UNIT 3 RATIONALE AND SCOPE OF INTERNATIONAL BANKING REGULATION

Objectives

After studying this unit, you should be able to:

- understand the rationale for regulation of banking
- appreciate the need for regulation of international banking
- distinguish the various forms of such regulation.

Structure

3.1 Introduction

3.2 The Objectives of Regulation

3.3 Forms of Regulation

3.4 Scope of Regulation

3.5 Risk and Regulation

3.6 A Caveat

3.7 Regulatory Dialectic

3.8 Regulatory Arbitrage

3.9 Summary

3.10 Key Words

3.11 Self Assessment Questions

3.12 Further Readings

3.1 INTRODUCTION

Though it is said that banking is a global industry, no other sector of the economy is so heavily regulated by domestic authorities like that of Banks. Banks are told how much capital they must hold, where they can operate, what products they can sell and how much they can lend to any one firm. This is not an industry where laissez-faire is the order of the day.

It is almost universally accepted that the regulation should be heavy and the risk-taking activities of financial institutions should be constrained. The nature, role and form of regulation varies between countries with considerable differences in scope, intensity and methods of regulation between national financial systems. In the US, since the 1930s, regulation imposed through extensive legislation has been comprehensive, while in the UK regulation has traditionally been operated more through restrictive practices, self-regulation and the strong moral suasion authority of the Bank of England.

The industry has important characteristics of a public utility, It can create significant social benefits and social evils to all the stakeholders — namely, shareholders, creditors, employees, managers, and customers. It is a fact that whatever happens in banking and finance usually has much broader economic and social implications and ensures that society, through governmental structures, will take a keen interest in its working, sometimes for good and sometimes for ill. It is also clear that there are important regulatory distinctions between domestic and offshore financial activities if only for the fact that a government's regulatory reach usually stops at its borders.

This unit considers the broad issues of regulation and public policy towards the financial services industry while the next unit focuses specifically on the critical issues of capital adequacy as a determinant of financial stability in this industry.

The first issue involves onshore or domestic markets for financial services which are fully subject to domestic supervisory, regulatory and monetary policy controls. Whether and how foreign-based financial institutions may compete in onshore markets is strictly a matter for national political decisions. When domestic institutions are systematically protected from outside competition they are frequently highly profitable. But they can also use that "artificial" profitability to cross-subsidize the penetralion of other markets for financial services.

The second issue involved offshore markets for financial services which arc substantially beyond the reach of national authorities. They include Eurocurrency and Eurobond markets, along with the peripheral financial services that complete the Euro credit business. These are largely untaxed, unregulated and highly efficient markets - in both static and dynamic terms - in which any number can play albeit with attendant risks. While it seems fair to say that such characteristics have exposed the international economic and financial system to certain risks from time to time, offshore markets nevertheless set standards of performance in financial efficiency against which all other financial markets must be measured.

3.2 THE OBJECTIVES OF REGULATION

a) **Monetary Rationale :** Firms in the business of financial services are to a significant extent constrained in terms of competitive behaviour within the context of onshore financial systems. Certain common patterns are apparent in the way these systems have evolved. The mast obvious is the integration of banks and other firms providing financial services into the formation and execution of national monetary and fiscal policies, as well as balance of payments policies, The tools of monetary control range from "sledgehammer" techniques such as changes in reserve requirements and mandatory asset ratios, open-market purchases and sales of securities by the central bank or monetary authority and moral suasion, to rather selective credit controls such as margin requirements on borrowings against securities purchases, limits on loans to certain sectors, ceilings on deposit and lending rates, and restrictions limiting the expansion of loans. Within an overall policy, financial institutions also carry a fiduciary responsibility. They hold assets in trust, as it were, for depositors and investors.

   In modern industrial economies, banks are the major issuers of money; when banks fail the money supply contracts. In short banks provide social benefits and when they fail, the social costs of a shutdown outweigh the private costs.

   Profitability in the financial services industry depends on astute management of assets and liabilities that often entail very high leverage ratios; the acceptance of carefully controlled interest-rate, exchange rate and liquidity risks; imaginative designs and marketing of fee-earning services; and resolution of agency problems in carrying out satisfactorily the wishes of the ultimate holders of the assets with which they are dealing.

   All of these characteristics have combined to make financial services at the national level a "sensitive" industry both as a central vehicle for the implementation of economic policy and as an industry subject to collective crises and failures by individual firms.

   Mismanagement or outright fraud have lefl prominent names like Banco Ambrosiao, Bank Bumipatra, Credit Suisse, Franklin National, Herstatt, Seafirst, Continental Illinois, BCCI, Barings, among the failed or seriously damaged in recent years.

b) **Prudential Rationale :** Governments are well aware of the inherent risks and potential conflicts involved in national and international banking, securities underwriting, and trading'and dealing in financial instruments, foreign exchange, precious metals and the like. Most notably in banking, these risks focus on the solvency of borrowers and the liquidity of institutions that are highly geared. Banking crises always carry with them negative externalities, damage imposed on individuals and institutions outside the firms directly involved and in some cases outside the industry itself. It is conventional wisdom that major banking crises can lead to severe damage to employment, income, economic growth, and related goals of society.

Banks are inherently unstable because the intermediary function of banks necessarily implies a relatively high degree of financial gearing or ratio of debt to equity capital. Because of their high financial leverage banks can be described as "conditionally" solvent, the condition being that depositors do not collectively exercise their contractual right of withdrawal and thereby force the banks into insolvency.

Accordingly a severe liquidity squeeze resulting from sudden deposit withdrawals can very quickly be transformed into a solvency probiem as the victim bank tries to unload Essentially unmarketable asset. The implication is that even the soundest of banks is viable only as long as it continues to enjoy the confidence of financial markets.

Secondly the financial condition of a bank is not readily determinable even by analysts with sophisticated techniques at their disposal, let alone ordinary depositors, since crucial parameters such as the quality of loan portfolio cannot be assessed on the basis of published accounts or other publicly available information. Furthermore, even if the relevant information were obtainable it would be very quickly outdated, since banks can adjust their risk profile within a very short span of time. This lack of transparency means that on the one hand, a bank's financial condition can deteriorate markedly before financial markets become aware of the fact while on the other hand even the soundest of institutions can fall victim to ill-founded rumours. For similar reasons, a bank experiencing deposit withdrawals cannot necessarily rely on the pricing mechanism, that is, an increase in the interest rate it is prepared Io offer on deposits to correct the situation. In the absence of reliable information, the fact that the bank Is prepared to offer a better rate of interest on its deposits can be misinterpreted and therefore be self-defeating.

These characteristic attributes of banks high financial gearing, reliance on widely dispersed withdrawable funds and lack of transparency - create the potential for a vicious circle of precautionary deposit withdrawals leading to collapse and insolvency. Beyond this, there is the danger that the failure of one institution will lead to the failure of others through a process of contagion as depositors act on the belief that the problems of the failed bank also affect other institutions.

According to a Federal Reserve publication "the most basic reason for regulation of banking is depositor protection". Individuals entrust banks with their saving and it would be costly and time-consuming for them to assess the quality of their financial institution; there are economies of scale and scope associated with information gathering and assessment. In essence a depositor is a creditor of the bank - he or she has loaned money to the institution but without full knowledge of the risks associated with the transactions. In few other business dealings do ordinary customers assume this role? This is a problem of "asymmetric information" which arises when a party on one side of a transaction has relevant information that the other side does not have. Financial services markets are an area where the problems of potential or actual asymmetric information are pervasive. Bank Managers know more about the values of their portfolio and their solvency than do depositors. Borrowers know more about their prospects for repayments than do lenders, Government regulations thus provide a protection wall between the consumers and their bank.

Banks are pivotal in the national payments system. The international inter-dependence of the payments system compounds the "externalities" problem since a banking failure in one country could have severe repercussions for banks in another country. In a bank in Country A has interbank loans outstanding to a bank in Country B and the former bank fails, this could cause liquidity or even solvency problems for the latter depending upon the level of exposure. Supervisors reinain fearful that such "cascading failures" could spread beyond their control.

Furthermore, as Federal Reserve Board Chairman Alan Greenspan has pointed out the financial marketplace is now confronted with new instruments of every kind, with uncertain risk profiles. Banks are filled with contingent liabilities that they could not possibly fund if a substantial number of them become due at the same time. In Greeenspan's words "A failure by one of these institutions to perform on the contractual obligations could impose serious losses on customers and could result in serious systemic problems".

In order to protect themselves against such adverse external consequences, therefore,

countries have built elaborate "safety net" systems thal are designed to provide liquidity to institutions in trouble, insure depositors, and sometimes bail out borrowers to help the bank maintain solvency. The operation of domestic financial safety nets invariably creates problems of efficiency and fairness; for example how to distinguish between institutions that are TBTF (too big to fail) and those TSTS (too small to save) and how to neutralize competitive distortions that may result from people's expectations about the operation of the safety net. Even more important the existence of a safety net creates potential "moral hazard" problems where managers of financial institutions, knowing that they are likely to be bailed out will behave in a less risk-averse manner and thus impose substantial contingent liabilities on those who hold up the safety net the tax payers and the general public.

To cope with this problem and to ensure the safety and stability of national financial systems governments apply various techniques of financial surveillance and control. ranging from careful bank examination procedures, reserve requirements, mandatory asset ratios and maximum lending limits to risk-related deposit insurance premiums, disclosure provision, securities laws and moral suasion. Countries deal with this problem in different ways. Regulation and contml usually damage the efficiency of the domestic financial system but this loss in efficiency can be considered as something of an "insurance premium" and is usually considered to be more than offset by the resulting gain in the safety and stability of the system.

Problems arise, however, when national financial institutions take some of their activities offshore into the Euromarkets and foreign markets. Though home countries are supposed to regulate offshore branches and host countries are supposed to regulate subsidiaries and other affiliates, the effectiveness of government regulation and controlwith regard to these activities remains the subject of intense debate. The oil shocks of 1973 and 1979, dramatic changes in the monetary policies of the United States and rising real rates of interest beginning in 1979, the severe recession of the early 1980s and economic mismanagement on the part of borrowers dong with intense competitive pressures in offshore lending and gaps in risk/return assessments of financial institutions all combined to produce the international banking crisis that began in 1982. The stability of the international financial system as a whole was called into question while holders of assets began a mass "flight to quality".

As central banks and other government authorities sought to stabilise the system through direct, bilateral financial infusions to countries in trouble, short-term leading by the Bank for International Settlement (BIS) and increases in the lending resources of the International Monetary Fund (IMF), the inevitable question of regulation and control of offshore financial activities arose. Legislation, such as the United States International Lending Supervision Act of 1983 has been enacted and tighter co-operation among national regulatory authorities has been sought.

While the precise design of an international financial safety net that goes beyond the moral obligation of governments to extend their support to offshore problems of domestic financial institutions remains in doubt any such arrangement will certainly entail greater regulation and control on the part of national authorities and thus an erosion–of efficiency in the delivery of offshore financial services. Spreads between what borrowers pay and what savers receive will tend to widen and financial innovation will be impaired. Such adverse implications have to be regarded as a price to be paid for greater financial stability,.

Whether financial regulation is in some sense optional and the cost of regulation therefore minimized is arguable. Characteristics of financial efficiency in the larger unregulated offshore markets can often yield useful insights into the nature and magnitude of these losses in efficiency in individual domestic regulatory arrangements and periodic offshore crises can indicate the nature and magnitude of some of the benefits of a more controlled domestic financial environment.

3.3 FORMS OF REGULATION

There is much variety in the form of regulation as between countries. Regulation in the financial sector must be more broadly defined than legally imposed requirements and

constraints. Regulation implies that the business operations, balance sheet structures and pricing policies of financial institutions are different from what would emerge in a fully competitive unconstrained market environment. In this context six forms of regulation may be established.

1) **Environmental** : Where financial institutions arc constrained not by regulation related specifically to prudential aspects of their business but by the government's monetary policy, for instance, credit restrictions are applied in the interest of macro-economic management, but not in the interest of any single organisation.

2) **Legal** : Sometimes the business activities of particular groups of institutions are constrained by the law. The enforced demarcation between banking securities business and Insurance is an example. In many countries, geographical restrictions and the legally imposed limits on the allowable types of business of building societies are other examples.

3) **Self-imposed** : Sometimes, few institutions may choose to restrict the range of business they are in. This is a common practice, where restrictive practices are chosen by the industry to govern their activities and pricing policies.

4) ***Moral* suasion** : Where "regulation" emerges through the general authority, for instance, the Central Bank.

5) ***Self-regulation*** : When an industrial agency is given formal authority or a legal duty to regulate the business of its industry and to impose standards of prudential norms for the conduct of its activities; and

6) **External agency** : Where an independent or external body is given express legal authority to regulate an industry and impose explicit regulations and monitor the business operations of its industry.

It is the unique mix of these six basic forms that determine the ethos of regulation in different countries.

3.4 SCOPE OF REGULATION

Richard Dalq notes that National Authorities apply a variety of approaches to regulation and control to increase Bank Safety and to maintain confidence in the Banking System. Following Dale we may classify these regulations as *preventive* (designed to limit risks incurred), ***protective*** (offer protection in the event of failure) and ***supportive*** (lender-of-last-resort function):

In general, *preventive* regulation is aimed at curbing tho risks incurred by banks in order to reduce the incidence of bank failures and/or the need for official support. However, certain limits may also be placed on the competitive process itself with a view to increase the returns associated with any given level of risk and to restrain banks' own propensity for risk-taking. These limits include:

- controls on market entry
- restrictions on price competition
- capital adequacy
- liquidity
- interest rate risk
- permissible business activities
- loan limits - concentration of loans and country risk exposures
- foreign currency exposures
- bank inspection

Protective Regulation includes deposit insurance. Most countries either already operate deposit protection schemes. In general participation in these schemes is mandatory. Typically the protection offered is territorial in scope, thereby covering branches and

subsidiaries of foreign banks and excluding deposits with foreign offices of domestic banks. In all schemes, there is a maximum amount per depositor per institution beyond which protection is not provided, the rationale being that large depositors are in a better positions to assess bank risk than small depositors.

Supportive regulation includes lender of last resort function. In general, national monetary authorities are prepared to provide financial assistance to comniercial banks experiencing temporary liquidity difficulties. A distinction can however, usually be drawn between routine use of the official discount window where conditions of access are often formalized and longer-term support operations undertaken on a discretionary basis.

The precise scope of the lender of lost resort function is not publicly stated. This calculated reticence applies both to the circumstances in which assistance may be given and to the allocation of support responsibilities between different national authorities. In Japan and US foreign banks have a formalized right of access to the central bank's discount window but this facility would not necessarily extend to emergency support. In general national authorities expect foreign parent banks to provide all necessary assistance to their local subsidiaries whether or not a letter of comfort has been issued, although the threat of shareholders' actions could in theory place a limit on this commitment.

Some of the other emergency regulatory measures are: assisted mergers and the appointment of caretaker managers to troubled banks. Furthermore, financial centers frequently look to parent institutions to support foreign-owned banks to which they are host, for which purpose irrevocable lines of credit and / or letter of comfort may be required or encouraged:

Finally, when banks fail, the ensuing liquidation proceedings may be specially-designed to protect local depositors. For this purpose several countries treat branches of foreign banks as separate entities requiring their own liquidation.

3.5 RISK AND REGULATION

In the final analysis, regulation is ultimately about risk; the extent of allowable risks financial institutions should take and who should bear which risks. The risk minimizing role of regulation is based on the premise that in an unconstrained competitive environment financial institution will be induced to take "excessive" risks to the detriment of their customers and/or society to the extent of any systemic risk. Although modern portfolio and risk analysis theory make substantial contributions to guide portfolio management of risk, it is generally assumed that the containment of risk needs the support of external regulation. Gardener suggests that in this role, through the ability to gather information, data and experience of all banks the supervisory authorities "are a kind of management consultant service, but with muscle".

3.6 A CAVEAT

Governments are far from perfect. The notion of the omniscient and benevolent government agency that can perfectly correct the failures of the private sector is a textbook construct that few, if any, real-world government agencies could replicate. In sum, since both red-world markets and real-world governments exhibit varying degrees of imperfection, the actual policy debate concerning regulation - whether to regulate, how to regulate, the breadth of regulation and so forth - must always involve choices among imperfect markets and imperfect governments.

3.7 REGULATORY DIALECTIC

Evolutionary perspectives are often dialectical in nature. The dialectic in financial services innovation focuses on the way that exogenous shifts in technological market and regulatory constraints play themselves out when the players possess different adaptive capacities. Dialectic is a philosophical term for a struggle model wherein events are moved by two forces that act in direct opposition to each other. Each force works

reflexively to undo the effects of the other. The basic idea corresponds to the mechanics of a seesaw, Regulators and regulatees ate counterpoised on either side of the seesaw, driving it up and down as they pursue their own goals. Political processes of regulation and economic forces of avoidance adapt continually to each other like riders on a seesaw. It develops as a series of lagged responses.

The regulatory dialectic emphasizes that decisions taken by regulators and regulatees jointly condition each other. As in a chess game, each player must anticipate the behaviour of players, that operate on the other side of the regulatory board.

The result is a cycle of regulation, da-regulation and re-regulation. De-regulation in financial services has become a fact of life in the US and in various other countries such as UK, Japan, etc. What are often archaic systems of financial institutions rapidly become streamlined under deregulation, as major wholesale and retail financial institutions spread geographically and across products while regional as well as local institutions plot defensive and collaborative strategies.

If there are potential benefits associated with the deregulation of financial services there are also potential costs with respect to both economic efficiency and equity dimensions. Potential costs include lessened stability of the financial system and the exploitation of conflict of interest on the part of financial institutions engaged in both commercial and investment banking activities. This results in re-regulation. The objective is to capture for society the efficiency gains from greater competition without at the same time compromising the safety and stability of the nation's financial system.

Activity 1

1. The objectives of Regulation are:

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2. List out the forms of regulation.

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3. Differentiate between the roles of Protective, Preventive and Supportive regulation.'

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3.8 REGULATORY ARBITRAGE

The globe is not a level playing field. There are gaps in the regulatory net which maintain opportunities for "regulatory arbitrage", in an environment where the regulatory function is essentially national but the business itself is international. While alignment in a number of regulatory and supervisory areas has been impressive over the years, major differences remain. The problem of reaching international consensus on regulatory approaches is still in search of solution.

The issue of international supervisory co-operation is discussed in subsequent units.

3.9 SUMMARY

Banking and finance constitute a highly sensitive sector embodying an inherent element of liquidity risk as do maturity mismatching in asset and liability management, trading and merchant banking activities. Exposures involved in lending activities always,involve solvency risks. The very role of financial intermediation entails assumption of risks. **Thae is** also a systemic risk since problems that afflict an individual institution may spill over to damage the entire fabric of the national financial and economic system. To cope with this problem countries have tried to establish safeguards that are robust enough to contain external damage triggered by crises in the financial sectors. Deposit insurance limits erosion of confidence by banking customers. The central bank as official lender of last resort exists to inject liquidity to individual institutions in trouble and to the financial system as a whole.

Along with institutional safeguards comes regulation to further support the safety and soundness of the financial system. The apparatus is familiar : reserve requirements, capital adequacy standards, bank examination and supervision, maximum lending limits, activity limitations on commercial and investment banks.

3.10 KEY WORDS

Financial gearing/leverage : The extent to which a firm relies on debt. This can be measured by the ratio of debt to equity.

Capital Adequacy Rules : The rules applied by the Basle Accord which require the maintenance of minimum capital adequacy standards applied to international banks operating in signatory countries.

Lender of last resort : An institution, normally a central bank, which stands ready to lend to the commercial banking system when the iatter has an overall shortage of funds and to individual banks experiencing a liquidity squeeze.

Level playing field : When used in conjunction with the Basle Accord, this relates to one of its objectives which is to reduce competitive inequalities arising from differences in capital requirement across nations.

Moral hazard : Moral hazard problem arises where managers of financial institutions knowing that they are likely to be bailed out, will behave in a less risk-averse manner and thus impose substantial contingent liabilities on those who hold up the safety net-the taxpayers and the general public.

Systemic Risk : In banking, any risk that affects a large number of banks e.g. the risk of a failure in one bank caused by specific circumstances, affecting the whole banking system.

Asymmetric information : The problem of asymmetric information arises when a party on one side of the transaction has relevant information which the other side does not have.

3.11 SELF ASSESSMENT QUESTIONS

1) What is the rationale for regulation of International Banking?
2) What are the various forms of Ranking Regulation? What is the scope of Banking Regulation?
3) Write short notes on:
   a) Regulatory dialectic
   b) Regulatory arbitrage

3.12 FURTHER READINGS

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