MODULE 10 – Supervision and Regulation

Introduction

In this Module, we will discuss supervision and regulation of the IB system. The Basel Committee and Basel Accord will be discussed comprehensively, especially the main pillars of the Basel Accord. Furthermore, we will discuss the role of the IMF and its guidelines for central bankers. A brief history of the Savings and Loan crisis of the 1980’s will be discussed. The issue of banking regulation, preventive measures taken to solve the Savings and Loan crisis will be discussed. The capital adequacy directive for the banking system through the Basel Accord will be reviewed. And finally, the credit risk issue for the banking system will be discussed and the student will be introduced to the VaR model.

Objectives

Upon successful completion of this module, the student should be able to:

- Articulate on the Basel Accord and its pillars.
- Discuss the role of the IMF and its guidelines for central bankers.
- Elaborate on the Savings and Loan crisis in the U.S. in the 1980’s, especially the causes and the solution.
- Examine the regulation of the banking system by the international regulatory authorities.
- Describe the Basel Accord’s capital adequacy requirement and VaR measure.

Like every other entity, the IB system requires a series of supervisory and regulatory guidelines in order to avoid banking crises and enable banks to provide credit and services in their IB activity. It is essential for every international bank to ensure that their operation and activities are prudent, especially in cross-border lending. Lack of prudence and supervision may eventually result in a bank’s failure in its international operation. Empirical evidences indicate that every banking crisis started with a lack of supervision and prudence; and gradually the liquidity issue was compromised and the domino effect caused banks to fail, and subsequent panic led to contagion in the banking system. Therefore, the need for regulations and supervision guidelines led to the establishment of several regulatory agencies. The most notable one is the Basel Accord. Banking members, through this Accord, have agreed to and are bound by certain guidelines to ensure liquidity, and thus maintain a sufficient level of capital to avoid insolvency.

The Accord agreement and its Committee, which is responsible for implementation of the Accord, operate in the town of Basel in Switzerland. Each central bank has representation on the Basel Committee, and there is also regulatory representation from each of the G10 industrial economies. The role of the Basel Accord is to enact supervisory guidelines and make recommendations for maintaining the capital adequacy requirement for all central bankers. Unfortunately, the Committee lacks enforcement power over central bankers, since each central bank operates based on the economic environment that they are supposed to manipulate through domestic regulatory guidelines. However, each central bank that is a signatory to the agreement chooses to follow the Basel Committee’s recommendation to honor the agreement and maintain the rule of law for standardization of capital adequacy requirements.
The central bankers, by maintaining the level of capital adequacy requirement dictated by the Basel Committee, guarantee a certain level of capital to avoid any losses due to unanticipated fluctuation in economic and financial activities.

The Basel recommendation for protecting banks from credit risk originated in 1988 and eventually was revised to also address market risk in 1996. For further information, please see Footnotes #1.

The original purpose of the Basel Accord came about when central bankers in Germany rendered the Bank of Herstatt insolvent. The story goes that a Herstatt Bank branch in Frankfurt received an installment of German Marks from several banks for exchange into US dollars, receivable in New York. Due to the obvious time zone difference between Germany and the US, the payments were never received, due to Herstatt Bank being liquidated several hours in advance of the opening of the bank in New York. This became known as Herstatt Risk or Settlement Risk. For further information, please see Footnote #2.

In order to avoid a similar problem, industrial economies established a committee supervised by the Bank for International Settlements (BIS), also located in Basel, Switzerland, that became known as the Basel Committee on Banking Supervision. To summarize, the Committee’s guidelines have evolved to detailing the role of domestic regulators and their responsibilities in cross-border jurisdiction, ensuring international banks are regulated by domestic regulators, and finally standardizing capital adequacy requirements.

In order to reduce risk by the banking system in the process of cross-border lending and other types of banking services that they provide, the new requirement for capital adequacy was established by the Basel Committee that eventually became known as the Basel II Accord. The modified Accord focuses on the level of capital requirements, supervision guidelines and market efficiency. Basel II’s main objective is to improve the financial soundness of the IB system by requiring it to maintain an adequate level of capital to manage its risk and be more competitive and disciplined. Furthermore, the purpose of the revision was to bring operational stability among bankers while allowing competitive forces to determine success or failure for each bank. When it agrees to follow the Basel II Accord, the banking system will benefit from its guideline by implementing more stringent risk management policies in its operational practices.

The Basel II Accord, while respecting each central banker’s decision-making concerning their regulatory and financial responsibilities over an international bank, promotes the idea that an international bank must be more risk conscious when it comes to capital requirements. The Basel II Accord maintains the featured attributes of Basel I which established the requirement to maintain 8% of their loan portfolios to support liquidity issues. For further information, please see Footnote #3.

It is a universal understanding among the central bankers, banking system and financial entities that the Basel Accord and its guidelines cannot be enforced, and its implementation requires cooperation among the entities mentioned above, especially when it comes to the capital adequacy requirement. But since the Accord is an agreement, its supervisory guidelines, to a large extent, are adhered to.
One must not forget the role that is played by central bankers in the operations of international banks, especially where liquidity and insolvency are concerned. This can be evidenced by the role of central bankers in being the “lender of last resort” which brings public confidence in the institutions of financial intermediaries.

The International Monetary Fund (IMF) also provides guidelines for central bankers to follow in order to direct the licensing and operation of the banking system. For greater transparency by the banking system, the IMF provides guidelines such as the role of the central banking system when conducting monetary policy, transparency in formulating monetary policy, removal of asymmetric information in the financial market on monetary issues, and ensuring reliability and honesty with central banking institutions. For further information, please see Footnote #4.

To maintain a sound financial system, especially in capitalistic industrial nations, it is essential that the government play an important role in helping to avoid the deviations that occur in macroeconomic variables through the fluctuations that occur in economic activity. There is also a school of thought that is debating whether the government’s intervention in free enterprise hinders the profit taking of the economic entities, and thus limits their economic freedom. But as we know, to avoid monopolistic forces, the government’s involvement is necessary in certain aspects of our economic system. This is evidenced in the deregulation of the banking system during the 80’s that led to the banking crisis. Though supervision and regulation are needed, there is an understanding among international players that forces in the free enterprise system must not be hindered, and thus limit profit taking in the international financial theater. Because of such an understanding, the role of the Bank for International Settlements (BIS), establishment of regional central banks, supervisory groups, and the G10’s new measures are a few examples of the legal regimes’ efforts to improve the issue of private decision making by international banks, and how much government involvement is required for supervision of the banking system.

It is evidenced that the banking crisis of the 80’s in the U.S. was caused by those deviations, coupled with deregulation that I mentioned above. Fluctuations in interest rates and market value of real estate, laissez-faire, the absence of government guidelines, financial crime and reckless speculative activity can be named as some of the reasons for the savings and loan crisis of the 1980’s. For further information, please see Footnote #5.

There are competing schools of thought concerning regulation/deregulation of any industry, especially in our topic of the banking system. There are qualitative and quantitative debates concerning the pros and cons of such an undertaking by the government. For example, the “too-big-to-fail” doctrine promotes recklessness in decision making by large banks. The question is, should they be regulated? Or, how about a small community bank that wants to establish a friendly relationship with the local merchants – should they allow liquidity on-the-spot for such a merchant, or should they be regulated? The debate goes on, and still no one can claim which side is the winner in this argument.

On one side of the debate, there is the argument that the free enterprise system should be free of any outside intervention and market forces should determine the economic and financial decision making on the effectiveness of macroeconomic variables that bring about either general equilibrium, or recessionary and inflationary phases of the business cycle. The other side of the
debate also argues that the free enterprise system is capable of creating monopolistic forces that could be disastrous in determining what commodities need to be produced, how many, and at what price. Therefore, intervention by governmental regulatory agencies is necessary to eliminate monopolistic forces for protecting consumer interest. The history of the banking system shows periods of regulation and deregulation. Deregulation manifested itself by the removal of regulatory influences, which resulted in the banking industry making decisions concerning how much money they can make, how many loans they can package, how much interest should be paid to depositors, and how much interest they should pay to borrow money through speculative processes. This was the philosophy of the banking operation in the 1970s and 1980s, and it was accepted by Wall Street, consumers and governmental entities.

Eventually, through governmental intervention, the Resolution Trust Corporation was established to look into the Savings & Loan Crisis. Many banks were liquidated; some merged with larger banks, and the crisis cost US taxpayers over $150 billion.

Many steps have been taken to correct the causes that led to a series of banking crises in the 80’s and 90’s, and the Basel Accord was a catalyst for some of the initiatives and proposals. For example, in order to adequately maintain capital, a new measurement for capital adequacy was proposed to avoid a bank’s market risk and foreign exchange exposure. Also, a proposal was made by the Basel Committee for minimum capital requirements to prevent market risk for the banking system, and the value-at-risk (VaR) model was introduced which required banks to hold 8% of their capital as collateral to protect them from portfolio loan risk. For further information, please see Footnotes #6, #7, #8 and #9.

Conclusion

In this module, you have learned about the Basel Accord, guidelines and pillars for the banking system. Furthermore, you learned about the role of the IMF and its guidelines for central bankers. Also, you gained understanding of the U.S. banking crisis of the 1980’s, its causes and consequences, and the solution applied. You have learned some of the international laws and regulations for the IB system. And finally, you gained knowledge of the capital adequacy requirement and VaR measure.
(1) Basel II History

(2) About the Basel Committee
http://www.bis.org/bcbs/index.htm

(3) Settlement Risk

(4) Basel II: Revised international capital framework
http://www.bis.org/publ/bcbsca.htm

(5) What the IMF Does
http://www.internationalmonetaryfund.org/external/work.htm

(6) Garn-St Germain Depository Institutions Act of 1982
http://www.federalreservehistory.org/Events/DetailView/45

(7) Garn - St Germain Depository Institutions Act
http://en.wikipedia.org/wiki/Garn_-_St_Germain_Depository_Institutions_Act

(8) The Basel Committee on Banking Supervision

(9) Basel Committee on Banking Supervision
http://www.riskglossary.com/link/basle_committee.htm

(10) Introduction - Market Risk
http://www.riskeye.com/paper/node1.html