IS THE FAILURE OF THE SUPERVISION OF BANKS THE ACHILLES HEEL OF THE GLOBAL BANKING SYSTEM?

By Ted Petropoulos
Head of Petrofin Research

for Nafs

The last five years have been marked by bank instability and / or failures. Bank failure is nothing new. Often, the management of banks fails to adequately assess the risk associated with the loans it provides. On other occasions, market changes bring about a deterioration of loans and the need to take substantial loan provisions. More recently, banks have become involved in riskier, sophisticated products, which, themselves, are highly leveraged, thus increasing further their risk. Banks have developed large dealing and investment departments, not only to service client demand but to make profits from taking positions in foreign exchange, commodities, financial and real estate products etc. These positions are invariably speculative and may involve a web of highly complex product or commodity structures.

The inevitable result of all the above developments has been that the capital of banks has needed bolstering, not only to cover the above risks and / or losses but to, also, provide a higher buffer in the capital solvency of banks. This has been one of the main aims of Basle I, II, and III, which has sought to, also, better regulate the banks.

Internally, risk has been addressed by banks by the development of sizeable and powerful risk handling departments.

New loans, nowadays, require the approval both of the credit, as well as the risk departments. The latter have developed sophisticated risk assessment models, which determine risk, the bank's capital that is "allocated" for each loan and the pricing that is required to compensate the bank both for the risk and the capital requirement. In addition, changes in each loan results in changes in the risk weighing. Hence, loans are being reviewed periodically (usually annually) or when significant events dictate an additional review.

The banks' internal audit department and auditors, also, play an important role in ensuring that all external and internal regulations are being adhered to and that the bank's financial statements represent an accurate picture of the bank's financial condition. Such financial statements and bank reports to the Central Bank are important both to the bank supervisory authorities, as well as to other banks and the bank's clients, including its depositors.

Banks and the Economy

Banks handle a very important function in a free economy. They receive deposits from individual and corporate depositors and use such deposits to grant loans. As banks are very highly leveraged (over 10%), they need to be extra careful, as the capital supporting such leverage is relatively thin i.e. often less than 10%.

The role of ensuring that banks are adequately capitalised and that their bad loan provisions are adequate, has rested with each bank's central bank authority that is responsible to supervise each bank. Central banks closely scrutinize all the loan exposure and all the other risk assets of each bank. Should they find that a bank's liquidity and capital adequacy levels fall to below the prescribed ratios, then pressure is applied on to the bank's management and they on the bank's shareholders, to provide more capital.

Should a bank have liquidity problems, i.e. loan and other risk exposure cannot be safely covered by its depositors base, including other forms of liquidity e.g. bank bonds, convertible bonds, etc. then the bank is pressed to reduce its loan book and / or other risk assets i.e. to deleverage. In all countries, there are emergency funding mechanisms in place, to assist banks through the above transition and to provide short-term liquidity, in order to prevent a "bank run". As all readers know, once a bank is seen as being in trouble, depositors rush to withdraw their monies. Due to the leverage of banks, this quickly develops into a bank run and the eventual closure of the bank.

Central banks receive continuous information from each bank and can detect early signs of trouble / bank run. Provided a bank remains solvent and its management is adequately and swiftly addressing its problems, a central bank would (within reason) support banks. It would

provide the necessary liquidity cushion until the bank's financials and liquidity would return to satisfactory levels.

The main aim of the central bank is not only to effectively supervise each bank and preserve an orderly market but to also preserve the deposits of "innocent" depositors, who have entrusted banks with their savings. Such deposit preservation is vital, as deposits represent the cornerstone of our banking system and allow banks to fulfill the primary task of supporting businesses in their investments and their ongoing financial requirements.

Should depositors take flight and hoard their monies or invest in non-productive assets only, e.g. gold, then the banking system slows down or even collapses. This is often described as the "multiplier effect", whereby based on higher depositors the banks generate credit and support an economy to expand. Withdrawal of depositors, restricts bank lending and this, if severe, may lead to the economy entering into a recession, with profound implications.

There have been many bank failures, in the recent past, the best known, perhaps, Lehman Brothers and Northern Rock. However, every day many smaller banks in the US and elsewhere close and there have been banks that nearly closed e.g. Royal Bank of Scotland and, closer to home, Agricultural Bank of Greece, Proton Bank and others. In general, small banks may be allowed to fail or be bought by other banks but large banks may be "too big to fail".

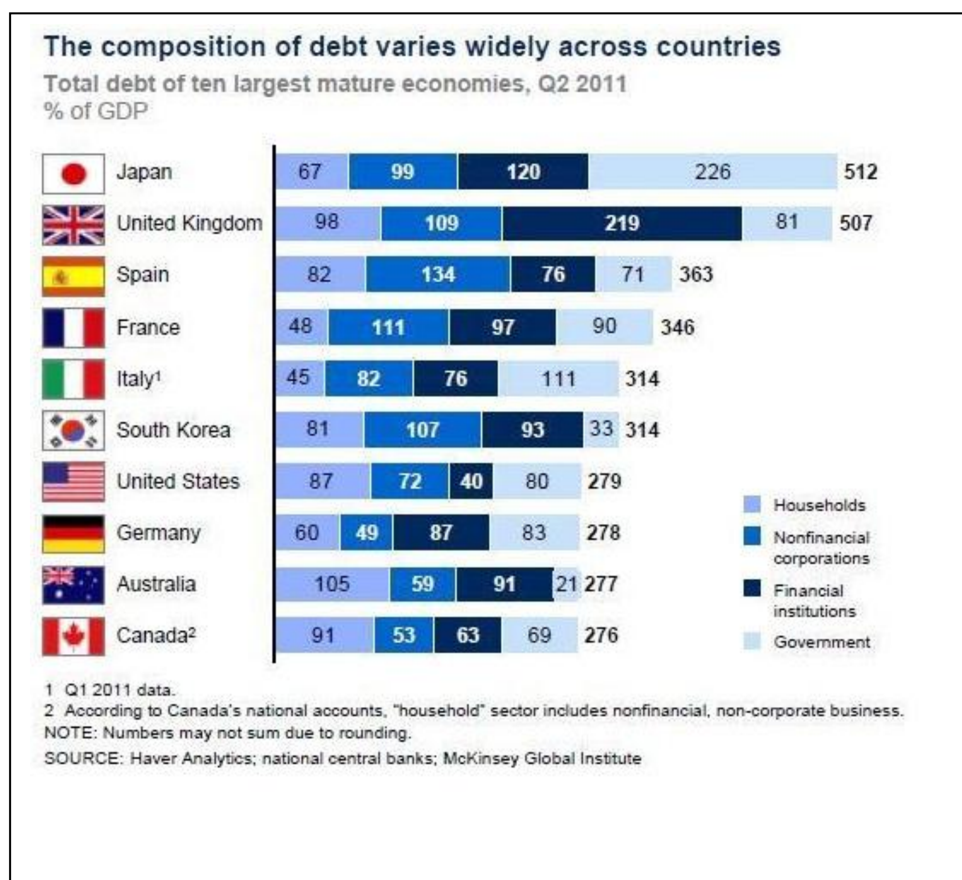
Some of the fallen banks may be nationalized, via the injection of state funds, with RBS being a good example, some are sold into stronger banks and some may receive and later pay back state funds, in the form of emergency loans, such as Citibank and other US banks, following the Lehman Brothers' bank collapse.

A common theme, running through each bank rescue, has been to safeguard deposits. This is provided up to €100,000, in the Euro zone, for each depositor. However, the aim has been for all depositors not to lose their deposits, as this would destabilize the banking sector. The protection of depositors has been EU public policy for over 15 years.

Recently, some affected banks have been divided into good banks and bad banks, e.g. HSH in Germany, as well as Agricultural Bank of Greece and Proton Bank, in Greece. Under this scheme, the good bank i.e. performing loans and deposits would be acquired by another bank, whilst the bad bank would go into runoff.

Whereas the bank's shareholders and holders of debt instruments, e.g. bonds, convertibles, etc., would, normally, lose a substantial and often all of their investments, the depositors' position would be preserved.

The provision to a bank of short-term or long-term financial support, by the central bank or, in the case of the Eurozone, the Central European Bank, would need to be kept under control for each bank and each country. Where country debt exceeds permissible levels, in order to reduce each country's debt, higher taxes would need to be raised and / or expenditure cuts as part of an austerity programme (see graph).



Ultimately, therefore, each bank rescue and / or widespread financial support to a country's banks would be "paid" by the country's tax payers. This is ethically and politically unacceptable, as the failure of

such banks should have affected the bank's shareholders and bondholders only. Had bank supervision been adequate and swift, a bank's slide into insolvency would have been detected and action taken at an early stage. Provided all shareholder value had not been lost, shareholders (existing and new) would have been called to provide more capital into the bank. This plus adherence to all the other measures undertaken by a bank's own management, as well as compliance to the directives of the central bank should have corrected the problem at an early stage.

For a bank to collapse or to be nationalized or supported to prevent a bank run, it is self-evident that both the bank's own management, as well as its supervision by the Central Bank, have failed.

Central banks, nowadays, have in-house experienced teams, dedicated to bank supervision. In addition, they can call in international firms, such as Black Rock, specializing in loan assessment, to conduct individual loan audits and determine loan loss provisions. How can, therefore, the Central Bank failure be explained?

In the past, a problem may have arisen when a rogue trader with no effective internal supervision entered into massive loss making transactions that endangered the whole bank. An example of this was Barings Bank. It is arguable that the Central Bank could have been "surprised" by such an event. However, although the magnitude of such losses may have been hidden by fraudulent reporting, their liquidity implications could not. Therefore, early liquidity warnings should have been given.

On other occasions, such as the subprime crisis in the US, a sudden collapse of a market through unreported high leveraged risks may have caught the Central Bank by surprise. Once again, however, effective supervising mechanisms and tools are available to prevent this.

On other occasions, a bank's management may have withheld or altered information that may have hidden the size of the problem from the supervisory body. Whatever the explanations or excuses, the failure of Central Bank supervision has resulted in the buildup of enormous losses and additional fundings falling onto the tax payers' shoulders.

Surprisingly enough, there have been no accusations against central banks, as to "dereliction of duty" or "concealment" or simple "ineptness". No central banker was called to account for his bank's failure to detect and remedy a problem at an early stage.

In addition, different reporting standards, financial presentation and bank supervision from country to country, has resulted in a widespread loss of confidence by depositors and the essential demise of the US dollar Interbank Market that had been such a good funding tool to banks, in the past.

In an effort to apply uniform supervision to all Eurozone member countries, a decision was passed six months ago by the EU that the ECB shall be responsible for uniform supervision across the whole Eurozone. For political reasons, though, this has not become effective in practice and, until it shall, depositors will continue to be wary of depositing with many banks.

Banks and the Depositor

Until recently, the position of the "innocent depositor" has been sacrosanct. This is no longer the case, though. The recent treatment of Cyprus and its main two banks have radically altered the position. In Cyprus, for unknown reasons, the two main banks (Bank of Cyprus and Laiki Bank) had been allowed to build up enormous bad loans and lost considerable monies in Greek state bonds that faced the impact of a haircut, last year. It is now emerging that what are essentially relatively small banks by international standards were being increasingly funded by the ECB to the tune of about €17 billion and that their problems had been unfolding over the last 3 – 4 years. One wonders what were the Central Bank in Cyprus, the ECB and EU doing all this time, as well as what were the Government of Cyprus and the banks' own managements doing to address the liquidity and capital issues.

What is more important, though, is that the EU decided, for the first time, to swift the cost of failure by banks under the supervision of the ECB and the national central banks to the bank's depositors over €100,000. This has been an unprecedented act. To justify their decision, they renamed "depositors" as "investors". Consequently, in the case of

Laiki, the depositors' losses are expected to be near 100% and in the case of Bank of Cyprus it is discussed that it might reach up to 60%. Moreover, strict withdrawal limitations have been applied to all depositors. It is a clear shift away from tax payers paying the cost of bank and central bank failure to depositors. It is ironic, of course, that for country nationals, most tax payers are also the depositors.

Recently, the president of the Eurogroup and various other officials, as well as member country ministers of finance, have made it clear that the "bail in" as recently baptized by the EU in Dublin, is a legitimate tool in the hands of the EU.

With the ECB having provided over €2 trillion in "emergency funding" to Eurozone banks and with further funds being provided under the EFSF EU fund, it can be argued that there are limits to the support to be provided to banks directly or indirectly, via tax payers. It should be noted that according to Bllomberg, the total assets of the global central banks shot up from approx. $8tr in 2008 to $15tr by end 2012.

Looking for alternative "pools of wealth" within the banks themselves, it is not surprising tht the EU focused on the bank's depositors.

In order to make the shift in policy more acceptable in their homelands, Eurozone countries that have up to now funded the support of weaker members, justified the shift by making reference to tax payers being unwilling to bail out "depositor investors", who were often earning higher interest rates or were depositors, who were using tax heavens to "wash clean" their monies.

There is an argument that investors that earn 3% and more on the US Dollar deposits, as opposed to 0.25% - 0.5% in Northern Europe, should have known that hey were running a risk. However, until recently, all depositors were lulled into a state of false security that their deposits would be defended by the EU, as per directive 94/19/EC of the European Parliament and the council of 30 May 1994 on deposit – guarantee schemes and subsequent confirmations thereafter.

Implications

Looking at the implications of the EU decision and its shift of focus towards depositors, we can foresee the following implications:

1) Massive flight of deposits away from Southern Europe states, e.g. Greece, Italy, Spain and Portugal towards Northern EU states, such as Germany, Holland etc. This would weaken the already weak EU states further.

2) Massive flight of deposits from the whole Eurozone banking sector towards the Far East, where depositors are not in immediate haircut risk.

3) Many depositors in fear of losing their deposits shall withdraw them (above €100,000 per bank) and either hoard them or invest in gold coins.

4) The above changes shall affect negatively the Eurozone and will exacerbate the forces that are building up for its breaking and the collapse of the Euro, and

5) The loss of confidence in banks will add as further impetus to the recessionary forces in the EU.

The shift in viewing depositors as investors and the increased risk of a haircut is, therefore, a negative development for the Eurozone that could have been avoided altogether, had the banks' supervision been more effective. An early diagnosis and cure is much better than a prolonged illness and an operation.

Finally, in view of the profound forces unleashed by the recent shift of EU policy, it is envisaged that this policy shall be reviewed in the future with a view to effecting damage limitation by the EU.

My overriding point is that had bank supervision worked, neither ECB / EFSF support nor deposit haircut would have been necessary and the capital bolstering process of banks would have been achieved more gradually and smoothly. Any banks failing to comply with the regulatory requirements, would have been forced to close at an earlier stage, which would have lessened the impact (if any) to the bank's shareholders. Hence, the supervision of banks is the true Achilles heel of our bank system.

In the meantime, uncertainty and loss of confidence rule.