

Lecture at the Central Bank of Russia

**Towards a European Banking Union:  
a euro-area central bank supervisor  
as a first step**

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### *Should there be one or more financial supervisors?*

The financial sector needs much closer supervision and stricter regulation than other economic sectors, because financial institutions are critical to the operation of the economy, and finance is based on public trust. Financial regulation addresses negative externalities by modifying private agents' incentives, constraining their action, and putting mechanisms in place to prevent the most damaging effects of failures, particularly those of banks. Financial supervision is needed to monitor agents' behaviour and to enforce the rules.

Supervision can be grouped into three broad categories:

(i) microprudential supervision: surveillance of the safety and soundness of individual institutions;

(ii) macroprudential supervision: monitoring the exposure to systemic risk, identifying potential threats to stability arising from macroeconomic or financial market developments, and from market infrastructures;

(iii) customer protection: monitoring business conduct and the disclosure of information to customers and other stakeholders.

Designing the 'optimal model' of a regulatory and supervisory architecture is a daunting task. The empirical evidence does not prove the dominance of any particular model over the others, although several studies have pointed out that weaknesses in regulation and supervision might be factors leading to a financial crisis (Cihák, Demirgüç-Kunt, Martinez Peria and Mohseni-Cheraghloo, 2013).

In principle, in any given jurisdiction these functions can be assigned to different authorities on the basis of two different (orthogonal) criteria: either by sector or by function. Or one could choose a ‘hybrid’ model.

In addition to this, the authorities, whatever their scope, can be placed within the national central bank or outside it.

The financial regulatory and supervisory architecture varies considerably across countries. Tables 1 and 2 show the models chosen by a selection of countries outside and inside the euro area, otherwise referred to as the Euro Zone (EZ). The models are based on data provided in Oreski and Pavcovic (2014) and classified as follows:

In the ‘sectorial’ (‘vertical’) model there is a regulator/supervisor for each main sector within the financial system – banks, insurance companies, non-bank financial intermediaries, securities markets, etc. – which is in charge of all functions: micro, macro, and customer protection.

In the ‘twin-peaks’ model, there is one authority for prudential supervision and another responsible for market conduct and customer protection. Each of them extends its competence over all sectors of the financial system.

The ‘integrated’ model combines the preceding two in a sort of universal authority responsible for both prudential and business conduct regulation/supervision for the entire financial industry.

Any other solution is dubbed ‘hybrid’ when it has elements of more than one model in it.

Finally, Tables 1 and 2 distinguish, but only for the ‘integrated’ and ‘hybrid’ frameworks, whether the authorities are, totally or mostly, part of the central bank (CB) or not.

The evolution over the last 15 years is also shown for all countries.

Outside the EZ we find two twin-peaks models (Australia and the UK), one sectorial (USA), and one hybrid (Canada). The four remaining frameworks (Japan, the Russian Federation, Sweden, and Switzerland) are integrated, and only in the case of Russia is the single authority part of the central bank. In the sectorial and twin-peaks cases, the central bank is involved at least partially.

In the EZ, we see two twin-peaks models (Belgium and the Netherlands), one sectorial (Spain), two hybrid (France and Italy, in both cases with a heavy involvement of the central bank), and three integrated (Austria, Finland, and Germany).

Theoretically, all these models have advantages and disadvantages.<sup>1</sup> The merits of one model are always the demerits of another, and vice versa. The main arguments in favour of greater integration are: i) economies of scope, ii) better assessment of risks, iii) effectiveness (better cooperation within one organization than between many agencies), iv) less regulatory arbitrage or supervisory gaps, and v) increased accountability.

The main drawbacks of integration cited in the literature are: i) dominance of one goal over the others, ii) misalignment of incentives (for example, focus on a particular objective only because it is more easily monitored by public opinion), iii)

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<sup>1</sup> See for example Abrams and Taylor (2000).

excessive bureaucracy, iv) a tendency to assign an ever-increasing range of functions to a unified agency, and v) an excessive concentration of power.

The relative weights attributed to the advantages and disadvantages in each country explain the variety of models adopted. They in turn depend on political economy factors, and may change over time. Figure 1 shows how the distribution of the four main institutional models – twin-peaks, sectorial, integrated, and hybrid – has changed since the late 1990s in a wide sample of 80 countries. We see a decline of the sectorial model and a growing diffusion of the others, especially the integrated model. The increasing integration between financial intermediaries and activities, coupled with the consequences of the global financial crisis, has pushed more and more countries towards some consolidation of agencies.<sup>2</sup>

In Italy, as I said before when commenting on Table 2, a hybrid model applies. The various authorities involved in regulating and supervising the financial system have mostly sectorial dividing lines: the Bank of Italy for the banking sector, Ivass for the insurance sector, and Covip for pension funds, all of them involved in both prudential supervision and consumer protection. But there is also an element of the twin-peaks model, with Consob in charge of market conduct and transparency for all listed intermediaries, and the Antitrust authority in charge of protecting competition in all markets, including the credit and financial ones. Furthermore, Ivass, the insurance regulator, was recently placed under the umbrella of the Bank of Italy, while remaining a separate legal entity. Furthermore, borders between the sectorial authorities are somewhat blurred, and conflicts of competence arise from time to time.

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<sup>2</sup> Borio and Filosa (1994) discuss the implications for supervision of the transformation of the financial industry.

## *Monetary policy and supervision under one roof? Effects on the independence of a central bank*

Part of the academic and political debate about the best financial supervisory architecture has been devoted to whether the central bank should be involved in the prudential supervision of banks.<sup>3</sup>

*Supervision within the central bank?* - This specific debate on the benefits and risks of entrusting a central bank with banking supervision is a long standing one.<sup>4</sup> The literature generally concludes that no single pattern of division of supervisory responsibilities between the central bank and other authorities is unquestionably superior.

Goodhart (1988) argues that central banks have been historically involved in supervisory functions because of their role in stabilizing the financial system, acting as lenders of last resort (LOLR). In the late 1990s in many countries financial supervision was moved outside central banks, into cross-sectorial or specialized authorities. According to Eichengreen and Dincer (2011) this process was related to the strengthening of the independence of central banks, in light of their narrow mandate to achieve price stability. However, the global financial crisis has shown that central banks cannot disregard financial stability considerations, whether they are part of their explicit mandate or not.

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<sup>3</sup> For an updated and systematic discussion of the relationship between central banks, financial regulation and supervision after the global financial crisis, see Eijffinger and Masciandaro (2011).

<sup>4</sup> See, among others, Pisani-Ferry, Sapir, Veron and Wolff (2012).

The most widely cited benefits of having monetary policy and bank supervision residing under one roof are related to: i) the exchange of information, ii) shared concern for financial stability.<sup>5</sup>

The first benefit may be well illustrated by the UK experience: the failure of supervisors to head off problems in Northern Rock and prevent the first bank run in more than a century is an outcome widely attributed to imperfect coordination and inadequate information-sharing between the FSA and the Bank of England (Eichengreen and Dincer, 2011). Bank-specific information is very important for central banks when they act as lenders of last resort. The central bank is the ultimate guarantor of financial stability during a crisis. In performing its LOLR function, the central bank has to assess the liquidity and solvency of its counterparts. More generally, central bank risk management would benefit from better access to information on the financial health of banks to assess the quality of the collateral that these banks provide. Especially in times of tensions, having such information in house increases the timeliness of the information flow.

Bernanke (2007) underlines that supervisory responsibilities give the central bank access to a wealth of granular on each bank's organization, management structure, lines of business, financial condition, internal controls, risk-management practices, and operational vulnerabilities. This is beneficial for the conduct of monetary policy because banks play a central role in the transmission of monetary policy impulses. For example, supervisory information on bank capital is useful to assess the contribution of capital constraints to credit developments (Bernanke and Lown, 1991). Similarly, monitoring the portfolio choices of banks is useful to assess the consequences of monetary policy on the accumulation of risks. This information improves the ability of central banks to prevent financial instability.

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<sup>5</sup> See for example Goodhart (2000) and Mishkin (2001).

Symmetrically, supervision benefits from information that central banks acquire from their frequent contacts with banks for monetary policy purposes. Also the role that central banks traditionally play in payment and settlement systems provides them with additional sources of information on linkages between intermediaries. Rapidly changing financial flows can affect the stability of intermediaries.<sup>6</sup>

The second benefit is related to the common concern for financial stability. Historically financial stability has been a main task for central banks, even without an explicit mandate. In many countries it has been a fundamental factor for their establishment.

Central banks conduct monetary policy to achieve price stability – in most cases their primary goal – and this in turn fosters broader macroeconomic stability and contributes to financial stability. But often central banks have specific responsibilities in the financial stability sphere, as this is a key precondition for price stability.

Central banks with prudential supervisory powers can pursue the objectives of price stability and financial stability with a wider set of instruments, whereas a central bank with monetary policy powers only might end up being overburdened.

*A common roof and the effects on independence* - The independence of central banks is a topic deeply debated almost from the time of their inception.<sup>7</sup> In an essay of 1824 David Ricardo identified the three pillars of central bank independence: institutional separation of the power to create money from the power

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<sup>6</sup> A number of theoretical papers analyse how illiquidity can turn into insolvency for intermediaries (e.g. Diamond and Rajan, 2011, 2012).

<sup>7</sup> This section is based in part on Rossi (2013).

to spend it; a ban on the monetary funding of the State budget; and the central bank's obligation to give an account of its monetary policy.

Ricardo's suggestions were taken up by the Brussels Conference of 1920. Price stability was indicated as the primary objective of monetary policy but – as the Final Report of the conference maintained – if it was to be achieved, it had to be entrusted to central banks that were independent of their governments.<sup>8</sup>

These principles were forgotten for many years after the Second World War (WW2). The conviction that a certain degree of inflation was necessary to support employment and growth came to the fore in economic thought and in the minds of policy makers. In many countries monetary policy was dominated by budgetary requirements (fiscal dominance) and central banks acted as buyers of last resort of government securities when they came onto the primary market.<sup>9</sup> The independence of central banks enjoyed little institutional protection.

The stagflation of the 1970s suddenly brought to light what farsighted economists, such as Edmund Phelps, had already foreseen in the previous decade: in the short term there may be a trade-off between inflation and unemployment, but not in the long term.<sup>10</sup> This radical rethinking of the theory was accompanied by profound changes in the organization and behaviour of central banks.

Economic literature once again looked at price stability as a supreme value and pointed to two prerequisites: the independence of the institutions called to guarantee it, i.e. central banks, and the adoption on their part of explicit objectives.

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<sup>8</sup> See Spinelli and Trecroci (2006).

<sup>9</sup> For the Bank of Italy, see Gaiotti and Secchi (2013).

<sup>10</sup> See Phelps (1967, 1968).

Here it comes a third benefit from having monetary policy and supervision under the common roof of the central bank: it mutually reinforces independence. As recalled by the IMF's principles, independence is a requirement not only for monetary policy but also for effective supervision.<sup>11</sup> Italy's historical experience suggests that attributing the supervision of banks to the central bank can not only strengthen the independence of the supervisor: credibility as a tough supervisor can in turn reinforce its reputation and standing in the enactment of monetary policy.

However, we must be aware that the common roof entails the risk of a conflict of interest. The central bank may have an incentive to keep monetary policy too loose to avoid the adverse effects of tighter money conditions on bank earnings and credit quality,<sup>12</sup> and provide liquidity to weak banks to avoid triggering losses.<sup>13</sup> A supervisor that is also a central bank may be tempted to forbearance during a downturn, delaying the closure of problem banks in the hope that macroeconomic conditions improve and the problems in the financial system disappear on their own.

The potential for conflicts of interest between monetary policy and prudential supervision is debatable. In many instances, such as during the global financial crisis, financial instability can generate deflationary pressures.

There is no clear evidence that central banks with supervisory powers were more or less prone to forbearance than other supervisory agencies.

Situations of conflicts of interest between supervisory objectives and monetary policy goals may exist, but these conflicts would not be resolved by simply

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<sup>11</sup> The IMF FSAP principles state that "The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources."

<sup>12</sup> This point has been made, among others, by Goodhart and Schoenmaker (1995).

<sup>13</sup> See for example Brunnermeier and Gersbach (2012).

attributing the functions to separate authorities. Having separate authorities would make coordination even more burdensome.

### ***Towards a European Banking Union: the new regulatory and supervisory framework***

*Origin and motives of the European Banking Union project* – The construction of Europe since the end of WW2 has followed a long and winding road<sup>14</sup>. The Banking Union (BU) is the most recent step. It is still an ongoing process; it has been designed to solve what can be considered the worst crisis ever of the European edifice: the sovereign debt crisis.

We know where the crisis came from. The triggers were local financial crises in two small economies of the EZ, Greece and Cyprus. The response by the European governments and institutions was flawed, and fuelled markets' suspicion that the euro was not in fact irreversible, as the European rhetoric had claimed until then: a sort of disaffection towards the euro was apparently spreading in important founding countries, particularly in the North of Europe.

Market turmoil receded after the announcement of the Outright Monetary Transactions programme (OMT) by the ECB ('Whatever it takes'), but meanwhile banks in high-public-debt countries had become the main target of the markets' concern: they held a considerable amount of public bonds of their respective sovereigns in their balance sheets; the riskiness now attached to the sovereigns was being transmitted to the domestic banks' balance sheets and back to the sovereigns,

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<sup>14</sup> See Rossi (2014).

perceived as the ultimate support to their domestic banking systems, in a vicious circle.

How to sever the sovereign-bank link? The safest way to do it was straightforward: we needed to convince the markets that the EZ banks belong to a common system, so that if one of them fails, or is likely to fail, bailing it out is no more the responsibility of one country, but of all. However, if we wanted all the EZ countries, in particular the low-public-debt ones, to share such a financial responsibility, we had to allow them also to share the *ex ante* supervision on all banks, not only on the domestic banks of each country. In other terms, we needed to create a Single Supervisory Mechanism (SSM).

The BU project was launched in 2012, and it was conceived as an institutional framework with three pillars: an SSM, a Single Resolution Mechanism (SRM), and a Single Deposit Insurance Scheme (SDIS). The three pillars were originally meant to be concurrent, symmetric and logically connected. The outcome has been different.

The SDIS has been postponed to an indefinite future. On the crucial issue of bank resolution, a long and tiresome negotiation took place, which eventually brought about a reverse approach: it was decided that sharing the cost of a banking crisis among all the EZ countries was not for now; it is foreseen as the final step of a many-year-long process, and in any case it will involve private funds only (the Single Resolution Fund, financed by all the EZ banks). In particular, the use of money from the taxpayers of countries other than the one where the bank's head office is located has been ruled out – contrary to the original intention.

During the negotiations Italy offered a view consistent with the very motives behind the BU project: the SSM was supposed to be the prerequisite of a common public backstop for distressed banks, with the aims of removing the “tail risk” from the EZ banking system and cutting the link between sovereigns and banks; any moral

hazard could be prevented by an effective common supervision. This view, also shared by several other countries, was eventually rejected by the majority.

Meanwhile the SSM was created. The new system has been in place since last November. It is centered on the European Central Bank (ECB) and comprises all the national competent authorities (NCAs) of the euro-area countries.

The Single Supervisory Board (SSB), which includes 6 members appointed by the ECB and 19 representatives of the NCAs, is directly responsible for supervision of around 120 ‘significant’ banks. In practice, supervision of each of those banks is conducted by a Joint Supervisory Team (JST) comprising experts from the SSM staff and from the NCAs of the countries where that bank is located.

We now have in Europe a very complicated regulatory and supervisory framework for banks. Regulation is provided by the EBA, an EU-wide entity, while supervision is the responsibility of the SSM, but only for EZ banks. Bank resolution is disciplined by a specific EU Directive and governed by the SRM. The European Systemic Risk Board (ESRB) is in charge of macroprudential monitoring<sup>15</sup>. This is the European layer. The domestic layer, the NCAs, is also fully involved in both regulation and supervision, to various degrees. The two layers coexist, although with different responsibilities: the multinational nature of the Mechanism implies a multiplication of resources dedicated to the various tasks, also because of the need for coordination. It is a costly exercise.

*The ‘common roof’ choice* – A crucial decision was to place the SSM within the ECB. It came after a prolonged discussion, where different lines of thought were confronting. The risk of a conflict of interest between monetary policy and

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<sup>15</sup> Although some macroprudential supervision tasks have also been assigned to the SSM.

supervisory action was meant to be mitigated by separating the analysis aimed at supervision from the one aimed at monetary policy, and analysis from decision-making.

The SSM Regulation actually establishes the separation between the monetary policy function and supervision.<sup>16</sup> Recital 65 of the Regulation states that the ECB is responsible for carrying out monetary policy functions with a view to maintaining price stability in accordance with Article 127(1) TFEU, while the exercise of supervisory tasks has the objective of protecting the safety and soundness of credit institutions and the stability of the financial system. The Regulation thus establishes that monetary policy and supervision should be carried out in full separation, in order to avoid conflicts of interest.

*The road ahead* – Is there a risk that markets will see the BU as a fragile, lopsided creature; that financial market fragmentation will remain untamed; that the BU objectives will be missed?

Not necessarily. What we have achieved so far may be not the first best, but it is something. The SSM, the starting point, is valuable *per se*. The Bank of Italy has supported it from the outset, and will continue to cooperate to make it a success.

What the NCAs have to do is to build a real single house. We have to bring to this common endeavour the best practices and the most useful experiences.

In order to exploit the potential of the SSM, it is essential to harmonize supervisory practices so that the resulting single standard be the highest possible, in terms of both prudence and effectiveness in financing the real economy.

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<sup>16</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

In the years preceding the global financial crisis, harshly competing and gigantic intermediaries, mostly in the US, pushed the authorities to lower their regulatory and supervisory standards; on the other hand, shadow banking activities were developed, totally hidden from regulators and supervisors. This latter phenomenon still poses a risk: overburdening banks with ever increasing requests for more capital may be pro-cyclical and counterproductive from the point of view of systemic stability, in that it incentivizes finance to go further into the shadow.

We must let our banks do their job better than they did before the crisis. They must be more stable, more efficient, more competitive, to the benefit of the whole economy. We must dissipate every remaining uncertainty in the markets regarding the irreversibility of the euro, so that the common EZ monetary policy can work fully and correctly.

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# Table 1 - Evolution of financial supervisory architectures: selected countries outside the EZ

Countries	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Australia	Twin-peaks															
Canada	Hybrid															
Japan	Integrated															
Sweden	Integrated															
Switzerland	Hybrid									Integrated						
United Kingdom	Integrated															Twin-peaks
United States	Sectoral															
Russian Federation	Sectoral															Int. CB

Source: Oreski and Pavcovic (2014)

Note. Int. CB = Integrated model with central bank.

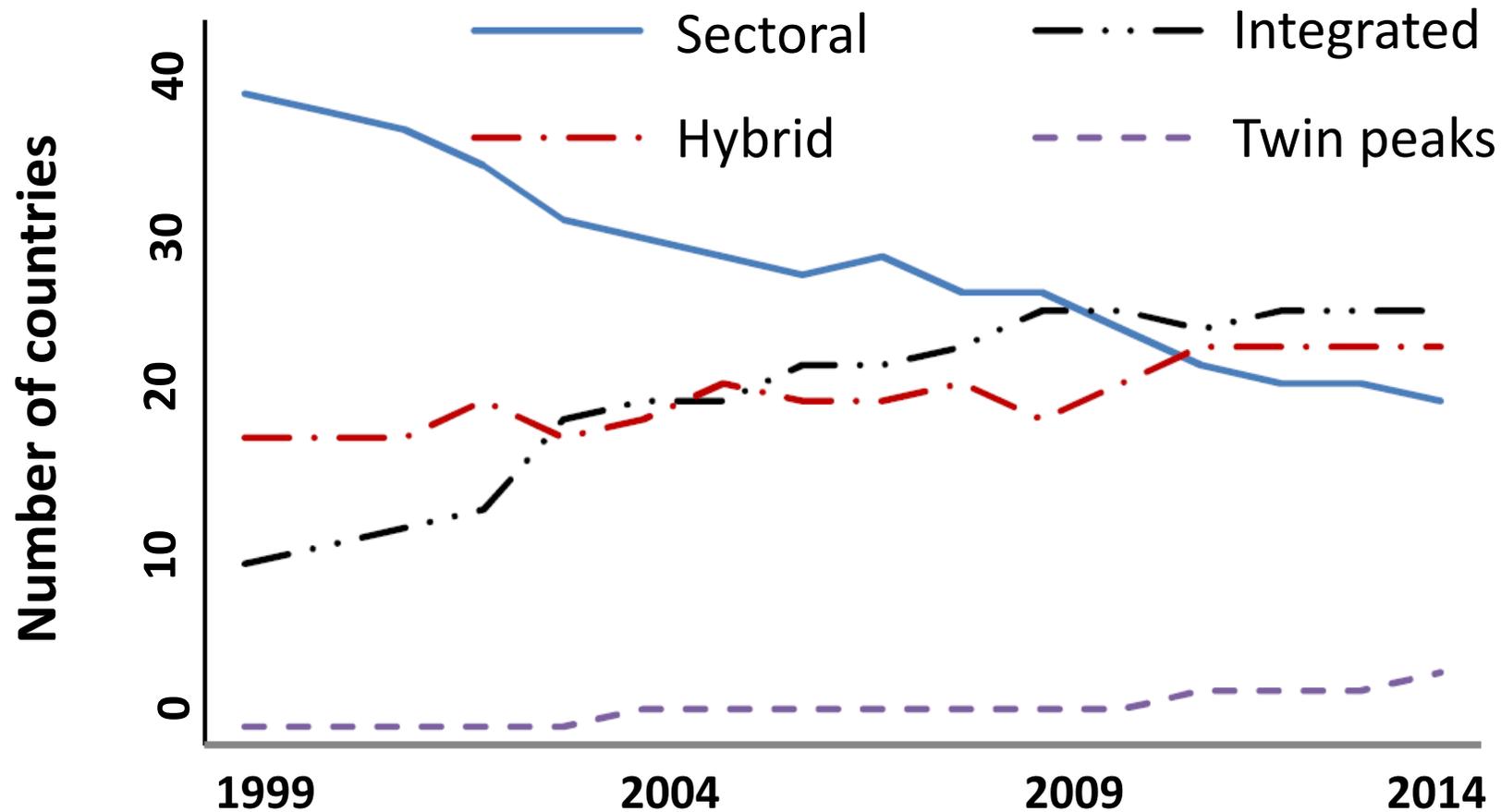
## Table 2 - Evolution of financial supervisory architectures: selected EZ countries

Countries	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Austria	Hybrid				Integrated											
Belgium	Hybrid				Integrated								Twin-peaks			
Finland	Hybrid CB									Integrated						
France	Sectoral										Hybrid CB					
Germany	Sectoral				Integrated											
Italy	Hybrid CB															
Netherlands	Sectoral				Twin-peaks											
Spain	Sectoral															

Source: Oreski and Pavcovic (2014).

Note. Hybrid CB = Hybrid model with central bank.

**Fig. 1 - Transition diagram for financial supervisory architectures over the period 1999 - 2014**



Source: Oreski and Pavcovic (2014).