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Central bank involvement in banking supervision

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I

Ladies and gentlemen

The design of supervisory rules and supervisory responsibilities is one of the key factors shaping financial market policy. There is, however, no one-size-fits-all solution. There is no way of deriving the optimum organisational structure for banking supervision from theory. We can therefore observe various operating methods in use in international practice. This diversity in the design of regulatory and prudential regimes is not surprising. After all, prudential supervisory systems are embedded in their respective economic and legal frameworks and have evolved over time. Of supervision, too, it may be said that “change is the only constant”. In the recent past, some countries such as the UK, Austria, Ireland and Germany have radically reorganised their supervisory structures.

There is no universal recipe for assigning responsibilities for creating an efficient supervisory structure, yet there are a few requirements which should be met.

- The supervisory structure should adapt to financial market structures. This means that market developments such as cross-border activities or the development of increasingly large conglomerates must be taken into account.
- The responsible institutions must have expert knowledge and experience in their fields of expertise; they need to be adequately staffed and to have an efficient internal organisational structure to ensure efficient and cost-effective supervision.
- Supervisors should be close to the supervisees and at the same time not be subjected to excessive political influence.
- If supervisory powers are spread out among several institutions, competencies have to be clearly defined. Efficiency is also essential in the flow of information and in the cooperation between participating supervisory agencies.
- To ensure a level playing field for financial institutions from the various sectors, it is necessary not only to have harmonised supervisory rules but also for these rules to be applied uniformly in practice.

It will not surprise you that I consider the participation of central banks in prudential supervision to be a necessary and important pillar of the supervisory architecture. There are objective reasons for this. Not only supervisory authorities but also, and in particular, central banks, in their role as “bankers’ banks”, have an inherent interest in a stable financial system. I therefore wish to discuss some aspects which argue in favour of extensive central bank involvement in prudential supervision.

Given the globalisation of financial markets and the attendant radical structural change within individual banking systems, it is becoming increasingly important to complement microprudential supervision by macroprudential analysis, ie studying the implications for the financial system as a whole. Actions which may seem reasonable from the point of view of each individual bank may, in the aggregate, lead to unpleasant consequences for systemic stability.

This is of particular relevance to central banks. After all, a stable financial system is the prerequisite for an effective monetary policy and, over and above this, for an economy to function in the first place. The combination of practical supervision of institutions and analysing the stability of the overall financial system – or, as former BIS secretary-general Andrew Crockett put it, “the marrying of micro and macro-prudential analysis” – generates additional synergies and advantages.

Proper financial market supervision is predicated on independent and direct access to the relevant information. It is important in this context

- that crucial information can be obtained quickly by the agencies or institutions which need it
- that this information is interpreted correctly
- and that a suitable toolkit for remedial measures exists.

Being close to financial markets as well as to the institutions is a major advantage when it comes to having direct access to information which is of relevance to the smooth functioning – and the stability – of the financial system. Those who themselves are active in the markets and know the market participants thanks to their own business relationships have important additional sources of information and insight which can benefit supervisors, too. It is precisely central banks which maintain these permanent contacts: not only for their monetary policy operations but also because of their role in payment systems. They are therefore in a position to detect problems in the financial system at an earlier stage than agencies involved exclusively in banking supervision.

The central bank’s own financial market analyses, which it needs for monetary policy purposes anyway, also provide valuable knowledge which is useful in terms of systemic supervision; also, they can contribute to the early detection of irregularities or tensions in the financial system. Moreover, central banks are able to interpret prudential supervisory data in a macroeconomic context. And, in addition, the central bank can also enlist its monetary policy infrastructure for the purpose of averting a crisis.

Synergy effects between the conduct of banking supervision and monetary policy work both ways. Central banks with access to confidential supervisory information can assess the current economic situation even better and therefore derive direct benefits for their monetary policy. This is reflected by the fact that, in most European countries and, above all, in the United States, central banks are either responsible for or involved in prudential supervision. Moreover, prudential insight makes it easier for central banks to assess the soundness of banks, which are their counterparties in monetary policy operations. Central banks, too, need to follow the dictum “know your customer”.

Moreover, it is my opinion that central banks make good crisis managers, as was borne out by the Fed’s action in the LTCM hedge fund incident. Under the Fed’s stewardship, the private sector was able to put together a package to save LTCM without using any public funds whatsoever.

In the event that the central bank may have to provide liquidity assistance, it needs not only information about the situation in the banking industry as a whole but also knowledge – “first-hand” knowledge – of the individual components of the system. However, since not only any central bank assistance in a crisis but also the mere expectation of such assistance creates “moral hazard”, ongoing analysis is necessary so that preventive action can be taken as and when needed.

In the public debate, some critics occasionally argue that a central bank may encounter a conflict of interest between monetary policy goals and prudential responsibility for systemic stability. The example of cutting interest rates in violation of monetary policy logic in order to stabilise the financial system is often cited in this context. In practice, however, this is not an issue. Monetary policy in the euro area is determined by the 18 independent members of the Governing Council of the ECB according to the “one man, one vote” principle. This ensures that the assessment of the financial market situation embraces the whole of Europe in a pluralistic manner and does not just focus on special developments in one country alone, especially once the eurozone is enlarged to 25 member states.

Yet even irrespective of the European situation, the supposed “conflict of interest between monetary stability and systemic stability” has to be put into perspective.

- Firstly, responsibility for systemic stability is one of the central bank’s primary tasks and does not ensue only from assuming prudential supervisory duties.
- Secondly, the conflict of interest I mentioned earlier would manifest itself only in very rare cases, in situations where serious problems have already developed. This, however, is precisely what a functioning supervisory structure seeks to prevent.
- And, thirdly, a potential conflict of interest cannot be eliminated merely by splitting responsibility between institutions.

In essence, it is about striking a balance in a given situation between two public goods: systemic stability and monetary stability. Experience has taught us that decisions taken by an independent central bank will not be detrimental to monetary stability. In addition, it should be remembered that maintaining stable money over the medium to long term per se makes a crucial contribution to the stability of the financial system.

III

Ladies and gentlemen

Until 1 May 2002, prudential supervision in Germany rested on three pillars: insurance supervision, securities supervision and banking supervision. In banking supervision, the Bundesbank played a key role over four decades through ongoing supervisory activities and close cooperation with the Federal Banking Supervisory Office. After initial considerations of transferring banking supervision to the Bundesbank, lawmakers then decided instead to create a single cross-sector prudential authority, the Federal Financial Supervisory Agency – the German abbreviation of which is BaFin. The legislators sought to create a supervisory body covering the entire financial sector in response to the increasing cross-sector integration of financial markets and the attendant blurring of the dividing lines between products and distribution channels. At the same time, lawmakers sought to reinforce and specify the central bank's involvement in banking supervision.

Central bank involvement in banking supervision has had a long tradition in Germany. Since the beginning of government supervision in 1931, the central bank has either supervised banks itself or – following passage of the Banking Act in 1961 – has played a major supporting role. A key objective of this reorganisation was to continue the tried and tested division of tasks in a new supervisory framework in order to benefit from the resources, specific expertise and, above all, synergy effects between the supervisors' and the central bank's tasks in the context of a harmonised system-wide prudential regime.

If one accepts the analysis that the borderlines between products, distribution channels and markets are being erased, that interdependencies in the financial sector are increasing and that market influences are having an increasingly large impact in the banking sector, this argues all the more in favour of bringing on board all parties responsible for financial sector stability, ie precisely central banks. Otherwise, the supposedly all-encompassing cross-sector prudential approach would fail to fulfil its envisaged role.

The Act concerning the Integrated Supervision of Financial Services, which entered into force on 1 May 2002, implemented a supervisory strategy in Germany which could be termed “Bancassurance Plus”. The rewriting of section 7 of the Banking Act placed cooperation between BaFin and the Bundesbank on a new basis. In principle, the tried and tested division of tasks has remained the same, with the Bundesbank remaining primarily in charge of “ongoing monitoring”, with all sovereign measures being reserved for BaFin. What section 7 of the Banking Act did for the first time, though, was to define “ongoing monitoring” in legal terms and to assign this task explicitly to the Bundesbank.

The ongoing monitoring of institutions includes, in particular, evaluating the documents submitted by institutions, auditors’ reports and the annual financial statements as well as performing and evaluating audits of banking operations with a view to assessing the adequacy of institutions’ capital and risk management procedures, as well as appraising audit findings.

In order to enhance the efficiency of supervision and to avoid duplication of work, the Banking Act provides for BaFin to base its sovereign measures concerning institutions as a rule on the audit findings and appraisals made by the Bundesbank.

To ensure that ample information is obtained first-hand, audits are generally conducted by Bundesbank teams. To a limited extent, however, they are also conducted by BaFin itself or by joint teams, in line with previous practice. Under the "old regime", prudential supervisory discussions took place on a regular basis between the Bundesbank and managers of credit institutions. In the future, these talks will be coordinated with BaFin. Other talks at various levels required in connection with practical supervisory work will be conducted by us and BaFin in line with the prescribed division of duties. In effect, this is a "dual system" of operational supervision and sovereign responsibility.

The methodology of supervision will change noticeably. Following Basel II – but also in the run-up stage – direct contact with institutions will be stepped up. The focus of supervision will shift from quantitative "off-site" activities towards qualitative "on-site" supervision. The greater emphasis on qualitative supervision – the

Supervisory Review Process as the second pillar of Basel II – takes account of the increasing complexity of banking business and risk management systems. At the same time, this intensifies communication with institutions.

Given the decentralised structure of the German banking system, the Bundesbank will make a decisive contribution precisely through enlarging the scope of its “on-site” contacts. Unlike BaFin, the Bundesbank has qualified and experienced staff members stationed all over Germany at its Regional Offices and branches.

However, the Bundesbank is also involved in further-reaching supervisory issues and analyses of stability regarding financial conglomerates. Cross-sector supervision and the stability of the banking system are discussed in the nationally oriented “Forum for Financial Market Supervision”, in which the Bundesbank is represented.

V

Ladies and gentlemen

How was the issue of organising supervision resolved in the European Union? Despite the introduction of a single currency, supervisory responsibilities rest with the individual member states. There is a wide variety of prudential supervisory models in the EU – all of which work. In Greece, Ireland, Italy, the Netherlands, Portugal and Spain the central bank is responsible for supervision. In Austria, France and Germany the central bank is closely involved in this task. The Bank of England transferred its supervisory functions to the Financial Services Authority. Responsibilities are divided in a similar manner in Scandinavia. In five of the ten acceding countries the central bank is responsible for banking supervision; in four other countries the central bank is involved in one way or another.

The ECB is likewise involved in supervision – yet this involvement is limited. In Article 105 (5) of the EC Treaty, European lawmakers gave the European System of Central Banks (ESCB) the task of contributing “to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system”. This assignment of responsibilities needs to be observed during the current restructuring of the prudential supervisory framework in the EU.

Close cross-border cooperation, as an indispensable complement to the principle of national responsibility, is important for the converging European financial market. That is why a comprehensive network of bilateral and multilateral cooperation exists. Multilateral cooperation, with the focus on macroprudential analysis, is carried out, for instance, through the Banking Supervision Committee (BSC) based at the ECB. This committee is composed of high-ranking representatives from the central banks <u>and</u> supervisory authorities of all 15 EU member states – as well as observers from the 10 acceding countries – and is therefore especially well suited to encompassing in its scope the various aspects of supervision. In the event of an impending systemic crisis with potential contagion effects, the BSC could also play a key role in crisis management by bringing the countries involved to the negotiating table. To this end, a memorandum of understanding on the exchange of information in the event of a cross-border crisis was recently signed by the BSC's members. The events of 9/11 have already demonstrated how helpful it was for European supervisors and central banks to have the BSC as a forum for exchanging information on the situation facing the markets and institutions.

At the end of last year the Ecofin Council decided to introduce the "Lamfalussy model" for all EU financial sectors. A four-stage procedure involving various committees is intended to accelerate the regulation process in the EU – the forthcoming implementation of Basel II is a case in point. In this connection, I should mention that the central banks of the countries in question are all key participants in the "Basel Committee on Banking Supervision" which is responsible for these global standards. In the Lamfalussy model, a "second-level committee" is to advise the Commission on regulatory issues, eg when drafting directives. This task is currently being carried out by the Banking Advisory Committee. One must ask oneself whether it makes sense to ignore the expertise of a tried and tested committee, in which central banks are participants, at a time when one of the most important reforms in prudential supervisory legislation – the implementation of Basel II – is just around the corner. In addition, the Committee of European Banking Supervisors (CEBS), the banking industry's "third-level committee", will play an important role in the implementation process. This committee's task will be to give expert advice on the banking industry to the overarching Comitology Committee, to promote the convergence of supervisory rules in Europe, and to facilitate the exchange of information among supervisors. All central banks will be represented in this committee irrespective of their national prudential supervisory role. The preliminary work for the establishment of this committee is proceeding apace. The question of where this committee will be based is still unresolved. The names in particularity of two European financial centres have already been mentioned in the debate: London, but also Frankfurt. I think that choosing Frankfurt would offer the opportunity to underpin "physically" what I believe to be the indispensable cooperation between supervisors and central banks, by basing this committee at the seat of the ECB and the BSC. The synergies resulting from this uniting of competencies should be considered as a valuable asset to safeguard financial stability.

The debate on the optimum prudential supervisory structure in Europe will continue. What we have today seems to be the political optimum! But there is one thing I wish to emphasise: the combination of national responsibility and close cooperation has a successful track record and is still the right approach. The time is not yet ripe for a centralised European supervisor. The precondition for such a centralised structure with far-reaching powers would be a political union.

VI

Ladies and gentlemen

I would like to conclude my remarks by saying that there are powerful arguments in favour of adequately involving central banks, at all possible levels, when assigning prudential supervisory powers. The “invisible assets” of a central bank, such as its experience of the markets and its familiarity with large cross-border institutions, are an indispensable prudential tool for assessing and containing systemic risk, and should therefore be utilised.

Thank you for your attention.