WHY ARE BANKS SUPERVISED?

This article by Bruce White addresses, from three standpoints, the reasons why banks are supervised. The discussion is set against the background of the objectives of banking supervision in New Zealand.

In most Western countries, the business of banking is mostly conducted by private firms, owned and operated for profit along broadly the same lines as other businesses. They prosper or languish according to how well they perform in terms of this profit objective.

It is often asked, therefore, why banks should be subject to official supervision in a way that other business enterprises are not. This article addresses this question from three standpoints. First there is the nature and importance of the role played by banks in the economy. Secondly, some aspects of the financial structure of banks are considered. Thirdly, the investor protection aspect of banking supervision is discussed.

I  The Role of the Banking System in the Economy

A smoothly functioning banking system is something which is taken for granted by most people most of the time. Indeed, banks (and banking supervisors) seem to feature in the public’s consciousness generally only when things go wrong, for example when there is a run on a bank, or when a bank fails. As a starting point to understanding why banks are supervised it is necessary to understand the nature and critical importance of the role played by banks in a modern monetary economy.

The functions banks perform can be summarised under three broad headings.

First, banks provide the means of settlement for the bulk of the transactions (by value if not by number) which take place within the economy and across countries. Apart from barter transactions and transactions settled in currency, most transactions are settled by way of a cheque drawn on an account at a bank. Even purchases which, in the first instance, are charged to credit, including credit card, accounts are ultimately settled in this way.

In simple terms, a cheque is an instruction given by the person who writes the cheque, ordering his or her bank to transfer value from his or her deposit account to the person to whom payment is to be made.1 This system of making payments works effectively, however, only if both the payer and the payee have confidence in the bank’s ability to carry out legitimate payment instructions given to it. The payer must be confident of the bank’s ability to perform in accordance with his or her instructions as and when they are given. Otherwise a more reliable means of payment will be sought out, of which settling transactions in currency, or barter trade, would be the only immediately available

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1 A number of instructions to transfer funds are additionally effected by 'direct credit' and EFTPOS electronic fund transfer at point of sale. These means of transferring money in settlement of an obligation have the same effect as writing a cheque; it is just that the written instruction takes a different form or, in the case of EFTPOS, the instruction is conveyed electronically.
alternatives. Similarly, parties receiving payment in the form of a cheque drawn on a bank must have confidence in the bank’s ability to carry out the instruction given, as well as be satisfied that the payer has the funds in his or her account for the bank to transfer.

It is, of course, the case that from time to time cheques are dishonoured because the person making payment does not have sufficient funds. This, however, does not result in a widespread loss of confidence in the system because cheque dishonours are sufficiently isolated events. Moreover, the person receiving the cheque will generally be in a position to make an assessment of the financial integrity of the person tendering the cheque in payment and/or will take precautions to protect their position, for example, by asking for the address of the payer. Alternatively, the payee can ask for a bank card guarantee or for a ‘bank’ cheque, in which cases payment is guaranteed by the bank. And failing all else, payment in currency can be insisted on.

If it were thought that a bank might not be able to honour payment instructions legitimately given to it, however, more substantial disruption would result. The many people holding balances with the bank in question will immediately seek to withdraw them, that is, there will be a bank ‘run’. If the run is not stemmed, then the likely outcome will be failure by the bank to perform on instructions given to it, including an inability to satisfy demands for funds withdrawals. More concern that a bank may not be able to perform, therefore, can result in that very outcome.

So far as payments arrangements are concerned, failure by a bank could be particularly disruptive. First, all outstanding cheques drawn on that bank and tendered in payment for goods and services, but not yet paid by the bank, would be liable to be returned as ‘not paid’. Particularly in the case of wholesale financial markets, the disruption would be compounded if, as happens, the same ‘funds’ had been transferred by cheque through a number of hands, in settlement of a number of transactions, all during the course of the same banking day. The financial system can operate in this fashion only because participants in the system assume that each cheque will be honoured, i.e., that both the customers who drew the cheques and their banks have sufficient funds. Clearly the functioning of the financial system and of transactions based economy more generally, is importantly dependent on maintenance of public confidence in the banks which operate these payment mechanisms.

The second major function of banks is to act as financial intermediaries. That is, they act as a repository for the savings of those who spend less than their income, and as a source of borrowed funds for those whose spending exceeds their income. In playing this role, banks facilitate real resource transfers amongst different groups of people, in accordance with their different needs and preferences. These needs and preferences depend, for example, on life cycle factors, such as the need to borrow to buy a house, and the need to save for retirement. Also, banks play an important role in making savings available to those with productive investment opportunities.

Of course, ‘banks’ are not the only institutions which perform this financial intermediation function. Other specialised institutions, such as life insurance companies and

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2 In some countries, payments systems, at least for high volume transactions, have been designed in a way which avoids the ‘ending back’ of payment instructions issued to a failed bank. One approach is for payment instructions to be passed via the central bank. Another involves all banking industry participants collaborating to effectively guarantee payments. This can be achieved by banks agreeing to provide the funding needed to enable a failed bank to perform on the payment instructions received but unpaid at the point of failure.
superannuation funds, also intermediate between savers and borrowers. Also a significant amount of borrowing and lending is arranged in the securities markets without the involvement of any intermediary. Nonetheless banks, in most countries, including New Zealand, are of major significance in the overall saving and investment process.

One reason why banks have established and maintained this intermediary role is because they specialise in assessing the creditworthiness of borrowers. A person who deposits money with a bank, in effect, lends the money to the bank which, in turn, lends to third parties (who the depositor does not know). The depositor entrusts his or her money to the bank on the basis of an expectation that the bank will ensure that the value of the loans backing the deposit, and hence the bank’s capacity to repay, is maintained. This the bank does by carefully assessing and monitoring the creditworthiness of its borrowing customers. In this sense, a large part of the service banks provide to their depositors is a credit evaluation service - the depositors lend to banks rather than directly to ultimate borrowers because of the costs and difficulties which can be avoided by having banks carry out the credit assessment and monitoring role. This specialisation of roles also has advantages for borrowers. By maintaining a banking relationship, the bank can keep the borrower’s creditworthiness under on-going review. This enables the borrower to access funding when needed on a reliable and timely basis, without incurring substantial ‘search’ costs.

As for payments services, however, these arrangements work only to the extent that the parties involved have confidence in the bank at the centre of them. If it were thought that banks’ standards of credit assessment and monitoring had deteriorated to the point where there were doubts about the value of the assets backing their deposits, then savings would be directed elsewhere, including to real assets. To the extent that resources are misallocated as a result, there are attendant costs for overall economic efficiency.

Thirdly, banks are an important source of liquidity for an economy. This is inherent in the payments services provided by the banking system, insofar as deposits held for transactions’ purposes must be available for transfer on demand. A substantial proportion of bank deposits are accordingly held in on demand or readily accessible accounts. Borrowers, on the other hand, generally have a need for longer term funding. Banks, to some extent, can reconcile these competing needs by operating on the basis of an assumption that not all customers holding demand deposits will wish to withdraw or spend them at the same time. Also, in the normal course of business, on any day a bank’s customers are likely to lodge to their accounts more or less as much as they withdraw. This balance, though, can be upset if a bank’s customers lose confidence in it. In this event, little will be deposited and substantial amounts will be withdrawn, ultimately resulting in the failure of the bank. Clearly, therefore, the role banks play in providing the link between the medium to long term needs of borrowers and the need the economy has for liquid transactions balances, is, as with the payments system, importantly dependent on the public having confidence in banks.

Another way in which banks provide liquidity to the economy is through the provision of loan standbys, acceptance facilities, underwriting facilities and through entering into commitments to lend. Through the provision of these sorts of facilities, many commercial transactions which would otherwise have to be made conditional upon the obtaining
of finance can be settled outright, i.e., as if the buying party actually held the liquid cash funds to settle the transaction. These sorts of credit arrangements facilitate the conduct of commerce to an important extent.

Taken together, the above considerations establish an important role for the banking system in the functioning of a modern economy. It plays a critical role in trade, both domestically and internationally, by enabling transactions to be settled, and in the saving-investment process through its financial intermediation role. More generally, the banking system is the major source of the liquidity which enables buyers and sellers of goods and services to effect their transactions in a smooth and continuous manner. Without this financial infrastructure the scope for an economy to progress beyond a subsistence level is limited.

II A Market Failure Basis for Supervision

The above discussion has outlined why the banking system is important but, taken by itself, does not make a case for supervising banks. Other industries are also critical in a modern economy, for example, the telecommunications industry. Indeed, a modern banking system could not operate without reliable telecommunications services. Yet telecommunications firms are not supervised for the purpose of maintaining their financial soundness. Why, then, is it that the telecommunications industry can be relied on to function reliably without official interventions designed to promote financial soundness, while the banking industry cannot? In other words, what is the market failure which suggests that supervision of banks is necessary, or at least could contribute to improved outcomes compared with an absence of supervision?

Banking supervision is basically concerned with constraining the risks which banks can take in using other people’s money: money which they have borrowed on the basis of a representation that it will be repaid in full together with interest at the rate contracted. To understand why it is necessary to place restrictions on banking firms, it is useful to consider the financial structure of a bank.

A feature of banks is that typically they have a low ratio of ‘own’ (shareholders’) funds to borrowed funds (deposits). This ratio is typically in the 5–10 per cent range, compared with a ratio of at least 40 per cent, and often higher, for non-financial business firms. The explanation for this atypical financial structure in the banking industry, lies, in part, in the nature of the business of banking, which substantially involves borrowing and lending in debt (value certain) contracts rather than in ‘equity’ or ‘participatory’ risk instruments.

By organising their funding structure in the way outlined, banks are able to service the appetite for low risk savings opportunities. But this additionally requires that they do not take excessive risks in investing their customers’ savings (and of course, that the

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3 The telecommunications industry, along with many other industries, are regulated for other reasons, for example, for competition policy and safety reasons. Banks are unique in this regard because supervision is directed at maintaining financial soundness.

4 This has not always been the case. For example in 19th century Scotland, bank shareholders were liable for a multiple of their subscribed capital, or in some cases, carried unlimited liability. Thus, bank shareholders carried a proportionately greater share of the risk of loss resulting from the failure of the bank than is the case today where banks typically are incorporated with liability limited to the amount of subscribed capital. Interestingly, early North American banks, before the creation of the Federal Reserve system, typically were also funded by their shareholders to a significantly greater extent than is the case today. The same was the case for the first banks established in New Zealand.
monetary unit of account is not eroded by inflation). Thus, on the lending side, banks are not primary risk bearers. They generally structure their lending contracts in a way that requires loans to be repaid in full, including where the ventures they finance are not as successful as the borrowers had hoped for. Of course, it is very much in the interests of banks to lend money only to those customers who they are satisfied will be able to repay their debts (and banks often work quite closely with their borrowing customers in this regard). But all lending involves some degree of risk. To guard against the possibility that a borrower will be unable to repay its debts in full, banks usually take the extra precaution of taking security over assets owned by the borrower for an amount sufficient to cover the debt.

The equity market, by contrast, services the appetite for savers’ direct risk participations in firms (including in banks), where returns are tied to the success or otherwise of the venture being financed.

In short, different sorts of financial instruments have developed to meet the different needs and risk preferences of different savers and borrowers. Banks are a group of financial institutions which specialise in supplying fixed value financial instruments.

An important additional point is that the payments system operates on the basis of transferable financial instruments (chequeable deposits). These instruments must be certain in value; otherwise payment obligations could not be settled exactly. It would be inconvenient, to say the least, if one’s cheque account deposit balance fluctuated in line with share market prices, for example. That is why bank deposit balances are fixed in nominal terms rather than vary according to the value of the bank’s assets.

But, the inherent imbalance between ‘own’ funds and ‘borrowed’ funds in a bank’s overall funding mix presents some potential problems. Because banks’ shareholders have only a small amount of their own funds at stake, there is an underlying incentive for banks to tend toward risk taking activities. This is because if risks pay off, then all the risk premium accrues to the shareholders. If not, shareholders’ losses are limited to the amount of their (relatively small) investment and banks’ depositors bear any remaining loss. In short, banks’ shareholders, in the absence of supervisory requirements and constraints, would potentially have access to large profit opportunities, but with limited downside risk to themselves. This could be expected to be the case most especially when the providers of the borrowed funds (depositors) are unable to effectively monitor and enforce constraints on the risk-taking behaviour of the bank.

This makes banks something of a financial paradox. They have a financial structure which suggests that they might be at the risky end of the spectrum of commercial enterprises, yet they represent themselves, and are widely regarded, as being financially more secure than virtually all other private sector firms.

The reconciliation of this apparent contradiction lies in the very conservative portfolio management behaviour which banks implicitly undertake, and are widely assumed, to maintain. The role of banking supervision is to ensure that this implied covenant is abided by.
Official supervisors have a role in this regard mostly because banks’ depositors are generally not well placed to monitor the portfolio behaviour of banks nor to enforce compliance with the terms of the notional covenant depositors have with their bank. One reason for this is because a substantial proportion of banks’ deposits come from a large number of depositors, each holding a relatively small, mostly on demand, balance. For these depositors the costs of monitoring the bank’s position in any detail would outweigh the benefits. A more cost effective strategy for them is to keep their ‘eyes and ears open’, and to be prepared to withdraw their deposits quickly should any doubts arise as to the bank’s ability to meet its obligations. This would be the case whether the doubts were based on fact or rumour.

Moreover, there is a risk that depositors may develop doubts about the soundness of one bank not because of any specific adverse information they may have about that bank, but because of problems being encountered by another bank. In the absence of information, the risk is that those with deposits at sound banks could also lose confidence merely on the basis of ‘guilt by association’. Thus, the consequences of a bank failure need not necessarily be confined to that bank and its customers, but can spread to other banks and their customers. This phenomenon is known as ‘contagion’.

The objective of banking supervision is broadly to replicate the disciplines which monitoring by depositors, if this were cost effective, would create. In so doing, supervision can maintain confidence in the banking system. This does not mean that supervision should be so intensive or hands-on that banks should never be allowed to fail, nor that depositors should receive absolute protection from investment loss. But it probably does require that these outcomes should occur only very rarely and then should be clearly identifiable as being the result of isolated, bank specific, problems not shared by banks in general.

Banking supervision seeks to achieve this objective through the following forms of intervention:

- A registration, licensing or chartering process. This is intended to limit ownership of banks to persons of integrity and standing, who would not be likely deliberately to engage in excessive risk-taking behaviour such that the interests of the bank’s depositors could be jeopardised.

- Prudential regulations which place outer bounds on risk taking. These usually include:

  (1) minimum capital (or ‘own funds’) requirements to ensure that the owners have some incentive to act prudently, and to protect depositors, up to a point, should losses be incurred;

  (2) maximum exposure limits, which place constraints on the maximum extent to which a bank’s capital can be ‘exposed’ to a single risk, and which therefore enforce a minimum level of portfolio diversification; and

  (3) constraints on lending to persons connected with the bank’s owners, to
guard against the bank engaging in lending which, whilst beneficial to the bank’s owners, could be prejudicial to the interests of its depositors.

- Monitoring arrangements. These usually entail monitoring by the supervisor, in some countries through on-site inspections and in others by involving banks’ external auditors. In some countries banks are also required to comply with compulsory public disclosure requirements designed to facilitate monitoring of the financial condition and of the risk taking behaviour of banks by their depositors.

- Failure intervention powers, which enable the supervisor to take control of the bank when its ‘own funds’ have been exhausted.

How the supervision process is applied in New Zealand will be the subject of a later Bulletin article.

III Investor Protection Issues

In many countries, an explicit objective of banking supervision is to protect depositors’ funds. In some cases this protection is provided by (public or private) deposit insurance arrangements, under which losses of depositors’ funds resulting from a bank failure are borne by the insurance fund. The insurance fund is usually maintained by way of premia charged to banks in proportion to the amount of deposits insured. In some other countries, there is no explicit insurance fund, but the supervision legislation makes it clear that the supervisor has a responsibility to depositors. In these ways depositors are provided with reasonably explicit protection against loss, at least up to certain limits (and sometimes, implicitly, for amounts beyond the specified limits). The corollary is that the supervisor or insurance fund takes on the role of underwriter of banks, at least to some extent.

Where the insurance fund, or the authorities, assume this role, the basis for supervision is more direct. If depositors are effectively guaranteed against loss, confidence in banks and the avoidance of disorderly bank failures is virtually assured. The role of supervision becomes one of limiting the risks the insurance fund or supervisor assumes through acting as underwriter. Deposit insurance effectively removes any incentive depositors may have had to monitor the bank and removes the threat of deposits being shifted elsewhere if the bank is thought to be risky. In the absence of these market disciplines and without supervisory constraints, banks could take unlimited risks in pursuing profit opportunities. The tendency would be for banks to take greater risks and to be less careful than they otherwise would. The insurance term for this tendency is ‘moral hazard’. The supervisor’s primary weapon in countering moral hazard where depositors’ funds are guaranteed is to require the owners of the bank to contribute and maintain a meaningful amount of capital funds. These funds bear losses ahead of depositors’ funds and, in this way, perform the function of a ‘deductible’ or ‘excess’ in an insurance policy.

In New Zealand the authorities have stopped short from guaranteeing bank deposits under deposit insurance arrangements or accepting responsibility for deposit losses resulting from bank failures. But, for the reasons outlined earlier in this article, this does not completely remove the need for interventions designed to support and reinforce market disciplines. It does, however, enable the authorities to apply a lighter regulatory
hand, first because the overall approach is one which bolsters rather than undermines depositor discipline and second because the authorities are not exposed financially and therefore do not have the same need to regulate to protect themselves against direct financial (underwriting) loss.

Finally, it should not be overlooked that the banks themselves are a set of ‘investors’ who have a strong interest in the stability of the banking system. Reasons for this include that:

- Banks from time to time carry large exposures against each other.

- The payments services offered by banks are critically dependent on public confidence being maintained in all the banking participants which make up the system.

- Banks have an interest in risk-reducing and monitoring arrangements being in place which counter the risk of contagion.

- It can be to banks’ competitive advantage to be able to represent themselves as being monitored under a credible set of banking supervision arrangements.

The existence of the various investor interest groups who benefit from banking supervision is also a factor in the explanation why governments around the world maintain banking supervision arrangements. Authorities must, however, guard against the risk of ‘capture’ by any of those interest groups. When ‘capture’ occurs the supervision process is prone to be redirected toward serving sectional, short term, objectives in a way which often accentuates rather than counters market failures.

For example, banks have an incentive to seek regulations which make certain types of business the exclusive preserve of banks, and/or which create anti-competitive barriers to entry to the industry. These sorts of measures, by sheltering banks from market disciplines, can contribute to stability in the industry in the short term. Also, however, they generate costs which undermine the system’s efficiency. The weight of these costs on consumers of banking services eventually can result in pressure for a move to a more competitive banking system. The costs of transition from a protected to a more competitive banking system can be high. This can be illustrated by recent New Zealand experience where, following deregulation of the financial system in the mid 1980’s and a drive towards financial sector competition and efficiency, some banks and other financial sector firms newly exposed to greater competition have incurred substantial losses (and some non-bank institutions have failed.)

Similarly, depositors have an incentive to press for officially provided protection for bank deposits. Again, these arrangements buy stability in the short run (by removing the risk of depositor loss, and thereby removing the threat of bank runs) but at the risk of accommodating greater risk-taking behaviour by banks. Where depositors’ funds are effectively guaranteed by an insurance fund or supervisor, depositors are relieved from responsibility for taking care in making investment decisions. The result is that banks are given more leeway by their depositors than they might otherwise have. In this situation, more reliance must be placed on the supervisor to detect and constrain risk-
taking behaviour by banks and where supervision proves to be insufficient, the cost may have to be met out of public funds. The recent problems encountered by the savings and loan institutions in the United States, where depositors’ losses to the extent of some hundreds of billions of dollars are being met from public funds, is an illustration of this sort of outcome.

**Conclusion**

Banks have a vital role to play in a modern monetary economy, particularly with regard to their role in the payments system, as financial intermediaries and as the major source of liquidity which enables commerce to function smoothly. But in order to carry out these functions, banks need to have a financial structure unlike that of most other firms. In particular, they are typically funded to a much greater extent by borrowed funds (deposits) and a substantial proportion of those borrowings usually are withdrawable on demand or at short notice, while the assets they finance tend to be much less liquid.

The cornerstone of a banking system structured in this way is market confidence. Depositors rely on banks to limit the risks they take to a level that at all times gives them an ability to repay all deposits as they fall due, plus the rate of interest contracted. Depositors themselves have an important role to play in securing this sort of behaviour by banks, through the discipline of their scrutiny of their bank’s affairs. But it is also recognised that effective monitoring of banks by depositors is costly. For many depositors, the most cost effective strategy is to keep their ‘eyes and ears open’ and, should uncertainties about the soundness of their bank emerge, to maintain a readiness to ‘run’ (whether the uncertainties are based on fact or rumour). As a result, banks, and the banking system, are vulnerable to any event that might result in market doubts about banks’ ability to meet their obligations.

Banking supervision is aimed at countering this inherent weakness in the system, primarily by establishing a framework within which banks are required, and are known to be required, to operate. This framework seeks to limit the risks that banks take, so as to provide the banking system with a reasonably high level of insulation from adverse events which occur elsewhere in the economy and to provide a basis for confidence in banks in general. But banking supervision is not intended to provide an absolute guarantee against any bank failing, nor against depositors of a failed bank suffering some loss. Certainly it is not intended to protect banks’ shareholders’ funds from the risk of loss. Rather, the objective is to provide a framework of constraints, disciplines and incentives designed to make bank failures rare and isolated events. The ultimate objective is to provide a basis for confidence in the banking system, while leaving banks with scope to respond competitively to customers’ savings and borrowing needs.
WHAT IS A BANK?

No attempt is made in this article to define a bank. There is no straightforward definition. The Banking Act 1982 defines a bank only as someone who carries on the business of banking, without giving any statutory guidance on what constitutes the business of banking. It is also evident that the term 'bank' does not have a common meaning internationally. In some countries, such as New Zealand, Australia and Canada, banks traditionally have been among the larger, more significant financial institutions in the economy, while in other countries, for example, a number of Western European countries, institutions, whether large or small, which take deposits have generally been regarded as banks. Under the Reserve Bank of New Zealand Act 1989, any person whose business substantially comprises the borrowing and lending of money, or the provision of other financial services, is eligible to be registered as a registered bank, if it meets certain qualitative and prudential standards. Upon registration, the institution can include the word 'bank' in its name, and becomes subject to prudential supervision. No particular area of business has been made the exclusive preserve of banks, and the range of activities which registered banks can engage in transverses the full range of financial sector activities. For the purpose of this article though, the main focus is on the role of banks as financial intermediaries (borrowers and lenders) and as providers of payments services, which historically have been, and remain, the principal functions of 'banks' in New Zealand.