Pentti Hakkarainen: Enhancing the free information flow and cooperation between supervisory and other authorities

Luncheon speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the 2nd FIN-FSA Conference on EU Regulation and Supervision – "Banking and Supervision under Transformation", Helsinki, 12 February 2013.

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Ladies and gentlemen,

One of the most important lessons from the financial crisis has been that there was no adequate coordination and exchange of information between central banks and supervisors. In other words, the macro and micro supervisory perspectives were not combined. Another lesson has been that there were no macro-prudential tools available to intervene effectively – for instance – in growing instabilities in real estate markets, and the necessary macro-prudential tools are only now becoming available.

It is certainly very important to develop the new macro-prudential instruments and policies – this is quite clear. However, ***it is even more important in my view that major trends and risks in the financial sector or the macro-economy do not escape the attention of financial supervisors.*** To achieve this you need constant and very close cooperation between supervisors and central banks. The macro and micro supervisory functions should not be seen as separate silos but two sides of the same coin!

After every financial crisis there are always needs to correct shortcomings which have appeared in the crisis as evident ex post. This time it is not different. Now we have seen many ideas how to step up the necessary cooperation between the macro- and micro-supervisory functions and move central banking and supervision closer together. In Finland, the decision to put supervision close to the central bank was made already earlier [– in 1994 regarding financial sector supervision and in 2009 also insurance sector supervision –] based on lessons learned from the banking crisis in the early 90's and on practical reasons like efficient use of limited resources in a small country.

The Financial Supervisory Authority (the Fin-FSA) is at the same time an independent organisation, with its own decision-making structure, but also an integral part of the Bank of Finland. ***We have now reaped important benefits from our model during the recent financial crisis. There are several examples of the benefits of our model.*** Common databases are shared, valuable information is exchanged and extensive cooperation takes place in financial stability analysis and stress testing.

One concrete example is the handling of the troubled Icelandic banks in 2008 here in Finland. I think it is a good illustration of how big the value added can be from close central bank – supervision links. Thanks to having access to signals from the central banking community of potential major liquidity problems in Icelandic banks, the Finnish Supervisor was able to act quickly in full cooperation with the Icelandic authorities and minimise the damage for depositors and the Finnish banking sector more broadly. Hence, information from the central bank was very useful for the supervisor to prepare timely actions. [Even though the banking sector remained stable, people were nevertheless nervous and – for example – currency in circulation increased. Good collaboration with the banking industry facilitated reaching a solution rapidly. Smooth cooperation also with the Ministry of Finance allowed effectively limiting negative consequences for financial stability.]

Cooperation between the macro- and micro supervisory functions should be so close that it becomes self-evident at all levels of the organisation and there are no bureaucratic obstacles or turf battles between the two functions. [You have reached a good level of cooperation, when the alternative way of working than doing things together and exchanging data and ideas, does not even cross peoples' minds.] We consider that our cooperation between the central bank and the supervisor is already at a good level. ***Having said that, there is always room to improve, and we are working further on that.***

Dear guests, you may now think that the model I have been describing may be good for Finland, but is it really fit also for larger economies or the Euro Area and the EU as a whole? My answer is yes. Also in the Banking Union, the macro- and micro supervisory functions should be as close together as possible also at the centralised level.

As a matter of fact, a similar model of close central banking and supervision links is being implemented for the new supervisory system in the Banking Union. The ECB will be leading the supervisory work for significant banks and hosting the new Supervisory Board. As a first fundamental thing, monetary policy issues and decision making are kept clearly separate from supervisory responsibilities. This model allows reaping the benefits of a close relationship between central banking and supervision and maintaining the independence of supervision through a separate decision making structure. Independence of the supervisory work needs to be safeguarded in the internal organisation of the ECB, while not preventing the necessary tight cooperation between the central banking and supervisory functions.

Cooperation between the two functions should be constant and effective in both directions. The macro-prudential risk assessment greatly benefits from the risk picture that is emerging from micro-supervisory data and ideas of where major risks are can be "reality checked" against supervisory data on banks' actual exposures. And in the other direction, macro-prudential risk picture needs to be taken into account in the design of supervisory plans and inspection programmes to direct supervisory resources in high-risk areas. It is important to note that micro-supervision actions can have an impact at the macro-level – i.e. micro supervisory tools also affect macro issues.

In addition to the close cooperation between macro and micro supervision, another issue is of crucial importance – that is effective resolution of crisis banks. Here, again, effective cooperation between central banks and supervisors is vital – as is equally important the cooperation with the potentially separate resolution authority; whatever the final institutional set up will be. This is really the core issue for the Single Resolution Mechanism – which is now being planned – to function properly.

While we are making very good progress with the Single Supervisory Mechanism, we need to make strong progress also on the resolution side. ***When resolution works well it will force the guiding principle that "bail-in" is the rule and "bail-out" a rare exception – and taxpayers' involvement will be minimised.***

[***For a successful resolution system, three elements are the most important.*** First, national authorities need new effective and harmonised powers and tools to resolve failed banks. Second, we should establish a Union-level resolution system – the Single Resolution Mechanism, which should go hand in hand with the Single Supervisory Mechanism as far as the scope of banks and countries is concerned. That is, the Single Resolution Mechanism should cover the entire euro area banking sector plus banks in those non-euro area countries that wish to join the SSM. And third, bank resolution funds, prefunded by the banks, should form the primary financial backstops. For deeply systemic banking crises there can be a need for an ultimate fiscal backstop, but it should be clearly emphasised that a bail-out would be a rare exception.]

Ladies and gentlemen, let me conclude by stressing again the most important issue I see, which is ***the free information flow and cooperation between supervisory and other authorities***. Improving this also by removing obstacles hindering the flow of information would guarantee efficiency in preventing and handling future crises. Even though it is tempting to think that "this time is different", I can guarantee that in the future things will not be different and nasty surprises and crises will surely occur, and that time again a well-functioning supervisory system is of essence.