

MONETARY POLICY AND BANKING SUPERVISION: COORDINATION INSTEAD OF SEPARATION

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Introduction

Eurozone policy makers have embraced the concept of a banking union as the latest tool to address the euro crisis. While many details are unclear and under discussion, the principal decision to make the European Central Bank (ECB) the responsible authority for bank supervision in the eurozone has been taken. In September 2012, the Commission published a legislative proposal on the Single Supervisory Mechanism (SSM). In this proposal it is foreseen that the responsibility for supervision should come under a new ‘Supervisory Board’, to be created within the ECB. This new board would have six members from the ECB, a President and a Vice-president plus four other members. The other members of the SSB should represent national supervisors.

Unifying responsibility for monetary and financial stability in one institution raises concerns of conflicting objectives, incentives and independence. A large body of literature has discussed the benefits and risks from unifying both tasks under the central bank’s authority. Most of this literature, however, refers to normal times rather than a crisis situation such as the eurozone is currently experiencing. In addition, currency unions pose additional challenges, with stronger conflicts between national and supra-national interests and the European Union still far from having

strong independent and democratically legitimized institutions outside the ECB.

This paper argues that a strict separation between monetary policy and supervisory arms within the ECB is neither desirable nor feasible at this stage. We consider it more important to complement the single supervisory mechanism with a strong set-up for bank resolution. The tendency of all supervisors to practice forbearance as long as possible could be countered, at least partially, if some members of the supervisory board were independent experts, drawn neither from national supervisors, nor from the ECB.

The remainder of this paper is structured as follows. The next section describes the proposed structure for the new supervisory authority at the ECB. The third section discusses critical differences in the conduct of monetary policy and supervisory tasks, while the fourth section provides a critical overview over the literature on the benefits and disadvantages of unifying responsibility for monetary and financial stability at the central bank. The fifth section points to additional complications arising from Chinese walls within the ECB in the context of the eurozone (see Figure 1); and the final section offers some concluding remarks.

The proposed structure

The proposal by the Commission says that a ‘*representative*’ of each national central bank or other national competent authority’ will sit on the Supervisory Board (SB) to be created within the ECB: the Chair of the supervisory board will be selected from the members of the Executive Board. The supervisory board will be led by a Chair and a Vice-Chair elected by the ECB Governing Council and composed, in addition to them, of four representatives of the ECB and of one representative of each national central bank or other national competent authority (see European Commission 2012a).

In about one-half of all euro area member states, the central bank is also the supervisor, that is, the ‘national competent authority’ as defined under EU rules.



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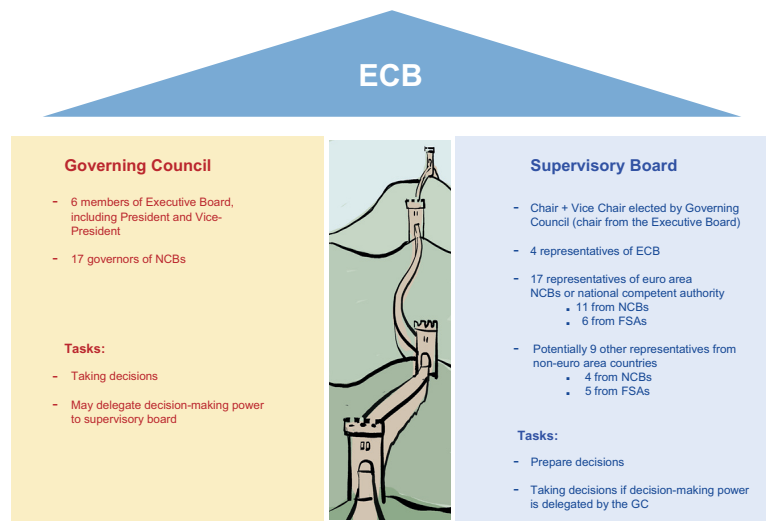
Table A1 in the annex shows the distribution of supervisory competence for banking supervision in greater detail. In some member countries, this is the responsibility of the central bank, together with a separate financial supervisory authority. The SB will thus be composed largely of representatives of the same institutions that also numerically dominate the Governing Council (GC), namely the NCBs. This domination of both boards by representatives of national central banks (NCBs) may be slightly decreased if the non-euro area group of countries were to participate fully. Five out of nine would delegate a member of their national financial supervisory authority (FSA).

However, the individuals who sit on the two boards might still be different because only the governors of NCBs sit on the GC, while the existing legislative proposals suggest that somebody else might represent the NCBs on the SB. The key practical question that arises is whether many central banks will have two different representatives within the ECB: one for the GC (the governor) and another for the SB (e.g. the vice governor or whoever is responsible for supervision). The two individuals will work most of their time in the same institution (probably also in the same building) and one (the governor) is hierarchically superior to the other (the head of supervision). It is difficult to imagine that these two individuals will not be in constant contact, thus rendering any Chinese walls between the GC and the SB somewhat permeable.

The presence of representatives of other institutions on the SB raises a delicate problem of independence. In Germany, for example, the supervision of banks and insurance companies is the responsibility of the Bundesanstalt für Finanzdienstleistungsaufsicht (BAFIN). In reality, supervision is executed together with the Bundesbank, whose staff participates in most on-site inspections and which prepares many of the reports. As a result, the Bundesbank automatically has an intimate knowledge of the state of the financial system and *de facto* access to all necessary detailed information, which is often highly confidential.

Figure 1

CHINESE WALL BETWEEN MONETARY POLICY AND SUPERVISION ?



Source: Authors' visualisation based on European Commission (2012a and 2012b); Council of European Union (2012), 15663/12; EBA (2012); EIOPA (2012).

One problem this raises is that BAFIN (like other supervisors) is not independent from the German Finance Ministry (in German BAFIN is '*weisungsgebunden*'). This means that some members of the Supervisory Board will not be independent. Would this be compatible with the overall independence of the ECB?

Another problem is that, in the countries where supervision does not reside in the central bank, the supervisors have other tasks, such as supervising insurance institutions or consumer protection.

Differences between monetary policy and supervision

Supervision and monetary policy are completely different functions in many respects, e.g. the nature of the decisions that are taken, the background information needed to take them, their implementation, the qualifications of the staff that is needed, etc.

Monetary policy, at least in normal times, required only relatively infrequent decisions about one variable, namely the interest rate that the ECB sets on its main refinancing operations. This decision was then implemented uniformly throughout the system by the national central banks, which all just changed essentially one element in their computer code. The NCBs thus had no discretion in how to implement monetary policy decisions. Moreover, central banks do not change their interest rate daily, but tend to do so on a

monthly basis. Monetary policy could thus be decided by a body that does not need to manage ‘hands on’, but that meets only every second week and essentially then has one big decision to take (whether to change rates).

The staff of the ECB naturally played a key role in preparing the material for taking monetary policy decisions (inflation and general economic outlook), but the staff of the ECB did not have to manage the actual implementation on a daily basis, which could be left to the NCBs. The latter had no leeway in this matter in any event.

With the crisis, the nature of monetary policy has, of course, changed somewhat. For example, collateral requirements had to be changed frequently and the use of new collateral has to be monitored. Even here, however, there is little need to take frequent decisions on specific cases, as the collateral rules are set in such a way (mainly ratings requirements) that the staff of the ECB only has to check the fulfilment of formal requirements.

Supervision is totally different from monetary policy in these practical aspects. Supervision is, by nature, an activity that requires hands-on management with thousands of pieces of detailed information to be collected. During normal times, when the financial system is stable, few decisions have to be taken as supervisors try not to interfere with the daily business of their banks.

During a crisis, however, major decisions regarding individual banks have to be taken almost daily. This requires more than broad rules and guidelines. Interpretation of the rules and the way they are applied then become crucial. It follows that the SB will have little influence if it meets with the same frequency as the Governing Council (once every second week).¹ Supervision can be said to be exercised by the ECB only if it is done directly by ECB personnel. Very little will change if the SB simply elaborates general guidelines for national supervisors.

Finally, it is usually argued that supervision can have immediate fiscal implications. Bini Smaghi (2012a and 2012b) argues that this is also the case for monetary policy in general. This is true, and in terms of the size of the fiscal consequences of potential mistakes there might be little difference, as an increase in interest

rates can cost a government much more than a bank rescue operation.

But the important difference between monetary policy and supervision is that the fiscal implications of monetary policy are much more diffuse, and arise throughout the euro area as a by-product of standard monetary policy operations; whereas the fiscal implications of supervision are much more direct and concentrated in perhaps only one member state (e.g. the decision to close down a bank or the failure to detect excessive lending). All this makes it politically much more difficult to accept the fiscal consequences of supervision at both the national and EU level. The best way to deal with this issue would be to create a European resolution fund and regime (as emphasised in Beck 2012).²

Monetary policy also differs fundamentally from supervision in terms of its legal nature: supervision can require acts that directly infringe the property rights of individuals and corporations. This implies that it must be possible to challenge supervisory decisions like the closure of a bank in the courts. Due process and clearly identifiable legal responsibilities are thus essential for supervision. By contrast, the typical monetary policy decisions like increasing interest rates or changing collateral requirements are not usually subject to any judicial review.

Review of the literature

The literature on supervisory structure contains arguments in favour of and against concentrating responsibility for bank regulation and supervision within the central bank. Most of the literature assumes implicitly that there are no Chinese walls within the central bank between the supervisory arm and the decision-making organ on monetary policy. In this section we list the main arguments in favour of and against this assumption and also relate them to the current situation in the eurozone.

Benefits of involving the central bank in bank regulation and supervision

- *Access to better information.* The central bank needs accurate and timely information about

¹ One is tempted to say that ‘supervision cannot just be supervised’.

² See also Schoemaker and Gros (2012), who propose a European Deposit Insurance and Resolution Fund (run by a European Deposit Insurance and Resolution Authority (EDIRA)), which should become the authority that decides on resolution and makes payments to depositors directly when required.

banking sector performance in order to effectively exercise its monetary policy functions (see Goodhart 2000; Peek, Rosengren and Tootell 1999). It might also help to improve assessments of the risk-taking consequences of loose monetary policy (see Jimenez *et al.* 2012). In the context of the current crisis, this will give a better assessment of the current bottlenecks in the transmission channels of easing monetary policy. It will also help the ECB better execute its new task in macro-prudential regulation.

- *Crisis resolution.* If the central bank has supervisory powers, it may be able to act more effectively *via* the banking system in times of crisis (see Goodhart and Schoenmaker 1995). Critically, the ECB has *de facto* taken over the lender-of-last resort function, without being able to judge the credit-worthiness of banks. This does not only exacerbate the tragedy of shared problems from the crisis (see below), but also increases risks on the ECB's balance sheet, i.e. the risk that there will be no timely intervention into weak banks (see Wyplosz 2102).
- *Independence.* Central banks are known for their independence, which is important for successful supervision (see Abrams and Taylor 2000). The ECB has achieved a reputation as being a truly European institution, well above national interests and being independent from political influence. In the context of constructing a banking union, it is therefore easiest to build on this already acquired reputation. The strong reputation of ECB might also help to attract more skilled staff.

Disadvantages of involving the central bank in bank regulation and supervision

- *Conflicts of objectives.* Combining prudential supervision and monetary policy could result in an excessively loose monetary policy, since the central bank might want to avoid the adverse effects on bank earnings and credit quality (see Goodhart and Schoenmaker 1995; Ioannidou 2012). In the current crisis, one could argue that the ECB might not necessarily be a tougher supervisor than national authorities. It might actually be more lenient, as it is concerned about contagion across the eurozone and because it has more resources available since it is also the lender-of-last-resort (see Allen, Carletti and Gimber 2012). On the other hand, it is not clear whether monetary and financial stability policies conflict with each other with the rise of macro-prudential regulation as an additional policy tool.

- *Reputational risk.* If the credibility of the central bank as a prudential supervisor is undermined, this could also negatively affect its credibility in the area of monetary policy (see Goodhart 2000). This risk is especially great in the area of bank stability as only its absence can be properly observed, while monetary stability is a more transparent target.
- *Loss of independence or too much power.* The central bank could become more prone to political capture when its role increases, thereby undermining its independence (see Goodhart 2000). In the context of the envisaged SSM within the ECB, this danger is especially grave, as representatives of national supervisory authorities do not enjoy the same degree of political independence as NCBs. Furthermore, supervisory decisions involving the taxpayer-financed recapitalisation of banks might make the ECB vulnerable to more political pressure. At the other extreme, there is the fear that a central bank with banking supervisory power will become too powerful, with limited accountability to elected legislatures and governments. This concern might be especially pertinent in Europe, where the European Parliament still enjoys limited legitimacy.
- *Scope diseconomies.* An institution with several objectives might tend to mis-allocate resources and neglect one of its tasks (see Abrams and Taylor 2000). A related argument is that the boundaries of financial intermediation have moved far beyond banking and that a bank regulatory authority tasked with systemic financial stability has to expand significantly beyond banking. This is also reflected in the eurozone, where bank supervisory authorities often have additional responsibilities for other segments of the financial sector.

It seems that while in general, there are arguments both pro and contra establishing bank regulation and supervision at the ECB, the current situation in the eurozone – both in the crisis and thus needing relatively fast action but also given its current governance structure – provides a strong argument for establishing responsibility for bank supervision and regulation at the ECB. In other words, some of the conflicts mentioned above will always exist, even if bank regulation and monetary policy are located in different institutions, but the ECB might be in a better position to internalise these conflicts (see Ioannidou 2012). In this case, however, Chinese walls between supervision and monetary policy do not make sense.

There are strong arguments for including bank regulation and supervision in the ECB's brief, rather than locating the tasks with a different institution. The most convincing argument, however, refers to the tragedy of the common problems caused by the crisis in the eurozone, as each member tries to shift the burden to the ECB. Only an institution that is free of direct national interference can overcome this problem and internalise the externalities stemming from national banking fragility for the overall currency union.

While the current situation might not be an appropriate one to distribute responsibilities across several institutions, there is a strong case for not bundling responsibility for bank resolution together with supervisory responsibilities at the ECB (see Schoenmaker 2012). The Commission is planning to come forward with proposals next year for a separate institution (which would also require funding) to deal with bank resolution. Such a separate institution could also counter the moral-hazard risk mentioned above, i.e. the risk that the ECB is reluctant to intervene in a bank to which it has high exposure as lender of last resort.

Market segmentation

Gros (2012) has shown how national supervisors have a natural incentive to 'ring fence' the banks under their watch, i.e. national supervisors actively encourage 'their' banks to reduce their cross-border exposure. This segmentation of the euro area's financial markets is one key cause of the crisis because it means that the savings surpluses of countries like Germany or the Netherlands can no longer be recycled to those countries with a current account deficit and even the existing stocks of cross-border liabilities cannot be rolled over in the market. In some cases supervisors in savings surplus countries have even *de facto* prevented the local subsidiaries of cross-border banks from funding their headquarters located in countries under financial stress.

Would the set-up proposed so far deal with this problem? Probably not. As long as resolution (and deposit insurance) remains totally national, the incentives of the national supervisory agencies (mostly central banks, except in Germany, whose savings surplus is a lynchpin of the euro area economy) will continue to be to ring fence because any losses abroad might lead to costs for them (or rather their own governments). Delegating supervision to the supra-national level,

but without a concomitant move of resolution powers, will thus not help to address the current crisis or change anything fundamentally in the set-up of the currency union. Some observers have even argued that this partial banking union might make things worse (see Wyplosz 2012).

The limited access to information is another problem whose solution would be hampered by Chinese walls. At present, the ECB can only observe that a number of banks have become dependent on its funding. Moreover, some have even needed Emergency Liquidity Assistance (ELA). Both developments are generally a sign of weakness, but the ECB has no way of knowing how weak or strong these institutions are in reality. Only the national central bank of the home country of these institutions has all the required information in its possession; but this information is not shared. National central banks have an obvious interest in championing the interests of their banks and therefore are not unbiased judges of the health of their banking system or of the quality of the collateral that their banks use for ELA. ECB staff has no access to any confidential supervisory information and cannot thus form its own independent view of the health of the euro area's banking system. The other members of the Governing Council (i.e. the governors of the NCBs) also do not have access to any information about the state of the health of banks in other countries; and they naturally mistrust the judgment of their colleagues. This, in turn, makes it very difficult for the Governing Council to form an unbiased opinion of the degree of financial market stress (and the measures needed to stem the crisis).

This is again totally different from monetary policy under normal circumstances when all the information required to assess the economic outlook in general, and inflation in particular, is publicly available. With Chinese walls between the two functions of the ECB (monetary policy under the GC and supervision under the SB), this problem would not be resolved. A key issue that has not yet even been broached is whether all members of the SB would have full access to all supervisory information, including that of a confidential nature. This must be provided for. Otherwise the board would not be able to be effective.

Conclusions

Our brief review of the literature suggests that during a financial crisis it makes little sense to try to separate

supervision and monetary policy when both functions are for all practical purposes exercised within the same institution. Moreover, the two boards responsible for these two functions will overlap to a large extent, at least in terms of the institutions that are represented on them. Some ‘osmosis’ is thus inevitable between the SB and GC.

Theory (and practice) suggests that the nature of the relationship between supervision and monetary policy might differ fundamentally between crisis and normal times. Since the basis for the SSM is being laid during a crisis, it might be useful to have an explicit review clause so that the arrangements can be re-evaluated when financial market conditions have returned to normal.

National supervisors will always have a tendency to defend ‘their’ national champions, and the judgment of representatives of the ECB will be influenced by the lending that might be already at risk. We would argue that this problem could be addressed by stipulating that four members of the Supervisory Board should be independent, i.e. outsiders who are not beholden to any institution and who would thus be free of any conflict of interest.³

The real problem for the euro area going forward is not the separation of supervision and monetary policy or the details of the composition of the Supervisory Board, but rather how to ensure that supervision is linked to resolution in a framework that encourages early loss recognition. This particularly applies to the current crisis. The earlier losses are recognised, the better.

In the longer run, it will, of course, be crucial to strengthen macro prudential supervision. To that end, ensuring a proper flow of information and division of labour between the Supervisory Board and the ESRB will be essential.

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Annex/Table A1

Who is responsible for banking supervision?

³ The presence of independents on the SB will probably be seen as incompatible with the free flow of confidential information. Yet this should not be a concern as many companies have independent directors on their boards with access to highly confidential information.

Annex/Table A1

Who is responsible for banking supervision?

Country	Bank supervision authority	Member of EIOPA	Member of ESMA
Austria	FSA	Yes	No
Belgium	NCB	Yes	No
Cyprus	NCB	No	Yes
Estonia	FSA	Yes	Yes
Finland	FSA	Yes	Yes
France	NCB (FSA) ¹	Yes	Yes
Germany	FSA	Yes	Yes
Greece	NCB	Yes	No
Ireland	NCB	Yes	Yes
Italy	NCB	No	No
Luxembourg	FSA	Yes	Yes
Malta	FSA	Yes	Yes
Netherlands	NCB (FSA) ²	Yes	Yes
Portugal	NCB	No	No
Slovakia	NCB	Yes	Yes
Slovenia	NCB	No	No
Spain	NCB	No	No
Bulgaria	NCB	No	No
Czech Republic	NCB	Yes	Yes
Denmark	FSA	Yes	Yes
Hungary	FSA	Yes	Yes
Lativa	FSA	Yes	Yes
Lithuania	NCB	Yes	Yes
Poland	FSA	Yes	Yes
Romania	NCB	No	No
Sweden	FSA	Yes	Yes
United Kingdom	FSA	Yes	Yes

¹ Autorité de Contrôle Prudentiel is closely linked to Banque de France. – ² Prudential supervision conducted by De Nederlandsche Bank. The FSA is the integral cross-sector authority for conduct of business supervision.

Source: Authors' own compilation based on information from EBA, ESMA and EIOPA.