Pros and cons of banking supervision

In general, before the financial crisis of 2008, the financial sector the world over had been steadily liberalizing. Limits on foreign ownership of banks and on the kinds of transactions they were able to engage in were being lifted. Rich countries were deregulating faster than others. Banks were given greater leeway on how much capital they should hold and how much risk they should take. But the world over did not maintain adequate capital cushions and balance sheets showed inflated profits. In 1999, America also repealed the Glass -Staegall Act – a 1920s Depression-era law separating investment and commercial banking-without bothering about the threat to the economy.

‘Restrictions are a sign of backwardness’- the resulting crisis of 2008 put an end to this belief. Banking supervisors in many developing countries said that tight regulations saved them from getting into trouble. Under the old rules, supervisors were simply referees trying to ensure that the game was played fairly. Now regulators have gone from saying ‘tell me that all your payment system work’ to saying ‘show me how your payment system works’. Regulators tentatively stepping over a long-standing are divided between enforcing basic rules and playing a part in business decisions. This shift is particularly marked in Britain, which once championed ‘light touch’ regulation. The pre-crisis behavior is being criticized as surrender to the banks or as a self-serving device for attracting financial activity in Britain. In truth it was neither. It was a simple belief that markets are better than governments at allocating services. In America too regulators were reluctant to suppress innovation because they felt that “the self-interest of lending institutions” would be enough to ensure they did not leap from the same tall building.

In rich countries, enthusiasm for prescriptive supervision depends on the degree of harm suffered during the banking crisis, or on the threat from the failing banks to bring down their government with them, but it is not easy to stop banks from making bad decisions. In the past regulators left it to the market to judge the health of the banks, but clever, well paid analysis failed to see the crisis coming. Now central bankers are expected to do a better job.

One problem is that rules and laws are written with the benefit of hindsight. The good ideas that may have prevented the last crisis, however, can make regulators dangerously overconfident about being able to predict and prevent the next one. Also, if regulators underwrite certain strategies that seem safe, such as lending to small businesses, they may encourage banks to crowd into those lines of business. If enough banks pile into these markets, downturns in them can affect not just a few banks but the whole system.

On the other hand prescriptive supervision can stifle financial innovation and squeeze all

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appetite for risk out of the banking system. In Japan, a banking crisis that started more than ten decades ago still lingers on, in fact because the country's bankers have become gun-shy and tend to buy government bonds rather than lend money or make foreign investments. Regulators are doing all they can to strike balance and mitigate these risks.

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