

The Dialogue Between Supervising Authorities & Supervised Institutions

By Peter Cooke

AS a former Bank regulator, I feel at the same time both at home in this setting among financial sector institutions - Building Societies and Housing Finance bodies - and also on somewhat alien ground, because, in my country at least, the bank regulator does not supervise the major mortgage finance institutions. So you must bear with me if some of my comments do not always hit the target in your particular field of activity.

I am delighted, however, to be able to participate in your discussions and also pleased with the subject chosen for this particular session. Pleased because, to this regulator at least, dialogue is at the heart of the process through which the authorities can do their job most effectively and the supervised institutions can operate with an appropriate degree of freedom, but not licence, in an orderly

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market-place. It has always been my strongly held view that the interests of the regulator and the regulated are broadly the same in the financial sector and that dialogue is thus both a natural and a necessary process. Regulation in financial markets is all about balance. A sound market needs sound players and vice versa. The system must balance, on the one hand, the need to give the market its head to innovate, initiate and compete and, on the other hand, the need to sustain a sound financial infrastructure for the benefit of the professional players and all those who use their services. "Regulation not strangulation" as the Governor of the Bank of England once remarked.

It is important, at the outset, to make a distinction between regulation and supervision. Regulation lays down the framework of law and administrative rules within which regulated institutions operate. Supervision is the process whereby the affairs of regulated institutions are monitored and their soundness and probity assessed. The regulator and the supervisor must, of course, always be able to act with authority and be underpinned by legal powers. Regulation, however, should sensibly be constructed through a process of consultation; supervision should always importantly include a process of dialogue. Regulation cannot always be pursued through dialogue. Certain elements of the framework within which financial business is undertaken have to be laid down by the authorities. The continuing erosion of capital adequacy in the face of competitive

pressures in the 1970's, threatening the soundness of the international banking system is one example of when the authorities have to step in and lay down some basic rules - to put in a peg to underpin the market. Even this formal exercise of supervisory authority, however, and the structuring of the underlying legislation can be and should be the result of a consultative process, but it is not dialogue between the parties in the same sense and to the same degree as may occur in the supervisory relationship. So I would characterise the ideal relationship between the authorities and the individual institutions as one of a continuing mode of **consultation** in relation to the regulatory function and of **dialogue** in relation to the supervisory function.

Let me begin my remarks by saying something about the process of consultation and dialogue in my own country. I would then like to widen out and discuss some aspects of the inter-relationships between the supervisor and the supervised in the European community context and finally to address the process in a global setting. My thesis - if one is to be discerned - is that whatever the scale of the environment in which the interlocutors carry on their business, dialogue is of great importance; but the wider the environment and the perspective the more difficult the process. It is the responsibility of both supervisors and supervised to ensure that machinery is in place and constructive relationships established so that a true dialogue can be pursued and

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not an exchange in form only which can so easily become a dialogue of the deaf.

In the United Kingdom, the Bank of England's approach has traditionally been described as participative. This does not mean that the regulator becomes a pushover, faced with a stropy and onery constituent. For at least a century, the Governor's eyebrows, in the absence of statutory authority, have been formidably powerful. The problems experienced in UK financial markets in the early 1970's, which came to be known as the secondary banking crisis, led in the late 1970's to the enactment of the Banking Act of 1979 which gave statutory backing to the exercise of the Bank's traditional authority. This legislation was further refined in 1987 when a second Banking Act extended those powers further. These Acts are, however, broadly drawn and the greater part of the detailed day-to-day supervision is left to the administrative discretion of the Bank. In regular contacts with institutions, the overall situation is carefully discussed; advice is given; medicine is sometimes administered (because, as Nanny says, you know it is good for you); the powers to require or enforce are seldom formally exercised. This framework of procedures evolves all the time. It needs to learn from the past. It also needs to be responsive to the changes taking place in the market and, for the supervisor to operate effectively, it has always been the Bank's view that he, or she, needs to be close to the market-place. This is the traditional argument for the involvement of the Central Bank in the supervisory process because, particularly in the case of the Bank of England, it is both **in and of** the market. Supervision can, of course, be undertaken by an institution at more arms length from the market, and often is very effectively, but its distance from the action makes it more likely that its supervisory regime will be more prescriptive and detailed.

The Bank of England's responsibilities of course only cover banking institutions. In

the United Kingdom, as you will know, the Building Societies Commission have responsibility under separate legislation for the regulation and supervision of the Building Society movement. I know less about the relationship between the regulators and the regulated in this sector, but I think it would be fair to characterise that relationship also as one in which dialogue is an inherent feature. There are some differences of degree, however. The Building Societies Act is more all embracing in its scope and endows the Building Societies Commission with quasi-judicial as well as regulatory and supervisory responsibilities. It is the Registrar of the Societies who approves their rules and has a more direct responsibility for the interests of Societies' members than a bank supervisor has for a bank's depositors. The provisions of the Building Societies Act are more prescriptive and thus more detailed than those of the Banking Act. But while the Building Societies' Commission may be endowed with a wider range of legal powers and responsibilities for the sector than the Bank, the prudential supervisory armoury of both bodies are rather similar and the process of dialogue between supervisors and supervised has many similarities.

Let me distinguish between the contact on broad regulatory policy matters and the relationship at the level of the individual institutions.

On broad supervisory policy matters, there will almost always be an extended consultation process with the industry before changes are effected. Consultation documents will be issued proposing changes in the regulatory arrangements and these will be discussed with representatives of the industry - typically through their professional trade associations - the British Bankers Association or the Building Societies Association. Typically, close working relations are maintained between

the staffs of these Associations and the supervisors. These contacts can often be used as early sounding boards for supervisory initiatives as well as early warning listening posts for the evolving views and practices of industry representatives. Regular meetings are held between the supervisors and the senior representatives of the trade associations to discuss together a broad range of issues of prudential or operational concern and these fora provide a setting in which representations can be made informally, but nonetheless forcefully, by the industry's spokesmen.

In my country, and I suspect most others, this process often can follow through to the legislative processes. Typically a draft bill presented to Parliament would normally be preceded by a White Paper which sets out the Government's proposals and a broad explanation of their rationale. Following its publication the debate is then carried forward in the legislature itself. Over the past 25 years or so, however, the practice of publishing "Green" Papers has grown up. Proposals outlined in these papers are less of the character of tablets of stone. They are more discussion papers with an outline of the authorities thinking, but not as firmly based as a White Paper. Some proposals indeed are now couched in documents described as white papers with green edges or green papers with white edges depending on the degree to which the Government indicates it is open to persuasion on the issues involved. Normally a process of consultation with those directly involved will be formally undertaken to discuss the proposals outlined in these green, and greenish, paper.

At the level of the individual institution - the micro-prudential level of supervision - personal contact and regular exchange between supervisor and supervised are a key element. Both in the Bank and the Building Societies Commission individual supervisors are responsible for a clutch of institutions so that at the operating level the supervisor will know each institution in his charge rather well. The supervisory

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system is based on regular sets of statistical returns cataloguing the evolving fortunes of the institutions, but these are always supplemented by face to face meetings between the supervisor and senior management of the supervised institution. Importantly so, because it is ultimately the judgements about the quality and probity of management which are the critical assessments by the supervisor. It is also valuable, in UK experience, that these meetings should take place, at least some of the time, on the supervised institution's home ground: management often appear in a different light when observed in their natural habitat rather than in the more rarefied environment of the supervisor's offices.

These contacts can, and often do, usefully extend across a wide spectrum of the institution's representatives. There will normally be a fairly formally structured annual meeting involving top executives and senior management, including particularly those with the finance function. For complex groups, there will also be meetings with those responsible for major subsidiaries, also the heads of different line functions - for example, lending, treasury and systems control. Depending on board structures, there may be discussions with non-executive directors: this I believe is encouraged among the building societies where, because of their mutual status, the non-executive directors have a rather special responsibility as guardians for the members who cannot seek accountability from management in the same ways as shareholders can. In the banking sector these contacts are less common but can be particularly appropriate when the activities of the bank's audit committee is being discussed. As you know, in the United Kingdom a practice has developed, both for banks and building societies, for tripartite meetings to take place between the supervisor, the supervised institution and that institution's external auditor and it may be desirable that the Chairman of the Audit Committee, who should be a non-executive director, be-

comes involved in these meetings.

All these contacts will be useful, depending on the circumstances, but I do not want to give the impression that the UK system is a complex web of interwoven chatty meetings and contacts which give management no time to manage and supervisors no time to do anything else. Of course, the supervisor has no wish to overregulate, to stand in the place of management and to be seen as taking responsibility for that which is properly the concern of management. Normally he does not have the time to do so anyway. But the variety of the potential contacts and discussions within one organization are valuable in building up a mosaic of the institution over time, to identify the depth of management talent which may be available (or its absence) and to enable problems to be identified early. It has always seemed to me to be very important that any supervisory system needs to establish that degree of rapport between supervisor and supervised which encourages management to confide in the supervisors, to seek their advice and help when problems emerge and to discuss them at the earliest possible stage. Frankness in these exchanges is very important too: when I was a regulator, I used to say that a half truth was as bad as, if not worse than, an untruth.

The other major benefit from this process of dialogue is that it enables the supervisors to learn from the practitioners. There is a lesson for supervisors in the old jibe about teachers: "those who can, do; those who can't, teach". Supervisors must not sit in an ivory tower and if they are not experienced in the business themselves, they must at least have some capacity to sit alongside those who are in order to understand how the business is done so as to determine how to regulate different activities appropriately.

What I have said up to now, I hope, gives you an impression of the way in which the dialogue is pursued in the United Kingdom. For the remainder of my remarks, I would like to extend the discussion into the international field. I would like to do this first in the context of the developing processes in the European Community and its institutions and then say a few words about the process in the wider international context. In broadening the focus, I am not too sure whether "dialogue" is the right word - it may become a trilogy or a quadrilogue or perhaps ultimately in the global context, a millelogue - and of course the more the numbers increase the more complex and difficult it becomes to extract real benefits from the process of dialogue and debate, let alone achieve a consensus at the national level.

I look first at the European Community scene, as we all seek to make a positive contribution to the creation of the structures within which the single internal market can operate effectively, in particular in the field of financial services. Here the web of relationships become more complex, but the essential object of them I suggest should be the same as at the national level - to promote a sound and efficient system of financial intermediation for the general good and, within that object, to promote the well-being and success of competitive and efficient institutions within the system. The process is complicated because the machinery of the Commission and of the other Community institutions are an additional layer above the national supervisor and the national industry bodies. In practice, however, there are many similarities to the process of consultation and dialogue at the national level.

A major difference of course is that the Commission at present at least, and probably prospectively too, has no formal supervisory responsibilities for individual institutions. It does, however, have a monitoring responsibility for the implementation at the national level of the various

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provisions of the different Community regulations and directives. This will become an increasingly important issue in the years ahead as the range and scope of Community legislative instruments increase and will almost inevitably involve the development of closer links between Commission officials and national supervisory authorities. It is not clear to me at present how far this is likely to involve contacts between the Commission and individual supervised institutions but probably the Commission itself and national authorities would hope these would be the exception rather than the rule.

As the integration process has matured, the Commission, with its responsibility for promoting the objectives of the Treaty of Rome, has improved its consultative procedures with the financial service industries. No longer are academically inspired undigested initiatives sprung upon a startled financial community. Regular meetings are held between Commission officials and European based trade associations - in the case of banks the Federation Bancaire, in the case of mortgage institutions their own relevant European organizations such as the European Federation of Building Societies. At the early stages of discussion on new Community initiatives, technicians and specialists from the different trade associations or individual institutions may be invited to participate in preparing the ground for new legislative proposals whether at specially organized seminars and workshops or alongside national officials, as national experts, in Commission working groups. But for financial institutions generally the message is the same as at the national level - keep close links to the policy makers through the trade associations and the bigger and more all embracing those associations are the bigger the likely effective clout in the debate.

So, in the EC context, it is important - and I am sure this is a point of which you are all well seized - that national trade bodies should seek to operate **through** their na-

tional authorities to influence the course of events in Brussels. In many cases if the national authorities and the national trade bodies are at one, the interests of the industry will be most effectively furthered through the official national representatives. The diversity of practice and law in the different member states means that similar institutions in different EC countries will have quite diverse interests and for the moment at least their interests are often best pursued through the haggling process between national officials. One day, however, if the single market concept consolidates and deepens, the impact of industry representatives speaking for themselves within the Community machinery with a single voice for that industry in the Community may become more important and effective. This at present, however, seems to be some way off and, of course, the Community machinery has not been constructed to incorporate formal relationships which are non-governmental. It is to the credit of the Commission officials that over the years they have worked hard to develop the informal links which enable private sector interests to make a useful contribution.

Now, let me extend my remarks into the wider international scene. As you know, in the banking field the international debate on supervisory matters has tended to be concentrated in the work of the Basle Committee on Banking Supervision. These representatives of the major industrialised countries meet regularly to discuss their systems and their practices and seek to improve the effectiveness and coordination of national regulatory systems. More recently, similar efforts have been pursued internationally among those responsible for the business of securities markets and investment activity. Beyond the European Community there is, of course, no overall legal context into which this process of co-operation can be structured. There is no international law

covering these and other similar activities and thus no legal form for the recommendations of the major countries' supervisors other than to exhort their adoption within the framework of each national legal system. So the process that has evolved can be described as the four 'Cs' - contact, co-operation, co-ordination and (as with minimum capital ratios) convergence - but it can only be made effective if countries want it to be effective. Dialogue, or "multilogue", is thus the essential process.

The development of the financial services industry in recent years has added another dimension to these exchanges. I know I am addressing the question of dialogue between supervising authorities and supervised institutions but these days, in the field of financial regulation, there is a very important and necessary dialogue among the regulators themselves between different regulatory jurisdictions, both within national systems and internationally. These occur increasingly not only between different national regimes in the same sector of financial business, but also across the whole range of financial service activities. The range and scope of many financial service institutions is now becoming so diversified that their multifarious activities fall to be supervised by different regulatory bodies. This raises difficult practical and jurisdictional complications about who takes the lead, who has the overriding responsibility, how do you handle jurisdictional conflicts arising from the need to fulfill different legal imperatives and how do you avoid an excess of regulation. In a specialised area such as mortgage finance these pressures are perhaps not so pronounced as in the banking sector but you have all probably had some experience of them.

These interweaves of regulatory responsibilities greatly complicate the dialogue between supervisors and the supervised at the international level. Also, of course, the financial services industry is not geared up to operate globally. Conferences such

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as this are enormously valuable, I am sure, in bringing together representatives from very many countries, but few parts of the industry have a formal multinational framework beyond that which exists within the European Community. Yet in banking and in many other areas of financial services we have a global market-place. The need to consider, and perhaps organize, the industry on a more comprehensively multinational scale may be increasingly important in the years ahead.

We saw the case for it, as well as the difficulties in achieving it, during the developing countries debt crisis in the 1980s. In handling the intensely difficult process of organizing an estimate of the exposure to the major banks of the world to the developing countries, the banks had great difficulty in marshaling themselves effectively. A new forum was created to handle this - the Institute for International Finance - to try to provide a focus for the major banks of the world on these and other issues of common concern, but the progress for all sorts of reasons, good and bad, has been slow. It has, however, become a place where bankers and officials can come together to discuss global financial issues.

Another particular initiative has I think been useful. When I was Chairman of the Basle Committee on Banking Supervision, following the principle that practising bankers and supervisors need to keep in close touch, I set up an annual meeting with a group of the Chairman of the European countries banking federations - an informal meeting, low profile, at which the important macro-prudential, and some not so macro-prudential issues in the banking field could be aired and discussed and the particular concerns and preoccupations of each side put on the table and frankly and freely debated. A small step but a useful one to extend the principles of dialogue which I discussed earlier in my

remarks on national environment.

Mr Chairman, I have ranged wider than the particular concerns of the industries represented here today but I believe that the topic of this session goes to the heart of the way in which all financial service business with fiduciary responsibilities to customers, clients, depositors, investors or policy holders need to approach their relationships with the authorities who watch over their activities. I hope we have had a fruitful dialogue; I hope too we may have reached a consensus on these important issues. ■

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institutions must be mobilized for their use.

CHF has developed and tested a program model that transforms the enabling strategy promoted by the United Nations into action. It unites formal sector financial institutions and nonprofit intermediary organizations in a partnership that enables low-income families to organize, plan, and carry out their own shelter and community improvement initiatives. As resources become available, Shelter the World is applying the program model on a global scale, providing a mechanism for formal sector financial institutions to provide shelter financing for the poor of the developing world. ■

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One of the major problems that private financial institutions have at present is how to avoid the risk of housing loans. Most private financial institutions raise the funds

for housing loans mainly from the short-term deposits that their customers make. The private financial institutions have to bear the risk of changing interest rates in the long term when they make housing loans.

Compared with a business loan, a housing loan is usually a smaller amount and has a longer repayment term. The interest rate is lower than that of a business loan. In short, private financial institutions have to bear the risk, in spite of a lower profit, when they make housing loans.

As mentioned before, the demands for business loans are decreasing, while the demands for individual loans such as housing loans are increasing. In this situation, many private financial institutions have put greater emphasis on housing loans and made efforts to decrease the risk. For instance, they adopted adjustable-rate housing loans to avoid the risk of changing interest rates. Furthermore, some private financial institutions began to securitize their housing loan credits.

The Japanese economy has so far depended on exports. Now, it is under international pressure to make its economic structure more dependent on domestic demand. One of the effective measures to accomplish this international obligation is the promotion of housing construction, because the housing industry links with other industries. It is not too much to say that the key to promote housing construction lies in the further development of housing finance by both public and private financial institutions. It is expected that, in the near future, the provision of housing finance by both public and private financial institutions will play a more important role not only in the housing industry, but also in the nation's economy. ■