

Research paper on regulation and supervision of international banks and nonbank f...

[Business](#), [Marketing](#)



PROBLEMS IN THE REGULATION AND SUPERVISION OF INTERNATIONAL BANKS AND NONBANK FINANCIAL INSTITUTIONS

INTRODUCTION

The banking and non-banking financial institutes have witnessed both growth and change in the functioning practices across the globe. Many economies have suffered severe financial crisis due to the global economic recession. It has disrupted the economic activities. The risk management teams and policy makers have focused their attention towards redefining the regulation and supervision practices of international banks and non-bank financial institutions. The objectives of these practices are to ensure stability and growth in the financial practices.

This report will focus on highlighting the changes in the regulatory practices which have been implemented on both banking and non-banking financial institutions over the years and the problems in those practices. Data from reputable institutions which are responsible for the supervision and their roles regarding policy implementation will be gathered to discuss their significance. World Bank conducts several surveys of regulation and supervision practices of financial institutes globally so that problems with the implementation of such practices can be identified and remedial measures can be taken. Policies made are implemented on international banks and financial institution which impact on the whole global economic systems. Formation of proper policies regarding regulation and supervision is drastically important for all such financial institutions.

ROLE OF BANKS AND NON-BANKING FINANCIAL INSTITUTES

Financial markets are considered an essential element for economic growth.

The stability of the financial system ensures economic growth. Countries try their level best to sustain growth in development of the financial markets.

Banks are essential in extending credit and designing a payment mechanism for the customers. These mechanisms directly impact on the monetary policies of the economy.

The role of banks constantly evolves with the economic development. This increases competition between banks and enhances the variety of offerings for the customers. The banking industry is globalizing and the need to cater and satisfy maximum needs of the customers is increasing. This has resulted in the banks going global and expanding their businesses internationally (Cihak, Demirguc-Kunt, Peria, and Mohseni-Cheraghlou, 2012).

The changing times have brought a change in the international banking practices. This requires proper regulation and supervision of the policies adopted by these banks. Most countries adopt the BIS guidelines for supervision. This helps in maintaining a balance and dividing the responsibilities of banking between the home and host country's authorities. This agreement between the authorities does not ensure complete and transparent flow of information between the authorities. Some information that is mandatory for the institutions to transmit is extracted from its financials. Other information which is not easily quantified or comprises of informal data regarding borrowers or market rumors about the financial institute is not easily accessible. This information is transmitted to the

supervisors of the institutes so that the issues can be dealt with accordingly. The financial markets include banks, insurance companies, consumer finance companies, investment companies and specialized financial institutes etc. All these institutes have the same purpose of catering economic growth but the Banks and the Non-Banking Financial Institutes differ significantly. The major components of banks are the commercial and foreign banks. These work for the fiscal benefit of the economy (Barth, Caprio, and Levine, 2013).

DIFFERENCE BETWEEN BANKS AND NON-BANKING FINANCIAL INSTITUTIONS

BANKS

Banks play a vital role in reducing transaction costs for the people. They create facilities for the investors and ensure that there is liquidity within the system. The banks are differentiated from other non-banking institutes in this regards. Banks reduce the transaction costs and they provide easy methods for lending and offering money and provide methods of utilizing assets effectively. The banks use the deposits from customers and lend them to the investors. The difference in the interest rates is the profit that is earned by banks. The services provided by banks of mitigating the risk of the customers attract the people towards banks. They use financial tools like offering debt contracts and making complex agreements with firms which is impossible for individuals to make. Banks collaborate with financial intermediaries and formulate ways to make this investment worthy and provide returns to the customers.

Banks are considered as a pool of liquidity. They are used to gather the funds and provide utility for other. The dilemma of banking is that if all the

depositors seek their withdrawals at the same time then the whole system will collapse. If this scenario takes up banks may have to refute their long-term investments and they may have to face several economic losses. The combination of the above three roles which have been discussed above create a difference between banks and financial institutions.

NON-BANKING FINANCIAL INSTITUTES

Non-banking financial institutes are a linkage which connects savers and the borrowers. The intermediation of the parties may be few like the banks or other brokerage chain of institutes which pool the funds of the investors and invest accordingly to generate returns. NBFIs are financial intermediaries; they place the capital of saver in form of portfolios which help in generating specific returns (Muller, Bishop, Devnani, Lewis, and Ladher, 2012).

The non-banking financial institutes include following sub-sectors of the financial systems. These are

- Money market funds
- Private equity funds
- Hedge funds
- Pension funds
- Insurance undertakings
- Central counterparties etc.

These institutes differ from banks as banks are liable to pay cash that is deposited by the depositors any time it is requested by them. Banks take the money of depositor and facilitate the bower. They pay interest and receive interest for this purpose. Non-bank financial institutes offer returns to the

depositors to encourage them to make certain investments. Withdrawal of cash bears conditions and is subdued to agreements between both the parties.

PROBLEMS WITH REGULATION AND SUPERVISION OF BANKS AND NON BANKS FINANCIAL INSTITUTES

Banks and other financial institutes are the key elements which stabilize the financial system by maintaining a proportion between borrowing and lending. The economic growth of economies depends on the goals set by the corporate governance. Financial markets are highly volatile due to excessive competition. Investments require to be diversified to minimize risk and upcoming challenges.

Corporate governance of Banks and Financial Institutions aim to minimize financial risks. Ensuring that risk is mitigated requires constant regulation and supervision. Corporate governance aims to ensure that the operations secure private and public interests of the economy. Banks and other financial institutes manage their profile in such a way that the benefits of the depositors and the shareholders are both secured. The stakeholders of banks and financial institutions which include directors, top management, regulators, supervisors and auditors both external and internal are involved in the risk management process (Barth, Gan, and Nolle, 2004).

International banking practices have taken toll because of diversification and globalization. The regulators have formed strategies to especially cater the cross border banking activities. The corporate governance of banks is unique as compared to non-banks financial institutes. The development of financial markets and the complexities which are faced by banks to secure and

minimize risks for depositors have pressurized regulators and supervisors to ensure implementation of policies.

Researches show that transparency and efficiency in supervision is correlated. Supervisors are accountable for supervision and function under the Basel Core Principles (Arnone, Darbar, and Gambini, 2007).

REGULATIONS

Key Elements of Banks

Banks have an integral role in maintaining economic stability. They also play an important role in financing the expenditures of the governments. The governments impose restrictions on the banks through regulations.

Regulations enhance their corporate values and ethics.

Regulations by banks aim to restrict to the following aspects which include

- Creating barriers to entry for domestic and international banks.
- Restricting banking activities for the benefit of the economy.
- Providing safety and support to the depositors and the borrowers.
- The information must be properly disclosed in the financials of the company to ensure that it is accurate and comparable.
- The government must own the regulations and ensure that they are for the benefit and securing the rights of the individuals.

The regulations implemented vary from state to state. This shows that the regulations implemented on the banks are market oriented (Barth, Caprio, and Levine, 2006). The main function of regulators is to carefully monitor the activities and prescribe methods for risk management.

The approach of the financial institutes is becoming market oriented. An economies political situation, culture and tradition influence the regulations that are implemented on them. The aim of the regulations is to recognize, monitor and control the risk. Regulations ensure that the system is running efficiently and banking problems are minimized or mitigated.

Key Elements of Financial Institutes

Regulators adapt to strategies which promote market development and financial innovation. Regulators ensure that the funds of the public are not misused. It prevents expansion of the credit terms which are unfavorable to the current economic terms. Regulations also reduce monopoly of large organizations. Regulations that are imposed on non-bank financial institutes are less harsh than those implemented on the banks. Certain regulations implemented on the banks are also implemented on the non-bank financial institutes to ensure that the deposits and savings of the investor are secure (Barth, Gan, and Nolle, 2004).

SUPERVISION

Key Elements of Banks

Regulators aims to create a market based approach for supervision of banks. Traditionally the regulations issued were difficult to enforce because of the operational environment internally. This discouraged compliance of regulations. Change in time brought reforms to the financial markets. This brought changes in the supervision. The supervision by the regulators has become market oriented. The objective of the banks is to minimize risk. The supervisory authorities have worked on methods to enhance the corporate

governance of banks. Complex and costly functions are used to ensure proper implementation. Risk management is essential for the regulatory bodies and in order to do that constant supervision is required (Holthausen and Ronde, 2004).

Key Elements of Financial Institutes

Regulatory bodies ensure that activities of financial institutes are properly monitored and supervised. The non-bank financial institutes are monitored to ensure that the funds of the investors are secure. All sorts of regulations are implemented to ensure proper risk management. Funds of the investors must be secured and protected against risk. Regulators supervise the activities as per the market development and financial innovations by the institutes (Holthausen and Ronde, 2004).

EXPLANATION OF PROBLEMS

The role of supervision is crucial for monitoring the functioning of financial institutes. This is because of market volatility that the policy makers have to design strategies which are essential or supervising. There are certain issues which are the primarily important and need to be resolved by issuing regulations and constant supervision.

Structure of the Organizations

The major regulations are about the structure of the organizations. These policies are significantly important because the inappropriateness of the organizational framework may undermine the performance of the banks and it may lead to a crisis of management (Barth, Caprio, and Levine, 2008).

Designing the structure of the organization include

- Supervisory system internally either single or multiple
- Supervisory role assigned to the representatives
- Authority delegated to the supervisors

The roles of the supervisors are integral for the organization. They are responsible for the interpretation and enforcement of the regulations. When banks are discussed supervisors are directly connected to the banks and they are the ones who inform about the unsafe and unsound banking practices which may affect the future growth of the organization.

Supervisors are the authorities which assess the organizational practices and they are responsible to highlight issues which may risk the future position of the organization. The supervisors of the organizations are held legally liable for their practices. They are liable to the organizations to suggest practices which mitigate risk. If they fail to do so fatally they may be legally liable. This implementation is only done by banks and non-banking supervisors liabilities vary (Barth, Caprio, and Levine, 2008).

Market Discipline and Corporate Governance

The corporate governance comprises of the stakeholder and the top management which includes the managers and directors of the organization. They always have conflict of issues and goals between them. The goals of the owners differ from the goals of the management. Regulatory bodies fail to address such issues or prescribe solution in this regard. The policies to deal with such issues vary according to the particular markets or the economies in which the system is functioning. Several researches have been

conducted by researchers to analyze the role of regulatory bodies for overcoming these issues (Barth, Caprio, and Levine, 2008).

Risk Management

Risk management is the core objective of the organizations. Regulations and supervision is done to minimize risk. The institutes and the regulatory bodies have to acknowledge that the financial markets are volatile. Due to this volatility the risk and its impact can be minimized but it cannot be mitigated. The risk management regulations are imposed on the banks more significantly because the banks are liable to repay the deposits of the depositors. Regulatory bodies ensure that banks don't indulge investing in highly risky investments which impacts the savings of the depositors. Such impositions are not implied on any other institutes (Barth, Caprio, and Levine, 2008).

Several approaches that are used to assess the risk are mentioned below

- Credit Scoring System – Traditional Approach

This model is used frequently to assess the credit risk. Econometric model used in the Credit Scoring System to measure risk are (Krugman & Obstfeld, 2009):

- The Linear Probability Model

- The Logit Model

- The Probit Model

- The Discriminant Analysis Model

- Value at Risk – Modern Approach

This model aims to estimate the value at stake so that the loss can be minimized. Credit Scoring System assessed the credit risk while VAR assesses the risk exposure.

- Credit Derivatives

This model is designed to transfer credit risk on portfolios. This is done by balancing investment between banks and non-banks. Instruments used are

- Credit Options

- Credit Swaps

- Credit Forwards

- Credit Securitizations

The tools mentioned above are essential for risk management. The banks and NBFIs overcome the problems by regulating the policies according to the markets in which they are functioning. This is adaptability which the financial institutes have to get prone to in the financial markets.

The major difference between banks and other financial institutes is the facility of depositing and withdrawal of cash. Only banks provide this facility to the customers. Banks function as they are the financial intermediaries and offer borrowing and lending services to their customers. The NBFIs serve as investment tools and they offer opportunities available in the markets to the investors.

The size of both the sector banking and non banking vary with the economies. Results of several industry specific surveys show that different countries have different strengths of banking and non-banking institutes. In growing economies these two sectors grow at the same pace. The assets held by the non-banking sector grow at a higher pace as compared o banks.

This is because higher risks yield higher returns. The volatility in the markets increased during the economic downturn but the markets revived with the passage of time.

The banking and the non-banking sectors are linked together in terms of the instruments they invest in. The risk which the NBFIs are engaged in is higher than that of the banks. The regulatory bodies ensure that the banks don't engage in high risk investments and projects. If they do so it is done using diversified portfolios which don't affect the deposits of the public. This explains that why the returns from the NBFIs are higher than the interest that is paid by the banks. The regulations are also for the NBFIs but they are not as harsh as they are for the banks (Barth, Caprio, and Levine, 2001).

CONCLUSION

This report aims to highlight the problems with the regulations of Banks and Non-Banking financial institutes. The differences between the banks and financial institutes have been discussed to explain that all the financial institutes play a major role in ensuring economic growth. Both the Banks and the Non-banks require being regulated and supervised by the regulatory bodies. This is because the investment markets are volatile.

The regulations that are implemented change with the changing markets. The globalization and diversification of the businesses have forced the companies to work partially on the strategic objective of the parent company and change the laws with the changing markets of the remaining partial portion. This ensures that regulation and speculation is essential for the functioning of organizations. Several discussions have been made to

highlight the problems with the regulation practices and what should be done to overcome those issues.

The problems which are faced are assessed using certain tools which have also been discussed in this report. Aim of all these regulations and supervision is to ensure that proper risk management of the funds invested.

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