THE INSTITUTIONAL STRUCTURE OF PRUDENTIAL BANKING SUPERVISION SYSTEM: ACROSS THE WORLD REVIEW

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Abstract

The article is devoted to the research of prudential banking supervision, as one of the key factors for ensuring financial stability. The fundamentals of prudential risk-oriented banking supervision system’s organization in current circumstances are defined. Particular attention of this article is paid to the question of optimal institutional organization of prudential banking supervision system with an aim to ensure stability of banking system of the country. The practice of foreign counties in organization of prudential banking supervision system is considered.

Key words: banking supervision, prudential supervision, banking risks, institutional structure, financial stability.

Introduction

Within current economic science the interest to prudential banking supervision, as an object of research, is relatively new phenomenon. It was taken into account since the acceptance of New Capital Accord (Basel II) by Basel Committee on Banking Supervision in 2004, when it was given to the supervisors Pillar II. The global financial crisis of 2007-2009 pushed the world financial community to focus on the optimal organization of prudential banking supervision to ensure the stability of the banking system.


The main object of our research is prudential risk-oriented banking supervision. In this case subject is considered as institutional structure of prudential banking supervision system.

Thereby, taking into account the complexity of this issue, we believe it is appropriate to carry out more extensive studies of both theoretical and practical aspects of the concept of prudential risk-oriented banking supervision. Thus the purpose of this paper is to identify the fundamentals and features of prudential risk-oriented banking supervision system’s organization in current circumstances.

Besides this, the main tasks of the research could be defined as:

- To determine economic essence of prudential risk-oriented banking supervision;
- To study fundamentals of prudential risk-oriented banking supervision systems’ institutional organization;
- To analyze foreign countries’ practice in organization of prudential risk-oriented banking supervision;
- To create a list of recommendations for prudential banking supervision institutional structure’s optimization to ensure the stability of banking system of the country.

Methods and results of the research

Nowadays, the central importance of prudential banking supervision in ensuring the financial stability of banking system is an axiom that does not requires any evidence and justification. It is proved by the variety of scientific researches all over the world, devoted to the issue of banking supervision, and existent practice of foreign countries.

Prudential risk-oriented banking supervision, by its economic nature, is a specific regime, a comprehensive method of banking supervisory tools’ application to identify high risk areas in banking activities (Dubkov S., 2012, p.28).

Within this is expected an establishment of rules and algorithms by prudential banking supervisor to manage the banking risks. Thus, the monitoring of risk-management systems of banks is realized in order to obtain data on the level of compliance with the requirements that are set by the supervisor. Namely, whether a bank does not assume an excessive risks and whether the requirements of bank’s stability are complied in order to ensure the reliability and stability of the banking system of the country (Mishkin FS, 2001, p.8).

According to the concept of banking supervision based on risk assessment, responsibility for risks’ control is taken by a bank and supervisory board of a bank. The prudential banking supervisor determines how well the bank manages risks during a specific period and not only evaluates its state at some moment. Also, under the prudential banking supervisions based on risks’ assessment, the supervisor acts more with an aim to supervise, than audit. Risk-oriented banking supervision allows to regulator to implement preventive supervision, focusing both on the risks of individual banks and the systemic risks of banking system in general.
Organization of prudential risk-oriented banking supervision system can be viewed from the perspective of its participants. Thus, subjects of prudential banking supervision could be represented in terms of two levels:
- In broad sense - subjects of prudential banking supervision are all members of the credit system, including those who are operating in the field of risks and those who supervise them;
- In narrow sense - the subjects of prudential banking supervision include only institutions, authorized by the state to carry out the prudential supervision of banks.

Accordingly, the legislation of each country determines one or a number of organs, authorized to realize prudential banking supervision. The function of prudential banking supervision could be carried out by central bank, specifically authorized state body or a number of government agencies that distribute the range of functions between them.

Taking into account available researches on features of prudential banking supervision system's building, we have developed an algorithm of identification the institutional structure of prudential banking supervision system, which is presented on Figure 1.

The first stage of this algorithm is to determine the type of prudential banking supervisory authority. Thus, it may be a central bank of the country or a specially created institution.

Within the second stage a number of supervisors has to be determined. There could be only prudential banking supervisory authority of all financial services sector (banking and non-banking institutions), or there could be a number of prudential supervisors, depending on the segment of financial services’ market. If the function of prudential banking supervision relies on several competent authorities, it is necessary to determine which of them is the main body on prudential banking supervision. If the function of prudential banking supervision is delegated not to the central bank of the country, is appropriate to move to the third stage.

Accordingly, the third stage aims to identify how independent is the prudential banking supervisor:
- Does the prudential banking supervision authority have its own sources of revenue and guaranteed budget, or it has to rely on parliamentary or government support to finance its activities;
- Whether the prudential banking supervision authority is a part of another state agency, such as the Ministry of Finance or the Central Bank, and whether it is independent of them.

In this case, the prudential banking supervisory authority could be defined as independent one, if it meets both of these criteria.

In continuation of mentioned above, a group of researchers carried out an empirical study within which the structure of prudential banking supervision system was analyzed by the example of 90 supervisors (including central banks and financial authorities). The results proved the fact that central banks as supervisors naturally are created and operate by public funding, while the main source of funding for financial supervisory authorities is financing from banks, subordinate to this supervisor, as fees and payments (Masciandaro D., Nieto MJ, Prast H., 2007, pp. 307-308).

In turn, representatives of International Monetary Fund consider independence of prudential banking supervision authority from the perspective of its two components: goal and instrument independence. The first is to create conditions in which the authority of prudential banking supervision will be able to achieve its goals, including: system stability, optimization of banking institutions’ operation, protection of banking services’ consumers. Instrument independence occurs in formulation and implementation of supervisory policies. Also, four elements of instrument independence could be highlighted: regulatory, supervisory, institutional and
budgetary. Thus, the regulatory and supervisory independence is the main manifestations of independence in selecting appropriate instruments of influence. In turn, institutional and budgetary independence designed to provide operational support of prudential banking supervision system and implementation of its major functions (Arnone M., Darbar SM, Gambini A., 2007, p.5).

In our opinion, prudential banking supervision will be effective only if it is independent from:

- Political forces - the prudential banking supervisors have to be objectively determined by the legislature of the country, and not by autocratic rule in order to meet someone’s personal needs;
- Banks under investigation - the prudential banking supervisors should be protected from legal claims initiated by the banks under their supervision. Such claims could be caused by decisions that supervisors, that are made to ensure the reliability and stability of the banking sector;
- Possibility of supervisor’s head to be fired without reason - a minimum and definite period of activity has to be given to the head of prudential supervisor in order to provide an effective implementation of supervisory policies and a number of necessary activities without a risk of being fired prematurely and without reason.

Also it is appropriate to note that the degree of independence of prudential banking supervisor is also closely linked with general standards of public administration in the country (Davis EP, Obasi U., 2009, r.6).

However, the compliance of prudential banking supervision authority to criterion of independence is not a guarantee of this system’s optimal organization. Thus, the system of prudential risk-oriented banking supervision should comply with main criteria, which could guarantee its efficient functioning. Among them:

- independence;
- accountability;

Independence of prudential banking supervisor is a degree of impact of other subjects of political sphere, institutions under supervision on its activity. Also this category means the ability of supervisor to resist to their influence of different subjects with an aim to make decisions that are a part of its supervisory competence. Thus, prudential banking supervisor’s independence is a key criterion to achieve and maintain stability of financial sector of the economy.

Accountability of prudential banking supervisor could be seen as a degree of its responsibility for held activity and decisions. This criterion is a specific requirement which is put forward to supervisor by those who have delegated to it some power to carry out banking supervision.

Transparency of prudential banking supervisor’s activities is a measure of information on certain areas to be continuously monitored and communicated to definite subjects. For instance, there have to be taken into account such elements as: goals, legitimacy, organizational and economic principles, decisions, actions, information is received within the supervisory policy, accountability of government.

Equally important is the dependence of these three components and their impact on the effectiveness of prudential banking supervision. Thus, presence of responsibility criterion of prudential banking supervision enables the formation of solid reputation and public recognition and is the key to maintain its independence. So, there is the next available direct correlation: the higher is the degree of prudential banking supervisor’s independence, the more important criterion becomes its accountability.

Correlation between the criterion of accountability and transparency is associated with the presence of relevant information. Transparency is a peculiar condition where adequate information is available, while accountability is associated not only with the provision of information, but also provides explanations and definitions of actions and decisions of supervisor.

Thus, an implementation of proposed algorithm allows to determine the model of prudential banking supervision, depending on the type of major supervisor, such as: an independent government agency, dependent authorized government agency or central bank.

Current experience of foreign countries proves in practice the fact, that countries with lower levels of development, low-income usually delegate a function of prudential banking supervision to central banks. This phenomenon could be explained by the fact that the central bank is one of the few government agencies, which is inherent by ability to conduct efficient supervision. The presence of a single prudential supervisor, represented by the central bank, rejected the need for separation of powers, information between multiple supervisors, which is especially appropriate to countries with low levels of development.

In contrast, the practice of prudential banking supervision system’s organization, which was mentioned above, is not proper to countries with an experience of recent crisis shocks. In these countries, taking into account unsuccessful experience of the central bank to realize its supervisory functions, it is likely to be carried delegation of prudential supervisory functions to independent public institution, including an.

The analysis of foreign countries’ experience conducted above let us notice that operation of prudential banking supervision have a number of features.

Thus, liberalization of monetary policy, high levels of economic development, the need to improve the supervisory authority and increasing responsibility for its implementation led to a trend of creating specialized prudential regulation. For instance, in England was established the only supervisor of all financial intermediaries - Financial Services Authority, while saving functions of monetary regulation by Bank of England.
In Germany, according to the Law on the Supervision of the financial services industry and the new version of Law on the credit system from May 1, 2002 began to operate a fundamentally new mode of integrated cooperation between the Federal Financial Supervisory Authority and the central bank (Deutsche Bundesbank).

Such a German experience is appropriate to Scandinavia countries, where the system of banking supervision is built by dividing functions between the central bank and the independent state institutions (Eichengreen B., Dincer N., 2011, p.5).

Supervisory functions’ differentiation is typical for the United States of America, where the function of banking supervision is divided between the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and banking commissions of states.

It has to be mentioned, that the financial and economic crisis of 2007-2009 became specific indicator of the effectiveness of prudential banking supervision of countries and shifted the priorities of prudential banking supervisors to stability of banking system. As a result of such actions was a series of reform in systems of financial prudential supervision during the period of 2010-2011.

Thus, in France in 2010 under the ongoing reform was established Prudential Control Authority as a part of central bank of France (Banque de France), which received functions of licensing and supervision of banks, payment systems, insurance and investment companies.

In turn, in Ireland in 2010 was created a single megaregulator at the base of Central Bank of Ireland.

According to the reform of 2011, in Belgium prudential supervision of financial intermediaries went to the National Bank of Belgium, and regulation of information representing was relayed on Financial Services and Markets Authority.

In contrast, in 2011 Germany made a specific return of prudential supervisory functions to the central bank (Deutsche Bundesbank). Similar trends were observed in 2011 in Greece, where there was strengthening of the role of the Bank of Greece through transferring function of supervision of insurance companies and the parallel reduction of Capital Market Commission’s authority.

Following the experience of Ireland, Lithuania in 2011 made a merger of all the types of supervisory functions into a single megaregulator as an autonomous department of the Bank of Lithuania.

The wave of reform has not passed the United Kingdom, which in 2010 took a route to reforms of prudental banking supervision. Thus, by 2012 should be held liquidation of megaregulator as Financial Services Authority and creation by the Bank of England a subsidiary institution on prudential supervision - Prudential Regulation Authority. Also will be founded a new body - Consumer Protection and Markets Authority.

This list of prudential banking supervision reforms, which was mentioned above, is not exhaustive. But it should be emphasized that the present changes lead to transformation of prudential banking supervision system and are carried out in two main areas, as: strengthening of the central banks’ role (Belgium, France, Germany, USA, Portugal, Greece) and consolidation of financial regulation and supervision at the central banks (the UK, Czech Republic, Ireland, Slovakia, Lithuania).

Thereby, taken into account some peculiarities in evolution of foreign banking systems, prudential banking supervision should be organized considering both international standards and national characteristics of the financial system of the country in order to provide its efficiency and ensure the stability of individual banks and banking system of the country in general.

Summarizing up all mentioned above, the experience of foreign countries enables us to distinguish a number of general trends of organization of prudential banking supervision system.

Firstly, delegating of prudential banking supervisory functions to dependent state authority is appropriate to countries that have a positive experience of good governance and existing quality of controlling mechanisms. Moreover, under these conditions it is possible to distribute of supervisory functions between several institutions, such as central bank and other state agency.

Secondly, it is appropriate to delegate the prudental banking supervisory function to independent state authority if the system of prudential banking supervision meets both criteria of independence, accountability and transparency.

Thirdly, the prudential banking supervision led by the central bank is more reasonable to implement in countries with high legal culture, strong legal framework and political stability. Under other conditions, the main criteria of the system of prudential banking supervision such as independence, accountability and transparency, will not comply completely.

Conclusions

Our research of current global trends has proved the fact that it is totally impossible to build universal institutional structure of prudential banking supervision system. The main reason of it – availability of a number of features due to historical, economic, social and political factors which impact on banking system of each country. Therefore, taking into account mentioned peculiarities, system of prudential banking supervision should be arranged considering both international standards and national characteristics of the financial system of the country.

The main point is that regardless of the type of institutional structure, an efficient system of prudential banking supervision requires a proper understanding by supervisor of the operations of individual banks and
banking groups, and the banking system as a whole. Such activity must be focused on safety, reliability and stability. In other words, the main condition of efficient prudential supervision system’s organization is consciousness by supervisor the importance of each banking institution. Within this, supervisor’s activity should be aimed to assessing the risk management strategy of the bank. Moreover, this process should be prolonged and continuous, because the system of risk management of the bank is based on the usage of a range of financial instruments, the quality and appropriateness of which may fluctuate from time to time. That is why the system of prudential banking supervision should consider these features by implementing prudential risk-oriented banking supervision.

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RIZIKOS RIBOJIMO PRINCIPALIS PAGRÎSTOS BANKŲ PRIEŽIŪROS SISTEMOS INSTITUCINĖ STRUKTŪRA: PASAULINĖ APŽVALGA

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Santrauka

Dabartinės pasaulyje ekonomikos sąlygos, kaip ir integracijos procesai, iškėlė visą eilę reikalavimų šalies bankinei sistemai. Pirmiausia tai komercinių bankų stabulumo didinimas ir procesųstabilizavimasbankinėje sistemoje. Visa tai gali būti pasieki tiukfaktyvuose vaivadyinant bankų priežiūrą, kuri yra pagrindinis šalies bankinės sistemas finansinio stabilumo veiksnys.

Bankų priežiūros funkcijos efektyvumo didinimas gali būti pasiekiamas pirmiausia suformuodami faktinei bankų rizikai ir nukreipiant valstybinės institucijų priežiūros funkciją į valdymo sistemos finansinio efektyvumą. Rizikos ribojimo principais pagrįstos bankų priežiūros institucijos savitaviesias įsipagrininus finansinius, užtikrinančius šalies finansinių stabulumą, todėl didelis dėmesys turėtų būti skirstamas riziką orientuotos bankų priežiūros sistemų organizavimui šiuolaikinėmis sąlygomis.