Concepts of Prudential Supervision

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Capital Markets

Sources of Long Term Financing

Sale of financial assets

- Via stock exchange or private placement
  - Stocks
  - Bonds

Borrow from Financial Institutions

Financial Institutions

- Banks
- Pension Funds
- Insurance Companies
- Single purpose lending institutions
- Mutual funds
- Finance Companies

Financial Intermediation

Gather the savings of many

- Households
- Entrepreneurs
- Businesses
- Government entities

Lend or invest in others

- Small Businesses
- Households
- Entrepreneurs
- Large enterprises

Invest in Financial Assets

- **Loans**
- **Stocks**
- **Bonds**
- **Equity interests**

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Asymmetric Information

Adverse Selection

- Lower quality borrowers with higher risk are more likely to borrow and to offer to pay a higher interest rate.
- Can create a condition where lenders will not lend at all.
- Minimizing adverse selection requires that lenders screen out good from bad credit risk.

Moral hazard due to Asymmetric Information

- **Borrowers may engage in activities which reduce the chance of repayment.**

- **There are incentives to shift to higher risk/return activities which may or may not pay off.**

- **OR, there are incentives to misallocate funds for personal use**
  - To undertake investment in unprofitable projects to increase power or stature.
  - To use funds for personal reasons rather than intent stated in lending agreement.

Asymmetric information

Borrowers know more about the potential risks and returns than lenders

Reducing Moral Hazard costs money

While moral hazard is not only caused by Asymmetric information, it can be reduced by –

Information gathering or monitoring

- Can be expensive
- Can be time consuming
- Will reduce return

Imposing restrictions

- Cash flow funding
- Strict limitations on use of loan proceeds

Why are Banks Special

Banks are generally well suited to reduce adverse selection and moral hazard due to asymmetric information.

It is the nature of banks to take risks.

Banks can reduce risks

- Engage in long term customer relationships
- Issue loans using lines of credit
- Scrutinize borrowers deposit accounts (additional advantage in monitoring borrower behavior)
- Can threaten the borrower with restriction of future lending
- Have contracting advantages over investments with the imposition of interest rates and collateral requirements

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What is the role of Prudential Supervision?

Back to Asymmetric Information

- Depositors lack information about the quality of loans issued by banks

- Depositors may not want to put money in banks due to distrust of the financial system or the government

- Banks operate on a sequential service constraint – 1st come 1st served

- Runs on banks with rumored problems are not unreasonable creating systemic risk via the contagion effect

- Panic or wariness reduces the financial intermediation causing financial contraction

Lessening Panic or Wariness

- **Government interventions**
  - Deposit Insurance
  - Lender of Last Resort
- **Can lead to Moral Hazard and Adverse Selection within a financial system**

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What is Prudential Supervision

Prudential supervision

Government regulation and monitoring of the banking system to ensure safety and soundness.

- **Bank licensing**
- **Capital requirements**
- **Bank Examination**
- **Supervisory vs. regulatory approach**
- **And**
  - Restrictions on asset holding and activities
  - Separation of banking and other Financial Services Industries
  - Disclosure requirements
  - Restrictions on Competition
  - Risk based Deposit Insurance Premiums

Licensing

Applications for new banks are screened to prevent undesirable owners

- Evaluate the quality of bank management
- The business plan of the bank and its potential to generate earnings
- The amount of initial capital

Capital Requirements

Paid in Capital requirement – Banking law requires 10 billion I.D.

Risk-weighted capital – Banking law requires 12% capital to risk-weighted assets.

Bank Examination

Banks must be monitored to make sure if they comply with regulations to limit risk taking

Enforcement actions must be taken in the event that banks engage in unsafe and unsound activities

Banks should be required to report their financial information on a regular basis

Supervisory v. Regulatory Approach

Regulatory approach:

- Prudential supervision based on regulatory rules.
- It is an assessment of quality of the bank's balance sheet and loans at a point in time.
- Determining whether the bank meets capital requirements and restrictions on asset holdings.
- It is reactive.

In today's world, financial instruments and markets are innovating at such a rate that banks and their staff can take significant risks rapidly while remaining within the boundaries of regulations, which cannot develop at same rate due to general regulatory and legislative process. This renders the regulatory process impotent against such risks since it only looks at the books of the bank at one point in time.

Sup v reg continued

Supervisory approach

- Builds on the regulatory approach.
- Assesses management's ability to set and administer its own policies of risk management.
- (S) in CAMELS – Sensitivity to Risk
  - Quality of oversight provided by the Board of Directors and senior management
  - Adequacy of policies and limits for activities that present significant risk
  - Quality of risk measurement and monitoring systems
  - Adequacy of internal controls to prevent fraud or unauthorized activities

Restrictions on Asset Holdings and Activities

In US – banks are not allowed to hold common stock.

In many other countries banks are not allowed to make major investments without the prior approval of the central bank or supervisor.

Regulations may also restrict banks from engaging in commercial activities through licensing.

Banks are restricted in order to prevent them from taking on too much risk.

Separation of banking and other Financial Service Activities

Depends on the development of the market

Effectively restricts the government safety net to Banking.

Limits an otherwise unfair competitive advantage.

Restrictions on Competition

Take four forms

- **Separation of banking and non-banking business**
- **Limitation of foreign banks entering the market**
- **Branching restrictions**
- **Ceilings on interest rates charged or paid**

Disclosure Requirements

- **Requires adherence to suitable accounting standards**
  - International Accounting Standards/International Financial Reporting Standards
  - BIS/IMF and other international reporting needs
- **Transparency at both systemic and individual level**
  - Borrowers have an obligation to fairly report their activities
  - Banks have an obligation to fairly report their commissions and fee structures and to fairly disclose to the public their financial statements
  - The system itself should be relatively transparent
    - Sanctions should be public information
    - The aggregate condition of the system should be reported

Risk-based Deposit Insurance Premiums

As an institution presents risk to the system based on an evaluation of on-site and off-site examinations, it would be assigned a premium rate based on risk of failure causing payment of deposit insurance.

Market Discipline

- **Monitoring by the investing public**
  - Stock prices reflect the investors' opinion of the company's profitability
  - Due to public trading – availability of information increases
- **Influence**

Principal Agency issue

The principal (depositors) expect that the regulator will

- **Allow only fit and proper bank management into the system**
- **Impose sufficiently high capital requirements as a first level of defense**
- **Set restrictions on holding risky assets**
- **Perform stringent examinations on a regular basis**
- **Close insolvent institutions in a timely manner**

Principal v agent continued

The agent, for fear of being blamed for financial difficulties, is prone to do the opposite "regulatory forbearance". This is in the hope that the financial system will work through its problems in a form of bureaucratic gambling.

Regulatory forbearance takes many forms:

- Allow unqualified management to remain in place rather than face public scandal
- Allow insolvent banks to remain open after failure to meet capital standards.
- Merge insolvent banks creating one big bad bank out of two
- Allow banks to violate rules and regulations without adequate sanctions
- ……..

Our Goal

The goal of the operation of the Central Bank of Iraq is price stability.

The Primary purpose of prudential supervision is to promote financial stability.