# Using international sound practices as a basis for banking reforms

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*Many countries have already completed or are today in a transition from a thoroughly regulated financial system to one based on market principles. In the article, the authors describe some of the international sound practices that should be the foundation for financial reforms, in particular in the banking sector. The authors also discuss successful as well as some less successful experiences of countries in reforming their banking systems.*

## Background to this article

In Toledo, Spain, in November 2006, the IMF together with the Banco d'España arranged a seminar primarily for central bank governors from Northern Africa and the Middle East. At the seminar also governors from other countries participated as speakers and discussants. There were two topics on the agenda: Central bank reform, and Banking system reform. On both issues, the speakers and the other participants sought to identify a framework of generally agreed sound international practices and how to modify and apply them in the specific circumstances of individual countries.

The Riksbank governor, Stefan Ingves, made a presentation on the topic of banking reform. He referred mainly to experiences from his earlier work at the IMF, rather than to developments in Sweden. Hence, the presentation reflected practices which have proven to function well, or in some cases not very well, in many countries of different structures and levels of development.

The presentation was drafted jointly with Göran Lind, Advisor to the Riksbank's Executive Board. Mr. Lind has conducted a large number of assessments of different countries' approaches to banking regulation and supervision and could thus supplement Mr. Ingves' own experiences on global practices.

The following article is based on the presentation at the seminar. However, it has been adapted to the format and audience of an article.

## Introduction

Many of the arguments and recommendations in the article are of a general nature and do not refer to banks only. For instance, a favourable economic environment, adequate legislation, good accounting and auditing standards etcetera, are necessary conditions for economic developments in general and not only for banks. That said, the article will argue that several of these general prerequisites are especially important for the establishment of a sound framework for banks.

It is a widely held belief, e.g. in academic literature, that "banks are special". Banks perform certain activities which are, as a combination, not open to other institutions. Banks transform short-term deposits into long-term lending; banks play a dominant role in conducting payment services, and banks assume and transform various kinds of risks. All these functions are vital to society. These unique roles of banks make them candidates for potential protection from society, for example in the form of depositor protection schemes, or liquidity assistance from the central bank. The roles also motivate special regulations for banks.

But banks are intrinsically vulnerable just because of those activities. A loss of confidence in a bank may lead to a rapid outflow of deposits, a so called bank run. Since a bank's assets generally are not equally liquid, it may suffer problems in meeting its obligations which might ultimately end in the closure of the bank. A small bank failure is a problem mostly for its owners and a limited group of counterparts, but the failure of a large bank or several large banks may have wider repercussions, threatening the stability of the financial system. As has been experienced in many countries, also in Sweden, major bank failures can lead to large losses for society as a whole. Society has sometimes tried to reduce the negative effects of bank crises, for instance by spending tax-payers' money to rescue problem banks or by providing financial support to facilitate mergers or other solutions. Many countries have implemented depositor insurance systems, whereby small and medium-large depositors will get reimbursed from the insurance system should the bank fail.

Based on painful experiences of bank failures in many countries and over many centuries, and the ensuing costs to society, a framework of regulations and supervision of banks has been established with the aim to reduce the risk of bank problems and financial stability disturbances. This framework develops over time, reflecting new theories but also the general development in banking activities and instruments. The following sections will discuss the present framework more in detail, but as a fundamental rule, the rules for banks should only be different from those of other companies insofar as this is needed to protect banks against

their intrinsic vulnerabilities. For instance, banks may have to hold more liquidity, and maintain a higher degree of solvency, i.e. equity capital in relation to assets and liabilities, because they are more susceptible to volatility in the economic climate.

There are several objectives for banking regulation. In addition to the one mentioned above, which refers to the maintenance of financial stability there are also the objectives of consumer and counterparty protection.

## The case for reforming a banking system and how to do it

Experiences from banking systems in many countries show that a top-down approach where the authorities dictate the structure and details of a banking system will generally not function well. The authorities in some countries prescribed, for example, an excessively restricted banking system which was not be able to fully support the economy or they tried to micro-manage the banks which made them less efficient. Some countries on the other hand opened their banking sectors on excessively liberal terms which led to the over-establishment of banks and ensuing problems and losses. Hence, the issue of banking reform should rather be approached by discussing how the authorities should establish a framework which promotes the spontaneous growth of a sound banking system.

This article will discuss a number of components which are necessary in a modern banking system to make it efficient, while at the same time flexible to accommodate developments and resilient to promote financial stability. In addition to issues about the banks themselves, we will discuss the underlying preconditions for banking, the legislative and regulatory framework, the supervisory agency and its work, and also the need to supplement the banking system by other financial institutions and markets. There is no single blueprint for banking reform, and our observations come from experiences in many countries, including our own.

Numerous assessments of country practices, conducted by the International Monetary Fund (IMF) and World Bank but also of many other parties provide examples of shortcomings in the preconditions for banking, in the regulation and supervision of banking and in the conduct of banking activities. As a minimum, these shortcomings have led to inefficiencies in providing a broad range of financial services to society. They have also led to higher costs and in many cases to bank problems and even systemic crises. An obvious conclusion is that banking reforms which do away with the flaws are worthwhile for all parties and countries. The cause for banking reforms is strengthened by current develop-

ments in banking, which includes a spread of cross-border institutions and activities but also new instruments and methods to handle risks in banking. Such developments generally increase efficiency and stability in banking, but need to be carefully regulated and supervised because they also contain inherent vulnerabilities and risks.

Before considering the truly bank-specific issues such as the conduct of banks, their regulation and supervision, we need to discuss the necessary backdrop to an efficient banking system, and indeed, an efficient financial system as a whole.

## Preconditions

The overarching aim of this article is to provide a blueprint of global practices for creating a modern and sound banking system. But experience has clearly shown that such a system can not be developed and maintained unless all the necessary prerequisites are in place. As explained in the introduction to this article, a society's economic progress in general, and the development of a modern banking sector in particular, is dependent on the existence of conducive external factors, often called preconditions.

The preconditions include macro economic stability, an adequate legislative framework and a well functioning judicial system. There should also be adequate rules for accounting and auditing, a well developed infrastructure for the payment system and a financial safety net. Only under such an overarching set of good preconditions will the banks develop favourably.

In most cases, it is not within the mandate of the bank regulatory authorities to affect the preconditions. Economic developments follow other determinants, and many of the institutional preconditions depend on legislation or decisions by other decision-makers. Nonetheless, since the preconditions are such important factors for ensuring a sound and well functioning banking system, the state of the preconditions must always be considered by those responsible for the banking sector reform. They must inform the decision-makers of the deficiencies in prevailing preconditions, for instance weaknesses in legislation, and press for adequate measures to be taken such as laws to be passed or institutional arrangements to be undertaken. Awaiting the implementation of such measures, the authorities should try to compensate for the present shortcomings. For instance, if the general accounting rules are seen as too lenient for banks, banks might be required to present parallel reports based on bank-appropriate accounting rules.

The description below of the major preconditions should be read in this perspective: Which general shortcomings in the external factors have in many cases lead to bank problems in various countries and how could they be counteracted?

- Macro economic volatility is harmful to banks, partly because of its effects on banks' counterparts but also due to the intrinsic character of bank operations. Periods of rapid credit growth in an upswing may be followed by a recession leading to problems for many companies. Bankruptcies could then increase leading to high credit losses in banks. High inflation, particularly if unpredictable, will disguise the underlying profitability of a loan project and could lead to an erroneous credit decision being taken by a bank. Also, bank loans extended in foreign currencies could lead to losses if the local currency depreciates when the borrower who earns his money in the local currency runs into difficulties to repay his loan. This is more dangerous in a situation of a fixed exchange rate since the depreciation could be more sudden and deep. Not least Swedish banks suffered from this during the banking and exchange rate crisis in the 1990s.

- In order to ensure credit discipline, there must be transparent legislation as well as court proceedings that are predictable and reasonably fast. If a bank cannot rely on seizing the collateral given for a non-performing loan it will be reluctant to provide future loans against similar collateral. Of course, the laws and the courts should also protect the depositors and borrowers from any abuse from the banks such as unfair contract terms.

- In countries where the accounting and auditing rules are weak, or where the accounting and auditing firms are inadequate, various financial problems may occur. Banks will not be able to rely on the financial statements when assessing their borrowers' creditworthiness. Nor can the depositors and other creditors to banks rely on the banks' own financial statements. The public authorities must compensate for these weaknesses by implementing additional rules. For instance, the supervisors may need to require stricter rules for provisioning against loan losses, or to set a higher minimum level for bank capital.

- An important function of the banking system is to facilitate payments between various agents in society. This is based on the fact that bank accounts provide the basis for all payments except cash payments. Most payments are executed through the payments system infrastructure, such as the systems for large value payments, cheque clearing, securities settlement systems, stock markets, other exchanges and so on. These systems must be efficient and they must also be secure. If not, there is a risk that problems in one part of the financial system will spread to other parts, including to the banks.

- Many countries have neglected the need for an adequate financial safety net. The safety net includes limited but explicit depositor protection which has to be supported by the necessary legislation, institutions and procedures to conduct an orderly management, resolution or winding-up of problem banks. When bank weaknesses are identified in a country lacking a proper safety net, various problems may occur. The authorities will be reluctant to take adequate and timely remedial action since there are no clear guidelines and since they are afraid of the consequences from non-protected depositors and from other counterparts to the banks. The authorities may instead extend excessive financial support to the problem bank through the central bank for instance in the form of exceptional liquidity assistance which is sometimes abused to cover solvency problems, or through the fiscal budget. Occasionally, even failing banks' owners have received public financial support to continue the operations of the defunct bank. The overwhelming evidence from experiences in different countries and situations is that letting problem banks continue to operate without taking adequate action simply means that the problems will increase over time and they may in the end result in a systemic and very expensive crisis.

To sum up on the preconditions, these must be taken seriously into account when reforming a banking system. Shortcomings must be dealt with in the appropriate ways, such as through legislation. While waiting for the preconditions to improve, the authorities and the banks must compensate for the shortcomings.

Having achieved an environment in which banks can thrive, the next issue is which general framework that should be established in order to promote a suitable mix of bank structures – by organisation, activities, ownership and other ingredients.

## International experiences of approaches to the banking sector

As already stated, the authors do not believe that the authorities can create an efficient banking system "by decree". However, there is a natural demand for good banking services in all countries and if the authorities and policy-makers set up a reasonable framework for banking there will be applications to open new banks or for existing banks to change their structures, activities or mode of operations.

In achieving an efficient banking system, the authorities are faced by a number of questions:

1. Is there an optimal number of banks or is this question irrelevant? In modernising a banking system the ideal situation is to arrive at a

"reasonable number" of banks – not too few but not too many. The number itself is not relevant, but an overbanked financial sector tends to be inefficient and unprofitable, whereas too few banks may lead to an oligopoly situation. In many countries the lifting of the old and restrictive regulations lead to an influx of a large number of mostly small "family-owned" banks but many of these tend to have overoptimistic plans for their activities and are closed rather soon leading to consolidation of the banking sector. As a result, some depositors and other counterparties suffer losses from dealing with these banks. Are such events necessary steps in the development or could they be avoided? In our view, some countries after scrapping their old regulations became ultra-liberals and provided licenses for banking on too lenient grounds. The authorities did not properly evaluate the prospects for the banks to conduct profitable business in a competitive environment and they set the requirement for basic minimum capital far too low. But doing the opposite is not the correct way forward either – namely, to let the authorities decide how many banks there ought to be and then allot a fixed number of licenses. This would certainly lead to distortions and oligopolies. Owners must decide for themselves if a new bank should be opened but the authorities should guide them by setting an appropriately high bar of regulatory prudential requirements, including for minimum capital. The first instance of ensuring that a bank will be able to meet the regulatory requirements is when the application for a bank license is processed by the authorities.

2. What then should be included in the banking license application? The content of the license application procedure is very important. Here the authorities have an opportunity to prevent bad apples from entering the barrel, the financial system. The authorities must check that both owners and managers are "fit and proper", which means competent and not criminal. The requirement regarding skills is of course higher if they want to run complex banking activities. It is not necessary that each Board member knows every bank activity himself but between them the Board should be competent on all issues. We should remember that Nick Leeson at Barings Bank all too easily convinced his Board that he could run a highly profitable derivatives trading operation without any risk to the bank!

The license application also includes an assessment that the organisation and structure of the bank group does not hinder the effective supervision of the group. This provision dates back to the collapse of the BCCI bank in the early 1990s. The bank's owners had created a structure for their group with the clear intention of making full insight by the supervisors in different countries more difficult. For instance, the main activities and risk-taking did not take place in the country where the main office and thus the main supervisor were located.

3. Should local owners be preferred or should you allow foreign owners freely, being open to the possibility that the foreign banks become dominant in a system? Believing in free markets we strongly advocate the latter. The prime aim should be to have a banking system which provides the best services to society, whether locally owned or foreign owned. Like in many other countries banks could also benefit from the influence of the foreign banks if they have more advanced systems or methods.

On the other hand, one should not be too lenient toward foreign applicants to set up or buy into existing local banks – we have seen many countries being too trusting toward foreign owners. These should be submitted to the same scrutiny as local applicants. The scrutiny should include a test of the origin of the money used to found (or buy) the bank. Obviously only known owners should be accepted and thus no beneficial owners who are hidden behind the veils of companies established on some offshore jurisdiction. And when speaking about foreign owners: When banks operating in a country have foreign parents the host country supervises must ensure that the home supervisor practices consolidated supervision which includes the entities in the host country. If this is not the case, the application for a license should be declined.

4. Who should be allowed to own banks in addition to individual persons and financial institutions; should non-financial institutions be allowed and could there be holding companies? The global standard-setters are open to such forms of ownership, but only on the condition that legislation and regulation provide the powers for effective consolidated supervision and transparency of such structures, including the parent company and any non-banks and non-financial companies in the group structure. A further condition is that the bank group can be protected from the risks emanating from the non-bank and non-financial owners, such as through ring-fencing. In our experience, non-financial ownerships have often caused problems for banks and the supervisors must monitor such relationships closely. This applies in particular to so called "pocket banks" which are dominated both in ownership and activities by the needs of the parent company or major owners.

A related issue is whether countries should allow "financial conglomerates" mixing banks, securities companies and insurance companies in the same groups. In line with our earlier views on a flexible financial system our opinion is that such structures should be allowed, provided of course that the laws and regulations allow for effective consolidated supervision of the whole financial conglomerate. The present development toward a blurring of the boundaries between the activities of different financial institutions makes it reasonable to allow financial conglomerates.

Broad groups conducting different activities may also be better able to diversify their risks and could thus be more resilient against financial shocks.

5. Should banks have a widely spread or a concentrated ownership? Country experiences give no clear indications on this issue. Both alternatives have their advantages and disadvantages. A broad ownership may better protect the interests of the minority shareholders, but if financial problems occur the majority owners have stronger incentives to provide capital injections. The governance of a bank is sometimes promoted by having strong owners, but there are also examples of strong owners misusing the bank for their personal purposes. All in all, countries should be open to different forms of ownership but monitor them closely.

Another ownership issue is whether there are reasons for retaining state-owned banks. An argument sometimes voiced is that they promote competition and provide services for certain parts of the population which are of little commercial interest to the other banks. The Basel Committee's core principles accept state-owned banks as long as they are run and regulated on equal terms with other banks. But experiences from many countries clearly indicate that countries do best by avoiding having state-owned banks. Simply put: The government is not a good owner and manager of banks since the bank will come "too close to the politicians". There is always a temptation for the government and parliament to use state-owned banks to provide what mistakenly looks like cheap services to the people. But there will be hidden costs for such services, not least in the form of disrupting competition in the banking sector. The government could certainly provide certain subsidized services if it so wishes, but the costs should be transparent. For instance, the government could pay the existing banking network on a commercial basis to provide such services.

6. Should different forms of banks, such as commercial banks, savings banks, credit unions, development banks and micro-finance institutions be allowed? Our view is clearly affirmative. Competition is best served by having a range of bank ownership structures such as shareholding, mutual ownership, non-profit organisations, etcetera. But having said this, experience has shown that some countries have established certain less appropriate practices which might be called "compartmentalization". This happens when the legislation prescribes unnecessary and ineffective borderlines between the allowed activities of defined banking categories. Usually, the intention is to ensure limited competition and high profits for the various categories. Such restrictions are in effect a subsidy to a certain category of banks and they are harmful to the consumers and to the overall economy. The rule-of-thumb should be that any bank should be allowed to conduct any of the generally regulated

bank activities if it can prove that it possesses adequate competencies, systems and resources.

7. Should there be one set of prudential rules for all institutions conducting bank-like activities or should there be differentiation? For instance, could there be "light-touch regulations"[1] for small and non-complex institutions such as micro-finance, local credit unions or exchange houses? There is no obvious answer to this issue. On the one hand you want to create a fair level-playing field for all bank activities which call for equal treatment. But on the other hand there is no necessity to burden small institutions with the elaborate regulations intended for large and complex banks. There must be a reasonable relation between the amount of regulation and its cost to the institutions. Consequently, there is a case for lighter regulation of small and non-complex institutions, but there must always be adequate regulation to ensure discipline also for those. Even when a small institution fails it causes disruptions and a loss of confidence in banks in general.

This issue should also be seen against the multiple objectives of bank regulation. The objective of promoting financial system stability is primarily applicable to the large banks, whereas the objective of consumer and counterparty protection is applicable to all banks, also the small non-systemic ones. This division could argue for some differences in regulation or in the application of regulation.

8. Going one step further – how to set the boundaries between banks and other financial institutions? In my opinion, it is very important to safeguard the general public's confidence around the concept of a bank and it must be protected by a clear definition of a bank and what it is allowed to do. In Sweden, the definition is based on the combination of a bank receiving deposits and being active in the payments system. However, a more common definition of a bank focuses on the combination of receiving deposits from the general public and granting of credits to borrowers using these funds. In accordance with international practice, this combined activity should be a privilege of banks. Other institutions may issue deposit-like instruments in high amounts and not directed to the small savers. To highlight their different characters, such instruments should not be protected by any depositor guarantee scheme. But apart from the "true" deposits, most bank activities might also be open to other financial institutions and vice versa. For instance, insurance companies should be allowed to sell savings products and banks could sell securities.

[1] This isue is related to the issue on risk-based supervision, which is discussed in the section on supervision. However, it is quite possible to apply the same regulations for different types of banks, while applying risk-based supervision, that is to spend less supervisory resources on the less significant categories.

## Other parts of the financial system

The title of this article talks about "banking reforms". However, an efficient and stable financial system cannot be founded only on banks. The risks of disruption to the overall economy from a break-down of the banking system are much greater if the banks are dominant than when there also exists a range of other financial institutions and markets. Hence, the development of other financial market participants should be facilitated, such as insurance and pension companies, securities trading companies, fund management companies etcetera as well as the creation of efficiently functioning markets in various equities and securities. Such diversification will also increase competition and lead to better services at lower prices. Diversified domestic markets also act as a kind of insurance in bad times – if there are problem in one part, another part may compensate by providing similar functions.

Neither should we forget the importance of the financial infrastructure, including payments and settlements systems, exchanges, custodians, etcetera. These provide the necessary "greasing" of the financial system and perform very important roles. Weaknesses in the infrastructure may lead to serious problems, so the infrastructure must be monitored as closely as the banks.

## Sound international practices in bank regulation

In the introduction to this article, the arguments for considering banks "special" and thus for enacting and applying bank regulation and supervision were presented. Banks will operate most efficiently when regulation and supervision is limited and transparent, intended to protect society against major incidents and costs but allowing banks to conduct and develop their business as flexibly as possible.

When assessing whether specific regulations are warranted we should evaluate them against the basic objectives for bank regulation. The first objective is to prevent or at least to reduce the incidence and costs of financial system stability disturbances. The second objective is to protect depositors and other counterparts to banks, "consumer protection". A third objective of regulation is to set out a framework to promote fair competition between banks, but also between banks and other financial institutions and markets. An often implicit, but sometimes even explicit, goal of regulation is to promote the efficient operations of the banking system, notwithstanding that many regulations themselves have the negative side-effect of reducing efficiency.

Let us first describe two types of regulations which still exist in many countries although experiences clearly show their shortcomings.

Only profitable banks will remain stable in the long run. The old-fashioned type of regulation forcing banks to do business on other than market-oriented terms reduced efficiency and led, in many countries, to acute bank problems. If a government wants to subsidize certain activities, such as banking for people in remote geographical locations, mortgage lending on favourable terms, or lending to important borrowers or projects, the costs for this should be transparent and show up as a part of the fiscal budget. Such activities should not be conducted by directives from the government to the banks.

Another type of regulation which is becoming increasingly obsolete and inefficient is when the authorities try to micro-manage the behaviour of the banks by setting upper or lower limits on fees, deposit rates, lending rates, and credit expansion. The situation in the economy changes so rapidly that the authorities will never be able to catch up and detailed actions could become more harmful than helpful.

Instead, a market-oriented approach to regulation is to be preferred. Such regulation will not obstruct developments in banking while at the same time it prevents banks from behaving in a way that might harm customers or themselves, other institutions or markets, or society as a whole. The new Basel II framework for capital requirements on banks could be seen as an example of market-oriented regulation. Under Basel II, banks may assume risks as long as they can prove to the supervisor that they have adequate capital to back up those risks. The banks must also have the necessary governance structures to ensure that they have the capability to identify, manage and control all major risks.

The Basel II framework maintains a balance between "carrots and sticks" mixing responsibility and flexibility for banks on the one hand with strong monitoring by authorities and the general public on the other. It lets the banks do their business as long as they manage and control it well, but if there are shortcomings in the banks' handling then Basel II provides strong powers to the supervisor to intervene at an early stage to rectify the problems.

Whenever feasible a functional approach to regulation is to be preferred to an institutional approach. This implies that financial instruments or activities which perform similar functions are regulated in the same way, whether the service provider is a bank or another type of financial institution. Such treatment ensures fair competition and facilitates the development of an open financial system. An institutional approach implies that there is different legislation for different categories of financial institutions, also in the cases where they perform similar services. This may sometimes be necessary, but should be avoided since it may limit market competition and development.

There is also a choice to be made between principles-based and rules-based regulation. In the first approach, general principles are provided such as "banks must make loss provisions for non-performing loans in relation to the expected recoveries of their loan claims". The authorities may then interpret this flexibly and take measures against a bank when they see fit. Rules-based regulation is more precise and states, for instance in some detail how large provisions a bank must set aside in individual cases, e.g. based on the length of the payment delay. There is no one-way answer whether to choose a principles-based or a rules-based approach. The choice depends to some extent on the country's legal traditions. Financial regulation in Sweden mixes the two approaches, setting the broad principles in the legislation and delegating to the authorities to formulate the more precise and detailed rules and guidelines. This approach also fits well with the fact that the financial sector is developing fast. It is quicker to change secondary regulations than itself.

When regulating financial activities, it is useful to apply an analysis of the costs and benefits to society. There is sometimes a tendency by the authorities to try to solve all problems by more regulation. It is true that we could regulate away all the risks in the banking sector – but such excessive regulation would seriously hamper economic development. There must be a balance. Thus for each regulation we introduce we must also conduct a fair analysis of its costs, also non-financial, as well as its benefits, also non-financial. This is not an easy task and will often not lead to clear answers, partly since in most cases there are no explicitly measurable indicators, but the process of conducting the cost/benefit analysis will in itself help you in your decision.

## Supervision

As we did above for regulation, we should first set out the basic objectives of supervision and then relate the application of practical supervision to these objectives.

A main objective of bank supervision is to identify potential or actual weaknesses or problems in banks. When such are identified, supervisors shall apply timely and appropriate measures to deal with the issue. Supervisors shall also ensure that banks comply with all relevant laws and other regulations and should sanction non-compliance.

To fulfil the objectives, the supervisory agency and its work must be structured in an efficient way. At least four broad fields of prerequisites for efficient supervision can be discerned. They have to do with operational independence including legal protection, resources and staff, supervisory powers, and the process of conducting supervision.

First. The supervisory authority must have operational independence from the financial industry as well as from politicians. These must not interfere in the operational decisions of the supervisors, e.g. to take remedial measures or to close banks. Such decisions must be taken on purely prudential grounds. The supervisors are responsible for their actions and could be criticized afterwards, e.g. in parliament hearings, but they must be able to perform their operational duties independently. The bank, its owners and management should be able to sue the supervisors for malpractice and they may receive compensatory payments. However, this should not stop an action started by the supervisor to deal with a presumed problem in the bank, in particular if the problem is acute and there is an obvious risk that it could get worse if immediate corrective measures are not taken.

As a part of independence, the supervisory management and staff must have reasonable protection should they be sued for their bona fide decisions taken as supervisors. In some countries the supervisors are harassed by frivolous lawsuits by bank owners, managers or other parties. Even if the supervisor is in the end acquitted from any guilt, the process may take years. During this time the supervisor will be severely hampered in performing her job having to concentrate on legal defence. Such lawsuits will also reduce the willingness of other supervisors to take necessary supervisory decisions, since they are themselves afraid of being sued.

A defence is to take all major supervisory decisions in a collegiate fashion at the top level. In these cases only the agency can be sued as an institution. Nevertheless, should individual supervisors be sued, they must be provided assistance in the court proceedings, such as legal counsel and protection against any costs. Of course, if the supervisor is finally found guilty and not to have acted in good faith, the supervisory agency should reclaim any outlays.

The second issue on effective supervision is that the supervisors must have a sufficiently large and skilled staff with satisfactory resources. With too few, or not adequately skilled supervisors, bank problems may not be detected early enough which may lead to major crises. With too many supervisors interventions in the banks might become excessive, thus interfering in banks' daily business. Supervisors should never act in a way which implies that they assume responsibility for the banks' ongoing activities, so called supervisory capture.

The third supervisory issue is that the supervisors must have a broad range of powers at their disposal to address different banking problems. This range should include limited measures such as requesting changes in the bank's management or requesting improvements in risk manage-

ment or control management. Also more far-reaching measures should be available such as stopping or restricting certain payments or activities, or the ultimate measures, to withdraw the banking license or to liquidate the bank. Preferably, some of these powers should be "pro-active" so the supervisor is allowed to act even before a problem becomes acute, for instance when the capital ratio is declining but has not yet reached the minimum level.

As a fourth issue, the supervisors must have a well defined, integrated and documented work process for the conduct of supervision. Since a few years there is a strong development towards what is known as risk-based supervision although a globally agreed definition of this concept is still lacking. Under risk-based supervision the supervisory authority focuses its main resources to monitor the major risks. With this approach, the priority is on the larger banks but also on banks with more risky activities and on banks which have shown to be weaker or more vulnerable than the others. A risk-based approach also means that the supervisor focuses on collecting information from banks about those activities or operations where there might be material risks. Since risk-based supervision does not encompass equally detailed scrutiny of all risks and of all banks it is important to check the corporate governance of the banks, including the control mechanisms. Provided that the board and management is of good quality, that there is a good balance between the board and the managers and staff, and that the control functions such as the internal audit do a good job, the supervisor can to some extent rely on their reports.

In summary, risk-based supervision generally leads to less intervention in banks as long as they are well run. Of course, this does not mean that some banks will never be supervised – all banks must provide their periodic supervisory and financial reports and they will also receive onsite visits, although some banks less frequently than others. But we should be aware that risk-based supervision also brings its own risks, namely that some minor banks may run into problems which are not detected in time – depositors and other counterparts may suffer losses.

Apart from risk-based supervision, an efficient supervisory process also includes a documented structure of approaches to collect and analyse information and to use this as a basis for taking action. The main approaches are offsite monitoring, onsite examinations and ongoing contacts with the bank. Offsite monitoring implies analysing regulatory and financial reports from banks, from their internal and external auditors, and from external media. Onsite examination is used to ensure that the bank actually operates as they report and to gain further insights into the bank's governance, plans and activities. In line with the risk-based

approach assessors no longer examine all transactions and documents but rather at a sample of those, including the more important ones. In addition to offsite and onsite, modern supervision includes closer, more frequent and less formal contacts between supervisors and banks. These contacts take place on different levels – on the top level of boards and managements but also on various mid-levels and staff levels. Sometimes also the owners are contacted. The aim of the contacts is to "know your bank" meaning that the supervisors should assess how the bank operates, and if the bank managements and owners are competent and honest. Contacts, onsite and offsite supervision should be integrated so that the onsite supervisor benefits from the know-ledge gained from the offsite monitoring, the contacts and vice versa. A good way to achieve this is to establish groups of supervisors composed of offsite as well as onsite staff who are responsible for the supervision of a specific banking group.

## Conclusion

During the last twenty years, many countries have embarked on reforms of the banking and financial services industry. Such reforms have provided obvious benefits in the form of a better functioning financial sector that supports economic growth and financial stability.

Old-fashioned regulations and supervision leading to reduced efficiency have in most cases been terminated. Some regulation and supervision need to be retained, amended or even introduced but these should be in more flexible and market-oriented forms than earlier. The balance between costs and benefits of reforms must be secured, as well as the balance between the objectives of financial stability and efficiency. The goals of each country's regulation and supervision should be explicit and objective, and may include overall financial stability as well as consumer protection. The regulation should promote a wide range of banks and other financial institutions to conduct their activities on a level playing field. The degree of regulation and supervision should be commensurate to the size, nature and complexity of banks' activities as well as to the potential negative side-effects for banks' counterparts, including society as a whole.