The banking supervisors dilemma: wearing many hats on one head

  

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Are banking supervisors asked to do too much? Their main job of promoting the safety and soundness of banks and banking systems have become more complex over time. To deliver on this mandate alone, sufficient time, resources and an extraordinarily skilled staff are needed. But what if governments stack on top of this safety and soundness mandate several other objectives that must also be simultaneously met? How do supervisors handle these additional tasks and what are the tradeoffs? Most importantly, what are the broader implications of these additional objectives on their ability to fulfil the safety and soundness mandate? How supervisory authorities address these challenges have profound consequences for the well-functioning of the banking system and ultimately, on society at large.

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Introduction

The multiple - and at times conflicting - mandates of central banks have been widely published and debated in academic and policy circles. These challenges, however, are almost always framed through the lens of monetary policy and its core objective of maintaining price stability. In contrast, relatively little has been written about the numerous mandates of banking supervisors and how they manage competing objectives. In a recently published paper of the Financial Stability Institute (Kirakul et al 2021) of the Bank for International Settlements, we take stock of supervisory mandates in 27 jurisdictions and explore how banking supervisors interpret and navigate their core safety and soundness (S&S) remit among other objectives. This SUERF policy brief summarises the main findings from our earlier publication.

Too many balls in the air?

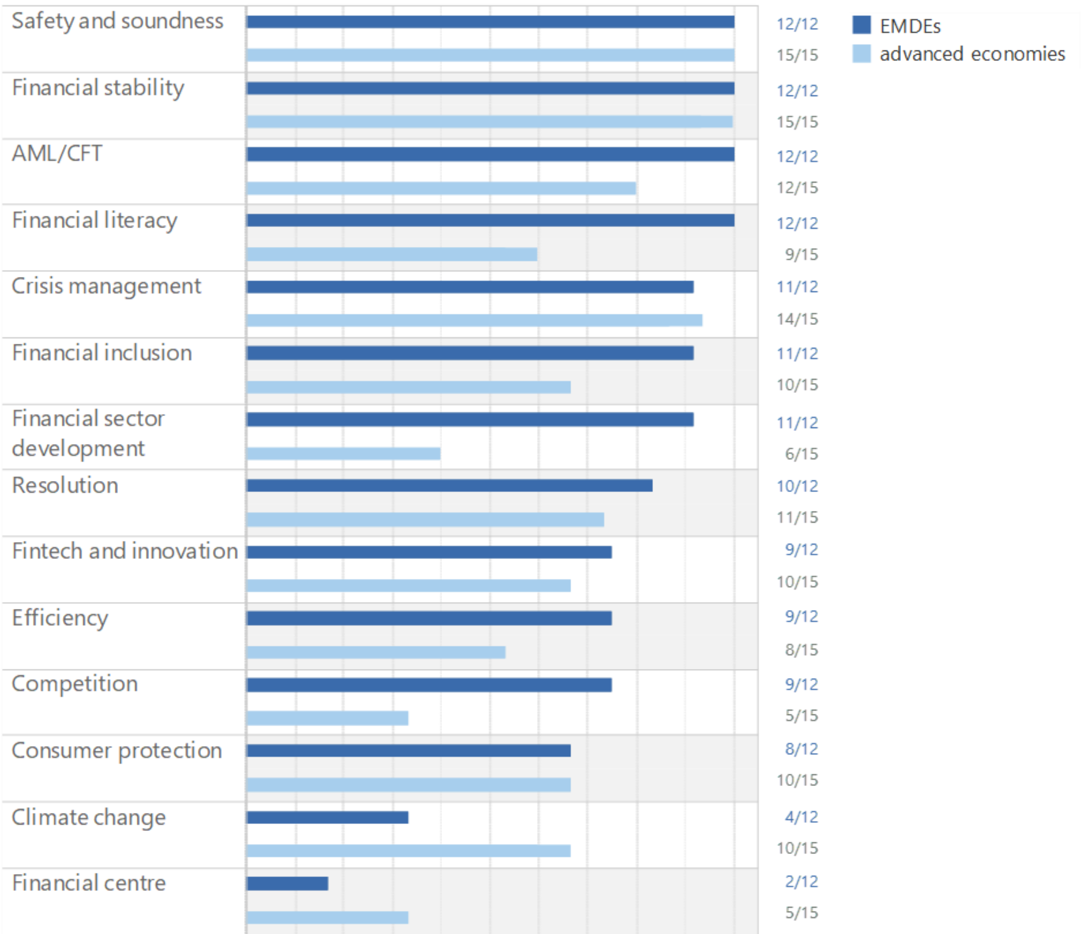
In addition to S&S, surveyed banking authorities report having up to 13 other objectives (figure 1), highlighting the enormous pressure placed on supervisors to juggle multiple responsibilities. The majority of surveyed banking authorities have at least 10 or more objectives and these are mostly supervisory authorities in central banks (SA-CBs). The additional responsibilities of SA-CBs – such as financial inclusion, developing the financial sector, and promoting fintech and innovation - may be due to their perceived benefits in promoting central banks' broader objectives, which implicitly target economic prosperity alongside price stability.

Figure 1: Range of mandates – central banks and standalone supervisory authorities

Surveyed authorities comprise 13 SA-CBs and 14 standalone supervisors.

Supervisory authorities in emerging market and developing economies (EMDEs) have slightly broader mandates than their counterparts in advanced economies (figure 2). A higher proportion of supervisory authorities in EMDEs is tasked with financial sector development, financial literacy, promoting competition, financial inclusion and facilitating fintech development and innovation. EMDE supervisors' larger role in supporting financial inclusion, with the corresponding supportive roles of fintech development, financial literacy and competition, may be due to the fact that greater portions of their populations are unbanked.

Figure 2: Range of mandates – advanced economies and EMDEs



Surveyed jurisdictions comprise 15 advanced economies and 12 EMDEs.

While there are advantages to broadening supervisory responsibilities, it also risks overburdening supervisors with managing and delivering on potentially conflicting objectives. As supervisory mandates multiply, the likelihood of potential conflicts between S&S and other mandates increases, with policy actions that support one objective having a potentially negative impact on the other. Managing these conflicts may be difficult if the prioritisation of multiple mandates is unclear or if institutional arrangements for mitigating potential conflicts are not in place. In this context, our study found that only 9 of 27 banking authorities prioritise among mandates in either law or through other means; and in these cases, S&S and financial stability mandates are typically prioritised.

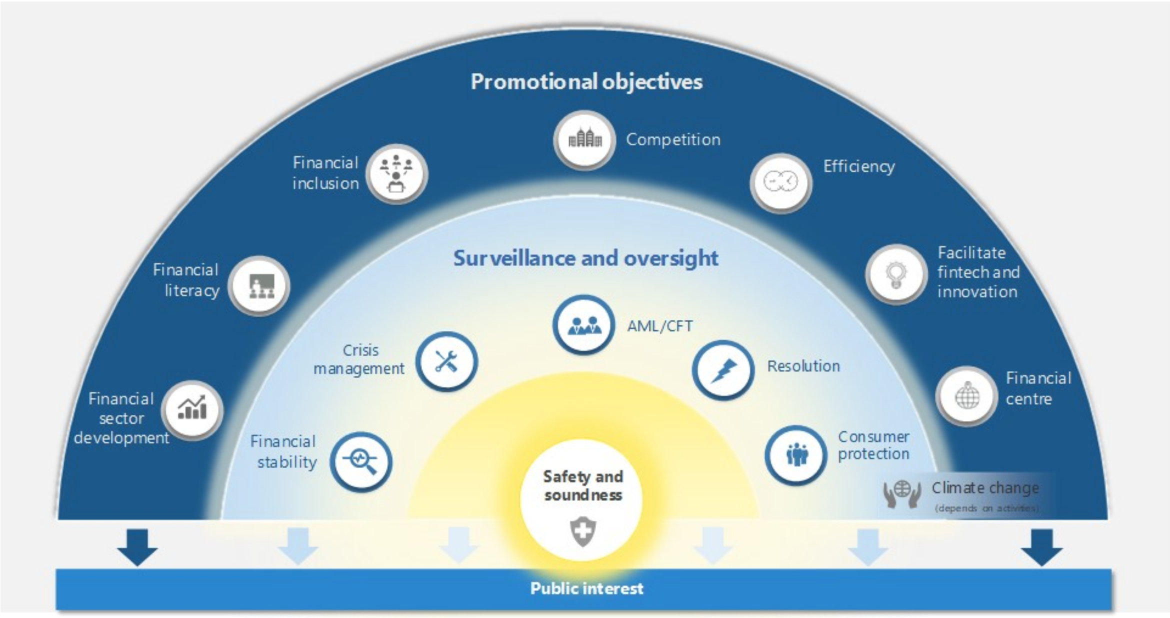
The S&S mandate - bursting at the seams?

To fully appreciate the scale of the difficulties in managing multiple supervisory objectives, it might be helpful to first take stock of the complexities in delivering solely the S&S mandate. There are at least two dimensions to these challenges:

- *First, the term 'safety and soundness' is difficult to define, clouding the powers it confers, including a mandate for early intervention*: The lack of clarity on what S&S means allows considerable scope for interpretation, making it difficult for supervisors to ascertain the contours of their S&S mandate. This is particularly relevant if other agencies are assigned statutory mandates in areas of potential overlap. Our findings indicate that banking authorities interpret their S&S remit in various ways, with some taking a broad interpretation, while others focusing more narrowly on the 'financial safety' dimension to guide their powers. In addition, while some banking authorities have defined the term 'unsafe and unsound', the lack of a general consensus on the opposite state – 'safe and sound'– may hinder supervisors will to act early and to fulfil their mandate.
- *Second, the range of risks that have a bearing on a bank's S&S is continuously expanding, stretching supervisory resources and demanding broader array of supervisory skills*. This evolution is due to many factors including market developments, a significant expansion of regulatory rules under Basel III, post-crisis scandals that called into question banks' behaviour and culture, technological innovations, and societal demands to consider climate related risks. To frame these developments in a historical context, the 1988 Basel I accord consisted of a simple framework covering credit risk. At that time, delivering on the S&S mandate meant focusing on credit risk and ensuring that banks had sufficient capital to absorb the underlying risks. In today's world, supervisors must oversee a proliferation of prudential risks – such as credit, market, liquidity, operational, strategic, culture and conduct, cyber and technology, and most recently, climate related risks, among others – to fulfil their S&S mandate.

A framework to assess multiple supervisory mandates through a 'constellation' prism

It is against the background of an exceptionally demanding S&S mandate that one must consider the additional objectives placed on supervisors. To help visualise the relative proximity of these numerous supervisory objectives to the core S&S function, our paper classifies the different mandates according to a "constellation of supervisory mandates". The constellation divides the universe of supervisory mandates into two categories: "surveillance and oversight" (S&O) and "promotional and developmental" (P&D) objectives, with the former perceived to be more closely related to the S&S remit than the latter. In other words, S&O objectives may help to reinforce the S&S mandate and vice-versa, while P&D objectives are further removed from S&S. However, it is acknowledged that certain mandates, such as those relating to climate change may straddle both categories.



Around half of the surveyed authorities acknowledged that potential conflicts could arise between their mandates. The three mandates cited most as potentially conflicting with the core S&S mandate are resolution, conduct of business and competition. Some examples of how these mandates could conflict are as follows:

- Resolution: differences in views between supervisory and resolution teams on when to trigger resolution of a banking institution.
- Competition: lowering regulatory barriers to entry could end up admitting banking institutions with unsustainable business models.

While not commonly cited by surveyed authorities as areas of conflict, various P&D mandates could also conflict with S&S. Some examples are as follows:

- Financial centre: regulatory incentives to attract banking players could weaken their financial resilience.
- Fintech and innovation: non-traditional bank owners may enter the system using new credit underwriting methodologies based on social media data, which may accentuate credit risk.

Policy considerations

Our findings identify a number of insights that could help supervisors fulfil their core S&S remit while addressing potential conflicts with other objectives. These include, but are not limited to the following:

- establishing a clear S&S mandate, developing guidance to operationalise the term and allocating sufficient resources to fulfil their mandates;
- prioritising the S&S mandate in law or through other means to promote supervisors' independence, thus helping them to balance their S&S remit against various P&D objectives that may conflict with or detract resources away from the core objective;

- developing appropriate institutional arrangements, such as separate reporting lines or structural separation of competing functions; and
- publishing public statements on authorities' interpretations of their mandates to promote greater accountability of supervisory objectives.

Above all, the staggering range of objectives that are imposed on supervisory authorities risks diluting their ability to deliver on their core S&S mandate – whose scope and complexity have evolved with time. This reminds us of a quote from Winston Churchill that encapsulates the extraordinary societal and governmental demands on banking supervisors: *'Never was so much owed (asked) by so many to so few'*.

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