THE REGULATION OF SOCIAL ECONOMY BANKING

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The publication of the consultative paper "A new capital adequacy framework, by the Basel Committee on Banking Supervision" is a useful reminder that there are shortcomings in the current capital adequacy framework for banks and it is appropriate to develop more sophisticated tools in order to strengthen the supervision of credit institutions. As the world's social economy banking sector grows, the thrust of that paper provides an opportunity and a hope that some of the special characteristics of social economy banking can be recognised by supervision authorities within the capital adequacy framework.

Social economy banking took on its formal status with the establishment of the International Association of Investors in the Social Economy (INAISE) in 1989. A small group of European credit institutions came together because of their common purpose of social economy banking; that is banking policy, procedure and practice, in particular investment, where the social outcome is a relevant criteria for the banking decision.

Whilst the Basel Committee on Banking Supervision is primarily concerned with systemic problems arising out of the internationalisation of banking groups and the development of bancassurance, social economy banks are concerned about the gaps in financial service provision which appears to go hand-in-hand with this trend. Gaps which are manifested in part in the absence of credit for the unemployed and socially disadvantaged; to organisations seeking to combat it; to new sustainable products and services and to some extent a closure of local financial facilities. Social economy banking encompasses such well known names as the Grameen Bank of Bangladesh, Finansol in Latin America, Shore Bank in Chicago and Triodos Bank in Europe. However, it also includes many much smaller institutions, some not strictly credit institutions and therefore without banking status, which are seeking to provide credit in these fields. Some of these are regulated as banks by national laws.

Social economy banking raises a number of competition questions for the supervisory authorities. Many social economy credit institutions have developed because of an absence of the provision of credit services to particular markets, or at least an inadequacy of provision. The development of credit unions in Ireland and the United Kingdom, and the development of credit institutions specialising in environmental funding in Germany and Switzerland, meet market needs which are otherwise unsatisfied.

In the United States the various Community Reinvestment Acts have been developed to bring more transparency into banking operations to use not, for the purpose of credit risk assessment, but for the purpose of ensuring appropriate market coverage in what are perceived to be, but are not necessarily, high risk areas of lending to businesses and individuals in poor communities. Whilst there has been some examination of whether a Community Reinvestment Act should become a new European Union Directive, discussion has so far been fairly limited as to the merits and demerits of this approach. If a more laissez faire approach is to be taken to community reinvestment by banks in Europe, then should there be a more uniform approach to the development of the regulation and supervision of social economy credit institutions within the European Union?

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One cap fits all?

The intention of the first Banking Directive of 12 December 1977 was that the scope of the measures relating to credit institutions would be as broad as possible, covering all institutions whose business is to receive repayable funds from the public whether in the form of deposits or in other forms such as the continuing issue of bonds and other comparable securities, and to grant credits for their own accounts. However, it was recognised that some exceptions must be provided in the case of certain credit institutions to which this Directive cannot apply. Article 2(2) of the Directive set out a list of credit institutions of member States to which the Directive did not apply. In Ireland this included credit unions and in the United Kingdom it also included credit unions, although there was no separate law for credit unions in the United Kingdom at the date the Directive was enacted.

The Council, acting on a proposal from the Commission, is entitled to decided on amendments to the list in Article 2(2). Subsequent Banking Directives have established minimum capital adequacy and other supervisory thresholds for regulated credit institutions which are linked to the Basel Committee on banking supervision.

At the time when the Directives were first crafted 20 years ago, it was envisaged that it would lead to increased competition between credit institutions. Whilst competition between regulated institutions has undoubtedly increased, it is much more arguable whether the range of services and their reach in terms of population has increased or decreased. In some communities within the European Union, not only is there an absence of competition, there is an absence of a product or service. The European Central Bank rightly has concern about the restrictiveness of certain labour markets within the European Union and is pressing for their deregulation. A similar argument could be made in respect of credit supply, whose purpose is to tackle, quite often, that same problem.

Safeguards for exempt credit institutions

The consultative paper on a new capital adequacy framework makes the point that "The financial world has developed and evolved significantly during the past ten years, to the point where a bank's capital ratio, calculated using the current Accord, may not always be a good indicator for its financial condition". The collapse of Barings Bank was a high profile illustration of this. The regulation of credit unions in Ireland and the United Kingdom demonstrates that it is possible to create credit institutions which do not, in their early development, meet the capital adequacy ratios of regulated credit institutions under the Banking Directives. This does not mean that they are not prudent and solvent credit institutions which lack supervision. Over time, a system of supervision has been developed for them. Why, however, should the establishment of these institutions be restricted to the United Kingdom and Ireland? Would they not equally meet the needs of consumers in other member States of the European Union? Similarly are their exempt institutions in other member States which should be permitted in the UK?

Some credit institutions, such as credit unions, are based on the assumption there is proximity between the investor and the borrower, as well as restrictions on lending, which together with internal assessment procedures and market discipline, involving restrictions to certain markets in which they specialise, ensure the safety and soundness of those institutions in conjunction with their supervisors. Such credit institutions are sophisticated within their own niche area of operations in which they have specialised.

The minimum regulatory capital requirements have on the whole served the European Union constructively in promoting safety and soundness in the financial system. Article 4(2)(a) of the second Banking Directive of 15 December 1989 grants the option for supervisory authorities of member States to grant authorisation to particular categories of credit institution, initial capital of which will not be less than one million ecu. If a competitive credit market is to continue, then social economy credit institutions, in particular, whose purpose is to invest for the general good, deserve particular support for development. The minimum requirement should apply to them, provided that they restrict their activity whilst growing their sophistication in their particular niche.

The Basel Committee in its proposal for the new capital framework, bases it on three main pillars. The importance of the retention of the minimum regulatory capital requirements. The second pillar is the importance of a Supervisory Review of an institution's capital adequacy and internal assessment process and the third pillar is the need for greater market discipline. The Basel Committee takes the approach that some banks may be more sophisticated than others. There is an inference in the paper that this sophistication is likely to be based on computerised systems and other techniques which enhance knowledge of the bank about its operations. The sophistication can take other forms too.

The Grameen Bank, for example, has developed a very sophisticated technique of lending relatively small amounts to poor people in what has become known as "microcredit". Each borrow, before receipt of a loan, becomes involved in a small group of four or five persons, (in the case of Grameen Bank predominantly women), who themselves assess the person who should receive the loan first in addition to the Supervisory Officer of the bank. This type of sophistication, which arises from specialisation and the use of credit risk techniques which are not generally used in the same manner by non-social economy banks, can lead to a low risk credit institution. On the other hand, the use of that same technique by a more sophisticated non-social economy bank may not be successful since it is not specialised in that field. The Committee is examining the capital treatment of a number of important credit risk mitigation techniques and it is hoped that it should examine the techniques of the microfinance banks too, in order to give comfort to regulatory authorities that the social economy banks can be sound even though the traditional risk rating of this type of loan portfolio would be considered unsound.

The Committee suggest that external credit assessment institutions might evaluate the banks and this might be taken into account as the basis for regulatory capital requirements. Social economy finance institutions have, under the umbrella of INAISE, been engaged in sharing experience and, more recently with the assistance of the European Union, benchmarking of best experience. Supervisory authorities might gain comfort from the external assessment of social economy finance institutions. Such external valuation would give comfort to advisory authorities in new member States of the European Union in which communities are seeking to respond to credit deprivation by the establishment of their own financial institutions.

The Committee's paper enhancing bank transparency discusses how a bank that is perceived as safe and well managed in the marketplace is likely to obtain more favourable terms and conditions in its relations with investors, creditors, depositors and other counter-parties than a bank that is perceived as more risky. This is one of the core elements of social economy banks whose transparency often involves the provision of information on all loans which they make and whose investors are more patient investors tied to the financial institution through support for the social purpose in which they are engaged. Nonetheless, supervisory authorities would need to mitigate this patient investor quality as the financial institution grows in size and perhaps become somewhat more remote.

Corporate risk and micro lending

The Committee recognises that a shortcoming of the current Accord has been that inadequate recognition is given to the differing credit quality of claims on corporates. The Committee proposes preferential risk only for the very highest quality credits. Proposals such as this are of little comfort to micro lenders to corporates since they essentially leave such loans classified as high risk. If credit mitigation techniques of the social economy micro lender are working, then its track record will demonstrate that a lower risk rating may well be appropriate. If the risk assessment techniques of social economy finance institutions are to make a significant difference, then it will be important to provide better information on the internal ratings of risk by social economy banks. The Committee appears to have an open mind and recognise that different banks and different systems may have equal validity and their problem is how can supervisory authorities understand the deviation from the standardised supervisory approach. The Committee welcomes a meaningful dialogue with the industry on these issues, which leaves open the opportunity for social economy banks to engage in this dialogue.

Importantly, the Committee seeks to evaluate the extent of risk reduction by guarantees, a technique that is used strongly by the anthroposophical social economy banks as well as some micro lenders. The Committee is concerned about the relationship between the default probabilities of the original borrower and the guarantor. The question for social economy banks is to how to evaluate what is often a personal guarantee in a manner which supervisory authorities can take into account.

So far as the second field is concerned, the supervisory review of capital adequacy, often the biggest hurdle for social economy banks, is the understanding by the supervisory authority of the nature of the bank's activities. This is not to say that other banks are not engaged in the same type of lending. What it usually means is that in other banks there is an absence of transparency and specialisation which would permit the bank itself to identify that type of lending as a particular subset of its overall activities. For example, the NatWest Bank plc only identified its lending to the charity sector, for the first time in its history, in 1999. For some social economy banks, this is a key area of their lending and data is regularly available. For the bank supervisors, this presents a problem because of their lack of experience with non-social economy banks' activity in these fields. Understanding by the regulators would be critical for the application of principles of bank supervision.

The Committee indicates that it will continue its efforts to enhance a supervisory review process. This gives an opportunity for social economy banks to share their experience with the Committee so as to enable it to make sounder judgements about the quality of social economy banks. The existing transparency of social economy banking is a key feature of its market discipline for its investors and borrowers and supervisory authorities. As social economy banks grow, they will inevitably compete with non-social economy banks who may themselves seek to develop market niches in competition with those developed by the social economy banks. If social economy banks are to remain true to their purposes, they should not let this competitive threat obscure their principle of transparency.

The growth of social economy banking since the first Banking Directive in exempt and regulated credit institutions has demonstrated the many shortcomings in the regulatory regimes for these institutions. Social economy finance institutions have demonstrated that there is a competitive market for their products and services, and by engaging in those markets where many non-social economy banks have retreated or reduced their service, create a competitive banking environment.

Regulatory authorities

The scale of operations of social economy banks, whilst still very small, has found itself on the agenda of national governments in the European Union as they seek to provide different ways of tackling social exclusion and sustainability. If the Committee can recognise that the existing capital adequacy framework is a 'blunt instrument' which requires elaboration, perhaps they can also recognise that to sustain competition in banking that provides services to all sections of the community, the regulation of social economy banking by both exempt and regulated credit institutions merits a more sophisticated treatment too.