III

Key Aspects of a Framework for a Sound Financial System

While not the subject of this paper, it must always be remembered that an unstable macroeconomic environment is a principal source of vulnerability in the financial system. Significant swings in the performance of the real economy, and volatile interest rates, exchange rates, asset prices, and inflation rates make it difficult for banks to assess accurately the credit and market risks they incur. Moreover, banks in many developing and transition economies have limited scope to diversify these risks as much as is possible in industrial economies. Large and volatile international capital flows often add to the challenges faced by banks in these countries. While Fund surveillance will seek to improve the macroeconomic framework, a structural framework for sound banking should also attempt to ensure that the macroeconomic risks are adequately reflected in prudential restraints and structural policies.

The second general source of vulnerability in the banking system, which is the focus of the framework for sound banking discussed in this paper, stems from weakness in the management of the banks themselves and in the structural environment in which they operate. Such weakness together with a poor incentive structure leads, inter alia, to excessive risk-taking, and undermine corporate governance and market discipline—fundamental ingredients for sound banking. For purposes of organizing the elements of a framework, five broad sets of challenges can be identified. First, inadequate bank management leads to undue risk-taking, to the detriment of the interests of depositors and other creditors. Second, a lack of adequate information on the financial condition of banks—due in part to inadequate accounting standards and reporting and disclosure requirements, but principally owing to insufficiently stringent rules and practices for loan valuation and loan loss provisioning—undermines the disciplining force of markets and delays recognition of banking problems until well after the onset of difficulties, thereby making their resolution harder and costlier. Third, the presence of implicit or explicit public sector guarantees of the liabilities of banks—the official safety net—in many cases has contributed to weakness in banking systems by encouraging excessive risk-taking by individual banks and weakening the discipline that would be imposed by depositors with money at risk. Forbearance in dealing with insolvent banks through a weak exit policy—in combination with generous support for depositors and extensive lender-of-last-resort assistance—frequently increases the ultimate costs of banking crises. Fourth, an ineffective bank supervisory environment frequently fails to counter the incentive problems created by the public sector safety net and by a lack of market discipline. Although most countries have elaborate regulatory systems, such systems often are not effectively implemented and enforced because of a lack of supervisory autonomy and capacity. Fifth, concentrated bank ownership and connected lending may increase the vulnerability of banking systems, particularly in developing countries. When banks are part of larger conglomerates, there is often a propensity for a significant portion of the lending of these banks to be directed to associated entities, making it difficult to evaluate the credit quality of loans and their collateral and to measure the origin and quality of a bank's capital. In addition, state ownership of banks is frequently associated with inadequate governance, extensive guarantees of bank liabilities, and lax implementation of supervisory requirements.

Raising the Competence and Integrity of Management

The first line of defense against unsound banking is competent management. Most bank failures can be attributed to inadequate management that allows the bank to acquire low-quality assets and take inappropriate risk positions and that fails to detect and resolve deterioration in existing assets and risk positions. Quantitative regulation, although important, cannot ensure that a bank is well run. Bank managements need to possess a high degree of integrity and have adequate training and experience to do the job. Sound management will ensure that good internal information and control systems are installed, for example to ensure that decisions affecting the rights and obligations of the bank never rest with just one individual (the "four eyes" principle). A sound bank will have prudent credit approval procedures, risk limitation, and administration procedures, which are well documented, and will appropriately delegate authority to the various levels of management.

Effective internal controls are necessary to ensure that established policies and procedures are followed and that special interests are not allowed to influence decisions. The bank's board needs to have effective control over the management, using internal and external audit procedures to satisfy itself, the shareholders, and the supervisory authority that the management is discharging its functions competently and in the interests of the bank as a whole. The board should also ensure a proper relationship between the bank and its proprietors as well as with the supervisory authority, avoiding conflicts of interest among these entities.

Increasing the Transparency of Banking

It is inherently difficult to obtain a reliable assessment of the financial condition of banks, since most bank assets are illiquid and lack an objectively determined market value. The estimated current value of banks' loan portfolios should be reflected in the size of loan loss provisions, but bank managers are often unable or unwilling to arrive at a realistic measure of banks' impaired loan portfolios. The incentives for underreporting or concealing data on bad loans grow as a bank's financial situation deteriorates. In addition, the growing internationalization of banks and the introduction of modern information technology by internationally active banks has enabled these institutions to rapidly move some of their risk positions into off-balance sheet or trust vehicles located on- and offshore. It has also become easier for banks to circumvent domestic prudential restraints on their risk exposures through the use of derivative products.[9] The ability of supervisors to monitor these activities has generally lagged behind the ability of banks to design new instruments.[10]

The opaqueness of banks' financial data is the Achilles' heel of effective corporate governance, market discipline, and official oversight in banking. External auditors and supervisors often fail to detect inflated loan values and inadequate provisioning. The monitoring of prudential ratios and restrictions on credit and market risk positions, including capital adequacy ratios, may thus become less effective as a means of detecting underlying problems. External auditors can play a useful role—in some countries a major role—but only where the profession is significantly skilled and has a direct reporting responsibility to the supervisor. Elsewhere, the only external agents generally in a position to assess the adequacy of banks' loan provisioning with a significant degree of confidence are the bank supervisors themselves. Arriving at such an assessment is one of the most important aspects of bank supervision, and one that requires competent supervisors with authority to overrule the valuations of banks and auditors. Misreporting of basic bank balance sheet data distorts not only prudential analysis but also monetary and macroeconomic analysis. Furthermore, the lack of "hard" data tends to encourage supervisory forbearance and makes the supervisory and judicial processes more vulnerable to political influences.

Realistic Valuation of Bank Assets

Hence, an important component of a framework for sound banking is that the system produces timely and reliable information for use by management, supervisors, and market participants. To this end, it is desirable to support the introduction of internationally recognized accounting standards, including a broad application of principles for consolidation of the operations of financial groups or conglomerates. Particular attention will need to be paid to loan classification, provisioning, and income recognition rules, and to the practices for their effective implementation.[11] Accounting, valuation, provisioning, and consolidation rules need to be complemented by proper procedures and practices for their effective implementation. Banks, therefore, need to have adequate internal reporting and control procedures and, in particular, appropriate credit approval, monitoring, classification and valuation, and recovery procedures.

Public Disclosure

The more reliable and extensive the information that is disclosed by banks to the markets, the more effective is market discipline. However, the accuracy of public data on the performance of a bank often diminishes during times of stress. Indeed, the integrity of financial data is likely to deteriorate precisely at the time when it would be most needed, that is, when the bank is experiencing serious difficulties. Given these complications, best practices for disclosure in many countries typically go beyond disclosing traditional financial statements to include providing other quantitative and qualitative information, such as the struc-

[9]Although, when used prudently, derivatives enable banks to reduce their exposures and to manage risk better for the benefit of depositors as well as shareholders.

[10]See Folkerts-Landau and Garber (1997).

[11]Internationally agreed accounting practices special to banks have not yet obtained widespread official recognition. However, the International Accounting Standards Committee (IASC) is developing such standards. Two of the standards particularly relevant to banks are IAS 30 and 32; and the Basle Committee has established a task force to contribute to the process. A complete set of accounting standards developed by the IASC is available from the International Accounting Standards Committee, 167 Fleet Street, London, EC4A 2ES, United Kingdom.

ture of the bank's ownership, risk concentration, and details of policies and practices of risk-management systems.[12] Rating agencies can contribute to improving the transparency of banking data by demanding increased disclosure as a precondition for a rating.

Prudential Reporting

Banks are required to report directly to supervisors, normally on the same basis as is disclosed to the public, but such reporting would include details of specific risks whose public disclosure would be unwelcome to individual customers as well as being market sensitive. It is generally acknowledged that supervisors should have the right to request all relevant data from banks at reasonable notice. Supervisory reporting requirements and associated off-site monitoring typically encompass both quantitative and qualitative bank-specific information that can be used to assess the risks that banks face (including weaknesses in their loan portfolios), the ability of managers to control risks, and the performance of the banking system as a whole. Qualitative information generally encompasses such items as credit policies, investment and trading strategies, the mechanisms of internal controls, the affiliations of major bank shareholders or senior management, and changes in corporate structure. Supervisors in the major financial centers increasingly focus on the adequacy of the internal risk-control capabilities of banks. Quantitative information typically includes data on balance sheet and off–balance sheet items, and reports on earnings, loan concentration, maturity and foreign exchange exposures. Not surprisingly, the greatest problems of reporting have been associated with loan valuation and (its mirror image) capital adequacy, and with offshore activities.

Limiting Public Sector Distortions

If markets are to play an important role in disciplining bank managers and owners, there must be a presumption that financial assistance will not be provided automatically to troubled banks, and that owners and large creditors will not be fully protected. This suggests that, as a general principle, banks that are deemed to be insolvent by supervisors should be forced to exit in a timely manner, to prevent problems in individual banks from growing and contaminating other banks. Recent experience in a large number of IMF member countries suggests that public sector support for failing banking institutions is generally unduly broad. While the danger of precipitating a general loss of confidence has frequently made it difficult to close large banks without fully compensating most depositors, it is almost always possible to make the owners and large creditors bear a substantial part of the financial burden of losses. Such a prospect enhances the incentives for large and relatively well-informed creditors, including other banks, to exercise market discipline on weaker banks, not only because large creditors have more resources with which to monitor and influence individual banks, but also because they typically have access to better information than anyone else. The broad goal for public sector policy is to leave enough room for markets to work sufficiently well that the banks' funding cost will appropriately reflect the quality of their balance sheets.

In countries where directed lending and other quasi-fiscal operations involving banks, including different types of guarantees, conceal government subsidies and transfers, it is difficult for the government to deny support to these institutions when they run into difficulties. When such quasi-fiscal operations are being used, they are more effective when fiscal authorities transparently record and present the cost of such operations in the budget. Furthermore, if the tax regime is not to discourage prudent banking, banks must receive the benefit of a lower tax liability in making required loan loss provisions.[13] Moves to limit such quasi-fiscal operations and to reduce such adverse incentives introduced by the tax system can make an important contribution toward sounder banking.

The framework of limited financial safety nets and strict bank exit policy described below is applicable to individual banks in relatively sound banking systems. If the entire banking system is in distress it may not be possible to apply bank-specific principles, but instead system-wide restructuring strategies may well be needed (see Alexander et al., 1997; and Lindgren, Garcia, and Kiyei, forthcoming).

Lender-of-Last-Resort Facilities

The proper role of central bank lender-of-last-resort facilities[14] is to promptly provide temporary support to illiquid but solvent institutions, typically at a penalty rate and against collateral, and to deny support to insolvent banks. Such lending can be an important instrument to prevent banking panics and runs that could cause sound institutions to become illiquid

[12]Chapter IV discusses what information is made available in countries that follow the International Accounting Standards and the most recent European Union and Euro-currency Standing Committee recommendations.

[13]See the discussion of loan loss provisioning in Chapter IV.

[14]Lender-of-last-resort facilities for banks, when they exist, are typically provided by the central bank as part of its role in assuring adequate liquidity in financial markets generally, but can also be provided by other public sector entities, such as state-owned banks, public sector enterprises, and pension schemes (depositing funds in troubled banks).

and precipitate their insolvency. In practice, however, such lending has often supported insolvent banks—allowing them to stay in business and compete with solvent banks—thus undermining market discipline and the profitability of the banking system. Such behavior by central banks usually reflects concern about precipitating a crisis of confidence in the banking system that is already generally weak, often due to adverse macroeconomic conditions as well as weak bank management.[15] Also, the data problems discussed above make it difficult to distinguish illiquid but solvent from insolvent institutions. And there is frequently hope that the institution will work its way out of trouble.

In order for a lender of last resort to operate effectively, without undermining market discipline, it needs to have sufficient information from the supervisory authority to determine which banks are approaching insolvency, to be able to limit support to sound but liquidity-constrained institutions, leaving the support of insolvent institutions to the fiscal authorities as soon as they can be identified.[16] This points again to the importance of good banking data.

Deposit Insurance

Deposit insurance arrangements are designed to compensate some classes of depositors in case of individual bank failures. However, deposit insurance schemes are prone to problems of moral hazard and need to be designed to contain such problems (see Lindgren, Garcia, and Kiyei, forthcoming; and Garcia, 1996). Most effective schemes are therefore limited to protecting small depositors and do not cover large depositors and other creditors, including other banks, so as to create incentives for market discipline to exert pressure on banks. The breadth of insurance coverage may vary depending on country-specific circumstances, but would remain subject to the constraint of containing moral hazard.

A deposit insurance system needs to be well funded so that it has the resources to pay off insured depositors promptly and allow the expeditious closure of insolvent members. As far as possible, the system should be self-financing. Insurance fees need to be high enough to cover the insurance cost of individual bank failures. Although it is desirable for fees to vary according to the estimated risk the insurance fund assumes, in practice it is difficult to arrive at an objective measure of risk that can be used for this purpose and, therefore, uniform premiums remain the most common form of pricing.

Exit Policy

A credible exit policy for problem banks is necessary for effective deposit insurance and lender-of-last-resort arrangements, and for the maintenance of a sound and competitive banking system. For exit to occur smoothly, the financial system must be sufficiently robust to limit the spillovers from the failing institution to the rest of the system. It is, therefore, desirable that banks be closed before they become deeply insolvent and cause major losses for their creditors. But even when these conditions are satisfied, the modalities of winding up a bank of significant size, whether through a merger, breakup, or closure, generally require intervention by the supervisory authority, rather than simple application of the general bankruptcy statutes.

To reduce the scope for political pressure to prevent the exit of a bank, it may be helpful to limit supervisory discretion in favor of rule-based policies in the form of arrangements requiring prompt corrective action.[17] In this case, the supervisory authority is required to force the bank to undertake remedial action well before it reaches the point of negative net worth. However, to be effective, a policy of prompt corrective action requires timely and reliable information. In general, bank closures require a strong supportive legal framework, and rapid official intervention requires that supervisors have the authority to act outside the standard corporate bankruptcy procedures and without the need for political approval on a case-by-case basis.

Controlling Risk Through Regulatory and Supervisory Oversight

Regulation and supervision of banks seek to limit the adverse impact of the official safety net on risk-taking and to force banks to internalize the externalities of failures.[18] The objective of such oversight should not be to guarantee the survival of every bank, but rather to make sure that the banking system as a whole remains sound. As discussed above, such oversight should result in the exit of insolvent banks when market discipline fails. The supervision of individual

[15]Banks typically become insolvent before becoming illiquid and the position of banks reporting near-insolvency often turns out to be much worse once their true condition becomes apparent in the course of official intervention.

[16]If the government would like to provide solvency support for individual banks, this should be done in a transparent manner through the national budget.

[17]For a detailed description of such schemes, see Chapter V.

[18]See, for example, the remarks by Chairman Alan Greenspan at the meeting of the Institute of International Finance, Washington, April 29, 1997: "The presence of the safety net, which inevitably imparts a subsidy to banks, has created a disconnect between risk-taking by banks and banks' cost of capital. It is this disconnect that has made necessary a degree of supervision and regulation that would not be necessary without the existence of the safety net."

banks is, of course, the responsibility of the national supervisory authority and is not an area that Fund surveillance would normally cover; nonetheless, there are cases in which inadequacy in the supervisory approach can be a cause of system weakness with macroeconomic consequences, thus making it a legitimate case of inquiry. The best practices discussed in this section, and further detailed in Chapter VII, are largely based on the Core Principles for Effective Banking Supervision developed by the Basle Committee in consultation with supervisors from emerging market economies.

Prudential Regulation

Banking laws and prudential regulations seek to (1) establish policies that allow only financially viable banks to operate; (2) limit excessive risk-taking by owners and managers of banks; (3) establish appropriate accounting, valuation, and reporting rules; and (4) provide for corrective measures and restrictions on activities of weak institutions. Banking laws typically leave implementation to be defined by prudential regulations, to permit flexibility as circumstances change. The responsibility for promulgating regulations is normally vested in the supervisory authority.

Appropriate entry policies are essential for prudent banking and for healthy competition in the banking market. Financial sector liberalization often leads to calls for market entry, but an excessively lax entry policy often leads to banking problems at a later stage, particularly when the capacity of bank management and domestic supervisors is inadequate. Licenses may be granted only when prudential criteria are met. Entry policy not only has to address prudential issues, but also has to pay due regard to the capacity of the supervisory authority to execute its functions. It needs to strike a judicious balance between the objective of fostering competition (by encouraging entry) and maintaining supervisory effectiveness (by limiting entry).[19] This is best achieved if licensing is the responsibility of the supervisory authorities, and supervisors have authority to deny a license.[20] If a bank ceases to meet its licensing agreement, this then triggers corrective measures or becomes grounds for withdrawal of the license. Major changes in ownership or management also need to be subject to supervisory approval.

The licensing process attempts to ensure that a prospective banking enterprise will have suitably qualified owners and be properly organized, professionally managed, financially viable, and potentially profitable. The process is typically set out in the banking law and, inter alia, verifies whether (1) the initial capital is sufficient; (2) the major shareholders and management are suitable for their offices; (3) the corporate structure is transparent; (4) the bank's organizational structure, including the quality of its administrative and internal control systems, is adequate; and (5) in the case of a branch of a foreign bank, the bank is adequately supervised in its home country and the establishment of the branch is approved by the home country supervisor.

Capital adequacy ratios are viewed by the supervisory community as the most important restriction on banks' portfolio positions. The ratios are intended to ensure that banks maintain a minimum amount of own funds in relation to the risks they face, to absorb unexpected losses and give owners and managers an incentive to run banks safely. The most widely accepted method of measuring capital adequacy is the risk-weighted capital adequacy ratio promulgated by the Basle Committee (the Basle Capital Accord). Under this system, banks are required to hold different categories (tiers) of capital against assets and off-balance sheet items with different risk weights. This system was originally designed for internationally active G-10 banks, with good management and widely diversified risk portfolios. Supervisors in many other countries, where risk is more highly concentrated, management less experienced, and markets more volatile and less deep, and thus asset values more questionable, have concluded that ratios need to be considerably higher, and risk weights assigned to asset categories may need adjustment. Moreover, many international banks have found that to obtain the lowest funding rates, markets require a margin over the Basle minima. The Basle Committee has also developed an expanded system of capital adequacy ratios designed to incorporate market risks (foreign exchange, commodity, interest rate, and equity risk).[21] As mentioned above, effective measurement of capital adequacy requires proper valuation of banks' assets, and until this has been achieved, any analysis of capital adequacy ratios has to be undertaken with special caution. Moreover, capital adequacy ratios are often lagging indicators of banking problems and can be prone to manipulation through data problems.

[19] However, supervisors need to beware of self-serving arguments by existing banks that more competition would endanger the system.

[20] The Basle Committee's Core Principles envisage the possibility of a separate body responsible for licensing, in which case the supervisory authority must have the legal right to have its views considered by the licensing authority. In either case, the licensing criteria should be clear and objective and the process transparent.

[21] The option that supervisors allow banks to use their own in-house risk management systems to calculate market risk-based capital requirements is so far applicable only to banks in major money centers with special expertise.

Limits on excessive risk-taking seek to promote prudent banking by constraining lending concentration, lending to insiders, liquidity mismatches, and net foreign asset (or liability) positions.[22] Needless to say, the enforcement of these limits requires reliable information on a consolidated basis in order to be fully effective. Limits on risk concentration take different forms, but irrespective of their form, such limits seek to restrict exposure to a single borrower or connected group of borrowers or counterparties, to various sectors, and to market risk. Connected and insider lending to counterparties that are related to a bank, such as directors, managers, dominant shareholders, and their families, and lending to related corporate units, is best done on a nonpreferential basis and subject to tight limits, both individually and collectively.

Prudential liquidity regulations are imposed on banks in many countries to ensure that they are able to meet their creditor and depositor obligations without having to resort to forced asset sales or other costly means of raising funds.[23] Ensuring that there is not an excessive concentration of funding sources or a significant maturity mismatch between assets and liabilities helps limit the risks in banks' liability positions. Frequently, liquidity requirements do not remain true to their intended purpose and are used to create captive demand for short-term government obligations.

Constraints on managerial actions may restrict activities that have been associated with high-risk lending or investment activities that could expose banks to excessive risks. These constraints have been both restrictive and prescriptive, and apply in particular in cases where there are doubts that managers and owners continue to satisfy "fit and proper" criteria. Preferential treatment of insiders is restricted in order to minimize conflicts of interest. Prescriptive rules have included requirements that managers put in place adequate risk-management systems, including procedures for credit approval, monitoring, classification, and recovery, as well as for accounting, reporting, and internal audit functions.

Prudential regulations normally define accounting rules for banks to use in compiling their reports on income and financial condition to ensure consistency. Most important, such rules establish how banks value and classify loans, make provisions for loan losses, and suspend the accrual of overdue interest. They include criteria for the treatment of loan rollovers, refinancing, and other forms of "evergreening" where management manipulates lending practices to make loans appear to be performing when they are not.[24] It is the responsibility of bank management to implement these rules, while it is the responsibility of supervisors to ascertain that banks have the policies and procedures in place to ensure that the rules are applied appropriately. Examiners have the authority to force banks to reclassify loans, require additional provisions, and reverse inappropriately accrued interest, where necessary.

The supervisor often specifies additional responsibilities for external auditors, has access to external auditors' reports, and has the right to require the replacement of a bank's external auditors.[25] Such responsibilities in many cases oblige the external auditor to report material problems to the supervisor.

The supervisory agency is normally empowered by law to apply a range of corrective and punitive measures, when banks breach laws, prudential regulations, or licensing agreements. Supervisors need to be able to tailor their responses to be commensurate with the offense and gradually intensify the corrective measures.

Prudential Supervision

As part of their general duty to promote financial stability, banking supervisors monitor the soundness of the banking system, the adequacy of banks' risk-management practices and financial data, and their compliance with prudential regulations. To be effective, a supervisory authority must have sufficient autonomy, authority, and capacity. Supervisory autonomy, of course, needs to be combined with legal accountability, and involves freedom from political influences and adequate financial resources to meet supervisory objectives.

The autonomy issue is often linked with the location of the supervision function. In many countries the function is located in the central bank, sometimes with a separate board, while in some countries it is performed by an independent supervisory agency. There are arguments for and against locating the supervisory function in the central bank. On balance, at least in many emerging markets, the central bank appears to be the best location because it places the supervisor close to the central banks' other functions, such as lender of last resort, overseer of the payments system, and collector of macro-financial data. Moreover, supervisors can avail themselves of the authority, financial independence, and expertise of the central bank.

[22]Some supervisors prefer to exercise control by the imposition of capital requirements and by examination of the bank's own control systems rather than absolute limits. This applies particularly to liquidity and foreign exchange and other market risk positions.

[23]Although reserve requirements can also provide liquidity, they exist primarily for monetary policy purposes.

[24]In some developed markets, such rules are left to banks and auditors to devise, and the supervisor's role is to ensure that the rules are prudent and that banks adhere to them. But in most countries, supervisors have felt the need to play a more active role.

[25]In many countries where standards of bank auditing are not consistently high, supervisors maintain lists of approved auditors. Overt approval can, however, create an additional moral hazard for the supervisory authority if an approved auditor turns out to be deficient.

An effective supervisory authority has sufficient powers, established by law, to carry out its functions, including powers to control the issue and withdrawal of bank licenses, request relevant data, conduct on-site examinations in a bank and any of its branches and subsidiaries, verify the data supplied by banks, call for loan provisions, and restrain unsound practices, including issuing cease and desist orders and removing managers, denying or revoking licenses, and—where needed—forcing the exit of banks. In the absence of timely and reliable data, the authority of supervisors to use their own assessment of a bank's financial condition as a basis for corrective action is particularly important. Supervisory actions are often politically unpopular. Supervisors must, therefore, be able to act against banks without undue delays or pressures that result from a need for political approval or protracted court procedures.

Supervisors cover a range of increasingly sophisticated bank activities. They must not only verify banks' compliance with regulations and the accuracy of their reporting, but must also have the capacity to assess the suitability of the bank's owners and managers, the adequacy of loan valuation procedures and the banks' net worth, internal controls and audit procedures of banks, internal risk models, where applicable, and complex consolidated financial statements. In addition, they must be able to analyze relevant macroeconomic and market information, and take a view on behavior that may heighten systemic risk. To accomplish these increasingly demanding tasks, the supervisory authority should be able to attract and retain employees of high caliber and provide them with the necessary training, support, and appropriate remuneration.

Effective bank supervision must be seen by banks as a continuous presence. This is mainly achieved through off-site monitoring, both micro- and macroprudential in scope. Micro-prudential monitoring is based on quantitative and qualitative information reported by banks, and consists of verification of compliance with laws and prudential regulations, analysis of prudential ratios, and assessment of the individual bank's performance against peer groups and the entire industry. Macro-prudential analysis is based on market intelligence and macroeconomic information, and focuses on developments in important asset markets, other financial intermediaries, and macroeconomic developments and potential imbalances.

On-site inspections are needed to assess the adequacy of management and internal control procedures and to verify the accuracy of supervisory reporting. The latter is particularly important, given the potential weaknesses of loan valuation. While national practices differ, there are some common best practices. In particular, these practices call for all banks to be subject to some on-site inspection on a regular basis, and problem banks to be subject to particular scrutiny. Inspections should be comprehensive in scope and build on the inputs from the off-site monitoring. External auditors may play an important complementary role in banking oversight, but cannot replace supervisors. In some countries, on-site inspection is carried out by auditors acting under the specific instructions of the supervisory authority.[26]

Strengthening the Broader Structural Framework

The structure and concentration of ownership of the banking system may adversely affect the performance and stability of the system. Although there is a trend toward larger banks and financial conglomerates, such concentration increases the potential for systemic risk, which in turn increases the need for official oversight. Market perceptions that institutions are too big to fail will undermine market discipline and, therefore, require increased official supervision. Concentrated ownership has also meant that more focused political pressure can be exerted to obtain public sector guarantees for the liabilities of the bank. At the same time, in some developing countries the absence of a qualified controlling shareholder can result in ineffective oversight over management.

One of the issues relating to ownership concerns the desirability of state, private, or foreign ownership of banks. The track record of state-owned banks (including banks owned by central, state, and local governments) has frequently been poor. State-owned banks tend to bring competitive distortions to banking markets because they typically have access to low-cost capital and their liabilities tend to be fully guaranteed by the public sector. They are frequently exempted de jure or de facto from prudential requirements and have preferential access to deposits.[27] Nevertheless, there may be circumstances in which state-owned banks can operate effectively, if they are required to operate according to commercial criteria and conform to the same prudential rules as private banks, and if they fully and transparently transfer all their quasi-fiscal undertakings to the government budget. Since these conditions are rarely met in emerging market countries, privatization may be the best way to attain a sounder banking system.

Private ownership in itself is no guarantee for good governance. There may be countries in which no suit-

[26]Unlike external auditors, these firms normally report to, and in some cases are appointed and paid by, the supervisory authority. For such an arrangement to substitute adequately for traditional examiners, a reliable, skilled, and independent auditing profession is required.

[27]It should be noted that state-owned banks often are conduits for quasi-fiscal operations, which may then be used as justifications for forbearance from normal rules.

able private owners are available, in which case the state may be called upon to provide banking services; in such cases normal prudential banking criteria are best applied. In some countries the lack of a capital market and the concentration of wealth are such that banking interests cannot be kept apart from other economic or political interests, frequently leading to conglomerates that include a deposit-taking institution. In such cases it is important that the bank not be used as a captive source of finance by their owners, other insiders, or related enterprises.

Efficient banking systems are open to foreign ownership (through branches, subsidiaries, or partial ownerships), especially when there are only a few private domestic banks, to stimulate competition. Highly rated and adequately supervised foreign banks often bring necessary competition to inefficient domestic markets, and introduce professional skills and new technology. Perhaps most important, they typically reduce systemic risk because they tend not to be affected as readily by confidence problems as domestic institutions and they are less likely to make claims on the official safety net.

One problem that many countries face is the treatment of nonbank financial intermediaries. These fall into three categories. First, there are insurance, securities trading, and fund management businesses, which are normally regulated separately but increasingly are in common ownership with banks, giving rise to complex consolidated supervision problems. Second, there are finance companies, often owned by banks, sometimes created to avoid the full rigor of prudential, monetary, or tax regulations. Such institutions are often constrained by not being permitted to take deposits or use banking names, unless supervised as banks, but they may nevertheless depend on banks for funding and thereby create the potential for systemic risk. Finally, there are less reputable entities and activities, such as the "pyramid" schemes seen recently in a number of countries and other forms of deposit taking outside the books of licensed financial institutions. Here, there is a need for effective legal provisions to prevent the taking of deposits (or the use of banking names) by unauthorized entities or in unauthorized forms, together with a prosecuting authority that will respond to requests for action by the central bank and the supervisory authority.

Sound banking is facilitated by a strong financial market infrastructure, including an efficient payments system and money, as well as foreign exchange and capital, markets. In addition, the presence of institutional investors contributes to corporate governance. Payments systems need to be designed to limit the volume of unsecured overdrafts, as in real time gross settlement systems, to prevent spillovers across the payments system from the failure of a bank. The availability of efficient money and capital markets is important to allow banks to manage their liquidity, raise capital, and issue debt. Such markets are best designed with appropriate settlements systems and collateral practices to limit contagion risk. Efficient banking also requires a "credit culture"—an environment in which credit contracts are customarily honored and enforced, in the context of a legal and judicial system that facilitates the enforcement of financial contracts, loan recovery, realization of collateral, and bankruptcy. In some countries, serious weaknesses in the judicial systems can negate improvements in corporate governance and official oversight.

Fostering National and International Supervisory Coordination

The various sectors of the financial system are prone to interact with the banking system in a number of ways, and disturbances in one sector easily spill over into the banking system. In many countries, banks and other parts of the financial system (at times organized as financial groups or conglomerates) are typically regulated and supervised by different national authorities. It is therefore important that regulatory and supervisory policies and practices be harmonized and coordinated, as far as possible, in order to reduce the scope for contagion and regulatory arbitrage. The need for consolidated supervision of financial conglomerates has led to the practice in some countries of designating one national supervisory agency as the lead agency to coordinate the work of all supervisory agencies that relate to a particular conglomerate.[28]

Regulatory standards and supervisory practices are also being harmonized internationally.[29] This not only facilitates consolidated supervision and information sharing among supervisors internationally, but also improves efficiency and can bring important additional discipline to national regulatory and supervisory structures. It is increasingly needed in an environment of growing internationalization of banking, which tends to undermine the effectiveness of nationally focused prudential supervision in a variety of ways, including the use of complex corporate structures and offshore derivatives to evade domestic financial restrictions.

The Basle Committee on Banking Supervision has led efforts to improve cross-border banking supervision, starting with the 1975 Basle Concordat on the supervision of banks' foreign establishments. The Concordat divides supervisory responsibilities as fol-

[28]This was one of the suggestions included in the recommendations of the Tripartite Group of Bank, Securities, and Insurance Regulators (1995), but it has not been universally accepted so far.

[29]For example, the Basle Committee and IOSCO (1996b) issued a Joint Statement in August 1996 detailing their coordination and cooperation.

lows. For branches of foreign banks, solvency supervision is primarily a matter for the parent authority. For subsidiaries, solvency supervision is a joint responsibility of both host and parent authorities. In both cases, liquidity supervision is primarily the responsibility of the host authority. For joint ventures, solvency as well as liquidity supervision should normally be the responsibility of the authorities of the country of incorporation. However, the key to effective supervision of foreign establishments is close cooperation between the relevant supervisory authorities. In each case, the bank and its affiliated institutions are to be supervised by the home supervisor on a consolidated basis. The Concordat was reinforced in 1992 by the following four "minimum standards": (1) all international banks or banking groups should be supervised by a home country authority that capably performs consolidated supervision; (2) the creation of a cross-border banking establishment should receive the prior consent of both the host and home country supervisory authority; (3) home country supervisors should possess the right to gather information for cross-border banking establishments; and (4) if any one of the foregoing minimum standards is not met to the satisfaction of the host country supervisor, it could impose restrictions and prohibit the operation of the foreign banking establishment. (See Basle Committee on Banking Supervision, 1992.)