



INTRODUCTION TO BANKING SUPERVISION

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Introduction to Banking Supervision

Delivered to Examiners at the Central Bank of Jordan

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Question: Which bank is better, A or B?

	<u>Bank A</u>	<u>Bank B</u>
(JD Millions)		
Assets	1000	500
Liabilities	800	450
Capital	200	50
Profit in 2007	20	10



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Question: Which bank is better, A or B?

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(JD Millions)		
Assets	1000	500
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Capital	200	50
Profit in 2007	20	10

Answer: Bank A has more capital relative to its assets (20%) than Bank B (10%).

Bank B has more profit relative to its capital (20%) than Bank A (10%).

Bank A and Bank B have the same amount of profit relative to their assets (20%).



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Introduction to Banking Supervision

What is banking supervision? Arriving at a single, comprehensive, informed opinion about the condition and performance of a bank and taking the appropriate actions if condition or performance are poor in any way.

How do we arrive at this opinion about the condition and performance of a bank? We look at:

- Compliance with legal and regulatory framework
- Compliance with "best banking practices"
- Financial data, past and present
- The bank's management structure, policies, and procedures
- The bank's record of making decisions in the past – bad or good?
- Comparison of this bank's condition and performance with similar banks



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Why do we supervise banks?

- To protect depositors of banking organizations against avoidable losses, thereby contributing to confidence in the financial system and the mobilization of private savings for credit.
- To promote the smooth operation of the payments system, uninterrupted by systemic failures of financial institutions.
- To prevent the abuse of financial institutions by money launderers and terrorist financiers.

Fact: Inadequate bank supervision in the United States in the 1980s and early 1990s contributed to the failure of over 700 banks, with losses to the U.S. taxpayer of \$120 billion.



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What are the mechanisms used to supervise banks?

Supervision consists of:

- licensing new banks;
- on-site examination and off-site monitoring;
- accounting and reporting requirements;
- enforcement of laws, regulations, and principles of sound financial management to achieve corrective action; and
- the promotion of orderly exit of financial institutions from the market when necessary.

Fact: Not even the best banking supervision can prevent all bank failures. The goal is to prevent avoidable losses that could result in the failure of a bank.



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What do we mean when we say a bank “fails”?

- Its assets are worth less than its liabilities (including deposits). This condition is called “insolvency.”
- It does not have enough cash – or assets easily converted to cash -- to meet a massive, temporary, unexpected withdrawal of deposits. This condition is called “illiquidity.”

How can a bank’s assets be worth less than its liabilities?

- $ASSETS = LIABILITIES + CAPITAL$. This equation is always satisfied.
- Because capital is a RESIDUAL claim on the assets of a bank, it is not an independent quantity. The value of capital is entirely determined by the value of assets and liabilities.



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- Therefore, we may also say that: $CAPITAL = ASSETS - LIABILITIES$
- This is true regardless of how much money the shareholders originally invested in purchasing their shares of the bank.
- The value of the assets and the value of the liabilities of a bank are changing all of the time. Therefore, the capital of the bank changes all the time.
- However, the value of the assets usually fluctuates by MORE than the value of the liabilities. So we may say that the value of the bank's capital is primarily determined by the value of the assets.

Fact: This is NOT to say, though, that capital is the same as assets. Capital is NOT cash or any other type of asset. Instead, capital represents claims on assets.



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What are the consequences of a bank becoming insolvent?

- The bank may have to be bought by a healthy bank. The healthy bank will want to be paid by the government for the excess of the liabilities it assumes over the assets it acquires.
- Example: Bank B has assets of 80 and liabilities of 100. Bank A agrees to buy Bank B, but demands that the government pay 20, so that the value of assets acquired and liabilities assumed will be equal.
- Or, the bank may simply be "liquidated" – its assets are sold separately and the money is used to pay the depositors.
- Either way, the government suffers a loss.



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Why do insolvent banks have to be handled quickly?

- The situation of assets < liabilities could last for a long time – but this is not desirable.
- Banks earn income on their assets – such as loans to borrowers, government securities, etc.
- But they also have to pay expenses on their liabilities – such as interest expense on deposits.
- This situation results in losses – and losses may decrease the confidence of depositors in the bank, causing them to withdraw their deposits.
- If the bank does not have enough cash to pay these depositors, it will have to sell some assets – probably at a loss – making the insolvency worse and maybe causing a loss of confidence at other banks.



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Let's go back to the mechanisms used to supervise banks...

1. Licensing new banks

- Organizers of new bank make an application to the CBJ – this application can either be approved, rejected, or sent back with requests for additional information.
- Criteria for approval:
 - *Is the business plan sound? Will the new bank be profitable after a certain period of time?*
 - *Are the proposed Board of Directors and Management of the bank "fit and proper" individuals? That is, are they honest and trustworthy? Have they ever declared bankruptcy? Were they ever directors or managers of another bank that failed?*



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2. On-site examination and off-site monitoring

Fact: On-site examination is the cornerstone of the supervisory process.

- On-site examination includes:
 - Interviews with management
 - Inspecting the written policies and procedures of the bank and the degree to which those written policies and procedures are followed
 - Evaluating whether the bank's financial statements accurately show the bank's capital – requires a determination of the value of the bank's assets
 - Checking the accuracy of accounting records
 - Checking the adequacy of internal controls and the audit function
 - Checking for compliance with laws and regulations
 - Writing a "Report of Examination" that summarizes findings and assigns a **rating** to the bank.



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2. On-site examination and off-site monitoring (continued)

- The Report of Examination and the Rating are organized according to the CAMELS rating system.
- CAMELS =
 - Capital adequacy
 - Asset quality (is the bank making good loans or bad loans)
 - Management (including internal controls, corporate governance, audit)
 - Earnings (profitability)
 - Liquidity (does the bank have enough cash or assets easily converted to cash to meet a temporary, unexpected excess of deposits over withdrawals)
 - Sensitivity to market risk (is the bank's capital or profitability overly sensitive to changes in interest rates, foreign exchange rates, or share prices, and does the bank adequately measure and monitor that risk)



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2. On-site examination and off-site monitoring (continued):

- Report of Examination assigns a rating for each CAMELS component
- Rating is 1 through 5 – where 1 is the best, and 5 is the worst
- In addition, a "composite" rating is assigned, again 1 through 5
- Composite rating is not necessarily the average of individual component ratings
- Example: C = 2, A = 3, M = 3, E = 4, L = 1, S = 2
- Average is between 2 and 3
- Generally more weight is placed on management than other components



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2. On-site examination and off-site monitoring (continued):

Fact: *The CAMELS rating is the single, comprehensive, informed supervisory opinion about the condition and performance of the bank.*

Questions: *Why not have examiners in each bank, at all times?*

If not, what is the appropriate frequency of onsite examinations?

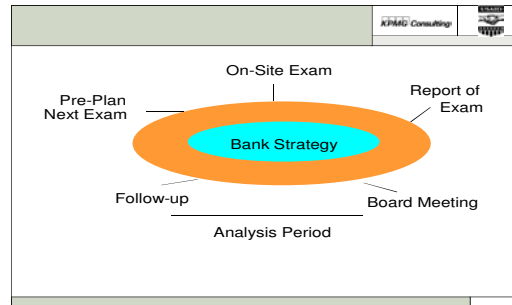
The answers to these questions lead us into a discussion of the role of off-site monitoring.



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2. On-site examination and off-site monitoring: supervisory cycle



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2. On-site examination and off-site monitoring (continued):

- Off-site monitoring covers the period in the supervisory cycle between on-site examinations.
- Off-site monitoring:
 - **Looks back** at the results of the last on-site examination and checks for the correction of financial problems revealed at the last examination.
 - **Looks ahead** to the next examination and identifies areas of emerging risk for the examiners to focus on.
 - **Describes** in a written analysis the current condition and performance of the bank
 - **Compares** the bank's condition and performance to similar banks
 - **Recommends** changes to the CAMELS rating, a targeted examination, or a full-scope examination earlier than scheduled, if necessary.



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3. Accounting and reporting requirements

- Banking supervision departments require banks to submit financial data on a daily, weekly, monthly, quarterly, semi-annual, and annual basis.
- The data are usually required to be submitted according to International Financial Reporting Standards (IFRS), but sometimes the bank supervisors require different standards ("regulatory accounting practices").
- In addition to the balance sheet and profit and loss statement, banks are usually required to submit data on non-performing loans, financial assets and liabilities categorized by remaining time to maturity and by currency, and other details.
- The data are used in both on-site examinations and off-site monitoring.



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4. Enforcement of laws, regulations, and “best banking practices”

- The CBJ has a variety of enforcement tools to force banks to take corrective action when problems are identified in on-site examination and off-site monitoring.
- These enforcement tools range from informal, mild measures to formal, drastic measures
- Some examples of formal, drastic measures are:
 - Removal of certain directors or management for negligence or misconduct
 - Installing a temporary administration
 - Recommending the forced sale or liquidation of the bank



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4. Enforcement of laws, regulations, and “best banking practices” (continued)

- Some examples of regulations to require best banking practices:
 - Minimum capital requirements
 - Minimum liquidity requirements
 - Maximum loans to a single borrower or group of related borrowers
 - Restrictions on loans and other transactions with related parties to the bank
 - Requirements to review, classify, and appropriately value loans
 - Required approval of increases in ownership of the bank (“change in control”)
 - Limitations on interest-rate risk
 - Limitations on foreign-exchange risk



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4. Enforcement of laws, regulations, and “best banking practices” (continued)

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Fact: It is not enough merely to comply with regulations. Banks also need to comply with many “best banking practices” that are not stated as formal regulations.



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***Thank you and best of luck in your
career as a banking supervisor with the
CBJ!***

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