Benoît Coeuré: Monetary policy and banking supervision

Speech by Mr Benoît Coeuré, Member of the Executive Board of the European Central Bank, at the symposium on "Central banking – Where are we headed?", in honor of Stefan Gerlach's contributions to the Institute for Monetary and Financial Stability (IMFS), organized by the IMFS and the House of Finance, Frankfurt am Main, 7 February 2013.

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The history of central banks and the European banking union

When we look at the history of central banks, contributing to financial stability was one of their roles in most countries, although to varying degrees.[1] Even when central banks were assigned a relatively narrow mandate, such as that of inflation targeting in recent years, they often played a decisive part as soon as financial instability struck. In particular, their ability to act as lender of last resort in the financial system and to manage liquidity in the interbank market typically made them a key player in crisis management. Even in normal times, the central role of bank deposits in the stock of money makes monetary stability dependent on the soundness of the banking sector. In sum, in the late Tommaso Padoa-Schioppa's words, financial stability has been part of the "genetic code" of central banks.[2]

There have been many cases of lender-of-last-resort interventions by central banks during the present crisis. For example, when we compare the total emergency liquidity assistance (ELA) that euro area national central banks granted to individual credit institutions last summer with the overall amount of liquidity provided at the same time by the Eurosystem, we can see that the total ELA amounts to almost one-seventh. Just to quote an example from here in Germany: the Bundesbank granted €35 billion of emergency liquidity assistance to the ailing bank Hypo Real Estate.[3]

More generally, the experience of the last five years has underlined the importance of central banks in financial stability, a task which they have historically performed. But central banks were not always and everywhere tasked with financial supervision, which aims to prevent crises from happening in the first place. For example, before the present crisis the institutions responsible for banking supervision differed from country to country.[4] In fact, in the late 1990s there was a trend for financial supervision to be placed outside central banks and entrusted to cross-sectoral authorities in charge of banks, insurance and securities markets. The crisis

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1 See, for example, M. Bordo (2007), A Brief History of Central Banks, Federal Reserve Bank of Cleveland Economic Commentary, December; C. Goodhart (2011), The changing role of central banks, Financial History Review, 18(2), 135–154; and C. Reinhart and K. Rogoff (2012), Shifting Mandates: The Federal Reserve's First Centennial, paper presented at the 2013 American Economic Association Meetings, San Diego, 5 January 2013.

2 T. Padoa-Schioppa, T. (2003), Central Banks and Financial Stability: Exploring a Land in Between, in V. Gaspar, P. Hartmann and O. Sleijpen (eds.), The Transformation of the European Financial System, Proceedings of the Second ECB Central Banking Conference, Frankfurt, May, 269–310.

3 Hypo Real Estate (2008), Press release: Hypo Real Estate Group publishing interim financial statements as of 30 September 2008, Munich, 17 November.

4 See, for example, C. Goodhart and D. Schoenmaker (1995), Should the functions of monetary policy and banking supervision be separated?, Oxford Economic Papers 47(4), 539–560; G. Di Giorgio and C. Di Noia (1999), Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?, International Finance 2(3), 361–378; and M. Horáková (ed., 2012), How Countries Supervise their Banks, Insurers and Securities Markets 2012, Risk Books, May.

seems to have reversed this trend, as recent reforms in the US and Europe show. Today, most Eurosystem governors are banking supervisors.

In December 2012 euro area finance ministers reached an agreement to create a Single Supervisory Mechanism (SSM). This is currently under discussion with the European Parliament and it will give the ECB a bank supervisory role.[5] As a result of the crisis, there is a consensus that a European banking union involving the ECB is an important component to complete the Single Market for financial services and for a genuine Economic and Monetary Union (EMU). Together with the other banking union components – common resolution and harmonised deposit insurance arrangements – this should help to overcome the fragmentation of money markets and break the vicious circle between financial and sovereign instability in Europe.

Since the ECB has not been a bank supervisor and since its primary mandate is and will remain to conduct monetary policy and maintain price stability, it is time to consider how monetary policy and banking supervision are related. I will do so in this speech, by first discussing the benefits a bank supervisory role could offer monetary policy – particularly in terms of informational advantages – and then by considering some design features, which are important when tackling the challenges of putting monetary policy and banking supervision under one roof.

How monetary policy can benefit from integrating banking supervision in a central bank

The banking union will strengthen the governance framework supporting the Single Market and EMU. Obviously, its primary purpose is not to support monetary policy. In fact, as the short history of EMU suggests, price stability can be maintained without the ECB being responsible for banking supervision.

But integrating the SSM in the ECB also creates some new opportunities for the conduct of monetary policy and other functions closely related to it. I particularly see four areas in this respect: the state of the macroeconomy; monetary policy options; interactions with supervisory policies; and the management of the central bank balance sheet. I will argue that these opportunities are greater in turbulent times than in quiet times.

Additional information about the financial sector and the state of the economy

Data collected and analyses conducted as part of banking supervision provide valuable additional information about the banking sector and may feed into the assessment of the macroeconomic situation. According to the proposed SSM regulation[6] it has been estimated that the SSM would directly supervise approximately 130 to 140 banks in the euro area countries, constituting more than 80% of total euro area bank assets, and well cover the banking sector in all these countries.

This information could complement the data collected for the ECB's monetary analysis. The ECB's monetary policy strategy is based on two pillars, an economic one and a monetary one, and thereby assigns an important role to money and credit. The broad range of tools regularly used in our monetary analysis already provides valuable information about the build-up and unravelling of widespread financial imbalances. Additional supervisory data and

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5 Interestingly, Tommaso Padoa-Schioppa (1999), in a lecture entitled "EMU and banking supervision" at the London School of Economics, Financial Markets Group, 24 February, regarded it as "absolutely necessary" even at the start of EMU that cooperation among bank supervisors would over time lead to a type of "collective supervisor" that would act as effectively as if there were a single supervisor. This would also desirable, he added, because it would "assist the Eurosystem in the performance of its basic tasks".

6 Document number 17812/12, as published on the Council of the European Union's website, http://register.consilium.europa.eu.

analyses, be they micro-prudential or macro-prudential, would further enhance the breadth, depth and granularity of information about the functioning of the banking sector.

The value added of this information will become even more critical in a crisis, given the important role of banks in severe financial crises and the nature of the data concerned. Moreover, analytical supervisory assessment indicators and early-warning tools can put the new data to work in assessing credit developments.[7] Additional information on the banking sector is likely to be more important in the euro area than in the US, because in the euro area bank lending accounts for almost two-thirds of the total financing of non-financial corporations, whereas in the US bank lending is only just above one-quarter of total firm financing.

Broader information basis for assessing monetary policy options

Given Europe's bank-based financial structure, monetary transmission channels through the banking sector are particularly important in understanding the effects of monetary policy actions, standard and non-standard. For example, a key feature of the present crisis is the impairment of the monetary transmission mechanism in which fragilities in banks' funding models and their exposure to government debt have played a significant role. A thorough understanding of banks' behaviour and health across jurisdictions facilitates the design and implementation of non-standard monetary policy measures and will also facilitate the exit from these measures when the time is right.

Better consideration of the interactions between monetary, supervisory and regulatory policies

Monetary policy interacts with supervisory and regulatory policies, be they micro-prudential or macro-prudential in nature. If the monetary policy objective and the supervisory objective are distinctly defined and separate instruments are assigned to each of them, then a single institution could take the interdependencies better into account than separate authorities. Interactions can be expected to occur in particular with macro-prudential policies, which increase in importance due to the lessons from the crisis, and operate through channels closely related to monetary policy transmission. The allocation of macro-prudential regulatory instruments under the SSM is therefore an important design feature of the draft legislation.

Research confirms that it is advisable for monetary policy to focus on price stability and prudential policy on financial stability.[8] Against this background, as an institution with a clear price stability mandate, compliance with which can be easily verified, the ECB will have incentives to intensify the prudential policies seeking to counteract emerging financial imbalances and risks. In turn, and importantly, this would reduce pressures on monetary policy to do so. It will also have incentives to conduct supervisory policies in a way that would reduce the likelihood of crises and therefore of lender-of-last-resort interventions. This would also diminish the possibility of generating adverse incentives for banks, i.e. moral hazard involved with emergency assistance.

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[7] J. Peek, E. Rosengren and G. Tootell (1999), Is Bank Supervision Central To Central Banking?, Quarterly Journal of Economics, 114(2), 629–653, argued, using US data from the 1990s, that the incorporation of supervisory CAMEL ratings may improve macroeconomic forecasts. CAMEL is an abbreviation for a system of supervisory indicators used in the US describing the conditions of banks aggregating information about capital, asset quality, management, earnings and asset-liability management.

[8] See, for example, I. Angeloni and E. Faia (2009), A Tale of Two Policies: Prudential Regulation and Monetary Policy with Fragile Banks, Kiel Working Papers, No 1569, Kiel Institute for the World Economy, forthcoming Journal of Monetary Economics, or D. Beau, L. Clerc and B. Mojon (2011), Macro-Prudential Policy and the Conduct of Monetary Policy, Banque de France Occasional Paper, No 8. A summary of the literature is provided in European Central Bank (2012a), Report on the First Two Years of the Macro-prudential Research Network, Frankfurt, October.

A single institution could also avoid conflicts and coordination problems between separate policy authorities, which might be particularly pronounced in a crisis and in a multi-country setting.

Better management of the creditworthiness of counterparties in monetary policy operations

Monetary policy operations expose the central bank to credit (and other) risks, which are controlled through adequate collateral and other risk management techniques. Good banking supervision and prompt corrective action ensure the soundness of counterparties in these transactions and a central bank therefore has particular incentives to make sure its supervision is rigorous. Rigorous supervision, in turn, protects the central bank's balance sheet and gives it greater control over it, also safeguarding the central bank's independence and credibility.

This is an important point. As the central bank has a direct interest in strong supervision, the risk of financial dominance over monetary policy becomes less likely, i.e. the risk that monetary policy operations could be increasingly dominated by the state of the banking sector. This, in turn, reduces also the risk of fiscal dominance over monetary policy, which means the risk that fiscal behaviour forces monetary policy to react in ways that it otherwise would not do. As governments are always reluctant to fund unpopular bailouts or incur the social costs of bank insolvencies, they may prefer to rely on prolonged central bank liquidity provision to keep banks alive. What is crucial for adequate supervisory rigour is of course the independence of the supervisory function in the central bank, a point I will come back to later in this speech. In order to protect a central bank from regulatory forbearance, supervisory rigour is necessary on an ongoing basis, as is the determination to wind up failed banks.[9] In turn, this requires the existence of orderly resolution mechanisms with an adequate financial backstop. I will also come back to that point.

Moreover, a central bank has an incentive to establish rigorous supervision since it would diminish the trade-offs between the need for tightening collateral requirements in downturns to protect its balance sheet and the need for relaxing these collateral requirements to stabilise banks. The tightening of collateral requirements in downturns amplifies the pro-cyclicality of financial systems, while relaxing those requirements increases balance-sheet risks and distorts financial sector behaviour.

When implementing the SSM in the ECB, we will make every effort to use these opportunities to the full. However, we will seize these opportunities only to the extent that they do not create conflicts of interest, reputational risks or risks to the independence of the monetary policy authority, a point I'll consider next.[10]

How to design monetary policy and banking supervision under one roof

At least three types of challenges and risks need to be managed when integrating supervision in a central bank alongside monetary policy. They relate to potential conflicts of interest, reputational risks and central bank independence.

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9 In the US, 469 banks were closed by the FDIC between September 2007 and December 2012.

10 There are also advantages for banking supervision if it is combined with monetary policy within one institution. For example, because of its role in monetary policy a central bank needs to assess the macroeconomy and its linkages to the financial sector, which implies a natural systemic/macro-prudential orientation. Such an orientation has been largely absent from traditional supervisory practices. Central banks also have a culture of using economic analysis and research, which typically does not exist or barely exists in supervisory authorities (see e.g. P. Dasgupta, C. Goodhart and D. Schoenmaker (2002), The Skill Profile of Central Bankers and Supervisors, European Finance Review 6, 397–427). Moreover, the role of central banks in payment and settlement systems and their frequent contacts with banks through their market operations provides them with additional sources of information relevant to financial stability.

Avoiding conflicts of interest

The literature on whether adding banking supervision to monetary policy creates conflicts of interest is not well developed.[11] The concern is that a central bank which is also in charge of supervision would turn into a supervisor with access to central bank liquidity. As recently pointed out by Stefan Gerlach,[12] it could then occasionally relax its monetary policy, potentially generating an inflationary bias impairing its credibility, and also contribute to more risk-taking by banks (moral hazard), and in turn breed future financial instability. The central bank could in particular be inclined to continue lending to weak banks for fear that winding them up would trigger losses.[13] Although this literature is not conclusive, we take such concerns extremely seriously.

To protect against such effects both the regulation proposed by the European Commission and the ECB's Opinion on this regulation call for a governance structure that strictly separates the monetary functions from the supervisory functions.[14] This should entail a separation of the decision-making bodies, including procedures to strictly limit the ECB Governing Council's involvement in supervisory decisions. It should also include distinct objectives for the decision-making bodies and different policy instruments. Eijffinger and Nijskens, for example, recently pointed out that the assignment of separate instruments to the two policy branches would solve potential conflicts.[15]

There is one situation in which the distinction between supervisory and some monetary policy instruments is less clear cut, namely, in the case of certain non-standard monetary policy actions in the midst of a financial crisis. However, in such a situation, the outlook for the economy and prices has considerable downside risks, so the direction of financial stability and price stability actions (e.g. to repair a broken monetary transmission mechanism) typically go in the same direction and a conflict between both policy branches is rather unlikely.

The draft legislation also confirms that the other statutory tasks and objectives of the ECB remain unaffected by the SSM, implying that monetary policy will continue to be conducted by the Governing Council in full independence, with the primary objective of maintaining price stability over the medium term. With our quantitative definition of price stability, it will be easy to verify every month that inflation expectations remain well anchored, as they are today. It is hard to see how financial stability dominance over monetary policy could occur if such precautions are taken.

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[11] Examples from this literature are Heller (1991), Prudential supervision and monetary policy, in Frenkel, J., and M. Goldstein (eds.), Essays in honor of Jacques J. Polak, International Monetary Fund; C. Goodhart and D. Schoenmaker (1992), Institutional Separation Between Supervisory and Monetary Agencies, Giorn. Econ. 9; C. Goodhart and D. Schoenmaker (1995), Should the Functions of Monetary Policy and Banking Supervision Be Separated?, Oxford Economic Papers 47(4), 539–560; and Di Giorgio and Di Noia (1999), Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?, International Finance 2(3), 361–378.

[12] S. Gerlach (2013), Banking and Fiscal Union, Introductory remarks at a panel session at the EUI conference on "The State of Play in the Euro Area – Fixing the EMU for the Long Term", Florence, 21 January.

[13] This argument is put forward by M. Brunnermeier and H. Gersbach (2012), True independence for the ECB: Triggering power – no more, no less, VoxEU, 20 December.

[14] European Central Bank (2012b), Opinion of the European Central Bank of 27 November 2012 on a proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and a proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), CON/2012/96, and European Central Bank (2012c), Towards a banking union, Financial Stability Review, December.

[15] S. Eijffinger and R. Nijskens (2012), Monetary policy and banking supervision, VoxEU, 19 December.

At the same time, in order to exploit the advantages that I was discussing before, it is necessary to put in place mechanisms that allow an adequate flow of data and (independently executed) analyses between the two functions. Of course, this flow of information should not weaken in any form the necessary separation in decision-making, objectives and instruments. In short, separation does not mean isolation.

Managing reputational risks

In order to ensure the success of banking supervision, competencies and policy instruments need to be assigned to the new SSM which would allow it to perform its tasks effectively. Otherwise, reputational risks could arise that might negatively affect the institution as a whole. The current draft legislation would grant the SSM an appropriate mixture of micro- and macro-prudential instruments for it to conduct supervision effectively. For example, on the micro-prudential side it would have all the relevant powers, ranging from bank authorisation to administrative sanctions, from the control of capital levels to compensation issues, through to structural issues such as business models and mergers.

But even if bank supervisors use their powers effectively, this does not imply that there will never be any bank failures, fraud or other highly visible negative events, which could affect the decision-makers' reputation. This is another challenge in the business of banking supervision. This residual reputational risk should also be managed through an appropriate separation of responsibilities. Beyond the *internal functional* separation this should be fostered through a corresponding separation in *external communication*. The Chair and Vice-Chair of the envisaged ECB Supervisory Board will play an important role in communicating publicly and reporting to the European Parliament, as will the heads of the national supervisory agencies belonging to the SSM in their respective jurisdictions.

Ensuring central bank independence

Bank failures and financial fraud often affect small savers or have an impact on public budgets, and lead to the involvement of democratically elected governments and Parliaments. While indeed, the highest standard of democratic accountability needs to be ensured, history shows that political interference can also constrain the effectiveness of banking supervision. In particular, if there is political interference to avoid costly bank restructurings or closures and it undermines supervisory rigour, then the beneficial effects in terms of control over the central bank's balance sheet and the avoidance of financial or fiscal dominance risks might not accrue. There should therefore be a strict separation between the supervisor and a resolution authority.

Against this background it is reassuring that the transfer of supervisory responsibilities to the SSM will not have any implications for the independence of the ECB in performing all its tasks. By implication, the necessary *internal* precautions against political interference in supervisory matters adversely affecting the ECB's independence in conducting monetary policy have been taken.

But further *external* precautions need to be taken to ensure that financial and fiscal dominance risks do not threaten the independence of the ECB. A crucial point in this context is the existence of a well-functioning European bank resolution mechanism. Such an outside mechanism provides further protection for the central bank's balance sheet and its monetary policy independence, and has a twofold objective: first, it aims to limit the residual risk to governments' balance sheets, in particular through the timely implementation of bail-in instruments, so that the risk of financial dominance is not compounded by a risk of fiscal dominance. Second, it aims to ensure a strict separation between supervision and resolution. 2013 will be a key year for Europe to make progress with this second leg of the banking union.

Concluding remarks

Let me now conclude. It is essential for Europe to introduce the different elements of the banking union as soon as possible, starting with the SSM involving the ECB, and promptly continuing with a separate bank resolution mechanism. This will not only contribute to the integrity of the euro area and the completion of EMU, but also has some benefits for the conduct of monetary policy.

The current draft legislative framework proposed by the European Commission and the preparatory work done by the ECB, the national central banks and competent supervisory authorities on implementing the SSM also takes a forward-looking approach to handling the challenges of integrating banking supervision in a central bank. This will make sure that the SSM achieves its objectives; that the desirable synergies between banking supervision and monetary policy (and other central bank functions) are realised; and that the primary objective of monetary policy to maintain price stability is fully respected. To achieve this objective, three conditions should be met: the internal governance of the ECB should strictly separate the two functions; the architecture of the banking union should provide for a separate, common resolution mechanism as soon as possible; and the ECB as a supervisor should not hesitate to enforce capital and liquidity regulations, recognise losses in the banking system and identify failed banks.

Price stability will remain the only needle of our compass for conducting monetary policy in the Governing Council. If we implement the SSM well, taking advantage of the opportunities and carefully addressing the challenges, we have a good chance of further improving our ability to conduct a stability-oriented monetary policy.