Pierluigi Ciocca: Supervision: one or more institutions?

Remarks by Mr Pierluigi Ciocca, Deputy Director General of the Bank of Italy, to the Conference on "The new structures of financial markets: how should supervision be organized?" held in Bologna, 4 May 2001.

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Introduction

The question of the allocation of responsibilities in banking and financial supervision is *not* a purely economic question, nor can it be solved merely on the basis of economic theories. Until quite recently Milton Friedman was the only great economist to have addressed the issue, and even then as part of the broader problem of money and its management.

Many other aspects are involved, however, including:

- the "legal experience" of a country, and hence the constitutional and institutional framework within which the question is set;
- how supervision has been and is performed, in terms of the resources, reputations and independence of the institutions concerned;
- the opinion of the markets in the light of their changeable "conventions".

The foregoing considerations suggest that the question should be approached, if not pragmatically, at least with prudent humility. The subject does not offer academic recipes suited to every context. One may nonetheless have opinions, based on arguments that have been worked out to a greater or lesser extent. I shall set out my own here, in the most generalized form I can achieve.

The international picture

These considerations regarding method are matched by an empirical observation. In recent times there has been no clear tendency for any one solution to predominate. Basically, there are three alternatives: extreme centralization (rare), extreme decentralization (less rare) and intermediate solutions (the most common).

The United States has remained faithful to a division of responsibilities in which the *types* of body entrusted with supervision are highly diversified, with 6 for banking supervision[1] (with 357 local offices and around 15,000 employees) and another 6 for financial supervision[2] (covering markets, insurance companies and pension funds with 137 local offices and some 8,000 employees). In addition, it is necessary to consider the self-regulatory bodies of the 9 most important financial markets. The overlapping of powers is accepted, desired, in view of the "dialectics", the "competition", it ensures between the various institutions and because it avoids monopoly. The number of persons engaged in supervision is huge. In the banking field it is about fifteen times the figure for the Bank of Italy (about 1,000), even though the US banking system (at current prices and exchange rates) is only five or six times as big as Italy's, while the GDP ratio is seven to one (on a purchasing-power-parity basis).

At the other extreme the United Kingdom is implementing the decision taken suddenly in May 1997 to bring all the supervisory powers — except that concerning "systemic stability", which has been left in the hands of the central bank — together in a newly-created organization, the Financial Services Authority (FSA). Japan has adopted a similar solution. The FSA has a head office with a staff of 2,300 (of whom no less than 450 deal with authorizations and consumer relations), no special body for on-site examinations and an annual budget of just 500 billion lire. With these resources, the FSA is expected to supervise a financial industry that, in terms of volume of funds, is about one quarter that of the United States and three times as big as Italy's. It is true that with 841 banks Italy has more than

[1] The Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Banking Department of each of the fifty states.

[2] The Securities and Exchange Commission, The Securities Commission of each state, the Commodity Futures Trading Commission, the National Association of Insurance Commissioners, each state for insurance matters, and the Pension and Welfare Benefits Administration of the Department of Labor.

twice as many as the United Kingdom,[3] but the combined human and financial resources of the various Italian supervisory authorities are not very different from those of the FSA (moreover, in addition to a body of inspectors, the Bank of Italy has a network of branches that monitor their "local" banks and markets).

Although the United Kingdom and Japan are major economies, the similar architectures they have adopted for supervision have not established a trend, for several reasons. The choice was influenced by the failure of their earlier architectures, with serious and unexpected failures of individual intermediaries in London and the structural crisis of the whole financial industry in Japan. It was made when the central bank was relatively weak in both countries. It does not reflect the great difference between the two countries' political and constitutional traditions.

The solutions to be found in the euro area lie somewhere between the extremes represented by the United States, on the one hand, and the United Kingdom and Japan, on the other. The changes introduced recently in the Netherlands, Portugal and Belgium increased coordination among the existing authorities (including the central bank), which nonetheless remained separate entities with each having specific powers. In Germany, Ireland, Finland and Austria proposals aimed more specifically at consolidation are under discussion. In some cases they have met fierce opposition. The question has become the subject of widespread debate. Some commentators believe that the monetary unification of Europe must be matched by some concentration of supervisory tasks.

Why centralize?

There are basically two general reasons that may lead to the decision to centralize supervisory powers:

- the possibility of obtaining an overall view, accompanied by economies of scale and hence lower costs for the intermediaries subject to supervision;
- the changes in the operational and geographical boundaries between intermediaries, markets and financial instruments, owing, among other things, to the emergence of "large and complex financial institutions".

The importance of these reasons increases with the degree to which finance is — or the authorities wish it to be — concentrated in a single centre (London accounts for about one third of all UK employment in banking and finance and produces 16 per cent of the country's GDP) and with the "smallness" and "openness" of the economy (on the assumption that international coordination is easier to achieve among a few supervisory authorities).

Two qualifications should be noted in the case for centralization:

- that it should not take place at the central bank, which is required to perform monetary policy tasks that are deemed to be in conflict with those of supervision;
- that the promotion of competition in the banking and financial sector should not be combined with the protection of stability, since these two functions are also deemed to be incompatible.

Why decentralize?

On the other side there are several reasons for decentralizing supervision, for adopting a solution somewhere between monopoly and extreme fragmentation.

Here are some:

- the switch from some degree of decentralization — the most common solution — to a centralized configuration inevitably involves costs and risks during the transition period;
- technical specialization in the exercise of supervision continues to have a value even when the internal boundaries within the world of finance are being eroded; banking risk, for example, continues to be different from insurance risk and from the risk affecting pension funds;

[3] In the United Kingdom there are 377 banking businesses subject to supervision by the FSA (186 UK incorporated banks, 67 building societies and 124 branches of non-EU banks; the 118 branches of EU banks are subject to home-country control).

- contact with the intermediaries and markets subject to supervision — closest where supervision is carried out by means of a network of “local” offices, as in the United States and Italy — gives supervisory authorities access to information and a power to discourage improper conduct;
- avoiding an accumulation of administrative power in an extremely delicate field limits the risk of its being abused or supervision being used, de jure or de facto, for political ends — the classical lesson of Montesquieu.
- in performing supervision it is important not to confuse the spheres of technical discretion and formal control of the conduct of business.

The last reason needs to be clarified a little.

Disclosure, transparency and correctness fall largely, although not exclusively, within the second sphere. Ensuring their respect implies, first and foremost, that rules must be detailed in advance in legislation and then that they must be enforced. It consists in administrative activities that are concerned less with the exercise of a natural and necessary technical discretion than with the discharge of a responsibility oriented primarily towards the control of legitimacy.

Competition, efficiency and proper risk control — i.e. stability — fall within the first sphere. The need to distinguish in a crisis between illiquidity and insolvency, assess the probability of contagion, and choose how and when to act so as to achieve maximum effectiveness and minimum moral hazard often requires supervisory <u>discretion</u> and hence the <u>independence</u> of the body responsible for carrying out what amounts to a form of economic policy.

Independence is inherent in the management of money and credit, which is entrusted to central banks. They are accustomed to exercising this independence in accordance with priorities they establish on the basis of the resources available. Independence is the cornerstone of central banking. An additional reason for entrusting so-called stability-oriented supervision to the central bank is the scope for synergy between this function and the monetary policy function. Far from being incompatible, these two functions are complementary, in at least three respects: staff’s experience and professional skills in the monetary, banking and financial fields; the two-way flow of information; and the risks facing individual intermediaries and the system as a whole.

One last consideration concerns stability-oriented supervision and antitrust action in the banking industry. There is absolutely no trade-off between these two activities. Competition is a necessary but far from sufficient condition for the solidity of the banking system. Without competition, there cannot be efficiency. Without efficiency, there cannot be stability — true and long-lasting stability, in contrast with the false and temporary stability produced where survival is guaranteed by the state. Defending and fostering competition are an integral, indispensable part of <u>banking supervision</u>. They must guide the use of the instruments of supervision, regardless of whether there is an antitrust law. This is the approach followed by the Bank of Italy, both before and after the approval of antitrust legislation in 1990. If the law entrusts the task of defending and fostering competition to the supervisory authority (as in the United States and in Italy since 1990), the latter’s position is strengthened.

The need for and shortcomings of coordination

A reasonable degree of decentralization implies coordination of the various supervisory authorities. The blurring of the segmentations within the world of finance and financial globalization call for forms of closer coordination.

This need has, or is being, met. It is being met in Italy, autonomously and in response to specific statutory provisions, through coordination of the Bank of Italy, the companies and stock exchange commission (Consob), the supervisory authority for the insurance industry (Isvap), the supervisory authority for pension funds (Covip) and the antitrust authority. It is being met in Europe and at international level through formal and informal bilateral agreements and through participation in multilateral fora, including the newly established Financial Stability Forum (in both cases with reference to common standards, such as those developed by the Basel Banking Committee).

Coordination nonetheless suffers from potential shortcomings, including the risk of confusion concerning responsibilities and the possibility of overarching that amounts to a surreptitious form of total centralization.

Conclusions

The present set-up in Italy is based on a reasonable allocation of supervisory responsibilities in terms of the aims to be pursued and the institutions to be supervised. The basic criterion is a division by goals — stability on the one hand, correctness on the other — supplemented by a division by category of institution (banks, markets, insurance companies and pension funds).

These arrangements appear satisfactory in the light of the principles I have expounded. Above all, they appear satisfactory in the light of experience, amply documented in the reports and analyses published by the Bank of Italy and the other supervisory authorities. Thanks at least in part to their action and cooperation, the Italian financial system has improved considerably in the last twenty or even ten years: it is now more widely diversified; more competitive, more efficient and more stable; it is in a better position to meet the needs of the economy. "Better" does not mean "the best", which, assuming it is definable, would require the contribution of supervision to be achievable. These are issues which go beyond the scope of my remarks and which I have addressed elsewhere.[4]

[4] P. Ciocca, *La nuova finanza in Italia. Una difficile metamorfosi (1980-2000)*, Bollati Boringhieri, Turin, 2000.