



## SOME OF THE PROS AND CONS OF CENTRAL BANKING SUPERVISION BY THE ECB

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### Introduction

If the EU follows the proposals of Internal Market Commissioner Michel Barnier,<sup>1</sup> the ECB will very soon assume responsibility as the central banking supervisory authority for all, or at least several credit institutions<sup>2</sup> within the eurozone. This would effectively mean the implementation of the thoughts and/or recommendations of the Federal Reserve: “generally, financial regulation and supervision, rather than monetary policy, provide more-targeted tools for addressing credit-related problems. Enhancing financial stability through regulation and supervision leaves monetary policy free to focus on stability in growth and inflation, for which it is better suited” (Ben Bernanke in September 2010 before the Financial Crisis Inquiry Commission of the US Congress). With this statement Bernanke implicitly supported the assumption that central banks cannot overcome both a financial market crisis and take precautions to counter the dangers of inflation or deflation using interest rate policy alone (see Schäfer 2009; Sell 2007).

The restructuring of banking supervision within the eurozone is part of a far more sweeping overall plan for a banking union, which, in addition to supervision, also covers deposit protection, resolution funds for insolvent banks and capital requirements. This article examines some of the tasks involved in banking supervision and the supervision of compliance with capital requirements by a central bank such as the ECB. This kind of analysis makes sense even if Michel Barnier’s plans will only be implemented in a

heavily curtailed form, which looks increasingly probable since the EU Finance Ministers’ Council in Nicosia on Cyprus in September 2012. Unlike the work of authors such as De Grauwe and Gros (2009), this paper deliberately focuses both on the instruments (interest rates, supervision) and on the targets (price stability, financial market stability) of central bank policy.

This paper excludes a whole range of topics, including the controversial question between the EU Commission and Germany (put forward by the Association of German Banks in particular) of whether all banks in the eurozone will be subject to banking supervision – which has to be approved by all 27 EU states – or if only around 25 of the ‘system relevant’ credit institutions, or only the members of this latter group that have remained ‘healthy’ to date will be supervised.

This paper will begin by looking at the question of how sensible it is for one and the same central bank to influence both interest rates *and* banking supervision. Secondly, it examines whether central banking supervision *via* the ECB could possibly throw up a new ‘trilemma’ for (in this case European) monetary policy. Thirdly, the paper discusses whether a central banking supervisory authority will tend to have procyclical effects (especially in terms of compliance with capital requirement regulations). Our approach to all of these questions will principally be of a macroeconomic nature.

### Banking supervision and monetary policy in the hands of a single institution?

The two most popular arguments for and against bundling the so-called duties of a central bank are as follows: one of the pros is that the central bank is a partner of the commercial banks in the framework of repurchasing agreements (‘repos’). As a supervisory authority, it is well-placed to assess not only the collateral submitted (securities), but also the creditworthiness and the conduct of the submitting institutions, which certainly constitutes a major advantage given

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<sup>1</sup> Notice that this paper collected recent information up to early October 2012.

<sup>2</sup> This also makes it clear that the EU is not striving towards some form of ‘bancassurance’ following the example of BAFIN.

the information asymmetry between the players involved. Moreover, this pro argument already has a backdoor: the central bank could be put in an uncomfortable position if its monetary policy suggests the need for an increase in interest rates, but considerations given to major financial institutions in the framework of its supervisory duties make it seem wiser to delay any change in interest rates. This argument already has a certain value in its own right, but it will be re-addressed in the framework of the ‘trilemma discussion’.

One of the contra arguments is the so-called ‘independence dilemma’. If the ECB were to be made entirely responsible for supervising the financial market, then it would also have to be given a mandate to intervene directly in banking business, to fire executives and close-down banks. However, that is a sovereign task in the states concerned, which is currently performed not by the ECB itself, but exclusively by authorities like BAFIN in Germany (on behalf of the Federal Ministry of Finance), or by independent national supervisory institutions. Should the ECB also receive such rights to intervene, the latter’s independence as monetary institutions would potentially be heavily threatened since their sovereign interventions would have fiscal implications in many cases. However, there is a back door here too: the ECB could delegate the implementation of recommendations to national agencies (like BAFIN) or to the EBA.

Very few authors go beyond this qualitative analysis to examine the bundling problem in the framework of a macroeconomic model. These authors include Gersbach and Hahn (2011): capital requirements have a dual effect when adopted. They reduce the probability of a banking crisis on the one hand, and curb the output expected with a rising degree of implementation on the other. If monetary policy were to be delegated to a conservative central banker, then that banker would attach comparatively little (or no) importance to output and/or stabilising employment. As soon as the central banker in question were also to be made responsible for EC regulations, s/he would tend to set them at ineffectively high levels; since a central banker would care little (if at all) about the related negative output effects. This outcome tends to support an institutional separation of monetary and supervisory policy. By other means (in the framework of an AS-AD model) De Grauwe and Gros (2009, 7) arrive at exactly the same conclusion: “strict inflation targeting cannot be maintained because it can conflict with financial stability”.

Conversely, this could mean that delegating monetary policy to a Federal Reserve banker – it is well known that the US central bank should also consider growth and employment as its goals alongside price stability – would reduce the bias in the favour of output targets, and make it easier to harmonise monetary and supervisory policy. In that case an institutional link between monetary and supervisory policy should be advocated. Since the ECB has come far closer to the Federal Reserve’s philosophy in the wake of the financial crisis, and a simple return to the two pillar strategy of the first 10 years of its existence now seems unlikely, if not almost impossible, this argument should also apply to a large extent to the ‘ECB banker’.

### Is there a new trilemma?

The so-called ‘monetary policy trilemma’, faced by all central banks in principle, has long since been well-known. According to this trilemma, it is not possible for a central bank to pursue the three goals of ‘free capital movement’, ‘autonomous monetary policy’ and an explicit ‘exchange rate target’ at the same time. It is far rather the case that only two of the three goals listed above can be achieved simultaneously. It is worth noting that the monetary trilemma outlined here presupposes that ‘complementarity’, or at least ‘neutrality’, exists between each of the two pairwise eligible goals/instruments. In response to the question of whether bundling supervisory competences in the European Central Bank represents an acceptable and economically effective solution, it is important to examine whether this would give rise to a ‘new trilemma’. Drawing on Neumann (2009), Figure 1 defines a new ‘target triangle’ for central banks. Using the conceivable combinations/pairs (1), (2) and (3), it is possible to question the existence of such a new trilemma:

- (1) The targeted acquisition of certain bonds/securities from the portfolio of credit institutions may positively influence the latter’s liquidity/solvency and, at the same time, change the incipient price gains which – in times of asset price inflation – shift the prevailing imbalance in the portfolio of private players in favour of less risky investments. However, this policy may endanger the central bank’s inflation target.
- (2) Pricking a price bubble with higher base interest rates (see Neumann 2009) can slow down, or even interrupt a boom in the financial markets, and may, at the same time, be a necessary way of countering inflationary tendencies. However, it may

also potentially pose a threat to the liquidity/solvency of weakened, systemically relevant monetary institutes.

- (3) A lasting policy of low interest rates may be appropriate in order to avert the threat of deflation and/or guarantee the liquidity/solvency of system-relevant monetary institutions, but it can precipitate the formation of a fresh bubble in the financial markets (see Kurm-Engels 2010).

These arguments sound convincing, but they do not tell the whole story: let us assume that the central bank supervisor induces market participants to behave prudently and thus limits ‘excesses’ in the market, this is also helpful in controlling inflation. This argument largely applies to the pair/situation described above in (2). Conversely, it supports bank supervision by the central bank if the latter pursues an interest rate setting policy that takes into account whether the interest rate chosen could promote a fresh ‘bubble’ in the financial/and or commodity markets, or at least have destabilising effects on the financial markets. This argument also supports pair/situation (2). It is often argued that central banks – quite in the sense of the principle of subsidiarity – are close enough to any potential problems/exaggerations arising in the financial markets. Thanks to refinancing operations with banks, they also function as direct partners of all players that may be potentially affected by (future) illiquidity/insolvency. This enables them to detect the corresponding risks early, and puts them in a position to exercise considerable influence over market events through their own activities. This argument primarily applies to pair/situation (1). Looking at pair/ situation (3), however, a central bank could be

easily put into an uncomfortable position if the stance of monetary policy signals the need for an increase in interest rates, but considerations given to the liquidity/solvency of major financial institutions make it seem appropriate to maintain interest rates at a constant level. This time, the new trilemma becomes sort of inconsistent as a pair/situation contains rivalling, and not complementary instruments.

The possibly pro-cyclical effect of important rules of financial market supervision constitutes a key aspect of the potential conflicts between the goals of financial market and monetary stability. That is why this paper devotes a separate section to this topic.

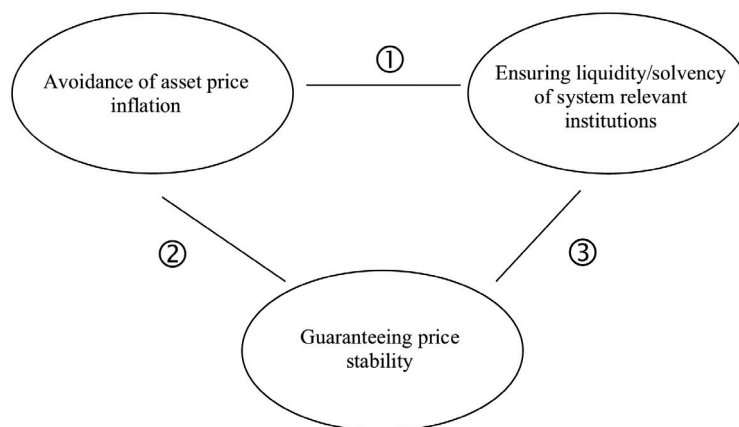
### Does integrated banking supervision have a smoothing or a pro-cyclical effect?

With the Taylor rule (see Blanchard 2009), today’s central banks have created an instrument for flexibly adjusting the base interest rate to shocks that could pull it down during an output slump and/or a deviation of the inflation rate from its target level. This type of process is anti-cyclical in its approach, but not discretionary, as Keynesian monetary policy used to be. For this reason a conflict-free, integrated bank supervisor can only implement monetary policy if the latter is at least neutral, but has no form of pro-cyclical effect. But can financial market supervision be prevented from having a pro-cyclical effect?

One possibility is naturally that the new regulation of the financial markets is itself able to suppress rules with a pro-cyclical effect, or to introduce rules with an anti-cyclical effect (see Herr 2010). Some time ago, several experts suggested countering the inclination of banking institutions to accumulate particularly high debts during boom periods by limiting the maximum leverage ratio. “The Basel Committee on Banking Supervision reacted to these demands in Basel III with a leverage ratio, which prescribes a risk under-weighted upper debt ceiling” (see Nguyen and Ben Shlomo 2012, 477). Moreover, back in January 2009, the Ministry of the Economy’s Scientific Advisory Body advised the German government to abandon the Basel II reg-

Figure 1

#### A NEW TRILEMMA FOR MONETARY POLICY?



Source: Sell and Hartung (2011).

ulations because it feared pro-cyclical value adjustments/increases in capital requirements during the recession in the real economy (see Hellwig 2009).

The second, considerably less favourable scenario for the central bank occurs if the pro-cyclical nature of financial market regulation can only be reduced overall, but cannot be completely eradicated. In such cases, the central bank will not only be concerned to ensure that the rules are obeyed, which themselves contain a pro-cyclical element, but will try to counteract pro-cyclicality in its own actions. The example given below should illustrate the connection.

It is widely recognized that the supervision of the obligation to respect so called core capital ratios<sup>3</sup> can trigger pro-cyclical effects (see Berka and Zimmermann 2012). This regulation forces commercial banks in a recession to reduce their loan volume, when receivables are to be written off anyway. Conversely, in boom periods, when demand for credit grows endogenously, commercial banks have a strong incentive to grant higher loans. In the end they have no reason to expand the expensive (in their view) core capital ratio any more than necessary. A central bank<sup>4</sup> in principle has several ways of counteracting this problem, including the three options outlined below:

- It can incorporate a further (third) term into the Taylor rule, which explicitly counteracts the pro-cyclical effect of core capital ratios on the interest base rate to be selected; any such or similar rule was not followed in the early years of the ECB, but this has changed considerably since 2008.
- It can provide guarantees for the increased risk assessment of the assets on bank balance sheets during the recession to prevent an increase in the core capital ratio denominator. As soon as a recovery started, the guarantees would cease to apply.
- It can directly buy the assets owned by commercial banks that have sharply increased in terms of risk, and thus make it easier for such banks to raise additional capital under favourable conditions. This would push up the core capital ratio counter, while the additional credit granting would also fall into

line with the more expansive orientation of the Taylor rule in a recession. Should the transaction – like repurchase agreements (repos) – be accompanied by a repurchasing agreement, then provisions would also be made, in principle, for a boom.

Unlike the first option, alternatives two and three represent a trade-off between greater liability on the part of banks on the one hand, and the prevention of pro-cyclical effects on monetary policy on the other. For if guarantees are provided or assets directly purchased, then the intended stipulation of a higher (unlimited) liability is reduced on the other side. This raises the fundamental question of whether the regulation desired would be leveraged by the compensating measures taken by the central bank (at least to some extent).

In a well-received paper Admati *et al.* (2010) showed that the regulatory increase of capital requirements does not, as frequently argued, automatically increase the cost of granting loans, and does not fundamentally force banks to reduce loan granting and/or make credit more expensive. One of the reasons for this is that better capitalised banks also grant more solid loans. The loans are better because banks are less tempted to take bigger risks:<sup>5</sup> “highly leveraged banks are generally subject to distortions in their lending decisions. These distortions may lead them to make worse lending decisions than they would have made if they were better capitalized, involving either too much or too little lending relative to some social optimum. First, equity holders in a leveraged bank, and managers working on their behalf or compensated on the basis of ROE (return on equity), have incentives to make excessively risky investments, and this problem is exacerbated when the debt has government guarantees. Second, when banks are distressed, credit markets can freeze and certain loans will not be made due to a ‘debt overhang’ problem. Valuable loans that are not made as a result of debt overhang would be undertaken if the bank were better capitalized, since in that case the value created by the loans would be

<sup>3</sup> “The core capital ratio can be found by dividing the core capital by the sum of the risk positions” (Sinn 2009, 152). Since the risk weighting of several assets increases in the recession, the core capital ratio denominator can only be reduced *via* a decrease in part of these assets, in the hope that the denominator (paid in share capital, capital reserves, silent partnership contributions) does not melt down too much.

<sup>4</sup> This paper deliberately does not discuss regulations that could conceivably counteract the pro-cyclical nature of core capital ratios, for such regulations cannot be motivated by central banks, but only supervised by them.

<sup>5</sup> “The presence of debt creates incentives for management, acting on behalf of shareholders, to engage in strategies that yield high returns when successful and negative returns when unsuccessful, increasing the likelihood and the extent of distress and insolvency” (see Admati *et al.* 2010, 22). On the other hand, a bank’s accumulated earnings give it a broader capital basis and enable it to expand its credit granting without having to raise additional external outside capital. However, earnings can only accumulate if the bank is not too highly leveraged: “if a bank is highly leveraged, the bank’s shareholders – and the bank’s managers as well – have strong incentives to have earnings paid out, rather than retained, since if earnings are retained there is the possibility that they will be used to satisfy the claims of the debt holders in financial distress” (see Admati *et al.* 2010, 34).

captured by those who would fund it” (see Admati *et al.* 2010, 38).

If this is true, it must also hold that the Basel III rules announced in September 2010 tend to mean that the issue of pro-cyclical effects – especially compared to Basel II (see Berka and Zimmermann 2012) – has been slightly defused. The new regulations on capital requirements should primarily take effect as of 2013 (see BIZ 2010): banks will have to retain 4.5 percent common equity as of 1 January 2013. There will be a transitional phase (up until 1 January 2019) for the additional capital conservation buffer of 2.5 percent that banks should only be allowed to touch in times of crisis, as well as for the accumulation of additional ‘common equity’ (4.5 percent by 1 January 2015) and of ‘tier 1 capital’ (6 percent by 1 January 2015). In total, banks will consequently need over eight percent of core capital, which is double the amount to date, and seven percent alone will be required as common equity.<sup>6</sup> However, to build up this capital buffer and common equity, the ten biggest German banks alone require over 100 billion euros in fresh capital, according to their own estimates – which will either come from current earnings, which will then no longer be available as dividends, or as capital increases (see ZEIT Online Wirtschaft 2010). The new, anti-cyclical element of banking regulation subsequently consists of the new capital buffer (see Resti and Sironi 2010), that banks can fall back on in times of crisis (to expand loan granting), but which they then have to replenish in good times (to reduce loan granting).

In its dealings with foreign commercial banks the Chinese central bank has linked a longstanding monetary policy instrument, namely the reserve requirement ratio, directly to compliance with core capital regulations. For the foreign subsidiaries of multinational banks, this means that they have already overcome very steep hurdles on their application for a licence (apparently proof of capital commitments up to 700 percent higher than for the same kind of licence in Switzerland is required) and they must also be able to comply with substantial core capital ratio requirements. Low core capital ratios are sanctioned by the Chinese authorities through the application of a higher reserve requirement rate. This kind of provision is also pro-cyclical in principle, since a higher reserve requirement ratio is widely acknowledged to reduce the credit multiplier of the commercial banking system

in a situation whereby the credit volume is downwardly adjusted in any case (see above). Moreover, the Chinese construction is of an asymmetrical nature, for a lowering of the reserve requirement ratio – below the generally prevailing percentage – is not provided for in a boom.

## Conclusion

This paper discussed the question of whether and in which ways central banks like the ECB seem to be suitable to assume sole responsibility for bank supervision. This would imply simultaneous responsibility for price stability and financial market stability at the level of goals, and the use of interest rate and bank supervision at the level of instruments. In the sense of the question raised by the title, central banks mainly seem to gain more opportunities than exposure to risks by expanding the scope of their responsibilities. This would constitute a meaningful expansion of their ‘classical business area’. One has to admit, however, that central banks are principally in danger of neglecting their macroeconomic responsibility in cases where interest rate policy would put system-relevant banks under pressure.

The independency dilemma could be resolved, or at least alleviated, if the ECB were not to take any sovereign actions itself, but were to issue strict recommendations for national authorities designated to implement them. That would enforce the subsidiarity principle. It would, on the other hand, be unsatisfactory to set up a financial market supervisor under the auspices of the ECB. Should the latter have the same rights as the ECB, then there would quickly be a squabble for competences, but if it were to report to the ECB, then national solutions would be preferable.

Does the additional responsibility of stabilizing the financial markets lead to a fresh (to a certain extent ‘internal’) trilemma for central banks? This paper’s answer to that question would be: yes, but the potential new trilemma is a very special one, as it is not consistent in all directions.

Should monetary policy counteract the pro-cyclical effects of financial market rules more strongly in the future? The paper finds that this necessity cannot be ruled out, however the new capital requirement regulations related to the planned capital buffer discussed under the Basel III heading should tend to limit the degree of pro-cyclicity.

<sup>6</sup> Most of the international banks have already accumulated additional capital reserves since the crisis and are thus at least above the six percent level.

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