VII

Supervisory Oversight

This chapter examines the attributes of an effective banking supervisory system. It is based on practice established in major supervisory authorities, and to a large extent reflected (sometimes only implicitly) in the published recommendations of the Basle Committee.[103] The first issue addressed is the degree of supervisory autonomy, which is necessary to permit the supervisory authority to perform its responsibilities without undue political interference and to allow the authority to acquire and allocate its financial and staff resources. The second issue relates to the tools that should be provided to the supervisory authority to carry out its mandate. The third section of this chapter addresses the powers of the supervisory authority to request information from and cooperate with other financial sector supervisors and law enforcement agencies. The fourth issue pertains to the choice of location for the banking supervisory function within the public sector. The fifth section discusses the characteristics of off-site analysis and on-site supervision. Finally, this chapter discusses the appropriate range of remedial and punitive measures available to the supervisory authority.

Autonomy of Banking Supervision

To allow the supervisory authority to resist undue pressures from banks themselves, their shareholders, depositors and other creditors, borrowers, or the government, the objectives and purposes of the supervisory authority and its autonomy should be as firmly spelled out and entrenched as possible by law. It is also in the interest of the banking sector to have certainty regarding the scope of authority of the supervisory authority.[104]

The law detailing the authority of the supervisor normally contains the following objectives: (1) to protect the supervisory agency against undue political influence in the exercise of its mandate, specifically concerning decisions with regard to individual banks, licensing, vetting of large shareholders and managers, compliance and withdrawal of licenses, and closure and liquidation; (2) to provide authority for the issuance of prudential regulations and standards and to protect the supervisory agency against undue outside influence regarding the issuance of such regulations and their content and other regulations issued in the interest of the proper exercise of banking supervision; (3) to protect the agency against undue influence in the implementation of its loan classification and provisioning rules, monitoring, and inspection tasks; (4) to protect proprietary information of the commercial banks and of the supervisory agency itself against unwarranted disclosure; (5) to protect staff of the supervisory agency against personal liability for decisions taken in the exercise of their duty; (6) to ensure financial autonomy of the supervisory agency; (7) to ensure the autonomy of the agency in its internal organization and procedures; and (8) to create an appropriate system to ensure the accountability of the supervisory authority.

Political Autonomy

To be effective, a supervisor needs sufficient political autonomy to take necessary measures. There are many examples in which supervisors have been persuaded to exercise forbearance and to believe that with a delay the bank could work its way back to being financially sound. However, a near-insolvent bank faces strong incentives to assume additional risks, and hence forbearance has rarely been a successful solution.[105]

While there is no way of legally constructing a supervisory regime that will entirely eradicate the possibility of undue influence being exerted, there are a number of areas where appropriate policies may re-

[103]See the various papers now published in Basle Committee (1997b).

[104]The Core Principles for Effective Banking Supervision support a system of banking supervision whereby clear responsibilities and objectives are delineated and operational independence and adequate resources are maintained. The objectives are similar to those suggested above, although the Basle Committee explicitly refers to the possibility of multiple supervisors, whereas a single authority is envisioned here.

[105]Countries with an effective supervisory authority have sometimes found limited forbearance useful when banks are viable business institutions, although technically insolvent.

duce the risk of such influence being applied. Among these are the legal status and powers of the supervisory agency; the location of the supervisory function; the dichotomy between rules and discretion; the need for transparency, an appeal and judicial review process, market discipline, and professional competence; and a fixed term of tenure for the head of the banking supervisory authority, appointed by the legislative body.[106]

Appropriate supervisory policies and procedures can be identified on a rules versus discretion continuum. A system heavily dependent on compliance with transparent rules and regulations lies at one end of the spectrum, while a system that gives the supervisor objectives but leaves the agency free to use whatever powers it thinks fit to achieve its goals lies at the other. The justification for discretion is that bank supervision is as much about making qualitative judgments about the integrity and competence of management as it is about maintaining compliance with quantitative rules or prudential ratios. However, one major problem with allowing supervisors discretion is that there is no guarantee it will be used impartially and objectively. Much depends on the integrity, public credibility, and competence of the supervisor, which can only be earned over time, as well as on the broader political and institutional environment.

An effective banking supervisory system therefore needs to be sufficiently transparent that the supervisors can be seen to be exercising their powers in a way that is beneficial to the objectives of maintaining a stable and sound banking system. One way of achieving such transparency is to provide for periodic reports to be published describing the actions that have been taken by the supervisory authority to achieve its objectives. In this way the supervisor's performance can be monitored by government, by the supervised banks, and by the public at large. Of course, there may well be justifiable reasons why the supervisor's actions in specific cases can only be revealed some time after the event, but the knowledge that they will ultimately have to be revealed can be a powerful tool.

The institution of a system in which banks, as well as individual shareholders, directors, and managers can within the limits of the law appeal against the actions of the supervisor is a useful element in ensuring the accountability of supervisors. It thus helps justify giving the supervisor discretion. It also reinforces the supervisor's autonomy from undue political influence.

A supervisory process based on best market practice is likely to retain more support from the banking sector. This may give the supervisor more influence in resisting pressures that derive from special interest groups. A supervisory body that can demonstrate a high degree of professional competence may find it easier to earn a position vis-à-vis the interested parties that enables it to resist improper pressure more readily.

Staffing and Resources

Without sufficiently qualified staff, the supervisory authority cannot fulfill its mandate. The banking supervisory authority needs to develop an on-site bank examination capacity with investigative resources and an off-site analytical capability, as well as being open to market intelligence and possessing an awareness of macro-prudential developments. Supervisors need examiners with knowledge and skills of the business of banking to be able to assess management adequately, including the control systems they employ. They need sufficient familiarity with banks' operations to know where to look and probe for weaknesses that may not be evident on the surface. Banking supervision staff need to have the ability to evaluate credit approval and monitoring systems and to assess the payment capacity of debtors, adequacy of provisions, et cetera. Increasingly, inspectors need the skills required to assess the efficacy of sophisticated risk management systems and the adequacy and vulnerability of electronic data processing systems used by banks. Off-site analysts need to be able to absorb and assess such information and direct examiners to areas of weakness. Skills to detect inconsistencies and identify potentially damaging trends are also important. In addition, when the supervisor suspects fraud or other illegal activity that may threaten the soundness of individual banks, he or she needs the capacity to investigate quickly and in depth. The banking supervisory authority also needs to develop effective working contacts with other supervisory bodies both at home and abroad.

The banks can contribute substantially to the work of supervision. For example, banks can complete their own calculations of required prudential ratios. Much of the work going into an examination can be facilitated by the banks, particularly by the internal audit function and external auditors.[107] The supervisory authority may also contract external computing and information systems specialists, lawyers, forensic accountants, former commercial bankers, or others with special skills, to conduct specialized tasks.

To be able to attract and retain qualified staff, a supervisory agency needs flexible pay and personnel policies that will enable it to recruit at appropriate levels people with the requisite skills. In many countries,

[106]A fixed term can also have disadvantages. The power of the supervisor can, for instance, be weakened when the term of office is close to expiration. If the term is renewable, the supervisor may be subject to pressure in order to secure a renewal. On balance, however, the advantages of a clear mandate for a fixed term period seem to outweigh any disadvantages.

[107]See Chapter VI for more details on the interactions between supervisors and internal and external auditors.

excessive differentials between pay levels for bank inspectors and commercial bankers lead to excessively rapid turnover of qualified staff and conflicts of interest. It is essential that banking supervisory staff be seen to be free from conflict of interest, from financial connections to any bank, and from obvious political or business affiliations.

The supervisory authority also needs some financial autonomy. It may have its own sources of income, for instance in the form of direct funding as part of central bank expenses, or indirect assessments upon the banks,[108] or as a direct lump sum budget allocation—or a combination of these—with the freedom to use these funds provided they are used in the proper exercise of its mandate. General oversight of a state accounting office could be considered, as well as an independent external audit.

Immunities

Banking supervision can substantially affect the conduct of business of a bank and the property rights of its owners. Situations can arise in which the bank, its owners, or its managers feel that their interests have been unjustly damaged by the actions of the supervisors. Although it should be possible for interested parties to appeal against any specific decision of the supervisory authorities with regard to an individual bank, the process is more effective if the supervisors themselves are not personally liable for damages caused by any actions legitimately performed in the course of their duties. The supervisory authority as such could conceivably be held liable for damages if it took obviously unreasonable and damaging decisions against the bank or its owners or managers. The criterion of reasonableness should only take into account the circumstances at the time the action was taken; liability need not be so strict that it could unduly hinder taking sufficiently speedy supervisory decisions and actions.

Powers of the Supervisory Authority

Ideally, the supervisory authority is endowed by law with a clear mandate and powers to carry out its function. The law defines the scope of authority of the supervisor and confers authority to license and to withdraw licenses of financial institutions, approve new owners, issue prudential regulations, obtain periodic prudential reports, conduct on-site inspections, take corrective actions (including the imposition of restrictions on banks' business activities), and close and liquidate banks. Actions taken by the supervisor to remedy an unsafe or unsound situation have immediate legal effect, notwithstanding appeals procedures. Which types of financial institutions are subject to supervision differs from country to country. Banks, credit unions, cooperative banks, mutual fund-type institutions, and investment funds are some of the categories of institutions that are included. For the purposes of this paper, the scope of the banking supervisory authorities is, as noted earlier, limited to banks defined as institutions that make it their business to take deposits or other nominally repayable funds from the public, and grant credits and make investments for their own account.[109] For a supervisory system to be effective, such institutions need to obtain a banking license and thereby submit themselves to banking supervision. Unlicensed institutions that perform banking activities can then be prosecuted.[110]

An effective supervisory authority has at least the following powers:

- Exclusive authority to license and to withdraw licenses. For optimal effect, these two functions should be exercised by one and the same agency (see footnote 20).
- Authority to issue prudential regulations and standards. Ideally, detailed requirements are not in the law itself as the parliamentary procedure may be insufficiently flexible to incorporate new or revised standards efficiently and quickly. The broad areas in which the supervisory authority is authorized to issue regulations are, however, normally laid down in law, thus providing an element of stability to the supervisory framework.[111] Preferably the banks are consulted on proposed changes, avoiding, however, the possibility of undue influence or "regulatory capture."
- Authority to obtain periodic reports in the format and periodicity established by the supervisory authority.[112] Banks can be required to show their own assessment of their compliance with the prudential ratios and limits. Untimely, incomplete, or incorrect submittal of the reports is subject to an administrative penalty, and ultimately to prosecution.

[108]Direct assessments are normally based on the size of the bank, but can also contain some element of cost-based fees, so that those banks that are onerous to supervise are not subsidized by the well-run bank that costs little to supervise.

[109]The Core Principles for Effective Banking Supervision clearly state that the term "bank" should be reserved for those institutions licensed and supervised as banking institutions.

[110]Also see Article 1 of the European Union Council (1989).

[111]The supervisory authority is normally authorized to issue regulations in at least the following fields: minimum initial capital in the context of bank licensing, capital adequacy, liquidity, risk diversification, market risks such as open foreign exchange positions, securities, interest rate risk, equity investments, loan classification and provisioning, internal control systems, and accounting and reporting. See Chapters IV and VI.

[112]The content of such reports is described in Chapter IV and VI.

- Authority to conduct on-site inspections. These are necessary to verify the information submitted and are also essential to assess management quality. Inspectors have full powers to enter the bank, inspect any information they consider useful, in whatever form, and have access to the management and any staff of the bank. Refusal to permit an inspection or to cooperate with the inspector is subject to an administrative penalty, and ultimately to prosecution. Supervisors also have the right to obtain information from all consolidated subsidiaries or equity holdings of the bank, as well as connected nonconsolidated entities.[113] Staff from nonsupervisory agencies do not participate in the inspection, nor are the results of an inspection shared routinely with them.
- Authority to take corrective actions. In case of breach of prudential regulations or of unsafe and unsound banking activities, the supervisor should be able to impose a progressively severe set of administrative penalties on individual managers of the bank, have them removed from office, or issue "cease and desist" orders constraining the business activities of the bank. Such action, which falls short of conservatorship or closure, can be kept confidential or publicly announced, according to the circumstances.
- Authority to take emergency action. Such actions can consist of the removal of management powers and the imposition of conservatorship. The conservator works under the close supervision of the supervisory authority and reports to it regularly. The conservator could be given the authority to obtain professional assistance, such as legal advice or auditing services.
- Authority to close and initiate the liquidation of banks. In cases of insolvency, gross and repeated breaches of regulations or other extremely unsafe banking practices, in cases of criminal behavior by, or tolerated by, the bank, and in cases of continued noncompliance with the licensing requirements, the supervisory authority has the powers to withdraw the license and close the bank. This includes the power to take control of the assets and to prevent looting of the bank. Liquidation should not normally be performed by the supervisory agency itself.
- Authority over the bankruptcy of banks. In light of the extreme vulnerability of confidence in banks, which could be very seriously damaged by an unfounded bankruptcy suit, a form of control by the supervisory agency over whether bankruptcy proceedings are started against a bank is sometimes considered.

[113]See Chapter VIII.

Interaction with Other Financial Sector Supervisors and Law Enforcement Bodies

The increasing linkages between domestic financial sectors and the internationalization of financial services have greatly increased the need for closer cooperation between different financial sector regulators domestically and internationally. The combat of criminal activities involving the financial sector has required closer cooperation with law enforcement agencies as well.

Cooperation between supervisors of different financial sectors is necessary, for instance, when there are corporate linkages between banks, securities, and insurance companies.[114] It may be necessary to obtain information about prospective bank managers that have previously worked in other financial institutions. The exercise of consolidated supervision may require taking measures against the establishment of a bank in another jurisdiction. Cooperation among different financial sector supervisors may be made difficult by different laws applying to banking, insurance, or securities business, for instance in the areas of licensing, prudential regulations, and accounting standards. It may be difficult to produce consolidated accounts of banks and insurance companies, for example. The exchange of information between supervisors can be hindered by confidentiality constraints that apply to each of the different regulators. Barriers of this nature should be removed. Supervisors over different financial sectors should be able to exchange information freely on individual institutions.[115]

It is essential that the supervisory authorities retain the trust of the banks, in order to be truly effective as supervisors and to be able to take proactive measures. Supervisors generally need at their disposal well-documented and easily accessible information about the banks. This makes the supervisory authorities an ideal witness in court cases against banks and their clients. However, if inappropriately used as witnesses, supervisors risk losing the confidence and trust of the banks. Thus, the supervisory authorities may need to be protected against excessive requests by the law enforcement authorities to provide information about banks. They should, however, be prepared to provide information in case of specific suspicions of criminal behavior, money laundering, or tax fraud, and upon an official request from the authorities.

[114]For issues related to the regulation and supervision of conglomerates that provide such financial services as banking, securities, investment management, and insurance, see Scott (1994).

[115]The Joint Forum on Financial Conglomerates is currently working to document existing impediments to information exchanges among the supervisors of banks, securities firms, and insurance companies.

Location of the Banking Supervision Function

Different traditions and systems exist for locating the banking supervisory function inside or outside the central bank.[116] Whichever institutional arrangement is chosen, it is of key importance for the effectiveness of banking supervision that the position of the supervisory authority be especially circumscribed in law and that a minimum set of institutional conditions be met, as described above (such as independence from political pressure, adequate coordination of banking supervision and monetary policy, and adequate staffing and resources). If these conditions are met, the location of the supervisory function becomes less relevant for practical purposes, although the autonomy and independence of the supervisory authority may be easier to maintain in countries with relatively weak institutional structures when the supervisory function is located in the central bank than when it is a separate agency. This is particularly true when the central bank itself has a high degree of autonomy and independence.[117]

Off-Site Analysis and On-Site Inspections

Banking supervision requires off-site monitoring and analysis as well as on-site inspections of banks' records, operations, and management. While the balance between on-site inspection and off-site supervision can vary considerably between countries, the supervisory authority needs to have both the right to require production of whatever information it needs and the right to conduct on-site inspections. The verification of the reliability of the reported information, its accurate reflection of the risks, the quality of assets, and the effectiveness of management and internal controls can only be effectively tested by intensive and well-targeted on-site inspections.[118] This can also provide indications on the effectiveness of external audits. The supervisors' inspections should encourage management to take appropriate precautions against imprudent transactions, and should support internal systems that prevent excessively risky transactions.

Periodic prudential reports are the basis for the off-site analysis of the condition of the bank. Off-site reports can also be used as input for an early warning system.[119] Noncompliance and submission of false or incomplete data are a punishable offence. Effective supervisors are also authorized to obtain from the bank any additional information they consider necessary for effective supervision. In addition to reports, off-site information could consist of a permanent file on the management and organization of the bank, as well as a collection of the bank's financial statements and articles of association, and an operational file on the contacts between the bank and the supervisory authorities, including records of any remedial measures that have been prescribed and taken and any permissions that have been granted or refused pursuant to prudential requirements.

On-site inspections are typically based on the following operational principles:

- A comprehensive on-site inspection program is prepared for each bank, setting out the coverage, time frame, and periodicity of the inspections. On-site inspections are announced in advance, unless there is a suspicion of fraud or bad faith.
- Inspections focus on asset quality, management, and risk-management systems, as well as on formal compliance with regulations.
- Inspectors use off-site data, results of previous inspections, market information, and other sources as the input for inspections. Inspectors should also have access to any information and staff, specifically including the internal and external auditors and their reports.
- The supervisory authority should know the institution well, including its business and its key staff, and build a relationship of trust and professional respect with the individual banks. The bank must feel free to discuss problems openly and in full confidence, without fear of provoking measures by other public agencies.
- Prudential on-site inspections are carried out solely by supervisory staff or by other qualified persons designated by the supervisory authority.
- An inspection is followed up within a specified time by a report to the management and the board of the bank to ensure that any problems are addressed. Conferences between the bank and the supervisory authorities to discuss the results of the inspection are a useful supervisory tool.
- The report contains proposals for prompt remedial measures and proactive recommendations, as appropriate. Follow-up inspections may be needed to monitor implementation.
- When dealing with branches or subsidiaries of foreign banks, the supervisory authorities must have as much access as possible to establishments of its banks abroad, allow access to foreign supervisors, and establish general good working contacts with the foreign supervisory authority (see Chapter VIII).

[116]For a discussion of the question whether the supervisory function should be located inside or outside the central bank, see Tuya and Zamalloa (1994).

[117]Similarly, if the supervisory authority were to be based in a different institution, the autonomy and independence of that institution should be assured.

[118]In some countries, on-site inspection is carried out by auditors acting under the specific instructions of the supervisory authority.

[119]The content of such reports is described in detail in Chapter IV.

Remedial and Punitive Measures

Supervisory authorities need a flexible range of remedial and punitive measures to correct unsafe or unsound banking practices and to punish transgressions.[120] Remedial actions are intended to improve the bank's operations before the problem becomes insurmountable, while punitive actions are designed to deter management from breaches of the regulations and from unsafe and unsound banking practices. These measures represent a backstop when market discipline cannot, perhaps due to insufficient information, or does not operate effectively.

The supervisory authorities need to be able to tailor their response to the seriousness of the problem. Whenever possible, the initial actions would be remedial. The supervisor would start by drawing attention to shortcomings and requesting management's written commitment to take corrective action. In more severe cases, when a more formal arrangement is appropriate, an exchange of letters between the bank and the supervisory authorities could be used. When compliance is inadequate, a next step could be a written warning by the supervisory authorities stating that they will take formal action if the bank does not take corrective action against specified breaches or unsafe and unsound banking practices.

Supervisory actions need to be carefully prepared and implemented, especially when they are not legally enforceable, to establish a track record against a bank, in order to defend such actions in a court of law or, possibly, before the political authorities. A track record of action should also lay the groundwork for possible further supervisory action, such as conservatorship or license withdrawal. The bank must never be in a position to claim that it had not been informed of the seriousness of the supervisors' view of the situation, except, of course, in rapidly developing cases or in cases of fraud.

The supervisory authorities also need to be able to take legally binding action to enforce compliance with specific remedial measures. Such actions could consist of a "cease and desist" order, ordering a bank to improve operations or close or limit deposit-taking or certain types of credit business, or other actions to correct specific breaches or unsafe and unsound practices. A next step could be a dismissal order against a director or manager who can no longer be considered fit and proper, as a result of major management failings or refusal to comply with corrective orders. In some cases, punitive measures such as fines levied against the manager or director personally can be effective. The most effective measures are those tailored toward remedying the deficiency. For instance, when capital is below the required level, a first step could be to prohibit dividend payments. The banking law normally specifies that noncompliance with a corrective order or dismissal order is a punishable offense, potentially subject to action by the prosecuting authorities, and leading to substantial fines or prison sentences.

As measures of last resort, but in urgent cases also as a first measure, when the financial condition of the bank has deteriorated to a potentially terminal level or there is evidence of serious criminal activity sanctioned by management, the supervisory authorities would have the authority to impose conservatorship or withdraw the license, to rehabilitate the bank or force its closure and liquidation.

[120]See Supervision Guideline No. 13, "Enforcement" in World Bank (1992).