detail, but which essentially remain the same; and which are mutually interdependent. At the most general level, the stability of the system depends upon the arrangements for the supervision of financial institutions, the deposit insurance scheme and any public safety net provided by the central monetary authorities. Each plays off the other and it is important that attention is given to them as a balanced package, rather than looking at them in isolation. The behaviour of both bankers and their customers is dominated more by these factors than they sometimes appreciate.

At the bottom of it all is the blend of market discipline and official intervention which the package delivers. There are three things to say about this blend. Ultimately it is a political decision, in the sense that the blend will reflect the social objectives of each country. Some will place a higher priority on the protection of the consumer than others, just as some will show greater trust in the market mechanism as a disciplinary force than others do. Secondly, the part played by the constituent parts—as well as the thrust of the package as a whole—may be expected to vary as the transition proceeds. In the earlier stages, it may be necessary to adopt a fairly generous and forgiving attitude to bank failures, given the need to avoid severe shocks to savers and to the evolving banking system. But that approach may have to change fairly soon if moral hazard is not to impose unacceptably high indirect costs on the same savers.

Thirdly, among the three elements of the package there is least room for compromise in the system of supervision. The banking system never will become strong if the supervisory arrangements do not seek to reflect the highest international standards from the earliest stage—consistent with the state of evolution of the national laws and accounting conventions, of course. It can also be helpful to introduce a two-stage process in considering whether to take supervisory action: are the prudential requirements being met and, quite separately, if they are, is it in depositors' interests that the banking supervisor should use his powers? This leaves open the option that other official or private remedies may be applied.

Before I go on to say more about the supervisory arrangements themselves, I feel I must say something to contradict any impression that it is entirely, or even primarily, the duty of the supervisor—or the authorities more generally—to protect depositors. From the very earliest stages of transition, the banker has to recognise his responsibility for the safety and soundness of his institution and for its creditors. He should put official supervision support in all of its manifestations out of his mind, and tell himself that he and only he (or she) is responsible for the success or failure of his institution.

Of course, telling himself this is only the beginning of his job, and must be supported by practical and workable systems and controls with the aim of limiting risk. There must also be a professionally trained internal auditor with access to an audit committee, which stands apart from management, or to the board of directors. Supporting these internal controls will, of course, be the external auditor who, in discharging his own legal responsibilities, nevertheless should develop a working relationship with the internal auditor. Together they can constitute a powerful safeguard against imprudent or dishonest behaviour, not only within the bank but also by customers or other outsiders. These three players—the manager, the internal auditor and the external auditor—form the corporate safety net. They are much closer to the action day by day, and so are both in principle and in practice the best safeguards against serious problems.

Supervisory criteria

Coming back to official supervision, here too one should think of the banking supervisor as providing a package of functions which are mutually interdependent and mutually reinforcing. The process of authorisation, the on-going supervisory arrangements, and the provisions for restricting or withdrawing authorisation must mesh together; no part is more important than the other. That said, I should like to concentrate on one or two elements in the supervisory package which seem to me to be of especial importance in the transition phase.

Banking supervision may appear to be about numbers and ratios, but is essentially and fundamentally about people. If the owners, the directors and the managers of a bank are not suitably equipped to play their separate parts, then one can predict confidently that trouble will arise sooner or later. For this reason, I would argue that it is vital that the authorisation criteria include one relating to the fitness and properness of each of these classes of people.

Clearly, whether a person is fit and proper to carry out the job which he occupies is a matter of judgment—indeed one of the most difficult judgments the banking supervisor has to make. However, it need not be just as difficult as it may seem. There are certain guidelines which may be used which, though they are not capable of being scored or quantified in any objective way, can nevertheless break the process down into something which is more structured and manageable, and less likely to be capricious.

Let me offer some suggestions drawn from the Banking Act here in the United Kingdom. Is the individual in question honest and does he possess the necessary integrity to be entrusted with other people's money: for example does he have any record of infringement of the criminal law or other official regulations? Is he competent: does he have any experience or training for the job in question, and has he demonstrated this over a reasonable period of time, using his own money rather than other people's? Is he a man of probity and is his word to be trusted? Here again there may be objective evidence to support this from his previous business dealings. Is he diligent, does he pay sufficient attention to detail and show the adequate seriousness of purpose in the way he has conducted himself in the past?

It will be quite clear that these questions may be particularly difficult to answer in a country going through the transition process. There is an absence of experience on which to rely, and indeed the standard of what is acceptable conduct may be hard to pin down in a society in which values and attitudes are undergoing radical change.

The link between ownership and the bank is, I think, particularly problematic. Individuals or companies with both capital and enterprise will normally be in short supply in these circumstances, and it is common—and perhaps even natural—for new entrepreneurs to wish also to own or direct banks. They may also have very considerable influence with government, which would itself wish to see the transition to a market economy achieved successfully and with maximum speed. This is a potent combination, and the banking supervisor may face very considerable pressures in resisting the ambitions of newly-rich or powerful individuals or companies seeking to own, direct or manage the relatively new commercial banks.

That is not to say that banks cannot and should not be owned by individuals or companies whose main interests lie outside the banking system. One has to be realistic about these things and the practice is common enough in developed market economies. But if there is one phenomenon that recurs in banking crises more frequently than any other, it is the large, connected loan. This often begins innocently but too often ends in tears. Management has to be sufficiently independent of owners to refuse to accommodate the latters' requests for bank finance, except within limits defined by the law.

The role of capital

This brings me naturally on to the role of capital, the benchmark against which most restrictions on banks' activities are set by the supervisory authority. As I said earlier, everything matters; but few things matter more than capital. The late Huib Muller, the last Chairman of the Basle Group of Supervisors, used to say that only three things mattered when the question arose about the safety and soundness of a bank: capital, capital and more capital. Banks need capital because of uncertainties about the value of assets. For all the reasons I have mentioned earlier, it is particularly difficult to value assets while an economy is undergoing a process of fundamental change. This is partly a matter of accounting conventions and techniques, since without a reliable means of measuring the value of assets the balance sheet of a bank lacks all proper substance. But beyond the question of accounting conventions, there lies the intrinsic difficulty of coming to a view on the value of any item where the market is illiquid and subject to unpredictable change.

The evolution of financial markets in developed market economies is leading bankers and banking supervisors to look increasingly at the concept of marking assets to market. If there is no market or if, more accurately, the market is truly in the early stages of evolution—when reliable values have not yet been established—then one can see how remote the concept of marking to market must seem to banks and banking supervisors coming from transitional economies. I remember that not very many years ago bankers and auditors would look to the Bank of England for some indication of the level of provisions that banks should raise against their portfolios of real estate. This arose from the fact that the commercial property market in the United Kingdom at that time was effectively moribund and the determination of a fair value for the property loan book was virtually impossible. There was no market liquidity. Without exaggerating the problem, I can imagine that, in some countries making the move to a market economy, this situation might be the rule rather than the exception. What do the bankers and banking supervisors do in these circumstances?

The answer, I believe, is that they must take great care to satisfy themselves that the bank has sufficient capital in the balance sheet to cope with a pessimistic estimate of the value of assets; the distinction between a going and gone concern can be crucial in this connection and poses a particular challenge for the supervisor.

The supervisor must also ensure that the bank is supported by proper capital. By this I mean that the banking supervisor should not compromise on the definition of capital. Given all the uncertainties, I am sure the bank manager shares this objective since it is surely in his best interests that the bank's assets are supported by as much equity as the owners can manage. I appreciate that this raises almost as many questions as it answers in countries where capital markets are themselves poorly developed. However the basic characteristic of capital is clear enough: those putting up the funds must understand with absolute clarity that what they are supplying is risk money and not loan funds. They must accept that they are last in line when any residual value is being paid out, if liquidation of the institution should ever be necessary. I would especially stress that bankers in the transition should rely as much as possible on pure equity and should not be tempted into thinking that capital instruments with bells and whistles can ever provide them or their creditors with the same comfort.

Fraud and criminality

I made reference earlier to the uncertainties created by changing social values, and by lack of experience with financial planning and accounting techniques. These circumstances create opportunities for fraud and for criminal activities of other kinds through or on the banking system. Of course, this is not a phenomenon peculiar to economies in transition; there is good evidence that financial systems everywhere face new threats from this source. But the problem may be more acute in countries where the institutions are still in the process of changing from one system of economic management to another. All that one can say here is that the premium attaching to well-trained and hard-headed bankers and supervisors is high, and that developed countries should be ready to assist in providing practical technical help. It is also important that the authorities in both sets of countries set up arrangements for exchanging information on people and institutions speedily and efficiently.

Conclusion

The challenges for both bankers and banking supervisors in the transition are many and varied, and I have been able to mention only a few of the more obvious of them. The objective of 'no surprises' is especially difficult to accomplish. Nevertheless from what we in the Bank of England can see, there is no lack of determination from those facing the challenges to tackle them. The Know How Fund is an important part of the effort to give what we can to help.

But of course, the main input comes from the countries themselves. And the signs are on the whole good: I take encouragement from the willingness to adopt the Basle minimum standards as a model for banking supervision in many countries. International contact between supervisors also plays a vital part in the learning process. This can range from attendance at the biannual international conference of banking supervisors—held last year in Vienna and next year in Stockholm—to participation in courses organised by the Bank of England's Centre for Central Banking Studies both in London and in participating countries. We are certainly keen to continue to do our bit and to adjust our courses as countries move along the path to a full market economy. Finally, let me point out that our experiences are not really so very different, even in recent years. After all, deregulation and liberalisation is a matter of degree, and in many countries commonly thought of as having highly developed markets, the process really got seriously under way only in recent years. Credit ceilings were in place as recently as 1970 here in the United Kingdom. So delivering safe and profitable banking in a changing economy is a task in which we have all been engaged during our working lifetimes. Let us therefore be ready to learn from one another.