Safe, sound and strong banks provide the underpinnings of a growing economy. In market economies, commercial banks play a critical role in gathering funds from the public and in channelling these funds to their most productive uses. Funds allocation decisions are made not in accordance with an economy-wide plan or credit directives from the government or the central bank, but instead, by a vast number of credit and investment officers, acting independently of each other and responding to market opportunity – basically market signals.

However, credit allocation decisions may be distorted by such unsound practices as insider and related party transactions, justifying the need for regulatory restrictions. In spite of the potential for these practices, supervisory oversight must not be so restrictive as to inhibit banks to compete effectively. Thus, the regulatory structures that accompany financial market liberalization must be designed to control the risks inherent in credit and investment allocation decisions. Risk control structures are even more pivotal when the basic source of funding of bank credit is considered.

What must be taken into account, in considering the regulatory and supervisory structures for banks operating in developing financial markets, is the elementary point that banks are fiduciary institutions. The public surrenders valuable purchasing power to banks while receiving nothing of concrete value in return. Depositors depend critically on trust. In fact, they merely receive evidence of the bank’s indebtedness to them, a promise that this indebtedness will be repaid on a demand or a term basis with or without interest. To be willing to hold balances with banks, depositors must have confidence that they will receive their funds, together with the promised interest on time. When such trust is lacking, the amount of available banking resources will be insufficient to support the capital formation process. An objective of bank regulation and supervision may, therefore, be to ensure that the banks that will be permitted to operate are those that clearly recognize and effectively perform their fiduciary functions by complying with the prudential standards established by the industry, and more particularly by the bank supervisory and regulatory agencies.
This chapter discusses a set of issues relating to bank supervision in developed and developing financial markets. It recognizes the need for effective bank regulation and supervision in situations of transition from a planned to a market economy, and from a repressed to a liberalized financial market. Both situations are concerned with the regulation and supervision of unaccustomed risks in the banking system.

Attention is focused on developed financial markets' regulation and supervision mainly to identify the scope for transferring the practices and experiences of these markets to the developing financial markets. The chapter reviews the techniques used by bank regulators and supervisors to promote safety and soundness and to maintain confidence in the banking system. It classifies these techniques into preventive, protective, and systemic support methods. It identifies two fundamentally different banking system models, and the regulatory and supervisory systems that fit them. It argues a case for adequate supervisory authority — the authority to stop violations of banking laws and regulations and to prevent the undermining of the regulatory and supervisory system's integrity.

Moreover, the chapter emphasizes the need for product and service restrictions on bank powers, loans to insiders, loan size, ownership, and guaranteed liabilities and the authority to impose such restrictions. Effective supervision of banks and their related entities in foreign markets depends on the availability of information on a consolidated basis and the ability of the supervisors to interpret the key indicators derived from consolidated and other regulatory reports. The chapter, therefore, identifies and reviews the supervisory implications of a set of key performance indicators and discusses a selection of regulatory and supervisors issues related to consolidated information. Finally, the chapter has identified a few regulatory and supervisory concerns about shell branches, parallel-owned banks and parent banks established in offshore and underregulated financial centers.

10.1 TECHNIQUES OF BANK REGULATION AND SUPERVISION

Besides taking deposits and extending credit, banks carry out a number of other activities in the areas of payments settlement, custody of assets and management of investments. And there are features in their balance sheets that can be sources of regulatory and supervisory concern. Examples of these features are: (1) mismatches of assets and liabilities; (2) low capitalization; and (3) high-risk loan and investments portfolios. These potential sources of concern, together with their close interaction with and influence