“Institutional Organization of Banking Supervision: Lessons for Ukraine”

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Institutional organization of banking supervision: lessons for Ukraine

Abstract

The paper addresses the issue of banking supervision organization and realization in Ukraine based on world's experience on the subject. Also the problem of potential modernization of banking supervision institutional base is explained taking into account the supervision authorities practices and banking system functioning in some European countries. The impact of central banks on the national systems of banking supervision is discussed. The conclusion is drawn that there is no clear tendency in relation to supervisory models; every country chooses an acceptable institutional structure depending on the specifics of its national economy, development trends in the credit system and its financial market.

Keywords: banking supervision, control, banking system, National Bank of Ukraine, Basel II.
JEL Classification: G21.

Introduction

Today the study and implementation of the basic principles of effective banking supervision introduced by the "Basel II" system are among the most important tasks for banking supervisory authorities in Ukraine. Ukrainian experts offer different opinions about the dates of Ukraine's transition to these principles. The management of the National Bank of Ukraine believes that the banking system of Ukraine will be ready for transition to the new standards not earlier than in 2016. In bankers' opinion the implementation of these principles by the United States, Russia and countries of the European Union, as well as Ukraine's joining the World Trade Organization will necessitate the rapid modernization of the existing system of banking supervision in accordance with the new rules.

The basic principles of banking supervision envisage the introduction of new methods for banking supervisory authorities, as well as the reconstruction of the existing relations between the banking supervisory authorities of the National Bank of Ukraine and banks of the second level of Ukrainian banking system.

1. Basic material

According to the first principle of Basel II, an effective system of banking supervision should determine the activity of all state authorities engaged in the banking supervision. Every administrative body must possess its operational independence, carry out its activity transparently, have a strong management and adequate resources in order to perform its duties. Also, it is necessary to ensure the effective legislative field for banking supervision, which has to regulate the issues of banks' formation and subsequent control of their performance. The legislation on banking supervision must ensure the protection of supervisors, exchange of information and confidentiality. The implementation of these principles envisages the development of both an adequate methodology and a proper model of the institutional system of banking supervision in the country.

In this connection, it is expedient to study the world trends in relation to institutional foundations of banking supervisory systems. The goal of this paper is to provide recommendations relating to possible modernization of institutional foundations of Ukrainian banking supervision considering the experience of banking supervision in some European countries.

Banking supervision dates back to more than one hundred years ago. During this period several models of supervisory systems were developed. Three basic models can be identified (Fig. 1).

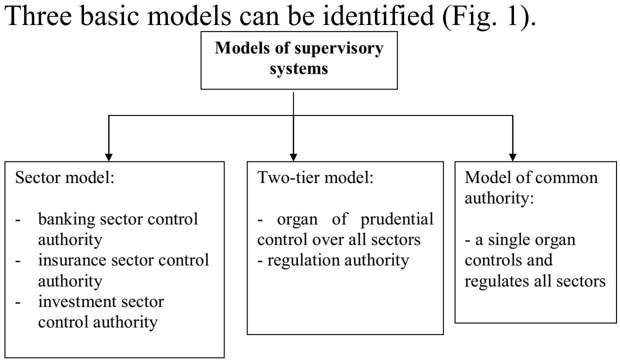


Fig. 1. Models of supervision systems

In case of the sector model, every sector (bank, insurance, investment) is controlled by a separate organ. Although in recent years some countries have abandoned this model (see Table 1) it is still widely used in 6 EU member states (Greece, Spain, Cyprus, Lithuania, Poland and Slovenia), and also with some modifications in France, Portugal, Finland and Luxemburg. One of these countries, Poland, is in the process of transition to a single board of supervision. As a variation of this model, in Finland and Luxemburg the supervision of both banking and investment sectors is carried out by a single supervisory authority.

Table 1. The structure of supervision in the EU states and countries joining the EU

Country	Sector model	Two-tier model	Model of single supervisory authority	Number of supervisory authorities	Central bank is responsible for supervision
Belgium	0 →		X	1	
Czech Republic	0 →		X	1	X
Denmark			X	1	
Germany			X	1	X
Estonia			X	1	
Greece	X			3	X
Spain	X			3	X
France	X	X		4	
Ireland			X	1	
Italy	X	X		4	X
Cyprus	X			4	X
Latvia			X	1	
Lithuania	X			3	X
Luxemburg	X			2	
Hungary			X	1	
Malta			X	1	
The Netherlands		X		2	X
Austria			X	1	X
Poland	0 →		X	1	
Portugal	X	X		3	X
Slovenia	X			3	X
Slovakia	0 →		X	1	X
Finland	X			2	
Sweden			X	1	
Great Britain			X	1	
Bulgaria	X			2	X
Romania	X			4	X
Total	12	4	14		

Note: the arrow means changes after June 2003.

In the second model, the duties are redistributed on the basis of supervisory tasks, with the prudential supervision and business regulation controlled by two different organs of power (so called two-tier model). This model is fully used only in one country – the Netherlands. The elements of this model are also represented in the structure of supervision in France and Portugal.

In the third model, all supervision functions are concentrated in one supervisory authority, which covers both the prudential supervision and protection of investors. This model is widely used by the new EU members. Some of them have established a new organ of supervision, separated from central bank (Estonia, Latvia, Hungary, Malta), while others have delegated all functions of financial market supervision to their central banks (Czech Republic, Slovakia). In some cases the existence of a relatively small financial market seemed to be a reason behind the creation of a single administration responsible for the supervision of financial market.

There is an interesting example of banking supervision in Switzerland, which is actually the third model of banking supervision. However, banking supervision in Switzerland is based on the distribution of tasks between the Swiss Federal Banking Commission (SFBC), which is a state supervisory authority, and a few authorized auditing firms (see Fig. 2).

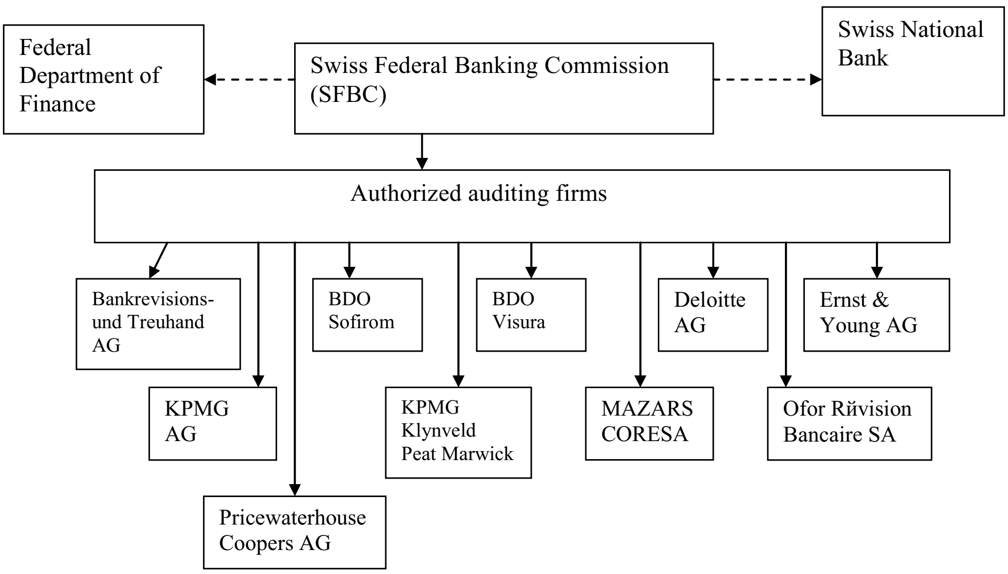


Fig. 2. Organizational structure of banking supervisory authorities in Switzerland

The Commission is independent in relation to the Federal Government and is not part of the governmental administration. Administratively it is integrated in the Federal Department of Finance. However, the Commission conducts the control over separate parts of financial sector independently.

Historical responsibility for the control of the banking sector had an influence on the expansion of controlling powers over all financial sectors. Today, the Commission performs the following tasks:

- control over banks and securities' dealers;
- control over auditing firms, which carry out the audit of financial market structural subdivisions;
- control over collective investment schemes;
- control of mortgage business;
- control of securities market;
- ensuring the transparency of information about owners and dividends of joint-stock companies operating in the financial sector;
- control of financial sector with the purpose of preventing money-laundering;
- making decisions relating to bankruptcies and restructuring of banks and securities dealers.

Along with its basic functions, the Commission also operates in other branches of financial and credit sector. It maintains contacts with the Federal Department of Finance, Swiss National Bank, Association of Swiss Banks, Associations of Swiss Funds, and others.

The goals of the Commission's activities are the creditors protection, investors protection, guaranteeing the functioning of investment funds and ensuring the performance of functions (Table 2).

Table 2. Swiss Federal Banking Commission (SFBC) activities

Creditors protection	*Investors protection*	*Functioning of securities markets*	*Support of functions performance*
Minimization of expenses for private investors	Protection of confidence for individual and collective investors	Transparence of markets	System's stability
Protection of customers	Transparence of investments	Balanced circulation of market's participants	Support of confidence
Prevention of unlicensed deposit collection from physical and legal persons	Saving of customers' assets	Protection of minority shareholders	Support of reputation
Effective reorganization and liquidation	Balanced circulation	Protection from illegal dividend distribution	Support in crime fighting
Indirect protection of owners, including taxpayers (in the case of public corporations)	Prevention of conflict of interests	-	International competition
-	Protection from unauthorized participants	-	Protection from unauthorized participants

Audit companies have a license to perform the functions of control in relation to banks, investment and financial companies.

In accordance with the two-level system, the authorized audit firms conduct guest auditing, while the SFBC Commission is accountable for general supervision and measures of influence.

The relations between the audit firms authorized by the Commission and financial institutions passing an audit are determined by civil law. As a federal administrative authority, the SFBC Commission has all the necessary powers of a state body, but in monitoring the activity of different institutions it relies on the information provided by authorized auditors. Only in special cases the SFBC Commission can conduct direct audits.

The Commission's task is the cooperation with the Swiss National Bank, which is responsible for the system's stability.

The banking system in Switzerland is very concentrated, with mostly foreign banks operating in the country. Therefore, in this case a single authority model is fully justified.

National supervisory authorities in the EU countries have to speed up the convergence of supervision and regulation in the EU. All central banks (regardless of whether they have supervisory duties or not) take part in the Committee of European Banking Supervisors (CEBS).

A common trend in supervisory systems of the European countries is the reduction in the number of supervisory organs (see Table 1). It is explained by both the rationalization of tasks distribution among different authorities (as in France) and by the concentration of supervisory functions (Belgium, Czech Republic, Slovakia). However, it is impossible to identify a general trend towards a specific type of supervisory system.

The analysis confirms that, on the whole, central banks are widely engaged in supervisory activities. The number of countries, where central banks have supervisory powers, is growing. Czech Republic and Slovakia have transformed their central banks into single supervisory authorities over financial markets.

The reasons for the transfer of all supervisory duties to central banks are as follows:

- independence;
- protection of the EU Agreement;
- credit solvency;
- experience of specialists.

Almost all EU member states, in which central banks are not responsible for making final decisions in the area of banking supervision, have, nonetheless, mechanisms that guarantee the participation of central banks in this process. Firstly, two central banks (Germany and Austria) are authorized by law to carry out the supervision of credit institutions (see Table 1). Secondly, as Table 3 shows, there is a wide spectrum of institutional agreements with a number of possibilities including joint use of personnel (Belgium, France, Ireland, Latvia), financial budget (Belgium, France, Latvia) or other resources as in Italy, and databases (Belgium, Estonia, France, Ireland, Latvia, Finland, Great Britain).

Three central banks can be authorized to carry out some supervisory tasks (Ireland, Latvia and Hungary). Finally, in nine countries (Belgium, Estonia, France, Latvia, Austria, Poland, Finland, Sweden and Great Britain) central banks are engaged in the banking supervision and have the following rights: authority to appoint some board members of banking supervisory administrations (Austria), or make recommendations relating to such appointments to government authorities (Finland, Latvia).

It is also worth noting that almost all EU states have formal agreements about cooperation and exchange of information between central banks and banking supervision authorities. On the whole, national central banks play an important role in ensuring financial stability, even if they are not engaged in prudential supervision. However, every country in the European Union chooses different methods for the formalization of cooperation: memorandum of understanding, cooperation committees or cooperation agreement.

In Estonia, Ireland and Finland banking supervision is performed by independent bodies. However, they include some of the central banks personnel. Regarding the joint use of personnel it should be noted that:

- in Belgium the law requires from the National Bank and the Supervisory authority for the Belgian financial sector (CBFA) to combine certain types of activities and personnel on conditions stipulated by the Royal Decree and Memorandum of Understanding between the CBFA and the central bank;
- in Latvia the Financial and Capital Market Commission (FCMC) and the Bank of Latvia have common representatives in Brussels (who work at the permanent representative office of Latvia in Brussels). According to the cooperation agreement, the representatives devote 30 per cent of their work time to issues concerning the FCMC interests. This agreement stipulates that the FCMC compensates to the Bank of Latvia 30 per cent of all its expenses, which are bound up with the presence of the representative office in Brussels;
- in Poland the executive branch of the Banking Supervisory Commission is financed and provided with personnel by the National Bank of Poland.

Table 3. Cooperation agreements between central banks, which do not conduct supervision, and supervisory authorities in the EU countries[1]

Country	Central bank takes part in the management of banking supervision	Joint use of personnel	Common resources of financial budget	Other joint use of resources	Central banks perform certain operational tasks
Belgium	X	X	X	X	
Estonia	X			X	
France	X	X	X	X	
Ireland		X		X	X
Latvia	X	X	X	X	X
Hungary					X
Poland	X	X	X		
Finland	X			X	
Sweden	X				
Great Britain	X			X	

[1] Made on the materials of Е. Хюпкес, М. Квинтин, М.У. Тейлор "Механизмы подотчетности органов регулирования финансового сектора" // www.imf.org

Central banks may take part in certain budgetary and financial affairs, which concern banking supervision:

- in Belgium the law requires definite resources for achieving a synergy effect;
- beginning from January 1, 2007 the FCMC Commission in Latvia is financed exclusively with the funds of the supervised market participants in proportions set by the law about the Commission.

Central banks in Germany and Austria are authorized by law to perform specific supervisory tasks. The National Bank of Austria conducts inspections of banks along with the Financial Market Authority (FMA), provides expert conclusions, analyzes supervisory reports and assesses bank risks. In Germany the Bundesbank and the German Financial Supervisory Authority (BAFIN) are authorized to work closely in the sphere of banking supervision.

In Estonia, Ireland and Finland banking supervision is carried out by independent entities, however, they include representatives of central banks.

Conclusions for Ukraine

In the European countries there is a clear tendency towards consolidation of supervisory authorities on the national level with the purpose to improve their efficiency. In our opinion, the main reasons for the unification of supervisory responsibility are the disappearance of clear borders between financial sectors or the existence of relatively small financial markets.

The choice of every country depends on its history, constitutional peculiarities or other factors regarding its national financial sector.

However, there is no obvious tendency in relation to supervisory models; every country chooses an acceptable institutional structure depending on the specifics of its national economy, development trends in the credit system and its financial market.

Governments bear the sole responsibility for the establishment of national supervisory systems. However, there are some political level agreements about the improvement of cooperation and convergence among European supervision authorities.

In one way or another, central banks perform direct supervisory functions almost in all national supervisory systems. In some EU countries there are agreements, which stipulate the joint use of budget, personnel or other resources by central banks and supervision authorities.

In keeping with the current European trend of improved cooperation between supervisory structures, almost all EU members are trying to reach formal agreements for ensuring cooperation and information exchange between central banks and banking supervisory authorities.

De facto Ukraine has the first model of supervision in which the spheres of activity of supervisory authorities are divided according to the sectors of financial market. However, the development of the banking system demonstrates the growth of tendencies towards universalization of bank activities, the necessity of concentration and centralization of capital of the national banking system.

The environment of the Ukrainian banking system is very competitive: no bank has a dominant position in a separate sphere of activity.

The dynamics of the Herfindahl-Hirschman Index (HHI) for Ukraine shows a low level of asset concentration, in particular, of credit portfolio and capital (Fig. 3). This index is similar to the indices in the UK, France and Italy, and it is better than that in Spain, Austria, Sweden and many other countries.

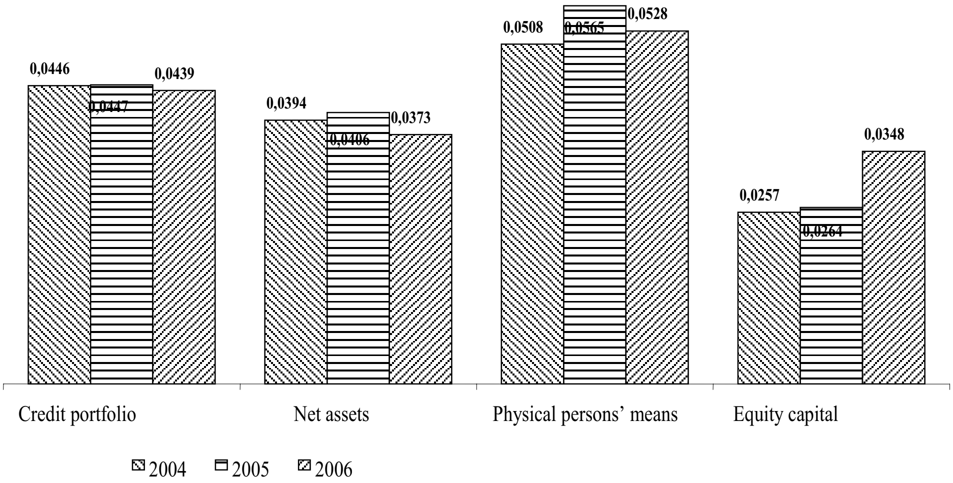
The index of concentration of the market of physical persons' resources is higher, but it is also indicative of the minimal concentration.

However, we can see the reduction of monopolistic tendencies in the banking sector. For credit portfolio the HHI fell by 0,0008 points, for assets – by 0,0033 points, for resources of physical persons – by 0,0128 points. The HHI for balance capital had a considerable growth – by 0,084 points. This demonstrates the unevenness of capital accumulation by banks.

The growth of this index in the European Monetary Union is indicative of decline in the banking sector competition and the growth of monopolistic tendencies (Table 4).

It is necessary for Ukraine to develop the legislative and institutional basis of the stock-market activity, the infrastructure of investment funds and other elements of the banking system.

At the moment the National Bank of Ukraine studies the possibility to introduce the monetary regime of inflation targeting, which envisages the coordination of activities of the Government and the National Bank of Ukraine in ensuring the implementation of the declared principles in relation to the level of prices in the country. The realization of these plans will result in the necessity of unification of supervisory functions in a single organ.



Source: The National Bank of Ukraine.

Fig. 3. Indicators of banking sector concentration in Ukraine in 2004-2006 (Herfindahl-Hirschman Index (HHI))

Table 4. Indicators of banking sector concentration in the Euro zone in 1999-2006 (Herfindahl-Hirschman Index (HHI))

Year	1999	2000	2001	2002	2003	2004	2005	2006
Indicator: Herfindahl-Hirschman Index (HHI)	0,062	0,0066	0,0068	0,0067	0,0070	0,0072	0,0078	0,0078

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