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David G. Mayes

Research Department
12.11.1998

Improving Banking Supervision

SUOMEN PANKIN KESKUSTELUALOITTEITA • FINLANDS BANKS DISKUSSIONUNDERLAG

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The views expressed are those of the author and do not necessarily correspond to the views of the Bank of Finland

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Abstract

This paper explains how banking supervision within the EU, and in Finland in particular, can be improved by the implementation of greater market discipline and related changes. Although existing EU law, institutions, market structures and practices of corporate governance restrict the scope for change, substantial improvements can be introduced now while there is a window of opportunity for change. The economy is growing strongly and the consequences of the banking crises of the early 1990s have been worked through. Greater market discipline, in the form of a regime of quarterly public disclosure by banks of their capital adequacy, peak exposures and risk management systems, along with improved incentives, will help improve the prudential management of banks, reduce the costs of supervision, enable supervisors to focus on systemic risks and help customers determine the risks they face. Banking inherently involves the taking of risks, but transparency and improved public information about them will help all concerned manage the risks more effectively and greatly reduce the chance that the taxpayer will again be called upon to help rescue the banking system.

Keywords: Banking supervision, market discipline, disclosure, systemic risk, financial system oversight

Pankkivalvonnan kehittäminen

Suomen Pankin keskustelualoitteita 23/98

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Tutkimusosasto

Tiivistelmä

Selvityksessä kuvataan, miten EU:n ja erityisesti Suomen pankkivalvontaa voidaan kehittää lisäämällä markkinakuria ja tekemällä siihen liittyviä uudistuksia. Vaikka EU-lainsäädäntö, instituutiot, markkinarakenne ja yritysten hallintokäytännöt rajoittavat mahdollisia muutoksia, merkittäviä parannuksia on tehtävissä. Tähän on poikkeuksellisen hyvät mahdollisuudet nyt, kun taloudellinen kasvu on vahvaa ja 1990-luvun alun pankkikriisin seurauksista on selvitty. Markkinakurin lisääminen yhtäältä julkistamalla neljännesvuosittain tiedot pankkien vakavaraisuudesta, riskikeskittymien huippuarvoista ja riskienhallintajärjestelmistä, ja toisaalta parantamalla vallitsevia kannustimia auttaisi kehittämään pankkien liikkeenjohtoa, vähentäisi pankkivalvonnan kustannuksia, edistäisi valvojien keskittymistä systeemiriskeihin ja auttaisi pankkien asiakkaita arvioimaan omia riskejään. Riskinotto kuuluu pankkitoimintaan, mutta toiminnan avoimuus ja nykyistä parempi julkinen informaatio auttavat kaikkia asianosaisia hallitsemaan riskejä tehokkaasti ja pienentämään mahdollisuutta, että pankkijärjestelmän pelastamiseksi jouduttaisiin joskus uudelleen turvautumaan veronmaksajan apuun.

Asiasanat: pankkivalvonta, markkinakuri, tietojen julkistaminen, systeemiriski

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1 Introduction

During the 1990s there have been rude shocks to the notion that the increasing sophistication of financial management and the increasing ability to obtain rapid information from banks might substantially reduce the chance of banking crises and the need to use taxpayers' money to prevent a disastrous impact on the financial system. These shocks were particularly unpleasant in Norway, Sweden and Finland. Much has been done already in these countries to reduce the chance of a repetition but in this paper I explore how further steps might be taken through increasing the degree of market discipline. The paper is particularly concerned with Finland but given the existence of the 'single market' for financial services the arguments apply to the whole of the European Economic Area. Indeed the increasing integration of the EEA itself is making the task of supervisors in small countries progressively more difficult (Mayes and Vesala, 1998).

As I argued in a previous paper (Mayes, 1997), greater market discipline will be more effective as one part of a banking supervision regime with three main ingredients:

- Careful regulation of the right of establishment as a bank
- A system of supervision based on market discipline stemming from public disclosure
- An effective system for crisis management.

On its own it might achieve little and indeed could be counterproductive in fragile regimes. Hence, while my focus as on the middle category the extent to which the other two assist it forms an integral part of the discussion. The paper takes the constraints from the system of European Union law and the competences of EU institutions (including the ESCB/ECB) as given, and considers what can be done within that framework now, rather than considering what might be done in a longer time frame if European regulations were to change. However, it is argued, in the last section in particular, that the system of 'home country' supervision needs some further thought, as the responsibilities for systemic risk and bank supervision are divided between the host and home countries. This poses information problems for a host where a substantial proportion of the banking system is supervised by other authorities and may limit the ways which systemic risk can be managed.

In suggesting a process for implementation in Finland, the existing framework is also taken as the starting point. Wider reforms are not addressed. The issue of the choice between progressive change and a 'big bang' of making all the changes together is tackled. Lastly, timing matters. If initial disclosure reveals a banking system, which is more fragile than markets expected, then that in itself could be destabilising.

Finland has a window of opportunity for introducing the changes suggested. The economy is doing well. The prospects for growth in the European Union, although moderated by the Asian crisis, remain promising as Stage 3 of EMU begins. The consequences of the last banking crisis are being steadily unwound. Banks are returning to the sorts of balance sheets that will be thought satisfactory by markets and the public sector is well on the way to disengaging itself from bank ownership and support. However, these conditions will not last for ever. With the next economic downturn or external shock bank profitability will

deteriorate and initial disclosures may appear less attractive. In any time period there will always be a positive probability that an individual bank will get into difficulties and the method of resolution chosen for the first problem will be very important in giving a signal to the rest of the banking system. The regime therefore needs to be clear before that crisis comes.

The structure of the paper is as follows: Section 2 sets out the supervisory functions to be discussed; Section 3 rehearses the rationale for a more market-based regime; Section 4 then considers the key ingredients of a more market-based; Section 5 the main difficulties that its implementation faces in Finland, while Section 6 suggests how implementation could take place in the light of both the objectives and the difficulties.

2 The functions of financial system oversight.

There are three main sources of confusion in discussing financial supervision. The first is in the discussion of what such actions are intended to achieve, the second in the structures and methods used to achieve those objectives and the third is in the meaning attributed to the terms being used. The principal focus of this paper is on one specific means for achieving one of the objectives, namely the use of more market discipline rather than supervisor intervention to improve the prudential management of banks. However, implementing such a scheme successfully involves a much wider range regulatory activity affecting banks and this section of the paper seeks to set them out.

The objectives of public sector involvement are perhaps the easiest to disentangle, although in most jurisdictions they tend to be implicit and hence have to be inferred from what has been implemented. Normally the public sector has *two objectives*:

- Systemic stability
- Consumer protection

(Goodhart et al, 1998).

In what is probably the most comprehensive recent survey of the problems and how they might be tackled in an embracing framework, the Wallis Committee distinguishes *three* main *functions* in its Report Australia, *The Financial System: Towards 2010*:

(i) the regulation of 'conduct' and 'disclosure' for financial institutions
(ii) prudential regulation (financial safety) and
(iii) systemic stability

and advocates the establishment of a regulator for each function ((i) Corporations and Financial Services Commission, CFSC, (ii) Australian Prudential Regulation Commission, APRC, (iii) Reserve Bank of Australia, RBA). The RBA is also responsible for monetary policy and the regulation of payment systems in this framework. Payment systems are clearly a component affecting all three functions.

What this Australian approach does, is effectively divide up the consumer protection objective in two. However, effective prudential regulation also

contributes to making the task of maintaining systemic stability easier. So the items are interrelated. The emphasis in the Wallis Commission discussion is on 'regulation'. However, it is not necessary to view the way that the public sector involves itself in these issues just from that perspective. In a second recent comprehensive survey, Goodhart et al. (1998, p. 189) cut the cake slightly differently, distinguishing the approaches of:

Regulation (the establishment of specific rules of behaviour)
Monitoring (observing whether the rules are obeyed)
Supervision (the more general observation of the behaviour of financial firms)

as *means* of addressing the regulatory goal. There are other approaches. Merton (1995) suggests distinguishing between *functions* in the sense of financial services: financial intermediation, risk management, etc.

There is no simple paradigm for implementing such systems in practice. Structures of financial supervision vary considerably across countries, even within the European Union. The effectiveness of the system and the effectiveness of a more market-based regime are affected by the structure chosen. The structure chosen often reflects decisions made in the past, usually implicitly rather explicitly, about the purpose of regulation.

Attitudes towards what should be done and how it should be organised tend to be heavily influenced by the prevailing regime and experience with it. There are several fundamental questions:

- Are banks separately regulated from other financial institutions?
- Is there a distinction between responsibility for the stability of the financial system as a whole and the supervision of individual banks?
- What functions of banks are covered by the specific regulator and what by regulators of general business practice – advertising standards, consumer protection, etc?
- How far do the powers of responsibility for the stability of the financial system extend – into the degree of monopoly?
- What powers are there for crisis resolution?

It is unusual for all functions to be the prime responsibility of a single body and the Wallis proposals are well towards the neater end of the spectrum. In many jurisdictions, not only may different functions be assigned to different bodies but responsibility for a single function may be shared. Normally, if there is a 'conduct and disclosure' regulator much of that function will be to administer rules set for the whole economy in the particular instance of the financial sector. As the Wallis Report puts it, '[while a]s a general principle, and to avoid regulatory inconsistency, economy wide regulation should not exclude the financial system ... the complexity of financial products and the specialised nature of financial markets has led most countries to establish specialised regulatory arrangements for the financial sector.' (p.17).

Table 1 cuts the functions of supervisors identified by Wallis in a slightly different way in order to highlight seven aspects that affect the applicability and effectiveness of a more market-based regime. Table 2 sets out the position for Finland. The central bank (Bank of Finland) is responsible for the stability of the financial system and for the payments system but the supervision of financial institutions is primarily the responsibility of a largely separate Financial

Supervision Authority (FSA). Although responsibility for the FSA also lies with the Board of the central bank and the FSA shares common services with the Bank of Finland. Some financial institutions such as insurance companies lie outside the ambit of the FSA. Insurance companies play a special role in the Finnish financial system as they administer funds that are compulsorily contributed towards the payment of occupational pensions. Since responsibility for the pensions system lies with the Ministry of Social Affairs it is the regulator of insurance companies in this regard. The primary concern of the FSA is prudential issues but it does have a somewhat wider regulatory role for Finnish banks, spilling into other aspects of commercial behaviour as laid down in the Credit Institutions Act (1993), such as Chapter 10 on Consumer Protection.

Table 1. **Functions of financial system oversight**

1	Prudential management of individual banks
2	Systemic stability – crisis resolution
3	Supervision of other financial institutions – including payment and settlement systems
4	Competition – regulation of entry
5	Management of deposit insurance
6	Fair trading
7	Corporate governance Reporting Structures Auditing Accounting standards

Tables 1 and 2 are somewhat more extensive than might be expected as corporate governance is a key determinant of the effectiveness of more market-based supervisory regimes. If incentives are to work well there needs to be a clear identification of property rights and avoidance of conflicts of interest. However, the system of auditing and accounting needs to be such that market information is understandable, verifiable and comparable. To some extent the Financial Supervisory Authority has jurisdiction in Finland over all of these and indeed the chapters relating to corporate structures and the keeping and auditing of accounts are among the most extensive in the Credit Institutions, Commercial Bank, Savings Bank, Co-operative Bank and Postipankki Acts (1993). However, the provisions fit within the overall framework of the Companies Act (1978, revised 1997) and the Accounting Act (1973 as amended).

Table 2. **Responsibilities in Finland**

	Function	Responsibility
1	Prudential management of individual banks	Financial Supervisory Authority[1]
2	Systemic stability – crisis resolution	Bank of Finland / Ministry of Finance / Financial Supervisory Authority[2]
3	Supervision of other financial institutions – including payment and settlement systems	Financial Supervisory Authority / Ministry of Social Affairs[3] / Bank of Finland[4]
4	Competition – regulation of entry	Financial Supervisory Authority / Office of Free Competition / EEA home country supervisors
5	Management of deposit insurance	Ministry of Finance / banking industry organisations
6	Fair trading	Financial Supervisory Authority / Office of Free Competition / National Consumer Organisation / Central Criminal Police Money Laudering Unit
7	Corporate governance	
	Reporting	Financial Supervisory Authority / Stock Exchange / National Board of Patents and Registration
	Structures	Financial Supervisory Authority / Ministry of Trade and Industry
	Auditing	Financial Supervisory Authority[5]
	Accounting standards	Financial Supervisory Authority / Ministry of Finance[5]

[1] The FSA, although independent, has common services with the Bank of Finland and has a Board member of the Bank as its Chairman.
[2] The ESCB/ECB and the Commission of the European Communities also have responsibilities particularly for cross-border implications.
[3] The Ministry is responsible for insurance companies.
[4] The ECB/ESCB also has responsibility for payment systems.
[5] There are Accounting and Auditing Acts administrered by the Ministry of Trade and Industry plus self-regulatory bodies, the Auditing Board of the Central Chamber of Commerce and the Regional Auditing Committee of the Chambers of Commerce.

In many respects the most important provisions concern the control of entry and exit. Banking licences provide a measure of rent to those permitted to be banks if the entry restrictions are at all onerous. They also provide a very important opportunity for the supervisory authority to exclude organisations over which it has any doubts. However, there are two restraints on this, first when banks have already been registered and, second, in the EEA where other national supervisors make (or have made) the decision over initial registration. Thus while the Financial Supervision Authority recommends to the Ministry of Finance who shall be registered (or indeed be deregistered) the main function in practice at present purely relates to registration of new Finnish institutions, extra EEA institutions

whose first point of entry to the EEA is Finland and to EEA institutions who wish to set up a subsidiary rather than a branch in Finland (ie a very limited group). Powers of compelling, managing or avoiding exit are, however, much more real and apply to all banks registered in Finland. In the event of insolvency and the failure of a bank to act voluntarily the FSA can have its licence cancelled and place it in liquidation. (Technically the actions are taken by the Ministry of Finance on the recommendation of the FSA.)

Lastly the operation of market incentives will be affected by the nature of the insurance that the parties can take out to avoid the direct consequences of bank distress and misguided actions. How well the system of supervision works and the extent of moral hazard depend in part on the structure of the system of oversight of the financial system. If the prudential supervisor is readily able to organise a bailout then the moral hazard will tend to be increased. Following recent changes deposits in Finland are now protected only up to a maximum value of 150,000 FM (about 30,000 USD). Legislation is currently in progress to remove implicit guarantees to other creditors by the public sector over and above their rights under liquidation. The main guarantee has taken the form of a Parliamentary resolution. At the time of the banking crisis at the beginning of the 1990s, the Ministry of Finance had rather wider responsibilities for banking supervision (including responsibility for the FSA) and hence the explicit and implicit guarantees it offered through access to taxpayer funds were considerable. Much of the point of the changes in the supervisory structure that have taken place since (Table 3) is to help convince people that in any future case of bank distress the insurance available will be strictly limited. A more market-based system will help reinforce that.

However, it is not the purpose of the present article make judgements about the appropriateness of the specific regime in place in Finland nor to recommend changes although the existence of some drawbacks will be evident as in almost any other existing system. The purpose is to explore the extent of the opportunity to introduce more market-based measures.

Table 3. **Main changes to the financial system in Finland since 1992**

(a) Financial Supervision
Transfer of supervisor FSA from Ministry of Finance to Bank of Finland
New banking legislation tightening up preconditions for registration as a bank
Reorganisation and increase in size and resources of FSA and change in focus from compliance monitoring to risk assessment.
Issuance of new set of banking regulations
Membership of EEA then EU and adoption of EU compatible legislation
(b) Banking System
Wave of mergers encouraged by the authorities eliminating many small savings banks.
Resolution of larger banks and assumption of non-performing assets by the state.
Restructuring of co-operative banks.

3 The rationale for a more market-based regime

The successful implementation of a more market-based supervision regime is expected to offer benefits on a wide front (Ledingham, 1995). Not only are gains expected for banking supervisors in the effective and efficient execution of their tasks but also for all the stakeholders in the banks themselves: – owners, managers, depositors, borrowers and creditors. Most important there are benefits to the public at large both as taxpayers and as employees and consumers through the reduced risk of banking crises and the consequent difficulties for the economy as a whole. Of course, no system of banking supervision is a panacea. Banking inherently involves taking risks but it is the prudent management of those risks that defines a successful bank. A successful supervision regime will provide effective incentives to keep the quality of management of risks by banks above the minimum acceptable level and should ensure that, in the event of difficulty in one or more individual banks, this does not spill over to the detriment of the banking system and economy as a whole.

In other words it is the aim of a successful regime to focus supervisors and the supervised on the aspects of the task that they are best equipped to handle. Thus the responsibility for the prudent management of any individual bank should lie not with the supervisor but with the managers and directors of that bank themselves. They are the only people with the information and opportunity to run an individual bank well. An outsider, however well qualified and however good the information system, cannot hope to do as well. If one is not prepared to accord this responsibility to the banks' management then the obvious alternative would be to opt for a publicly owned banking system and to reject the hypothesis that the disciplines and incentives of a well-operating market stand the best chance of maximising welfare for society.

It is the role of the supervisory authority, to quote the Reserve Bank of New Zealand's *Commitment to New Zealanders* (RBNZ, 1998) '[to] do everything in our power to build national and international confidence in the stability and integrity of New Zealand's money and monetary system by:

- operating monetary policy so as to maintain price stability,
- *promoting the maintenance of a sound and efficient financial system*, and
- meeting the currency needs of the public.',

where the italicised phrase provides the key remark. In this view it is not the job of the supervisor to support any individual bank. Indeed if it were thought that the supervisor would provide such support this would increase the moral hazard that bank managements might run greater risks as owners and depositors would not have funds at risk.

A more market-based system operates by revealing publicly the sorts of information that would previously have been disclosed only to the supervisor and by providing a system of incentives that encourages banks to operate in a prudent, efficient and indeed profitable manner. Although the supervisor needs to lay down the minimum of information to be disclosed, the practice in New Zealand has been for banks to disclose more as they seek to demonstrate their strengths compared to their competitors to depositors, actual and potential shareholders, counterparties and other customers. There is a trend towards increasing voluntary disclosure as companies in the United States move towards quarterly accounts and

a trend among supervisors to encourage more disclosure both through the Basel Committee and within the EU.

Some people view public disclosure as a support to the traditional regime of the collection of detailed undisclosed information by the supervisor. However, this belt and braces approach is not advocated here and it is anticipated that the supervisor would follow the New Zealand approach of only seeking more information if the disclosure statement seemed inadequate or unclear or in the event of a difficulty emerging. Even in the event of difficulty the emphasis would be on openness and revelation as soon as possible as to how the problem would be solved.

a increasing effectiveness of supervision

Putting the emphasis on public disclosure and the forces of market discipline is not washing one's hands of supervision in a difficult world of technical change and international business. It is an attempt to provide a system in jurisdictions where the banks are strong and accounting and auditing rules adequate, which increases the chance of prudential behaviour. It is clear from experience that current regimes of detailed supervision cannot 'succeed' in the sense of stopping banking crises but then nothing can, because we are talking about managing risk prudently not eliminating it, which is impossible. There are downsides to any approach and detailed supervision can be costly and inhibit banks in undertaking profitable business. The advantage of this arrangement is that it allows the supervisor to focus on the parts of the problem where it has a clear advantage:

- Assessing the quality of new entrants
- Ensuring that banks comply with the disclosure rules and following up problems
- Oversight of the system as whole – identifying potential problems which relate to banks as a whole, eg exposure to particular markets or sectors – considering social costs and risks.
- Resolving problems when they emerge and ensuring that crisis resolution capabilities are in good shape.
- Advising banks that have not as yet managed to get to the stage where they can comply with a full disclosure regime.

(These comments all relate to prudential supervision, corporate governance and disclosure but not to other aspects of conduct such as fair-trading. It is an open question whether this last should be covered by a special financial sector or banking regulator. OECD countries show a variety of decisions.)

b reducing costs of banking supervision for the tax payer, customers, banks and the supervisor

It is a relatively trivial consequence that the scale of supervision necessary will be reduced and hence the cost of supervision, which in most countries is borne by the banks themselves, or more literally by their customers, rather than the taxpayer, is reduced. Given the scale of other bank costs, the effect on interest rates and other prices will be difficult to detect. Secondly, if it is more costly for the banks to

comply with the disclosure regime than it was with detailed supervision then this gain will have been lost. However, if the New Zealand approach, of trying to align what is disclosed with what banks need to compute for internal purposes, both for decision-making and monitoring, is followed, then any extra costs are likely to be small and not sufficient to offset the gains from reduced detailed supervision costs. The New Zealand banks report that possibly one or two more staff may be involved and that extra printing may be required. On the whole, however, the extra printing replaces the costs that would otherwise have been incurred in printing prospectuses and annual or other reports in order to inform potential investors or depositors (Mayes, 1997). In Finland a substantial proportion of the information reported to the FSA is not used by the banks in internal decision-making.

The bigger gains come because banks are now able to run their businesses in a less constrained manner. Rather than having to conform to specific ratios or limits to exposures in particular sectors laid down by the supervisory authority, their requirement is simply to disclose the risks they have taken on. They are therefore able to pursue opportunities for profit and to differentiate their business from that of competitors as they think appropriate provided they can convince markets that they are managing their risk satisfactorily when they do so. The New Zealand banks reacted particularly well to this freedom (Mayes, 1997). They use the disclosure documents as an opportunity to convince customers that they manage risk well. If the gains are large then banks may actually be encouraged to locate in Finland.

Customers will also be able to benefit, not just because costs will be reduced but because they can choose institutions whose business more closely reflects their own needs. The efficient assessment of the quality of banks will then be largely assigned to the market and to competing private sector analysts and rating agencies. The role of the supervisor is to ensure compliance with the law. Disclosure thus tends to permit a rather wider range of choice rather than a clustering of bank behaviour close to but above the minimum standards that the supervisor requires.

Secondly if the risk of bank failure is reduced through better incentives for prudential management then the potential cost to the taxpayer is reduced in addition to any small costs that could not be passed on by the supervisor to banks. Given the scale of the bailout in the banking crisis at the beginning of the decade then this would be the largest single source of gain, totally dwarfing those relating to compliance costs.

c focusing supervisor on systemic risk

This is the key point. Governments do not seek to protect people from all risks but they do wish to act where the public benefit and the private benefit diverge. If banks are in general well supervised, there is insurance available, particularly for the small depositor and a wide range of choice, then the main concern is that a problem in a specific bank spills over into the rest of the system and causes a loss to society as a whole that could be reduced by public action. Otherwise one set of individuals who have taken a specific risk are going to be bailed out by the community at large who take a general risk over which they have little control.

d placing responsibility for the management of banks on the management of banks

The people who can ensure prudent management are the directors and managers of banks themselves. Disclosure will help achieve this because markets and customers will penalise banks that are not well run. The cost of raising capital will tend to rise and banks will have to cut margins in order to attract customers. This information on how the market views moves by banks will also help them in running their business. However, this information alone is not likely to be sufficient. Directors and managers need to be held accountable for their actions, both within the framework of the firm, for poor performance, and legally in the event of fraud or failure to conform with disclosure or corporate governance standards. The shareholder always faces a difficulty in knowing whether the management it has appointed is doing an adequate job. Disclosure assists this assessment because it is more readily possible to compare the performance of banks with their competitors and indeed with banks in other jurisdictions. (Of course, with the exception of large shareholders, it will be analysts and market commentators who will provide much of the advice. If there are problems then competitors will be only too keen to point out the difficulty and their own success in countering it.)

In the New Zealand system all bank directors, whether or not executives have to sign an attestation on the accuracy of the accounts and on compliance with the rules for prudential management. Thus it is not just that such rules be in place but they actually be followed.

e establishing incentives for all 'stakeholders' in banks

For this regime to work well there needs to be as comprehensive a set of incentives as possible. This comes not just from setting out regulations and having penalties for not following them. It is not possible to specify in sufficient detail what any individual organisation should do in order to manage its risk 'properly'. It is, however, possible to lay down general principles and then get banks to disclose enough of what they are doing so that people can decide whether they like the specific risks involved. We do not expect banks to be identical. People are prepared to take different risks. The concern of supervisors is to limit the risk to the system as a whole and for that reason they insist on minimum standards.

All those involved therefore need to have appropriate incentives: not just managers but owners – shareholders, depositors, borrowers and of course the supervisors themselves. The key ingredient of the disclosure system is that it provides the basis for people to take informed decisions – one requirement of an effective market-based regime is that there is a sufficiently large group of professional analysts crawling over the information to provide advice for the rest of customers and investors to act on. Clearly the message will be more limited if the shares in a particular bank are not actively traded or if shareholders do not have much say in the way the bank is run.

A feature of a disclosure regime is that it makes it easier for incentives to be progressive rather than there being simply penalties for stepping over a specific line.

f reducing moral hazard from implicit and actual guarantees

One of the main problems is that the public at large may feel that there is no risk from bank failure. Even if they know that banks can fail they may have the expectation that the bank will be bailed out. Experience supports this view. As a result (Llewellyn, 1995) retail customers will tend to choose the banks that offer the most favourable terms, as they treat all the risks as being effectively zero, not recognising that higher returns are normally associated with higher risks. Worse still this view can extend to creditors, shareholders, directors and managers. Bailing out a bank may mean for them that they do not lose as much financially as they would with a commercial company. It may mean that reputations and future employment are not expected to be harmed substantially by bad performance. One could scarcely give a worse signal than show that someone who has been held responsible for major losses by others in the past continues to prosper personally.

The moral hazard may extend to the banks themselves if they regard interbank risk as zero. They might, for example, prefer a 'cheaper' netting system to real-time gross settlement systems that effectively eliminate the exposure.

g precommitment - focusing supervision on banks with potential problems

In most circumstances bank failures are fairly isolated and in a well-regulated system only some institutions will have difficulties even for common risks associated with the macroeconomic cycle. There is a role for a supervisor to focus on those institutions and help see how the problems can be resolved. Here an extra step is required that was not a concern for the introduction of the New Zealand regime, because Finland and most other European countries are not starting with a clean slate. It is not a matter of being able to choose just strong banks for registration. Some banks have been in difficulty and may not yet be fully out of the wood. The decision to allow them to continue and work their way out of the problems has already been made. The supervisor may therefore want to keep an especially close eye on them until they are either closed, taken over or move into satisfactory performance. There will be a strong incentive for a bank to move as quickly as possible out of the problem category, if the position is public knowledge, as being there will affect its cost of capital and business adversely.

Section 5.1 suggests that within the group of 'strong' banks it could be possible for individual banks to make precommitments to avoid actual exposures to market risk exceeding a given level and to provide capital cover of at least that amount. This would enable them both to use their own risk assessment methods and to choose the appropriate level of cover, instead of following some predetermined rule applied to all banks irrespective of the particular characteristics of their business. It would be up to the market to judge the quality of these commitments ex ante and for the supervisor to decide if they were to be allowed to continue in future if either the commitment were violated or the standing of the bank fell.

It would be possible to invert this idea and allow banks to choose the level of supervision. In this case a bank might feel that it could enhance its standing by exposing itself to more vigorous inspection. However, if such inspections were thought to imply validation of the bank by the supervisory authority then it might be argued that the supervisor should bear some share of the responsibility if the bank subsequently fails. To some extent this choice can take place if the area of

competition from non-banks is increased, say, by permitting entry into e-money without a banking licence.

h comparability

The disclosure regime needs to require banks to report on a basis where they can be compared with a standard and with each other.

Somewhat ironically, disclosure means that there is much less incentive for banks to try to choose one supervisory regime rather than another as their position is clear and can be compared across borders wherever they are located. With the advent of the euro area comparison will be greatly facilitated.

4 The ingredients of market based regimes

This section reviews the key ingredients of a more market-based regime and examines which of them apply in Finland and, if they do not, it considers whether it would be either easy to introduce them or not of great significance to proceed without them.

4.1 A well-functioning market

The market itself needs to operate well, in the sense of there being

- an active share market,
- good market analysts,
- rating agencies,
- effective competition among banks and
- an effective market for corporate control,

if the disclosure is to mean something. Clearly if banks do not need to raise capital in the open market and if their customers have no effective choice the system will work poorly. Disclosure tries to overcome some of the problems of asymmetric information that may inhibit the effective operation of the market. While all five desirable aspects exist in Finland there are also limitations. Not all banks are quoted; some are co-operative and others effectively private (the structure of the Finnish banking system is discussed in section 5.2). Finland is a small and somewhat peripheral market so not all market instruments, such as ratings and informed analyses, are so readily available as in the larger markets and foreign participation tends to be somewhat lower. The market structure is somewhat skewed with one dominant player and since the reorganisation stemming from the banking crisis it is not clear how open is the market for corporate control and hence how well the market itself manages to eliminate the weaker players without cost to depositors and creditors.

4.2 Good corporate governance

Establishing a structure for the governance of financial institutions which maximises the chance of good prudential management is clearly an important starting point for an effective supervision regime. The New Zealand system focuses on four key features

- Incorporation and ownership structure
- Size
- Ability to carry on business in prudent manner
- Standing in the financial market

which between them cover the likely range of issues. However, much of the relevant legislation for ensuring good corporate governance is not in banking law but in company law. Very much the same arrangement applies in Finland. Although banks will be covered by the appropriate banking act – Credit Institutions Act, Postipankki Act, etc. – they are also bound by more general company law, the Accounting Act, etc.

4.2.1 Ownership structure

It is a simple starting point that the ownership structure needs to be transparent. This is particularly important in the case of conglomerates, where one might question the role of the bank compared to other parts of the company, and to international institutions where the network of ownership may be obscure. The BCCI debacle has been very helpful in sharpening the mind in this regard.

The principles that need to apply within an institution are fairly commonplace and include that the ownership structure needs to provide incentives for owners to monitor the performance of the bank closely and seek to ensure that it is managed prudently. If owners have a substantial stake in the business and are among the first to absorb the losses from poor performance then this will tend to be the case. However, owners and the board of directors need to be separated, as the interests of the bank and the interests of the owners may not always be identical.

Finnish banks exhibit a very wide range of ownership structures, with government ownership, co-operative banks, private banks, savings banks as well as limited liability joint stock companies. None of these structures is without problems.

Private banks and joint stock banks with dispersed ownership present contrasting difficulties. The worry in the case of the private bank is that activities could be run in the inappropriate interest of the owners, providing them or friends with cheap or inadequately collateralised loans. In the case of a diffuse ownership no single owner will be able to exert any effective control and the holding in the bank may only form a very small proportion of their total assets, thus tending to leave the company to the interests of the management and ineffectively monitored. In savings and co-operative banks the interests of owners and customers are not clearly separated and the position of the managers and directors vis-à-vis the owners may also be somewhat unclear in practice.

One of the key features of the New Zealand system is the role of independent directors. All banks are required to have at least two independent directors and an

independent chairman. These will offer not only the benefit of experience from outside the bank but will tend to have a more independent and dispassionate view of the running of the business. Since they, like the rest of the board, will be personally liable for the accuracy of the disclosure statements, they will have a particular interest in being convinced that the bank is applying all the appropriate risk management measures. A common arrangement is for one of their number to chair the audit committee, for example. Their presence on the board will tend to give comfort to small shareholders, depositors, creditors and indeed the supervisory authority that the business is likely to be run prudently.

The boards of Finnish banks have a somewhat different structure. They tend to be divided into two in a manner similar to that in Germany, with an executive board on which there not normally independent outsiders and a supervisory board where the majority are outsiders. Clearly the members of the executive board would need to attest to the correctness of any disclosure statement. To mirror the role of external directors or to demonstrate the supervisory board's confidence in the activities of the executives then a matching action would be for the members of the supervisory board to sign the attestation.

Resolving the problem of the blurred distinction between owners and customers in co-operative and savings banks is also difficult. New Zealand faced this problem potentially with the trustee savings banks but they voluntarily changed their structure shortly before the introduction of the new regime (with the exception of the small Taranaki Savings Bank) and have since been acquired by one of the larger banks. However, while this was seen as a difficulty it was not viewed as being insurmountable. The main difficulty is a lack of any public quotation and hence clear expression of view by shareholders and the market as to the performance of management that is incorporated in a price. However, views would still be reflected in the action of depositors so market pressures, although perhaps a little weaker, would still exist. The worry would be that depositors might not be very well informed particularly if they were largely individuals and not corporate entities. However, difficulties would be reflected in the costs of any market finance required by the bank.

The particular structure of the co-operative banks in Finland poses a further anomaly in that they are effectively treated as a single unit and have to meet constraints such as capital adequacy jointly rather than individually. This structure is less than fully transparent and may mean that the incentives and responsibilities for individual entities are somewhat blunted. Raising market finance is an issue for the co-operative banks as a group so market signals will not tend to apply so clearly to the individual banks.

4.2.2 Accounting and auditing practice

Secondly, an essential feature of good corporate governance is independent verification of the accuracy of the accounts and statements made by the directors. This role of independent auditors is crucial both for reassuring the directors themselves and for external purposes. It was simultaneous developments in financial reporting standards that made the development of the New Zealand system possible. The innovations were already being made in the United States and the accounting profession in New Zealand based its changes on them. The Reserve Bank was a party to the discussions (through membership of the professional association) but implemented its proposals ahead of the final

decisions of the association, as their progress was too slow. However, only very limited amendments had to be made when the Financial Reporting Standard (FRS33) was actually published.

The key changes related to the frequency of the production of accounts – quarterly – and to the valuation of financial assets. In the Finland the Financial Supervisory authority has already moved banks towards quarterly accounting (FSA instruction 106.13 and regulation 106.15). Moreover, companies commonly produce considerable detail for even shorter frequencies for internal purposes. Valuation, however, does pose a clear problem, as there is some variety of opinion on the best way forward. The Financial Supervisory authority has been pressing for 'fair value' (mark to market) and the discussions within the profession appear to be going in the same direction. At present practice varies with use of historical cost, revaluation and mark to market. Revaluation to current prices proved one of the factors assisting the banking crisis in the early 1990s when some property portfolios were revalued to prevailing prices shortly before the asset price bubble was pricked (Bordes et al., 1993). As a result the value of the liabilities incurred against those property assets did not fall. Indeed where they involved foreign currency borrowing the liability actually increased substantially, emphasising the solvency crisis in the banking system.

The passage of time since New Zealand's implementation of the disclosure regime means that there is now a clear model to follow from international accounting standards, should Finland wish to adopt a similar approach. However, the IASB standards follow the 'Anglo-Saxon' approach to accounting, which Finland does not, so adopting a more transparent valuation basis will involve a complication to the way in which accounts are presented. As things stand the additional information would need to be presented in the form of notes to the accounts. This is the same sort of procedure that is being followed in the agreement on accounting standards within the EU to which Finland will have to conform. There, although there is a general preference for the international standard, the pressure for the retention of the 'continental tradition' is sufficiently great that both systems will be permitted with an encouragement to follow the international standard in the form of notes to the accounts. Thus while the necessary standard will not be compelled, it will be permitted.

Of course, the accounting bodies are not the only relevant organisations as others accepting accounts for official purposes, such as the tax authorities, would need to agree to the changes if the system were not to become unduly complex.

4.2.3 Size

In one sense size is an important issue. The minimum size for registration as a new bank in Finland (5mn ECU (30mn FIM)) is similar to that in New Zealand and follows the EU standards. There needs to be a reasonable minimum size in order to make sure that organisations really are going to operate as banks and are on a scale such that they can reasonably be expected to have the resources to operate proper risk management. In practice most new entrants lie well above the minimum and banks from elsewhere in the EEA opening branches in Finland are likely to have very substantial asset backing. The reservation comes from the large number of small savings and co-operative banks that already exist – not so much that their small size makes prudential behaviour more difficult but simply that their sheer number makes the process of analysis and comparison complex

and less valuable, as the ordinary depositor or investor is not going to be considering the whole range of banks but just those that can readily operate in the relevant region. This immediately reduces the comparison to a small dimension, as the small banks are mainly regionally concentrated.

4.2.4 Prudential potential

Assessing the potential for the applicant to exercise prudence in management is a complex issue but one where there is considerable agreement among supervisors. The simplest is capital adequacy. Here there are accepted rules through the Basel criteria. Finland applies them, as do the other EEA countries, so all banks operating in Finland could be expected to meet these minima. However, it is a separate issue whether these criteria are adequate in all cases or indeed necessary in others (Mayes, 1997). For banks operating very cautious lending strategies, such as those specialising in house mortgages, where loans involving high percentages of valuation of the property require further security, the necessary capital levels could be quite small. For some wholesale institutions the risks could be large and the appropriate backing larger as well. Indeed this is one advantage of a disclosure system as a bank facing relative high risks can demonstrate that it has adequate capital over and above the Basel minimum. For example, Bankers Trust (1997) in New Zealand goes out of its way to explain that it has more than the minimum cover, as this is appropriate for its business.

Capital adequacy alone is, however, is thought to be inadequate by most supervisors. The main areas of contention are

- loan concentration and risk exposures
- separation from the interests of owners
- internal controls and accounting systems
- fit and proper persons.

New Zealand does not impose exposure limits but does seek to get disclosure so that concentration of loans to particular parties, sectors or countries is known. It is then up to the market to decide whether these exposures are acceptable. Clearly before registering a bank a supervisor has to form a view. However, some supervisors are more prescriptive and set limits. This of course begins to reintroduce the moral hazard as it could be taken to imply that exposures up to the limit are in some sense satisfactory. Following the EU requirements Finland currently imposes exposure limits of:

- 25 % of own funds to a single customer
- 20 % to parent or subsidiary
- total large exposures less than 800 % of own funds

with a set of exemptions for asset quality and borrower status. There are also some net overnight exchange risk exposure limits (section 105.9 of the FSA regulations). While these may not be necessary under market disclosure, they are unlikely to impose any great inhibition on banks' activities. It would be for the banks to make a case that such restrictions were important but, where the limit is imposed by EU agreement, the regulations will have to stand.

The existence of adequate controls is a much more difficult subject. There are several important structural steps that can be taken, separation of front and back offices, establishing a strong internal audit function and audit and risk committees that are chaired by external directors, for example. Within reason it is possible to get banks to describe what they do but such descriptions where they do not relate to well-known products will tend to be rather inexplicit and will convey little information. A good example of what can be done is the disclosure statement by Bankers Trust in New Zealand (Bankers Trust, 1998), which covers some four pages and deals explicitly, inter alia, with how they are handling the Year 2000 problem. Bankers' Trust has its own proprietary system RAROC, which is well known, as well as the Daily Price Volatility assessment. In any case it is not the existence of systems alone that matters but the effectiveness with which they operated in practice as well. The supervisor, large counterparties and analysts can use the disclosed information to enquire further.

For an existing organisation one can see the track record but that is a combination of the operation and the risks encountered. Indeed for an existing organisation, based abroad but coming to Finland for the first time, it is possible to get a view on its success in the existing jurisdiction from both supervisors and markets. For a new organisation it may be possible to see the track record of the individuals concerned but the validity of that also depends on the environment in which they then were. It is difficult to go beyond the New Zealand solution of getting the directors to attest that the appropriate systems are in place and effectively applied and to make them liable should that statement be shown to be untrue.

Similarly if one wants to vet the appropriateness of bank directors one can only look at their record. In Finland the attestation required is simply that the individual concerned 'has never been sentenced to a fine, unconditional imprisonment, community service or conditional punishment or that the person has never received an admonition concerning his duties from a properly constituted supervisory body' (FSA Guideline 101.3). Even so the FSA can evaluate a person who does not meet these conditions. The aim is at least to comply with the BIS recommendations on what constitutes a 'fit and proper' person. As a result a bank will tend to choose its directors and senior management with a view to their external reputation as well as their internal competence.

It is, of course always helpful if there are strong independent credit rating agencies that can give their own view of the quality of banks. Indeed if a bank wants to give an idea of its quality to outsiders it will promote its rating in its statements in the same way that commercial companies are concerned by their ratings. Such ratings are also of considerable value in supporting a disclosure regime to which we now turn. International agencies operate in Finland but a wider development of domestic agencies could also be helpful.

4.3 Transparency – availability of information – disclosure

The public availability of meaningful information sufficient for people to make informed decisions about the likely standing of banks both individually and relatively is the keystone of market discipline. (It is interesting to note that the rating agencies were among the more vocal in support of the disclosure regime in

New Zealand. Publication with liability for accuracy of statements is likely to produce information in which rating agencies can have greater confidence.)

There are several different ways we can approach this issue. New Zealand has made a decision about the level of information that it feels is necessary (see Table 4). It has also chosen to go for quarterly accounting periods, although a full audit is only required half yearly. This approach has been made in conformity with emerging practice in the US and international accounting standards – international standards have now caught up with the New Zealand practice or at least are about to with the interim proposals being developed by the IASC this year. (Clearly in implementing any proposals one should try to align them with standards in a forward-looking not backward-looking manner, otherwise they will be rapidly outdated.)

Table 4. **Disclosure requirements in New Zealand**

- the income statement and balance sheet (including a 5 year summary of key financial data
- directors and their interests
- asset quality and provisioning
- the number of large exposures (including interbank exposures) as measured relative to the bank's equity
- related party exposures as measured relative to the bank's tier one capital
- sectoral exposures
- capital adequancy, including off-balance-sheet items
- market risk exposures
- credit rating (if held).

Most importantly New Zealand requires the disclosure of peak exposures not just some quarterly average or end period value. This enables the disclosure of the full extent of the risks that have been run. Disclosure in Finland would clearly be of much less market value if it did not also include peaks or the number and nature of the greatest exposures. It is quite possible that peak exposures will exceed either limits prescribed by the authorities or limits voluntarily imposed in advance by the banks on themselves but this is not a problem for disclosure as such. It is up to the bank concerned to explain the overshoot in a manner which the market finds convincing. As it happened the illustration of a disclosure document shown in Mayes (1997) for the National Bank of New Zealand included an overshoot of the limits to exposure to related parties laid down by the RBNZ. The NBNZ explained that this exposure – to its parent – occurred as the result of a failed transaction and when this was publicly disclosed it went completely without comment or noticeable reaction by the market. (The overshoot was notified immediately to the supervisor without waiting for the next public disclosure date.) If an overshoot were the result of an internal system not working properly not only would the bank wish to correct that but it would want to do so in a manner that convinced outsiders. Disclosure of excess risks does not therefore place obligations on banks that they would not wish to place on themselves.

A second issue that arises from the New Zealand context is the need to bring as much as possible of the bank's activities into the frame for disclosure and not just to consider what is on the conventional balance sheet. It is risks associated with market activities and in well-known cases with derivatives that have

provided the crucial source of risk for some banks. It is therefore necessary to go rather further than the traditional accounts. (As there is a problem with the regime that has been implemented in New Zealand in this regard, I will deal with the specific issue of market risk later in Section 5.1.)

To some extent New Zealand requires the disclosure in public of what other authorities collect in private and do not disclose. One obvious approach would be to say that everything which is currently (or planned to be) disclosed to the FSA in Finland should be disclosed in public, as clearly the FSA feels that all that information is necessary in forming a view about the standing of the institution. This criterion might however be too detailed and banks would feel that some of this information is too sensitive. A simple example is that currently the FSA requires data on real estate and share holdings not just by size and proportion but also by name (FSA Guideline 105.2) although this particular instance is set to change. Some level of aggregation might be appropriate. Optimistic valuation of such assets was a contributory factor to bank distress in the crisis at the beginning of the decade so the market, just as much as the FSA, would want to be convinced in disclosures that such problems were not going to recur. However, it is not the purpose of this paper to pre-empt the sorts of detailed negotiation that would be necessary to establish acceptable rules. At this point I am merely indicating the areas where current compulsory disclosure to the FSA would be likely to be replaced by rather less detailed disclosure to the public.

Some of the information that is currently provided to the FSA by banks, such as the detailed quarterly country risk covered by forms CC1-4, is collected for international statistical and surveillance purposes on behalf of the BIS and IMF and so would not directly indicate the appropriate level of detail that should be disclosed. Similarly, daily foreign exchange transaction information is collected for reasons of financial system management rather than for prudential supervision and hence would not be affected by a change in the supervision regime. Nevertheless it is to be expected that the burden on banks would be reduced and the specification of the disclosure requirement such that they could use the data that they collect for internal management purposes for public disclosure and not need to collect information for disclosure alone.

However, it is inappropriate to look only at Finland, as there is a parallel discussion being undertaken by the European Commission (DG XV) on 'Disclosure of Financial Instruments'. The detail being discussed here is also greater than that required in New Zealand and fairly similar to that currently required in Finland. It would therefore seem to be sensible to ensure that whatever system is applied in Finland at least meets the level of detail in these draft proposals, assuming that is that an agreement is likely in the reasonably near future. It is anticipated that due course there will be an EU recommendation advocating a similar level of public disclosure (but probably at annual rather than quarterly frequency).

4.4 Rule of law – responsibility

A disclosure system is only going to work if compliance is the norm and, in general, breaking the regulations is by accident and not fraudulent intent. The system of penalties needs to act as a deterrent and as an adequate punishment in society's eyes. For large institutions like banks, penalties have to be huge to be

effective. However, if they are to be administered at a time when the bank is in distress they may end up being levied in effect on creditors and depositors not on the management and shareholders of the bank. It is therefore difficult to get them to be very effective. New Zealand tries to get round this by imposing penalties on the individual directors who have signed the disclosure statement. Here jail terms and unlimited civil liability can have a very real impact, as they apply to the individual and not the institution in difficulty. If the prospective penalties are such as to act as a genuine incentive to prudence by bank directors and are believed to act as such by the public then the system is likely to function.

Of course, the penalties must not be so harsh that they deter reputable people from becoming bank directors. This is not the case in New Zealand where the penalties are:

- a fine of up to $NZ 25,000
- a jail term of up to 3 years
- unlimited personal civil liability for losses sustained by reason of subscribing to any debt security (including bank deposits) issued by the bank in reliance on false or misleading information contained in a disclosure statement

It is well known in economics that the system that maximises welfare is a compromise and not just one where all fraud is deterred (Acemoglu and Verdier, 1998; Tirole, 1996).

In Finnish Law, where no other legislation applies or imposes heavier penalties, individuals who make false declarations can be liable to a fine or up to six months imprisonment. The exposure to civil liability is, however, somewhat limited. There may therefore be a case for toughening the incentives somewhat. Penalties also need to be progressive. If the only effective threat is deregistration as a bank then the transgression of the regulations would need to be correspondingly drastic and persistent. The authorities need not merely to be able to deter infringements at the margin but also to discourage banks from thinking that once they have broken a regulation there is no greater stigma from a large rather than a small breach. In general, the EU has not been very active in trying to establish market-wide minima for effective penalties and incentives for prudence.

However, the importance of a reliable legal framework stretches rather wider than just compliance with regulations. Property rights need to be clearly established for incentives to be effective. Not only does the valuation of assets have to follow a generally agreed system but the ownership of collateral needs to be clear if risks are to be properly assessed. In general this does not appear to be a problem for Finland, although the Wahlroos Report (1997) indicated that there were some areas of conflict of interest in respect to the compulsory pension insurance sector.

4.5 Banks can fail

Perhaps the most important part of the incentive structure is the understanding by all parties that bank failures are possible, even in well managed organisations, because banking involves the taking of risks. *And* those banks that do become insolvent will be allowed to fail by the authorities. If that is understood then shareholders will know that they will be the first at risk if the bank fails. They will

then seek to ensure that the directors that are appointed are suitable and that the information disclosed is adequate for them to be convinced of the sense of their decisions. Customers, counterparties and depositors (who are not otherwise insured) will be keen to satisfy themselves about the strength of the bank. The directors and management themselves will be keen to ensure that they do not lose their jobs.

Unfortunately it is impossible to set up a completely credible prior commitment not to bail out insolvent banks but the system can be set up in such a way as to make it difficult and the extent of prior reassurances to the contrary can make reneging very expensive. Credibility of course breeds credibility. If people believe that there will be no bailouts and hence banks are run in a more prudential manner the risk of insolvency falls and the authorities' resolve under pressure is not so tested. Indeed in small markets like Finland, even where there are many small banks, the chance of testing the authorities resolve may be small. Small banks in difficulty either present little public problem if they fail or more likely they can rapidly be reconstructed by one or more larger banks through voluntary agreement. It may be some time before a larger institution whose failure would have a noticeable impact (in political as well as economic terms) gets into a difficulty that cannot be resolved within the banking sector.

Similarly if a bank actually fails and is not bailed out this will also increase the authorities' credibility in the future. Finland faces two problems in this regard: history and the structure of the banking system. Since the banking system was effectively bailed out in the last crisis at the largest proportionate cost compared to GDP in any OECD country in the last fifty years it is necessary to be even more effective in designing a system that makes it look less likely in the future. There are some simple structural aspects that will assist this:

- making sure that those responsible for resolving the crisis do not have direct access to public funds
- making sure that those who resolve the crisis are completely independent of those who have funds at risk

4.6 Good effective systems to handle systemic risk

The final requirement for the successful operation of a more market-based system of banking supervision is that there should be arrangements for the resolution of difficulties that enable the incentive structures to be effective. Namely, it must be possible to resolve a bank that is either insolvent or unable to meet the capital adequacy or other requirements for registration rapidly and without the need to bail out the shareholders. Liuksila (1998) suggests that there are some question marks over whether this is possible without shareholder agreement in the EU (which could effectively preclude a rapid resolution). In the New Zealand case there is no such barrier 'a statutory manager has, and may exercise, in the case of a body corporate, all the powers of the members in general meeting and the board of directors of that body corporate' (Reserve Bank Act, 1989, section 129). The statutory manager can also:

- Carry on the business (section 130)
- Pay creditors and compromise claims (section 131)

- Sell the bank (section 132)
- Petition to wind the bank up (section 136).

By following the route of statutory management there is a clear separation between the process of resolution and any access to government funds. That separation is not so clear in Finland where the ultimate responsibility lies with the Ministry of Finance.

The Reserve Bank of New Zealand also shall if it 'considers it necessary for the soundness of the financial system, act as lender of last resort for the financial system' (section 31). There has been no explanation either of the conditions that would merit such lending or the terms under which such lending would be made. Clearly it will weaken any incentives if the banks believe such facilities will be readily available or that the prospect of failure of any large bank would be thought to be an unacceptable threat to the soundness of the financial system as a whole.

5 The main barriers

The discussion so far has identified five main issues that need to be addressed if greater market discipline is to be introduced successfully in Finland and elsewhere in the EEA:

- accounting and auditing standards
- the structure of the banking industry with high concentration on the one hand and a string of small banks on the other
- the role of deposit insurance
- the powers of crisis resolution

and

- the treatment of market risk.

The last of these is qualitatively different, as, unlike the first four, it is not a just a question of whether existing experience in successful supervision regimes can be emulated but whether existing regimes, and the New Zealand one in particular, can be improved upon. I therefore turn to this point next, along with the issues of 'too big to fail' and deposit insurance.

One further problem that does not affect New Zealand or other jurisdictions is the requirements of EU legislation. One issue has been clearly identified in this regard

- the problem of *home country control.*

The single European market legislation as expressed in the Second Banking Directive (1989) required that, subject to a set of minimum prudential requirements that must be applied by all members states, a bank headquartered in one member state and meeting the requirements to be registered as a bank in that state has the right to set up branches in other member states. Furthermore although some data will be collected from branches in other host countries supervision will be exercised on a consolidated basis by the authorities in the home state. (The

issue of home country control is treated in more detail in a companion paper, Mayes and Vesala (1998).)

The host authorities may thus have limited information on banks operating in their market but headquartered elsewhere in the EEA and even more limited powers of action should those banks get into difficulty. While the host authority has the responsibility for the systemic implications for its own market, the authority with the power of resolution will have responsibility only for its own financial system. Thus small member states may find they have banks with significant implications for systemic stability in their market yet rather less importance for the financial stability of the home market.

Secondly, if multinational banks have an element of choice of where to be headquartered and registered within the EEA, they may move away (towards) a jurisdiction that introduces a less (more) favourable regime.

Clearly Finland, like other countries, is facing the consequences of trends in financial markets, such as the rapid growth of information technology, improved payment systems and the introduction of new products, especially derivatives. All of which will have an influence on the introduction of changes to the supervision regime. These will be exacerbated by the completion of the single European market and the innovations involved with participation in Stage 3 of EMU. In general these forces either increase the need for introducing greater market discipline or make its introduction rather easier, such as the improvements in payments systems. So I do not deal with them explicitly in this section.

5.1 Market risk

I want to deal explicitly with one problem with the New Zealand regime that I identified in the previous paper (Mayes, 1997), namely, the treatment of market risk. The New Zealand authorities had wanted to introduce a regime that required the banks to disclose how they handled market risk and to ensure that the quality of that management at least met the latest Basel standards. This latter did not imply that these standards were thought to be either ideal or adequate but that they were likely to become the international standard and New Zealand was concerned that its banks would face difficulties in capital markets if standards were perceived to be below the norm.

The problem is simply that assessment of market risk is not a simple task and assessment methods are complex and difficult to describe. Disclosing the methods used would therefore be a substantial process and one only assessable by a very small group of specialists. In other regimes it has only been supervisory authorities who have been prepared to assess alternative risk management models against the standard, through methods such as 'back testing'.

The Reserve Bank therefore found itself pushed into setting out a version of the emerging Basel standards as a description of the sort of regime that would be acceptable. A bank could then apply that model of Value at Risk and disclose the outcome without any need to justify the method being used in the disclosure statement. However, the RBNZ did not want to compel banks to use that specific model, as it might very well not be appropriate to their specific businesses. For example, covariances might be important either in reducing or increasing the overall risk. The RBNZ did not want to impose a compliance cost on the banks by compelling them to use one model for disclosure while they actually used another

in managing the risk in practice. Having different internal models and disclosure models is suboptimal in two further respects. Not only does it mean that banks do not demonstrate that they are employing risk management methods that they think are superior to the standard model but it may also mean that banks have to have cover in excess of the risks they perceive internally, thereby inhibiting the business and imposing further costs (on customers). However, one point to note in the New Zealand system is that there is no requirement to hold capital against the disclosed Value at Risk. That is a commercial choice for the banks. The market can observe what capital they do hold. It practice the retail banks have not always held enough capital (in addition to the capital adequacy requirements) to cover this risk fully in the manner normally advocated (see Ruthenberg, 1997, for example). Wholesale banks, on the other hand, have normally exceeded it, sometimes by a substantial margin, which could be interpreted as a demonstration of the prudent management of risk in relation to the specific business.

The result of specifying the standard model as a guideline was that all banks disclosed using that model, irrelevant of whether they used the model internally. While this has the advantage of comparability, it did not really reflect the intent of the regime. Some of the banks claimed that they preferred not to disclose their internal models because this revealed more about their competitive strategies than their competitors were revealing. This is a classic prisoners' dilemma. If all the banks revealed their internal models then the playing field would be even again, the disclosures would be more meaningful and the banks could demonstrate a competitive edge over each other in terms of the quality of the methods they used. The incentive structure would tend towards encouraging greater quality of risk management not the bare minimum.

Kupiec and O'Brien (1997) offer an alternative approach, which might get round this difficulty, by suggesting that banks could 'precommit' themselves to cover value at risk. They would use their own VaR models and choose what capital they wish to hold against the computed risk. If the capital held turns out to be inadequate then the bank is faced with having to recapitalise itself to meet both the capital adequacy standards and the market risk for the future under what are likely to be adverse conditions. The market will be aware of why the self-imposed capital cover has been breached because the bank will have had to disclose it. If that reflects bad luck rather than bad management then the market may be relatively tolerant but if in the opinion of the market the risk should have been identified then the bank will be penalised in terms of the costs of recapitalisation and can expect to have to take appropriate measures in terms of improving procedures and probably dispensing with the services of those responsible in order to secure the new capital backing. This regime would reflect clear market discipline.

It also has the advantage that it is progressive. The self-imposed limits do not have to be breached for the market to start raising the cost of capital for the bank. Indeed, prudent behaviour can also be rewarded as investors seek to provide capital to a well-managed bank.

In the literature surveyed by Kupiec and O'Brien (1997) it is usually suggested that the supervisor might wish to impose some penalty on the banks in addition to market discipline if the precommited value is breached. This could take a number of forms. The idea of a fine seems rather inappropriate as it would be eroding the bank's capital base just at the time it needs to replenish it and would make resolution of the problem more difficult and increase the chance of turning a difficulty into failure. A more appropriate threat, which is also

suggested, is to relate the supervision regime to the past performance. Thus a bank that fails in its precommitment could expect to have to face a much more intrusive supervisory regime until the supervisor is convinced that the new processes and management are adequate for a return to precommitment. (Indeed some market valuation approach could be used so that the regime switch is in effect dictated by the market.)

There is some attraction in this latter approach particularly if market discipline is being introduced (see Mayes, 1998, for an application to the transition economies). A supervisor could progressively grant banks the freedom to operate under market discipline instead of detailed supervision as it became confident of their standing, an idea that is being trialled in the US (Kupiec and O'Brien, 1997). This is relatively easy under the US framework as the Fed assesses the quality of banks regularly according to a battery of criteria. A cut-off value could be established at which the regime shift could take place. However, this assessment is not published at present.

It is also the case that in the US system the Federal Reserve assesses the adequacy of the VaR system that is being used. Any such assessment would tend to reintroduce an element of moral hazard in the sense that it could be taken both by the management of the bank and by the market as an endorsement that the risk management system is appropriate. It also exposes the authorities to an implicit obligation that, should the system be shown to be inadequate, they should prevent the failure of the bank or ease its recapitalisation in the event of difficulty. It would be up to the authorities to make it clear that they recognised no such obligation under a disclosure regime and that any individual bank would be allowed to fail. Nevertheless, either the VaR model itself or its properties relative to the 'standard' would have to be disclosed, if the market is to be convinced and adequately informed in the absence of an official 'acceptance' of an undisclosed model.

5.2 'Too big to fail'

The system of market discipline works well in New Zealand, first because all of the main banks are quite large and are publicly quoted either themselves or through their parents. Secondly not only are there six main banks competing for retail deposits but none of them has a dominant position. Competition is thus very real. The structure of the banking system in Finland is rather different from that in New Zealand in two respects. First of all one bank, Merita, has nearly half of the market (Table 5) with two main competitors. The state-owned Postipankki has a 20 per cent market share and has more recently merged with the export credit company to form the Leonia Group. Secondly, there are 250 co-operative banks, which effectively operate as a single group and between them also cover 20 per cent of the market. The remaining 10 per cent is divided among 40 savings banks and 6 other commercial banks. The co-operative banks share many common services and on the whole, like the smaller savings banks have largely non-overlapping territories. Of these other banks only two have a share of total assets that exceeds 1 per cent. There are some foreign banks who have a small but growing market share, currently less than 10 per cent in total, mainly with branches only in Helsinki. However, two of these banks Handelsbanken and

Skandinaviska Enskilda Banken (both Swedish) rank third and fourth in size after Merita and Postipankki in the Finnish market.

Table 5. **Structure of the banking system in Finland**

	Total assets FMbn	Share of total (incl. foreign banks)[1]	
		%	%
Total	624	100	93
Commercial	480	77	71
Merita	293	47	44
Postipankki	124	20	18
Okopankki	7	1	1
Co-operative	118	19	17
Central bank	44	7	6
Savings banks	27	4	4
Aktia	11	2	2
Foreign banks	49		7
Svenska Handelsbanken	30		4
Skandinaviska Enskilda Banken	15		2

[1] Assets of branches of foreign banks are not necessarily measured on a strictly comparable footing.

This structure poses four problems. The first lies in the nature of effective competition. Although the market is both contestable and contested, with such dominance there are bound to be limits to competition however much the dominant players try to avoid exercising their market power. One must therefore question how effective market discipline might be in these circumstances. Secondly, with such a structure it is going to be difficult to reduce the moral hazard. If Merita were to get into difficulties this would imply difficulties for the system as a whole and if Postipankki were to encounter problems one would expect the government as owner to step in. Thus it is unlikely to be possible to allow Merita to fail in the sense of ceasing to trade. In any case Merita has merged with a large Swedish Bank, Nordbanken, which itself has a substantial shareholding by the Swedish government. This leads one to question the extent of the effect that external pressures, whether from the market or from government, would have. However, such problems remain whether or not more market discipline is introduced. Thirdly, with so many small banks the degree to which they would be effectively monitored by the market is limited. They are mainly regional and therefore would attract interest in the region but perhaps not much from the main Helsinki or international money markets. Lastly, since many of the banks are co-operative in structure the nature of the incentives varies from the traditional model. Owners are not so readily divorced from customers. Nevertheless the management still has the same incentives if they are personally at risk.

Small banks pose problems for appropriate supervision. On the one hand should any of them fail the systemic consequences will be negligible. Larger banks can afford to acquire them. Hence there is less 'need' in some senses to spend major effort in supervising them. On the other hand smallness makes it less likely that sophisticated risk management methods will be applied, often because the business is sufficiently simple that it can be monitored by more direct means. The risks of poor management could therefore be greater but by the same token the risks in the type of business may be less with no extensive trading in

derivatives that could bring the bank down. There is a general danger in supervision systems that small banks may have more than proportionate attention paid to them compared with their importance in order to ensure equal treatment of banks irrespective of size. While large near-bank financial institutions, whose demise would propose substantial problems, may receive attention less than proportionate to their importance. Such near banks normally do not have so much reliance on assets that are difficult to value in a crisis or realise without substantial penalty.

All supervision regimes face a test of credibility. In a crisis there are enormous pressures to bail out a bank in difficulty with tax payers' money, particularly because far reaching decisions have to be made at high speed. If there is a history of such bailouts it is even more important to give a clear signal that a different approach will be followed in the future. Regrettably the most convincing way of giving that signal is to allow the first bank which encounters difficulties to fail (and to hope that it is not so large that it presents serious systemic problems) (Mishkin, 1998).

5.3 Deposit insurance

In New Zealand there is no deposit insurance, so in one sense the moral hazard is reduced as bank managements and owners can expect that they will have to face the full responsibility for the loss incurred even by small depositors. However, it is not clear how much this is a realistic difference from the EU schemes, which have insurance up to some limit. It is unlikely that it will be politically viable to allow large numbers of small depositors – who are also voters – to incur losses that amount to a substantial proportion of their small resources. Indeed it may be better to have explicit rules, which are known in advance and cover the political risk, than to leave the position open for people to guess. Their uninformed expectations may be rather larger than could be agreed beforehand at a time when there was no crisis and hence no specific people who were about to become losers unless the authorities acted.

With the partial insurance provided in Finland, at least some depositors know their funds are at risk. Since these are the larger deposits there is a good chance that their holders appreciate the risks involved. With only limited insurance there is less of a barrier to entry for banks in terms of the funds they must hold against the risk.

What is more interesting in the EU environment is whether the hazard is affected by the nature of the insurance system and the relationship between the insurer and the authority responsible for deciding upon how the problem should be resolved. If the insurance is provided by the public then the insurer may want to try to trade off the costs of a bail out against the insurance. Certainly any insurer will want to trade off the costs of the resolution against the costs from paying out on the insurance, as in the case with the FDIC in the United States. Hence industry-based insurers would increase the chance of the industry itself mounting a rescue for the bank in difficulty. Here the incentive structure is quite complex. If banks think they will be bailed out by their colleagues then they may be less prudent. However, they do not want to be pushed into acquiring their competitors' assets at a time when the market as a whole is under pressure. There could be an incentive then to weaken a competitor that is having idiosyncratic

difficulties in order to pick up its assets at a discount. This would strengthen the case for having a resolution procedure based purely on avoiding systemic risk and one where the concerns of those with assets at risk are only treated relative to each other and not in some context of the wider good or the interest of one specific group. Mishkin (1998) has recently made some interesting additions.

5.4 Home country control

Although there are agreements on minimum requirements for aspects of financial supervision among the member states considerable scope remains for individual jurisdictions to decide to improve upon them. The risk that banks would indulge in 'regime shopping' is fairly small for the major retail banks but rather higher for the more specialised banks operating in a variety of EU markets and rather higher for the EU subsidiaries of large non-EU banks which may be rather more flexible about where they headquarter their activities. On the whole the larger concerns have chosen one of the established financial centres, but as the case of BCCI illustrates the choice of a less regulated centre may attract those who intend to act outside the rules. By and large the main regime shoppers are likely to present relatively limited systemic risk.

The major concerns in the present circumstances are not from the point of view of the systemic risk which may occur within a country which has 'lower' supervision requirements but from the sheer complexity of having banks operating under several different regimes in the same member state and from the problem facing the authorities in the host country when a bank headquartered elsewhere has difficulties. This latter problem has two facets: the home country authorities are unlikely to view depositors, shareholders and creditors in other member states as being equally important as they do not represent the same political risk. Although EU legislation limits the extent to which there can be any home country preference there is no requirement to concentrate attention in the state where the systemic risk is greatest. A bank may be a smaller systemic risk in its state of incorporation than it is in some of the other states where it operates. If a substantial proportion of the banking system were to be foreign owned this would pose problems that are not present in New Zealand.

It has yet to be announced how the supervision of Merita is to be organised following its merger with Nordbanken. Here the scale of the operation compared to the size of the markets is likely to entail a degree of co-operation between the Finnish and Swedish supervisors in a way that has not hitherto been necessary in much of the EEA.

In the New Zealand case the RBNZ still supervises the local branch or subsidiary and needs to be convinced that branches provide adequate arrangements otherwise it can demand local incorporation. Thus while New Zealand banks may face the problem that the New Zealand supervisor requires one disclosure regime, the home country supervisor a second and both of these differ from the information and risk management systems used for internal purposes the problem would be the other way round in an EU country with substantial foreign ownership. Customers would face one level of disclosure from banks that are locally incorporated and different levels from those headquartered elsewhere. This could weaken the effectiveness of market discipline. However, if banks find that there are benefits from disclosure, it is likely that those

headquartered elsewhere within the EEA will voluntarily disclose similar information to that required of the domestic banks, if they are not to suffer a competitive disadvantage. 'Competition among rules' could emerge with some banks trying to offer the reputation of their home supervisors as a substitute for disclosure (Mayes, 1997).

6 The process of implementation

The concern of this paper up to this point has been to establish that there are no facets of the structure of the Finnish financial system or Finnish and EU law that make a more market-based banking supervision regime either impossible or unsuitable. We have noted that some of the incentives may be rather more blunted than in New Zealand, where such a scheme already operates, due to the structure of the banking system, aspects of corporate governance, the existence of deposit insurance and the history of having had to bail out the banking system, at an overall cost variously estimated between 8 and 17 percent of GDP, during the last decade (Halme, 1997). We have also noted that there is a somewhat bigger step to be taken in getting the information to be released onto a generally accepted and clearly comparable basis. Auditing and accounting conventions will require some modifications.

The question addressed in this section is whether there are any obvious lessons that should be borne in mind when implementing the regime, if a decision is taken to move ahead. This raises two subsidiary questions:

- Are there any requirements for the ordering of change?
- What are the minimum requirements for a more-market based system to operate effectively?

There is always the temptation to push steadily in the direction of change rather than take large steps and implement a new system as a whole rather than in parts.

6.1 The process of change

The disadvantage of proceeding piecemeal is that a new regime may not prove effective until most of it has been implemented. In the meantime, existing controls may be weakened or the burdens on the banks and the costs on the system in general increased. Indeed both could occur, giving increased costs and decreased effectiveness. With progressive change the participants have to change on a number of occasions. There is a cost associated with making any change and hence by separating the process into separate steps the total cost may be increased. Banks might have to change their internal systems more than once for example. Secondly, the will to change may alter during the process, leaving the system between regimes.

Table 6.

	Commitment	Market Discipline	Control
Management	*Responsibility* * clear cut rules for responsibility for different sanctions *Sanctions* * clear cut tort and punitive sanctions for non-compliance of key rules	*Obligations for disclosure* * key financial ratios * key risk exposures * key incentive schemes *Code of ethics*	*Efficient internal control* * audit committees * reporting to independent units *Efficient shareholder control* * NED's, GBD's, constitutency directors
Owners	*Responsibility* * capital adequacy * rules for wrongful intermediation *Sanctions* * liquidation rules * zeroing of share capital	*Take over threat* * obligations for disclosure of ownership *Effective competition* * neutralising the too big to fail effect	*Efficient legal form for ownership* *Control of abuse of legal form*
Regulators	*Responsibility* * limitations of discretion * schemes for early intervention *Sanctions* * reputation	*Obligations for disclosure* * decisions * special provisions * exercised sanctions *Role as a communicator* * minimisation of private information	*Supervision vs. Norm-setting* *Control by legislator*

Source: Halme (1997)

However, this does not mean that trying to achieve more rapid and complete change is without drawbacks either. Because of the extent of the change, the number of items to be agreed on any one occasion is higher. The chance of finding at least some individual aspect with which any party to the discussions is uncomfortable is increased. If one party can hold up the whole process then the period before which any change occurs is lengthened. The costs of the change are likely to be more concentrated than if they were separated into a series of steps. That single lump may prove more difficult to accommodate in purely cashflow terms than the greater but more spread out cost of gradual change.

Implementing any change takes time. If we take New Zealand as an example, about five years was required between starting the discussions in late 1991 and full implementation in 1996. New Zealand had one important advantage in that legislative change was not required. The Reserve Bank Act of 1989 was sufficiently encompassing in its terms that the Reserve Bank had the power to introduce the new regime through regulation alone. However, it had to ensure that what it was suggesting for the banking sector was compatible with legislation covering the corporate sector in general. Most of the time was taken up with discussions between the Reserve Bank, the commercial banks (both individually

but mainly through the New Zealand Bankers Association) and the accounting profession to ensure that the proposals would be practical, not unduly costly and would actually achieve the objectives of the change.

If New Zealand had had a previous pattern to follow progress could no doubt have been swifter as both the Reserve Bank and the commercial banks would have had other experience to turn to. Now the New Zealand example exists, other countries can implement a similar (but improved) regime rather more swiftly. However, as we have noted, there are some aspects of the system in Finland that may make change a little more cumbersome. In the first case Finnish law tends to be rather more prescriptive in detail and hence changes to reporting requirements and incentives may require legislative change (Halme, 1997). Indeed these requirements may extend somewhat further into aspects of corporate governance. Secondly, there may be some changes in the structure of the system necessary to ensure that the system of crisis resolution enables the authorities to reconstitute a bank rapidly without bailing out the existing shareholders (Liuksila, 1998) and to avoid ready access to public funds so that shareholders, management, creditors and uninsured depositors do recognise that their own funds (or jobs) may be at risk. EU legislation is in the main concerned with the imposition of minimum standards and in the case of accounting standards seeks to permit both Anglo-Saxon and continental approaches. Thus while it does not compel a disclosure regime, nor indeed does it seem likely to do so at present, it does not forbid one.

Nevertheless, it seems difficult to disagree with the dictum that one should 'do as much as possible as soon as possible'. Finland has a window of opportunity, as it is important to introduce banking system regime changes when the economy is not fragile. The economy is growing rapidly, without the inflationary pressure in property prices of the scale of a decade ago. The advent of stage 3 of EMU and the increasing integration of financial markets both enlarges the window and poses a threat. On the one hand makes it more likely that the current economic cycle will be prolonged beyond what would have been possible had Finland continued to have independently determined prices and monetary policy. Without the threat of competition from a more integrated EU economy, inflation in Finland might well have been higher at this stage in the cycle, necessitating a reaction from monetary policy and a downturn to the profitability of the banking sector. On the other, the introduction of the euro and the increasing integration of financial markets may mean that financial innovation or entry into new markets results in the sorts of increase in risk that have accompanied other bursts of financial deregulation (Llewellyn, 1998). There is hence a threat that when the next downturn does come it will contain an increased risk of financial difficulty. The ECB has an extremely difficult job in estimating how a new currency area may work and might, for example, underestimate the degree to which there is an increase in the velocity of circulation of money. The resulting crack down to restrict the inflationary consequences may put pressure on the banking system. Of course, at the same time, increasing integration may result in arrangements among banks that increase their capital base in Finland.

It therefore seems that rapid progress would be desirable, even if some of the changes in structure come later. The accounting and auditing requirements are already incorporated into international standards so there is a blueprint to follow that could be transposed into regulation by the FSA.

6.2 Consultation

It is worth recalling finally that one of the key features of the successful introduction of what was then a radical change in New Zealand was extensive consultation between the parties: the various authorities, banks and the accounting bodies. While the Reserve Bank produced an initial draft, it was the consultation that ensured that the proposals did not put undue pressure on banks. These discussions were held not in the framework of trying to decide whether the changes should be made but how the principles should be implemented. Ultimately it was still up to the Reserve Bank to decide. However, to illustrate what such discussions can achieve, two main changes, inter alia, can be observed from the initial proposals as result of consultation: a reduction in the detail of disclosure; the introduction of a 'standard model' for assessing market risk. (As we have seen the second of these was necessary to get the proposals implemented rapidly although better compromises now seem possible as suggested in section 5.1.)

Since the more market-based regime is intended to produce benefits for the banks themselves as well as for society at large as customers, creditors and taxpayers, it is only appropriate to try to ensure that the nature of those potential benefits is properly understood by the authorities when drawing up the regime.

6.3 The next steps

There are two key areas, ongoing supervision and crisis management. In the case of ongoing supervision the path is more straightforward, though arduous over the coming years. While it is open for the Financial Supervision Authority to produce a Discussion Paper explaining outline plans, a timetable and the consultation process for the introduction of public disclosure and the change in its focus towards systemic issues, some parallel steps would help ease the change. It would be helpful to explore whether the appropriate incentives are likely to be sufficient, not just in terms of penalties and legal liabilities, but also in terms of market institutions – rating agencies, independent analysis, etc. Secondly, it would useful to investigate whether the system of corporate governance was likely to produce adequate transparency and effective procedures within banks to encourage greater prudential risk management: through audit committees and independent directors, for example. The small co-operative and savings banks present problems under both headings and indeed it may be more appropriate to offer to continue with current arrangements if they wish it. Although international standards for financial reporting are now adequate for a successful disclosure regime, implementing the appropriate valuation, accounting and auditing arrangements is likely to provide the most time-consuming part of the process.

Crisis management provides a greater problem, as it requires both the development of co-operation with supervisors in other countries and the attempt to convince markets and shareholders, in particular, that there will be no bailouts – without wishing to have even a small crisis that gives an opportunity to demonstrate that resolve. The development of greater powers to help resolve crises and permit the authorities to organise the management of insolvent or undercapitalised banks without bailing out the existing owners would help make that message more credible.

Given the benefits anticipated for all those involved: – customers, creditors and counterparties as they see information on the risks they face improve; shareholders, customers and managers as they see the costs of compliance and the restraints on well-managed business fall; supervisors as they can concentrate on systemic issues and all parties including the taxpayer as they see the risks of distress or failure recede – the earlier the process starts the better. While there are difficulties and the process of implementation is unlikely to be either as straightforward or as comprehensive as it was in New Zealand, where such a regime was implemented in 1996, these do not appear insurmountable. Furthermore it has been possible to learn from experience and design a scheme more suited to the specific conditions in Europe. As economic conditions are now favourable and integration and innovation in financial markets are likely to increase the pressure on existing methods of supervision, the changes proposed would be timely.

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