
Lecture 21: Banking supervisions

20 April 2012

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Common forms of the government (central bank) **safety net**:

- Deposit insurance: to short-circuit runs on banks by protecting depositors
- Lender of last resort: to bail out troubled banks

Is the safety net necessarily desirable?

- **Moral hazard:** increase banks' incentives for taking risks
- **Adverse selection:** encourage risk-loving entrepreneur to enter the banking sector
- **'too big to fail':** the failure of a very large bank can cause a major financial disruption, regulators are reluctant to allow a big bank to fail, which increases moral hazard
- **Financial consolidation:** financial innovation induces financial consolidation. The increased size of banks as a result of financial consolidation increases the too-big-to-fail problems. Financial consolidation of banks with other financial services firms means that the safety net may be extended to new activities such as securities underwriting, insurance, or real estate activities, therefore increasing incentives for greater risks

How to discourage risk-taking activities?

- By bank regulations – to restrict banks from holding risky assets and promote diversification by limiting the amount of loans in particular categories or to individual borrowers through *bank capital requirements*

Bank capital requirements

Take two forms:

- **Leverage ratio**: the amount of capital divided by the bank's total assets. The leverage ratio must exceed 5% to be well-capitalized. This does not, however, take into account risks associated with the assets held.
- **Risk-based capital requirements** (The Basel Accord/Basel I): assets and off-balance sheet activities are allocated into 4 categories, each with a different weight to reflect the degree of credit risk:
 - zero weight: reserves and government securities
 - 20% weight: claims on banks
 - 50% weight: municipal bonds and residential mortgages
 - 100% weight: loans to customers and corporations

Banks are required to hold at least 8% of their risk-weighted assets as capital.

Example: Bank A Balance Sheet

Assets			Liabilities	
Weight	Type	Amount	Type	Amount
0%	Reserves	200	Deposits & Borrowings	900
0%	US treasury securities	200		
50%	Mortgages	300		
100%	Consumer loans	300		
			Capital

Basel I – sufficient?

- However, this rough measure of credit risk may not necessarily reflect the actual credit risk. For example, loans to companies with low credit rating is certainly more risky than those to the ones with high credit rating. The former tends to be kept on book assets by banks because they usually yield better returns. The Basel Accord could lead to increased risk taking. The Basel Committee on Bank Supervision then released 'Basel 2' a new capital accord.

Basel 2 is based on three pillars:

- *Pillar 1* – link capital requirements more closely to actual risks by specifying more categories of risks with different weights (standardized approach) or sophisticated banks can use their own models of credit risk (internal ratings-based approach)
- *Pillar 2* – strengthen the supervisory process, in particular, assessment on the quality of risk management in banking institutions and evaluation on whether the institutions have adequate capital
- *Pillar 3* – improve market discipline through banks' information disclosure, such as their credit exposures, reserves and capital, effectiveness of the internal ratings system

Still, the recent global financial crisis exposed insufficiency of Basel II...hence, Basel III was initiated!

Basel III

Capital Reform

Quality, consistency, and transparency of capital base

Capturing of all risks

Controlling leverage

Buffers

Liquidity standards

Short-term: Liquidity Coverage Ratio (LCR)

Long-term: Net Stable Funding Ratio (NSFR)

Systemic risk and interconnectedness

Capital incentives for using CCPs for OTC

Higher capital for systemic derivatives

Higher capital for inter-financial exposures

Contingent capital

Capital surcharge for systemic banks

The changing regulatory landscape of the Thai financial sector

Major developments

- Implementation of the Financial Sector Master Plan I and II (starting in 2004)
- Establishment of Deposit Protection Agency (DPA) (August 2008)
- Implementation of Basel 2 in December 2008

Implementation of the Financial Sector Master Plan I

- Measures to broaden general access to financial services
 - promoting grass-root financial services
 - transforming the Bank for Agriculture and Agricultural Operatives (BAAC) into a rural development bank
 - encouraging existing financial institutions to increase the level of financial services to low-income household

Implementation of the Financial Sector Master Plan I (cont.)

- Measures to increase efficiency of the financial sector rationalising the structure and roles of financial institutions to better meet customer demand and avoid duplications of functions by
 1. issuing only two types of licenses to financial institutions that take deposits from the public: commercial banks and retail banks
 2. 'One Presence' policy: to reap full benefits from economy of scale and eliminate duplicate functions, there need to be only one type of deposit-taking institution in a financial conglomerate.

Implementation of the Financial Sector Master Plan I (cont.)

- Measures to increase efficiency of the financial sector (cont.)
streamlining rules and regulations to improve basic infrastructure of the financial sector, resolve tax impediments to mergers, remove regulations impeding financial sector efficiency and strengthen financial institutions by enhancing the development of risk management capability
- Measures to protect customers

Implementation of the Financial Sector Master Plan II (2010 – 2014)

***Pillar 1* Reduce system-wide operating cost**

- Regulatory costs
- Cost of legacy NPL and NPA

***Pillar 2* Promote competition and financial access**

- Promote competition in the financial institutions system
- Promote financial access for various groups of the population

***Pillar 3* Strengthen financial infrastructure**

- Enhance the capability and tools for risk management of financial institutions
- Improve the information system for risk management of financial institutions
- Reviewing financial laws that support risk management of financial institutions
- Strengthen the information technology (IT) infrastructure and capacity
- Enhance the capacity of human resource in the financial institutions system

DPA: Deposit Protection Agency



The coverage amount specified by law are as follows:

Year	Period	Coverage Amount
1	11 Aug 2008 - 10 Aug 2009	Full amount
2	11 Aug 2009 - 10 Aug 2010	Full amount
3	11 Aug 2010 - 10 Aug 2011	Full amount
4	11 Aug 2011 - 10 Aug 2012	not exceed Baht 50 million
5	11 Aug 2012 onwards	not exceed Baht 1 million