



EUROPEAN CENTRAL BANK

## THE ROLE OF CENTRAL BANKS IN PRUDENTIAL SUPERVISION

### Introduction

In ten of the twelve euro area countries, national central banks (NCBs) are either directly responsible for prudential supervision or strongly involved in this activity. The present note intends to present *arguments supporting the preservation of a fundamental role for NCBs in prudential supervision in euro area countries*. After an overview of the debate in some euro area countries (Section 1), the points usually raised against and in favour of separation between central banking and prudential supervision are first recalled (Section 2) and then reviewed under the Eurosystem perspective (Section 3).

### 1. The debate in the euro area

Following the changes introduced in the United Kingdom, proposals aimed at setting up a single supervisory authority with responsibilities for all financial intermediaries and markets have been presented in several euro area countries. In some countries adjustments in the institutional structure have recently been made. In other countries a debate is ongoing.

In **Luxembourg** the *Commission de Surveillance du Secteur Financier* was created in 1998 and entrusted with supervisory responsibilities extending to all financial intermediaries and markets, with the insurance sector being the only exception. There are no institutional relationships or formal bilateral co-operation arrangements in place with the Banque centrale du Luxembourg.

In the **Netherlands** the growing role of financial conglomerates and the development of hybrid financial products were perceived as a challenge to a supervisory framework based on three sectoral authorities in charge of overseeing banks (De Nederlandsche Bank), securities firms and insurance companies respectively. A *Council of Financial Supervisors* was set up in July 1999, which consists of the three sectoral authorities. It is not a separate supervisory body, but it provides for enhanced co-operation in the formulation of policies as regards important cross-sector dimensions like the supervision of conglomerates, information disclosure to consumers and integrity issues (e.g. fit and proper management). Within the Council, the three sectoral authorities co-operate to issue regulations or give advice to the Minister of Finance on these cross-sectoral issues. If new developments in the financial

sector require a cross-sectoral approach, the Council of Financial Supervisors will also deal with these issues.

Mainly due to the growing role of financial conglomerates and the need to reach similar policies and practices on other matters of common interest in **Portugal**, the *National Council of Financial Supervisors* (NCFS) was set up in September 2000. Its legal framework does not introduce any amendment to the competencies of the sectoral supervisory authorities – the Banco de Portugal, the Securities Exchange Commission and the Portuguese Insurance Institute. The NCFS is intended to provide for a more regular exchange of information and enhanced co-ordination among the sectoral authorities; it is also entrusted with the task of promoting supervisory rules and practices concerning financial conglomerates, preparing draft regulations on cross-sectoral issues and proposing co-operation mechanisms with foreign regulators and organisations. The Governor of the Banco de Portugal chairs the NCFS, given the role the NCB plays in the field of the stability of the financial system.

Recently the debate on supervisory structures has accelerated in **Germany**, where the Minister of Finance has announced a reform that would create a single federal agency for the supervision of the banking, securities and insurance sectors. Even though the plan has been accompanied by a call for extensive co-operation between the new single authority and the Deutsche Bundesbank, the effects on the involvement of the latter in prudential supervision are still unclear. The Deutsche Bundesbank has put forward arguments for a greater role in prudential supervision, supporting also a full integration of banking supervision into the NCB. Such integration would, however, necessitate a more efficient and streamlined organisational and decision-making structure within the Deutsche Bundesbank.

A move in the opposite direction, namely one of reinforcing the supervisory role of the NCB, has recently been made in **Belgium**, where the Minister of Finance unveiled a proposal to integrate the Banking and Finance Commission (CBF) in the National Bank of Belgium. The CBF would remain a separate legal entity, but the two decision-making bodies would partially overlap and human and other resources would be pooled (in particular, research, international activities and macro-prudential analysis could be merged). This institutional closeness would lead to a situation tending towards the French model, although the Governor of the National Bank of Belgium would not be the Chairman of the CBF.

In **Ireland** the “Implementation Advisory Group on the establishment of a Single Regulatory Authority” published a report in 1999 that argued for the adoption of UK-like arrangements. The creation of a new authority with responsibilities over the whole financial sector and the removal of any direct supervisory tasks from the Central Bank of Ireland were envisaged in the document. After a long debate, a Government decision was recently taken on the matter, whereby a Single Financial Regulator will be set-up within a re-structured Central Bank of Ireland and will include a remit for both prudential supervision

and consumer protection issues. Legislation to give effect to this Government decision will be introduced in due course.

In **Finland** proposals to create a single agency with supervisory responsibilities over all financial institutions and markets have been put forward. A more in-depth analysis has been mandated to an ad hoc committee which is expected to submit its conclusions for consideration by the Government after the summer.

In **Austria** the Minister of Finance informed the Council of Ministers in January 2001 of his plans to establish a new independent supervisory authority outside the NCB which is to be in charge of all financial institutions. A proposal is expected to be forwarded to Parliament by mid April 2001. There does not seem to be a political consensus on the institutional shape of the new authority, in particular on the degree of involvement of the NCB.

## **2. Central banking and prudential supervision: a survey of the issues**

Supervisory functions entail an array of tasks, which can be grouped into three classes: (i) *investor protection activities*, which are focused mainly on the issuance and enforcement of rules on the conduct of business and the disclosure of information; (ii) *micro-prudential supervision*, which includes all on and off-site surveillance of the safety and soundness of individual institutions, aiming – in particular – at the protection of depositors and other retail creditors; and (iii) *macro-prudential analysis*, which encompasses all activities aimed at monitoring the exposure to systemic risk and at identifying potential threats to stability arising from macroeconomic or financial market developments, and from market infrastructures. While the third type of task is performed, in some way, by all central banks, the activities relating to investor protection, especially in the securities markets, are very rarely included in their mandate. For separate supervisory agencies, the opposite is generally true, i.e. a strong emphasis on investor protection is usually coupled with a minor role in the monitoring of systemic risk. The critical issue when discussing the most efficient institutional framework is the performance of micro-prudential supervision, which most NCBs tend to view as being strictly linked to systemic concerns and which separate agencies interpret as being geared to protect depositors and investors.

### *2.1 Arguments in favour of combining*

Arguments in favour of combining prudential supervision with central banking can be grouped into three basic categories: (1) ***information-related synergies between supervision and core central banking functions***; (2) ***focus on systemic risk***; and (3) ***independence and technical expertise***.

The **argument of information-related synergies** stresses the importance that the confidential information collected for supervisory purposes may have in the oversight of payment systems and in the “safe proofing” of other market infrastructures, which are essential for the smooth conduct of monetary policy. Central bank access to prudential information, especially on systemically relevant intermediaries, is essential also for the conduct of macro-prudential monitoring. Some analyses for the United States provide some empirical support for the idea that micro-prudential information allows more accurate estimates of economic activity and inflationary pressures to be achieved, thereby favouring the choice of a more appropriate stance for monetary policy. Furthermore, should there be a crisis in financial markets, the central bank would be inevitably involved. Supervisory input is crucial for assessing whether an illiquid bank asking for emergency liquidity assistance is solvent, for instance, in order to limit the scope for moral hazard. Of course, it might be argued that the relevant information could be obtained indirectly by the separate supervisory agency. But if this is the case, the ready availability of and ability to interpret relevant information might not be warranted, especially in cases of stress.

The information-related synergies also work the other way round, since a central bank’s insight into money and financial market developments and information from payment systems and monetary policy operations are extremely valuable for the performance of supervisory tasks. The Federal Reserve System, for instance, has stressed the importance of the fact that, since the central bank is itself an active player in the market, it naturally interacts with private financial institutions. This is an important source of information. Contacts with major, market-leading intermediaries are useful for producing timely and meaningful information on major trends and sentiments in the financial system, such as developments in market liquidity, and on any concerns market participants might have. This information is complementary to that obtained through the exercise of supervisory functions. Moreover, market participants may have a greater readiness to speak to the central bank acting in this context, since these contacts are outside the scope of the formal supervisory scrutiny.

The **systemic risk argument** relies on the close relationship between prudential controls of individual intermediaries and the assessment of risks for the financial system as a whole. Even in countries where a separation of supervision and central banking has been implemented, as in the United Kingdom, Japan and Canada, the central bank is acknowledged to have an unchallenged responsibility for systemic stability. Central banks’ focus on systemic stability puts them in a position to better assess not only the likelihood and the potential impact of macro-shocks or disturbances in domestic and international capital markets, but also the operation of common factors affecting the stability of groups of intermediaries. On the other hand, a separate authority with a mandate more focused on investor protection is more likely to concentrate its attention on the relationship between individual intermediaries and their customers (according to the Financial Services Authority (FSA) in the United Kingdom, these activities account for around 70% of the staff’s working time). Furthermore, by putting systemic concerns at the centre of

analysis, central banks might be less reluctant to let individual intermediaries fail when this is not likely to trigger domino effects, thereby limiting the scope for moral hazard. On the other hand, conflicts may well arise when the micro-prudential functions are exercised jointly with the investor protection activities. For instance, the supervisor might be tempted to depart from its function of a watchdog of the accuracy of the information disclosed by listed companies if this would unveil the real situation of a distressed intermediary, in the hope of gaining time for managing the crisis.

The **independence and expertise argument** highlights the quality of the contribution central banks can make to financial stability. Independence of supervisory authority from political interference is important for effective supervision. This is particularly true in some emerging countries, where so-called “policy loans” – i.e. loans granted under formal or informal pressure from governmental authorities – are still a reality. More in general, the laws, regulations or acts of the public administration may interfere with the entrepreneurial choices of financial intermediaries. In such cases, when the intermediaries get into trouble because of the wrong incentives they were given, pressure to bail them out might be very high. Central bank independence might shelter supervision from undue external interference, as well from the risk of regulatory capture by the supervised entities. Even though empirical evidence in this field should be interpreted with caution, there is some support for the thesis that crises are more likely to be solved through the use of private money when the central bank is in charge of supervision. The need to endow supervisory authorities with a satisfactory degree of operational independence is also highlighted in the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision. Of course, independence should not be interpreted as a lack of accountability, nor does it exclude the role of governments in the case of a crisis when taxpayers’ money is involved. An additional argument for combining central banking and prudential supervision is that central banks are generally recognised as sources of excellent research and analysis on the banking and financial system. They have gained a wealth of knowledge on the structure and performance of the domestic financial system over time, which is continually renewed through their active presence in financial markets.

## 2.2 *Arguments in favour of separation*

Three arguments are most frequently presented in favour of attributing extensive supervisory powers to a single agency outside the central bank: (1) ***the potential for conflicts of interest between supervision and monetary policy, and moral hazard***; (2) ***the tendency towards conglomeration and the blurring of the distinctions between financial products and intermediaries***; and (3) ***the need to avoid an excessive concentration of power in the central bank***.

The **conflict of interest argument** is based on the possibility that supervisory concern about the fragility of the banking system might lead the central bank to pursue a more accommodating monetary policy than warranted for the pursuance of price stability. The basic argument is that, by maintaining price stability,

the central bank will in fact automatically promote financial stability and should only focus on the objective of price stability. By doing so, it would take account of financial instability only to the extent that the latter is relevant for the prospects of inflation. In the strongest form of this argument, any explicit consideration of financial instability by the central bank would only destabilise the economy because of moral hazard. To support this beneficial narrow mandate to fight inflation, the central bank should not have exclusive or even shared responsibility for supervision. The empirical relevance of the conflict, however, is debatable: a widespread fragility of banks and their counterparts should generally occur in conditions where the risks to price stability are on the downside, so that the conflict is more apparent than real. Furthermore, if a conflict between two policy functions exists, it is not likely to disappear simply by attributing the functions to two separate authorities. As a matter of fact, complex co-ordination structures pooling together the central bank, the supervisory authority and the Minister of Finance are generally in place in those cases, so that co-ordination between the two objectives becomes potentially more burdensome. A different form of conflict can be seen insofar as the conduct of supervision – especially a perceived misconduct in cases of crisis – might prove detrimental to the *reputation* of central banks, thereby jeopardising their credibility as a monetary authority as well.

The related **moral hazard argument** in favour of separation is linked to the role of central banks in crisis management stemming from their supervisory responsibilities. This is said to create the moral hazard of excessive risk-taking by the supervised entities, since the central bank would come to the rescue of the banks via emergency liquidity assistance (or by manipulating interest rates), possibly also seeking to cover up a failure in the supervisory function. The argument can be mitigated by recognising that emergency liquidity assistance is preferably extended against adequate collateral and subject to a fair (even a penalty) interest rate. In addition, a potentially more important source of moral hazard is related to the way winding-down and liquidation measures are carried out, which are not usually under the responsibility of central banks. Nevertheless, the importance of moral hazard may sometimes be overstated in general, since managers and shareholders of defaulting institutions, for instance, can be appropriately penalised.

The **conglomeration argument** has been widely used in the recent debate. It rests on the evidence that closer linkages are gradually developing between banks, securities companies, assets managers and insurance companies, while the traditional distinction between different financial contracts is blurring, so that different types of intermediaries actually compete in the same markets. Under these conditions, sectoral supervisors might be less effective in monitoring overall risk exposures in large and complex financial groups, and differences in sectoral rules or practices might alter the “level playing field” between competing intermediaries. Tools for co-ordinating the different sectoral authorities, such as committees, memoranda of understanding, joint board participation and the like, could alleviate the problem and have proven successful in many countries. But the conglomeration argument is often also

related to the goal of achieving more efficient supervisory structures and limiting the burden that regulation imposes upon intermediaries. Financial groups with many lines of business would avoid reporting and paying for the supervision exercised by different authorities, thereby minimising the costs of compliance (and, perhaps, of lobbying) and the risks of conflicting supervisory assessments. It is not surprising, therefore, that the financial industry frequently supports reforms introducing a single supervisory agency. If supervisory responsibilities over the whole financial sector have to be assigned to a single authority, the central bank is not the most obvious candidate. Central banks traditionally play a role in banking supervision, i.e. in the monitoring of counterparties, who are an essential component in the transmission of monetary policy. However, their “natural jurisdiction” seldom encompasses securities firms, and almost never insurance companies.

The **concentration of power argument** is strictly linked to the previous ones. Attributing to an independent central bank regulatory and supervisory tasks, especially if extended to the whole financial sector, might be considered detrimental to the system of “checks and balances” on which democracies rely in order to avoid potential abuse in the performance of public functions.

### 2.3 Overall assessment

While there is no agreed framework for weighting these pros and cons and for achieving uncontroversial conclusions, experience has shown that the costly procedure of undertaking institutional changes in the supervisory structure has usually been a response to signals of a malfunctioning of prevailing arrangements. Thus far, the operational experience, not only in the euro area but also in the United States, indicates that central banks are carrying out supervisory tasks in an effective way. At the same time, little experience has thus far been gained with the performance of the FSA-type single agency model.

## 3. The Eurosystem perspective

When the institutional framework brought about by the introduction of the euro is considered, *the balance of the arguments changes considerably*. Arguments in favour of a separation of prudential supervision and central banking lose most of their force, while those in favour of combining become even more prominent. In particular, *an institutional framework in which the Eurosystem’s responsibilities for monetary policy in the euro area are coupled with extensive supervisory responsibilities of NCBs in domestic markets, and with reinforced co-operation at an area-wide level, would seem appropriate to tackle the changes triggered by the introduction of the euro*.

**Systemic focus is increasingly relevant.** Economic and Monetary Union (EMU) has changed the nature and scope of systemic risk. The amalgamation of infrastructures for large-value payments and the restructuring of interbank activities have already altered the traditional channels for contagion at the liquid end of the market.

The reorganisation of major banking and financial groups and their growing involvement in increasingly integrated European securities markets are also affecting the likelihood that disturbances originating or channelled through capital markets will expand beyond national borders. NCBs may benefit from their traditional focus on systemic risk and, especially, from the knowledge of area-wide developments in money and securities markets and in market infrastructures that they acquire as components of the Eurosystem. This provides the NCBs with a comparative advantage in monitoring the risks incurred by individual institutions and, especially, the correlation among their risk profiles. The composite nature of the NCBs, which are components of an EU organisation and, simultaneously, a national institution, might be an asset when cross-border or area-wide issues are to be tackled in the pursuance of non-Eurosystem tasks. National non-central bank agencies have an exclusively domestic mandate and are generally characterised by strong formal or informal connections with the Ministry of Finance. In the case of problems they would tend to attach relatively minor weight to cross-border effects and favour co-ordination only with the national government. NCBs, which have also been assigned an EU mandate, will be more likely to couple the necessary co-operation with national authorities with a network of contacts within the Eurosystem, thereby providing for more co-ordinated answers to systemic disturbances with cross-border spillovers.

**Conflicts of interests and concentration of power are not a real concern.** The introduction of the euro has implied an institutional separation of monetary jurisdiction (the euro area) and supervisory jurisdiction (domestic institutions and markets). Hence, the NCBs no longer have any independent control over money creation. Their extensive involvement in prudential supervision, therefore, would not be source of any major conflict with monetary policy functions, since the relevant decision-making bodies for the two sets of functions do not coincide anymore. The same line of reasoning also deprives the concern about an excessive concentration of power of most of its content, since monetary policy decisions are outside the exclusive control of NCBs and reside with the Eurosystem. In some debates at the national level, however, the peculiar institutional nature of the NCBs as independent entities and components of the Eurosystem seems to be perceived as an obstacle to their accountability towards national bodies. But there is no good reason why NCBs should not, in the discharge of their supervisory duties, be fully and transparently accountable to the relevant national authorities, including Parliament, in particular.

**Conglomeration arguments need to be restated.** The trend towards conglomeration and cross-sector competition is admittedly the strongest argument in favour of a single supervisory agency. However, if correctly addressed, even this point would point towards the need for a fundamental involvement of the NCBs in prudential supervision.

First, the trend towards conglomeration increases the complexity of monitoring large and complex multinational institutions. This creates a direct concern in the field of NCB responsibilities, since large and complex groups are likely to create systemic concerns. Unlike an NCB, a separate supervisory agency



would most likely not be in a position to assess quickly and effectively the potential for a systemic crisis, since its predominant micro-focus does not allow an evaluation of the consequences through payment and settlement systems or, as in the case of the Long-Term Capital Management (LTCM) fund, the effect that an unwinding of positions might have on asset prices and, subsequently, on the soundness of other financial institutions. It is not without reason that the newly issued US regulation on financial holding companies has put them under the direct responsibility of the Federal Reserve System. When attention is correctly focused on systemic concern, it is clear that a euro area perspective becomes all the more relevant, since the behaviour of such large and complex financial groups is likely to affect money and capital markets, as well as payment and settlement systems, well beyond domestic borders. Hence, the arguments for a strong involvement of the NCBs in their monitoring apply.

Second, the blurring of frontiers between financial intermediaries poses “level playing field” concerns. However, this frequently raised issue now appears far less relevant in the supervisory debate. The new capital adequacy framework, which is to be released by the Basel Committee on Banking Supervision, creates a regime which is more sensitive to the risks incurred by individual intermediaries. The principle that intermediaries should not fulfil the same supervisory requirements if they have different risk profiles, if it is also applied to other financial intermediaries, would significantly alleviate level playing field concerns.

Third, conglomeration also raises the question of giving similar protection to investors receiving equivalent services from different types of institutions or from institutions whose complex nature might create scope for conflicts of interests. These implications are definitely less close to traditional central banking activities. A euro area perspective is also much less relevant in this respect, since the EU framework recognises that these concerns remain of far greater relevance to the “host country”, at least as far as retail investors are concerned. Therefore, if deemed necessary, institutional solutions might be devised which attribute the responsibility for protecting investors to separate agencies, while acknowledging a major role for NCBs in prudential supervision. In countries where cultural traditions imply a more blurred demarcation between micro-prudential supervision and investor protection, the NCB could in any case be specifically mandated to pursue such objectives.

All these considerations support that, *when viewed from a Eurosystem perspective, the attribution of extensive supervisory responsibilities (i.e., both macro and micro-prudential) to NCBs is likely to prove beneficial.* It would allow the networking of supervisors within the Eurosystem to be exploited, with an improved monitoring of risks to financial stability in the single currency area and a closer co-ordination with central banking functions exercised at the Eurosystem level. The NCBs’ involvement might also extend beyond the banking sector, since systemic concerns are more and more related to the presence of large, cross-sectoral organisations. If some of the arguments for separation were still considered to be of some relevance in the national institutional framework, solutions other than the outright attribution of

responsibilities to the NCBs might prove quite effective, provided that the NCBs were granted a wide-ranging operational involvement in prudential supervision. In such cases, it would be advisable to link the NCBs with other agencies through joint decision-making bodies, a pooling of human and other resources as well as other effective arrangements for co-operation and sharing information.