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The Twilight of Banking Supervision

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The Twilight of Banking Supervision

Though the problems I describe in this address may also exist elsewhere, I will be talking basically about banking supervision in Europe and, in particular, in Spain. Let it be understood from the outset that I mean “supervision” in the broad sense of regulation, oversight and resolution.

- Though it already had excellent inspection teams, the Spanish supervisor applied a series of criteria and mechanisms to address the recent crisis, but they were not fit for purpose and the treatments applied were largely unsuccessful. Nor did they work well in other European countries for a variety of reasons.

- I have always believed that crises and the lessons learned from them revamp and enhance supervision. Not so in the last crisis. In fact, I believe that some of the rules issued by the Basel committee, which have been almost universally adopted, and the new regulations and practices resulting from European banking union (EBU) are quite clearly counterproductive.

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- Supervisory decline has gradually taken hold since the end of the 20th century, when a school of thought emerged which sees financial regulation as basically perverse, and as a brake on innovation and the development of glitzy new products. However, this deregulatory approach has only fostered malpractice and increased banks’ exposure to risk, undermining solvency and the stability of financial systems. Meanwhile, the pervasive idea behind the Basel II capital regulation, in force since the end of the 20th century, is that banks should set their own minimum capital requirements using mathematical modelling and stress tests as the new wonder tools to determine risk. These turned out to be mere theoretical exercises, however, and unreliable at that. Furthermore, some countries prioritized procedural controls over asset valuation, conceptualizing supervision as a means of helping banks rather than a mechanism to pinpoint possible difficulties and demand solutions of problem institutions. Spain was one of these.

- The European banking union (EBU) finally created in 2014 with the ECB at its core was seen as the panacea for the ills of the financial system. changing and harmonizing the regulation, oversight and resolution of banks in Europe. Sadly, however, its effect has been to hasten the decline of once highly effective supervisory arrangements.

- Let me tell you a couple of anecdotes, which I think you will find revealing. About 18 months ago, I happened to cross paths with a Spanish auditor for whom I have the utmost respect, but as we talked he reeled off a series of notions that left me flabbergasted. "Asset valuations and on-site inspections are a thing of the past," he argued, and "When impaired loans and interest are refinanced, the balances concerned should be treated as normal and no special provisions should be required, while refinanced interest should be recognized as current." Meanwhile, "fresh capital should be used to cover underlying losses and not provisions, which should be phased out entirely."

- I argued back with conviction but without success. We were worlds apart. My auditor friend's universe seemed to ignore the reality that banks conceal their problems, which is why they must be inspected. I cannot this, and I have the grey hairs to prove it.

- Let me tell you another significant story: Andrea Enria, recently appointed Chair of the ECB's Supervisory Board has publicly acknowledged that there are serious weaknesses in the Single Supervisory Mechanism (SSM), and he is on record as saying that "not all bad loans are classified as delinquent, even though they may be legally in default".

  We may well ask, then, what is actually happening to our supervisory system?

  Let me begin with regulation. For the last couple of decades, International Accounting Standards (IAS) have increasingly pushed the recognition of expected losses and related provisions into the background in favour of losses actually incurred. Yet this creates a major loophole, since expected losses have historically always been a multiple of actual losses, and they lie at the heart of insolvency. Meanwhile, failure to recognize and provide for expected losses opens the way to the recognition of uncollectable interest income. Expected losses were finally addressed in an IAS issued in 2018, but it is still based on internal models and its scope is highly restricted, so that it has hardly any more demanding than the existing rules.

- Minimum capital requirements have been raised, meanwhile, but they are artificially padded out with non-equity components covering eventual losses in respect of "unknown unknowns". Goodwill and tax assets are the perfect examples. Furthermore, capital requirements are established by the banks themselves as a proportion of risk-weighted assets, but the risk assessments concerned are open to manipulation and are not subject to proper inspection.

- As if that were not enough, two parallel methods currently exist to calculate capital. On one hand, there is conventional equity defined as the difference between actual assets and liabilities. On the other, there is the new regulatory capital, with all the drawbacks I have described. Among other matters, this duality allows banks to operate with equity equal to just 3% of total assets while scoring 12% in terms of regulatory capital. This is an incentive for managers, auditors and supervisors alike to use the new regulatory system, which is a lot less demanding.

- It is true that Basel III also sets the capital requirement in proportion to total assets (the so-called "leverage" ratio) so as to avoid the problem of manipulation of asset risk, but the proportion of 3% is nugatory and should be more than doubled.

- In terms of supervisory mechanisms, on-site case-by-case inspections have been replaced by mathematical modelling and stress tests. However, the models used are designed by the banks themselves—even those that are known to sweep their problems under the carpet, and while their procedures may be inspected, the fair value of their assets is not. This ducks the adjustment of asset values, which is indispensable if a bank's true level of capitalization and actual results are to be established.

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- Against this worrying backdrop, the ECB took on the mantle of supervisor of Europe's largest banks in 2014, with responsibility for institutions accounting for some 80% of the total assets in the financial system. In this role, the supervisory policies and criteria it has championed have further darkened the outlook, despite some ostensible successes. Let me cite some pearls of the official wisdom. “Accounting matters are not the business of the supervisor, who should not question the information reported by the banks;” “Inspections should be short;” and “Written demands should be avoided.”

- Moreover, the ECB seems to believe, on questionable theoretical grounds and in view of an alleged “shortage of resources”, that it should be up to the big audit firms and select external consultants to crunch the numbers and diagnose the banks’ overall health. This would replace public servants (the supervisory agencies) with private firms, which have a history of misdiagnosing the health of financial systems.

- The resolution mechanisms established by the ECB are complex, opaque, difficult to coordinate with the supervisory authorities involved and, in my own opinion, only half baked. Meanwhile, the “bail-in” system it has created places the onus for bank rescue not only on the shareholders, which is logical, but also on the holders of convertible debt, which is less so, because these investors are not generally able to verify information and they anyway have no say in an organization’s management. Be this as it may, the high interest rates paid on debt of this kind have a detrimental impact on profit and loss. The aim seems to have been to regulate catastrophe but not to avert avert it. Leaving aside the possibility that investors may in future become more wary of convertible securities given the opaque resolution measures adopted in recent cases, these circumstances should encourage calls for material changes in the system.

How can this picture be explained? The system’s design seems to be inspired by the following considerations.

The ECB is apparently not much interested in the problems of the present or in early warning mechanisms. Instead, it has prioritized a “forward-looking” approach based on theoretical future estimates. In this context, its panacea now seems to be better governance. This is all very well and good in itself, but it is a moving target and in any case only partially achievable. Meanwhile, governance will displace opportune, timely verification of banks’ solvency, diluting any preventive measures that might be adopted to correct problems while there is still time. Though the appointment of the banks’ senior officers is now subject to official approval by the ECB, other key issues that go to the heart of poor governance, like the clarity (or otherwise) of the financial statements, have paradoxically been sidelined.

A serious structural problem also exists, insofar as all of the European banking union’s supervisory mechanisms, including rescue, are paid for by the member states. This creates an asymmetry, and it may also encourage the common supervisor to relax while discouraging action by national supervisors, who could take the view, “It’s not our problem; let the ECB deal with it.” May I remind you here that Spain is the country with the highest concentration of bank assets supervised by the ECB, 90% above the European average compared to just 60% in Germany.

Experience has taught me that strict supervision can produce highly effective results even in the context of weak regulation. However, this is not currently the case. Furthermore, certain debatable supervisory practices now seem to have been accorded the status of law under a certain interpretation of the new regulatory framework.

Above and beyond the technical issues arising directly from the regulatory framework and supervisory practice, let me now move on to discuss other causes of weak supervision both by the European supervisor and the national supervisory authorities.

1. As a possible extenuating factor for the common supervisor, it might be imagined that the ECB has opted for the least rigorous rules and practices in an effort to harmonize supervision in what are very different countries, while preventing any outbreak of the grave underlying problems affecting certain financial systems and/or institutions. We are all too well aware of the vulnerability of countries like Germany, Italy, Portugal and Greece.

2. Feeble supervision may also reflect a certain lack of experience among the new supervisory teams at all levels. If so, the problem should be addressed as a matter of urgency.

3. As I have already said, some countries appear to conceive supervision, and even the interpretation of accounting rules, as a means of helping or protecting the institutions supervised rather than an instrument to identify banks' problems and demand that they seek solutions. the fundamental tasks of the supervisor.

4. The use of fundamentally unsound assumptions is a further factor that can inhibit the supervisor. Recent examples include the idea that a deep-rooted crisis was no more than a passing storm and that merely a matter of liquidity rather than insolvency, and the nostrum that a sinking bank might be able to ride out its problems simply by waiting for an elusive moment of stability.

5. Opposition from the financial industry is undoubtedly another reason for slack supervision, whether the banks act in concert or alone, as systemic institutions with the power to face down the supervisor sometimes do.

6. Then again, a supervisor may slacken its grip if it is trapped by its own past errors (commonly enough claiming victory ahead of the game), so that it becomes unwilling to admit to policy mistakes or make a U-turn.

7. Meanwhile, excess liquidity in the system can also cause the supervisor to relax, especially where the idea takes hold that business cycles are a thing of the past, that debtors will always find a way to settle their obligations, and that an expanding market will easily absorb fixed assets. The truth is, however, that supervision is actually needed more than ever when excess liquidity appears, because the extra cash sloshing around in the markets can easily be used to conceal cases of insolvency. Furthermore, it dulls bankers' sense of risk. Consider for a moment the unprecedented monetary expansion of recent years by the world's leading central banks. This may have been providential in the early years, helping kick-start economies and preventing collapse, but zero and low interest rates undermine profitability and can distort financial systems when they are maintained indefinitely. Moreover, easy access to cash is a source of moral hazard.

8. The fundamental reason for supervisory permissiveness, however, is the lack of political will on the part of governments and supervisors themselves, and of professional determination on the part of auditors, who tend to follow the official lead. This may be a matter of electoral calculation or prestige, or the result of a short-sighted fiscal policy that seeks at all costs to avoid spending public money,

which is of course an ideal goal, but one that is impossible to achieve without causing worse evils.

Meanwhile, we see that the European nations have accepted this new supervisory framework as if it were immutable, when it is actually a minimum structure, which each can and should strengthen as necessary to achieve a robust financial system The upshot of all this is that banks are today more vulnerable than ever and are likely to suffer grave problems if returns stay low but economic and geopolitical conditions grow worse. Even more worryingly, this is the situation more than ten years after the crisis broke and four years after most of Europe's banks came under the supervisory aegis of the ECB. The reality is that many of the factors that triggered the banking crisis, which gobbled up untold amounts of public money, are still with us today. The banking system has actually changed little, but supervision has grown ever feebler. There are many who claim that the banks are now safer, but this is akin to saying that lowering the speed limit for lorries carrying high explosives from 100 to 90 km per hour will make our roads safer, even though the traffic police no longer check drivers' tachographs, which they anyway manipulate.

Let me conclude with the overarching issue of responsibility. Evidently, a bank's own directors and managers must bear the primary responsibility for failure, especially towards shareholders and creditors. However, both internal and external auditors also have a responsibility, not only towards management, as they too often see it, but principally towards shareholders and investors, who rely on them to adopt many decisions.

What about the supervisor? As the provider of a public service, the banking supervisor is responsible to the country as a whole for ensuring the stability and solvency of the financial system, and for protecting depositors. But this responsibility is dynamic not static, since lax supervision provides an incentive for the market to engage in and intensify malpractice by transmitting the perverse message that "Nothing will happen whatever you do." Yet creeping negligence and wrongdoing can eventually cause bank failures and systemic collapse, leaving the taxpayer eventually to foot the bill.

All countries, including Spain, have much at stake in this game. The social and economic costs of our supervisory system's decline may turn out to be huge. Future generations should not to be asked to pay for the mistakes of the present.