Edgar Meister: How should regulatory and supervisory responsibilities be shared among the national functional regulators?

Lecture by Mr Edgar Meister, Member of the Directorate of the Deutsche Bundesbank, held at the Multinational Banking Seminar in New York, 9 June 2001.

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I

Ladies and Gentlemen,

Voltaire, the famous French philosopher, once said: "If you see a banker jump out of the window, jump after him – there is sure to be profit in it". Well, having experienced the latest financial crises, I am not entirely convinced that it would be <u>always</u> wise to follow Voltaire's advice. The topics of this seminar perfectly illustrate the potential risk of this kind of “herding behaviour” and – not least – the challenges for regulators and supervisors. I am delighted to have been given the opportunity of speaking here this morning, and I would like to elaborate on the issue of how regulatory and supervisory functions should, or could, be shared between national authorities. Naturally, I wish to go into the current debate on this topic in Europe.

II

The design of regulatory and supervisory responsibilities is one of the most important matters affecting the future course of financial market policy. There is, however, no universally valid answer to the question of *how* this should be done. The best way of organising supervision cannot be derived from theory. That is why we can see many forms of supervisory organisation in international practice that function well. This diversity in the design of supervision is not surprising; after all, the supervisory systems are, in each case, incorporated into their respective economic and legal structures and have evolved over time.

However, it may also be said about supervision that "the most constant thing is change". That is why, in the recent past, some countries – such as the United Kingdom – have radically reorganised their supervision or are discussing changes, as in Austria, Ireland and Germany, for example.

Although there is no ready-made solution as to how responsibilities should be assigned in order to put in place an effective and efficient supervisory structure, there are nevertheless a few requirements that should be fulfilled.

- The supervisory structure should be geared to the financial market structures. In other words, due account has to be taken of developments on the markets, such as national and international mergers and acquisitions, and the emergence of ever larger business enterprises.
- The institutions in charge must have expert knowledge and experience in their special field, they need an appropriate number and quality of staff as well as an efficient internal organisational structure in order to make possible efficient and cost-effective supervision.
- Supervisors should be in close proximity to those who are to be supervised, and at the same time not under too much political influence.
- If regulatory powers are shared among several institutions, there has to be a clear definition of powers and responsibilities. An efficient structuring of the flow of information and of the cooperation between the supervisory bodies involved is also important.
- Harmonised supervisory rules as well as their consistent application in practice are essential for creating a "level playing field" for the financial institutions in the different sectors.

Here in the United States, the role played by the Federal Reserve in financial supervision is not only well recognised but regarded as indispensable. In Europe, however, that role is hotly debated. In addition to the above-mentioned general requirements, I would also like to mention some aspects which argue for central banks having a substantial involvement in supervision.

- Owing to the globalisation of financial markets and the accompanying profound structural changes within individual banking systems, not only microprudential institutional supervision but also looking at the implications for the financial system as a whole are becoming ever more important.

- In this context, central banks are particularly affected since a stable financial system is an essential prerequisite of monetary policy. Combining the practical supervision of institutions with the analysis of the stability of the financial system as a whole - "the marrying of micro- and macro-prudential analysis" – as the General Secretary of the "Bank for International Settlements", Andrew Crockett, once put it – brings benefits for supervision and monetary policy.

Effective financial market supervision relies on its own direct access to the relevant information. Especially when there is an impending crisis, the key factors are

- how quickly crucial information is available to those parties who need it,
- how extensive that information is,
- that the information is interpreted correctly
- and that an appropriate set of instruents for countermeasures is available.

For direct access to information, proximity both to the financial markets and to the institutions is an advantage. Supervisors, who are active in the markets themselves and know the market participants from their own business relationships, possess major additional sources of information. It is precisely the central banks which maintain these permanent contacts – not only for their monetary policy operations but also because of their role in payment systems. Central banks are therefore in a position to identify problems within the financial system earlier than pure bank supervisors are able to.

The central bank’s own financial market analyses, which are needed for monetary policy in any case, also provide valuable information for the purposes of system supervision, and can help to identify irregularities or tensions within the financial system at an earlier stage. Moreover, central banks are able to perform the necessary interpretation of prudential data within the context of the economy as a whole. Ultimately, supervision has to serve the economy. And, finally, the central bank can also use the infrastructure, which it has available for monetary policy, for purposes of crisis combating.

However, there are also synergy effects between the implementation of prudential supervision and monetary policy, since, with access to confidential prudential information, the central banks are even better able to judge the current economic situation and gain direct benefit from it in terms of monetary policy.

Furthermore, central banks are in my opinion well suited to be crisis managers, as was illustrated by the action undertaken by the Federal Reserve in the case of the hedge fund LTCM. Under the leadership of the central bank, a private sector bail-out program was organised entirely without the use of public funds.

When struggling for the best possible way to organise supervision, one is caught in a dilemma between the supervisor’s need to be close to the market and the global orientation, above all, of the big market players. Equally, as far as supervision is concerned, market proximity and the need to take due account of specific national features pose a conflict of aims with cost-effectiveness. The collection of information and its analysis could – in theory - be handled more cost-effectively by a mega-supervisor – at least from the point of view of the global players. The global supervisor might also be able to play a larger part in preventing global financial crises.

In practice, however, such theoretical considerations are faced with scarcely surmountable problems. As an alternative, the conflicts of aims which I have described are therefore to be solved by intensifying cooperation further among the responsible supervisors which in fact is already in place. This holds true internationally as well as within national borders – if different institutions are responsible for supervision – and especially across sectors.

III

How has the question of supervisory organisation been solved within the European Union? Despite the introduction of a single currency in most of the EU countries, the supervisory responsibilities have remained with the member states. There is a wide range of models in the European Union, all of which are functional. In Greece, Ireland, Italy, the Netherlands, Portugal and Spain, the central bank is responsible for supervision. In France and Germany, the central bank is closely involved in this task. Not too long ago, supervisory functions in the United Kingdom were transferred from the Bank of

England to the FSA, an authority with a very wide-ranging mandate. There are similar divisions of responsibility in Scandinavia. In Belgium, banking supervision and securities supervision are combined in one agency, whereas in Austria the ministry of finance has so far conducted banking supervision in close cooperation with the central bank.

The ECB is also involved in supervision, albeit to a limited extent. This is based on the relevant European legislation contained in Article 105 (5) of the EC Treaty which provides that "the ESCB shall contribute 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".

Close cross-border cooperation is important for the converging European financial market. On a multilateral level this is carried out, for example, by the Banking Supervision Committee (BSC) residing at the ECB. This body consists of senior representatives of the central banks and regulatory authorities of all 15 EU countries and is thus well suited to covering the various aspects of supervision. In the event of an impending systemic crisis with potential contagion effects, the BSC could also play an important role in crisis management bringing the countries involved together.

In the public debate, reference is sometimes made to potential conflicts of interest with which a central bank might be faced when caught between the aims of monetary policy and its responsibility for systemic stability within the context of supervision. An example that sometimes is mentioned is an interest rate cut for the purpose of stabilising the financial system, which is inappropriate from a monetary policy standpoint. In practice, however, things look different. Within the European Monetary Union, monetary policy is determined by the 18 independent members of the ECB Governing Council. In terms of an appropriate monetary policy, this ensures a pluralistic assessment of the financial market situation for Europe as a whole and not with a view to specific developments in one country.

Quite irrespective of the situation in Europe, I think that the argument of a "conflict of aims between price stability and systemic stability" can be debated.

- First, the central bank has the responsibility for systemic stability anyway and not only when it assumes supervisory tasks.
- Second, the conflict of aims alluded to would become apparent only in very rare cases when serious problems have already emerged. An efficiently functioning prudential supervision, however, would prevent this.
- And, third, a potential conflict of aims cannot be settled more effectively by sharing responsibilities among different institutions.

Essentially, in a specific situation it is a matter of weighing two important public goods, systemic stability and monetary stability. There is no argument in support of this tending to be to the detriment of monetary stability if these two goods are weighed up by the central bank. As a more general observation, I should mention that in the medium term, sound money contributes to the stability of the financial system.

IV

On balance, central banks should be taken into consideration in an appropriate manner as far as the distribution of supervisory powers is concerned. For that reason – in the light of the current debate being conducted in Germany on the restructuring of the financial services supervision – I also regard a major participation by the Deutsche Bundesbank in prudential supervision as being essential. The Deutsche Bundesbank is not against an integrated supervision with banking, securities and insurance supervision under one roof. However, it must be able to continue making a contribution to systemic stability within the European System of Central Banks. The Bundesbank's "invisible assets" such as experience and knowledge of the big internationally operating institutions are indispensable for the evaluation of systemic risks. The proposals which the Federal Government presented last week are moving in the right direction. Some remaining issues need to be clarified and settled during the legislative process.

Thank you for your attention.