THEORY AND PRACTICE IN BANKING SUPERVISION: SOME REFLECTIONS BY EDWARD P.M. GARDENER, INSTITUTE OF EUROPEAN FINANCE, UNIVERSITY COLLEGE OF NORTH WALES, RESEARCH PAPERS IN BANKING AND FINANCE, NO. RP86/2, JUNE, 1986

The paper, Theory and Pactice in Banking Supervision, was written by Edward P.M. Gardener of the Institute of European Finance, University College of North Wales, Bangor and published in Research Papers in Banking and Finance. The author examines the broad role of theory and practice in banking supervision by looking at the economic nature of regulation and the justification for regulation in the banking system. The paper is divided into eight sections with a conclusion. Sections 1 and 2 deal with the background and definition of regulation generally in the economic system and how it applies to the banking system. Sections 3 & 4 deal with the primary aim of supervision and the role of information in bank regulation. Sections 5 & 6 examine the place of market economic theory and its relevance to the system while sections 7 & 8 look at the influence of the market and try to reconcile the theory and practical experience in banking regulation.

In section 2, the author defines regulation as a form of command and control. This is to suggest that we are not dealing with pure economic matters. However, lawyers and economists have different views as to how regulation should be implemented. While legal practitioners favour legislative process, economists however think it should be through the market. Since there is no universal definition of regulation, the author thinks that regulation can be referred to as control over what economic units do, and how they do it.

Section 3, shows that in providing an answer to the inability of the market alone to improve the society's welfare, economic theory and practical supervision often clash. The author sees banking supervision as very important for preserving confidence in the banking system. It is also believed that even in a free enterprise economy, regulation is needed to correct certain market anomalies. For example, in the banking system, regulations may be used to prevent merger, promote competition and even encourage or discourage new entry into the market.

The author noted in section 4 that lack of information is the cause of most market failures including bank collapse. It is lack of information about the soundness of a bank that often leads to the withdrawal of funds from the bank by depositors when liquidity problem is noticed. This information deficiency has led to the rationale for supervision.

The premise on which the market economy is built is that under perfect competition, marginal cost is equal to marginal revenue at the point where welfare is maximised. This idea has made economists believe in the market as the most efficient allocator of resources rather than rely on the commands and controls of regulation. The author is of the view that since there is no empirical evidence to support free market as a good allocator of resources, it can safely be said that free market is not a replacement or substitute for external regulatory agency.

In examining the validity of the perfect competition model premise on practical banking markets, the author noted that a condition of perfect or near-perfect competition in banking markets does not exist since money which is the major commodity traded in the market is subject to monopoly control by the Central Bank. Also, the assumptions that: firms are selling their products at lowest price, no firm is earning any excess profit or monopoly rent, new entrants are encouraged by the rising profits until excess profits are eliminated, may not hold. This is because the banking system is built on confidence – a small bank failure can have a significant and far-reaching effect on the economy. Market deregulation may suggest an improvement in the efficiency of the system, but unfortunately, we have not seen this from experience. This is an observable fact, rather than a premise. This is why supervision is designed to help prevent exceptional and essential distortions in the system.

The author thinks, however, that the role of the market in the regulation of banks cannot be over-looked. Even though the market premise may be criticised, the failures, inefficiencies and competition in the system exposed by the market are met with prompt supervisory responses like granting of licensing to protect banks from high competition. Insuring the depositors funds against risk by introducing a flat rate of deposit insurance for banks is a way of encouraging stability in the system. Therefore, despite the shortcomings of the market premise, market still helps to expose structural inefficiencies in the system which invariably call for adequate regulations.

Because the market has an important role to play in resource allocation through the price mechanism, the role of the regulators are also very important. This, the author said, can be seen in the way regulators respond to some of the short-comings of the market by ensuring efficient regulation of the banks and the market in which they operate. Good supervision therefore, does not necessarily have to be a particular system of supervision. The system of bank regulation in any country is a product of their past experiences. The job of the regulators is to see that banks conform with the laid-down rules and are run in a prudent manner. To be able to do this, a supervisory system that will ensure banking stability and also allow price-market mechanism to work efficiently must be developed. Because of the problems of information and risk-exposures, it has become necessary to have a supervisory authority who will act as a perfectly informed market. The authority is to receive all relevant information and data on the banks and use them for decision-making.

The final section concludes the paper by trying to show that the role of theory in bank regulation is to help us handle and understand the fact. This will also help us to have insight into what is happening in the real world and lead us to formulating appropriate policy to deal with the problem However, according to the author, there is always a problem when it comes to using theory to deal with the real world. This is where the regulators are relevant, since failures can not be prevented by theory alone. While theory is essential in order to understand and be able to attend to the basic problem of the system, the regulators are needed to look into the causes and how to solve the problem identified.

Therefore, it will be wrong to draw a distinct line between theory and practice. They are both needed if concrete achievement is to be made.

The issue examined by the author has been a very controversial topic among economists and bankers. The experiences of bank failures in the recent past in several countries have undoubtedly increased concern over banking supervision. The resulting debate has been on whether to intensify regulation or to allow the market to instil discipline on ailing banks. The currently observed illiquidity of some banks in Nigeria has kept this debate alive in the country.

I consider the complementary nature of market force and regulation as a way out of the problem of the banks. The paper has already shown how one complements the other. While it is expected that the debate will continue, I hope that bank regulators will find the paper useful in blending theory and regulation.

J.A. BABALOLA,
Financial Institutions & Policy Office,
Finance Analysis Division,
Research Department.