



OPINIONS ON THE OPTIMUM INSTITUTIONAL STRUCTURE FOR BANK SUPERVISION

Ing. Tomáš Tózsér
University of Economics in Bratislava

In parallel with development trends in European financial markets discussions are being held in academic and professional circles of the European Union (EU) on the optimum institutional structure for bank supervision and the functional organisation of regulation and supervision over the financial services sector. Slovakia as a state applying for membership of the EU is trying by means of new legislation to standardise the environment of its financial sector. An integral component of this is also state regulation and supervision over the business conduct of financial companies. One of the current issues in effective financial regulation and supervision is the institutional arrangement of supervision over the banking sector.

Central banking and financial supervision

Within the function of financial supervision there is generally included a wide range of tasks, which may be put into three groups:

- business conduct, which concentrates mainly on the issuing and enforcement of compliance with regulations on performing transactions in a relationship with clients and the publication of information by financial institutions on their business,

- transparent supervision focused on the micro-economic level, into which fall all tasks of remote supervision and supervision in situ aimed at the transparent and comprehensible conduct of business by financial institutions with the objective of protecting depositors and other retail lenders,

- transparent supervision directed at the macro-economic level, which includes activities concentrated on monitoring systemic risk and on the timely identification of possible threats to financial stability as a whole, which may arise from the market infrastructure, new macro-economic trends and development trends in financial markets.

Banking supervision in a large majority of countries is concentrated mainly on lowering the probability of a situation where a bank becomes insolvent, whereby it pursues the objective of forestalling a disruption to the stability of the financial system as a whole. This orientation of banking supervision is connected with the fact that systemic risk is, in the case of banks (primarily large banks), much more relevant than, for example, in the case of insurance companies. Despite this, activities in the field of investor protection are only rarely a component of the mandate assigned to central banks.

The trend in recent years has been a gradual shift of bank supervision competences away from central banks and their integration into one independent institution for

supervision (a single regulator)¹. For these agencies, however, it is generally more typical to put stronger emphasis on the protection of consumers, with at the same time weaker involvement in monitoring systemic risk.

There does not exist, however, a clear consensus in the question of the role of central banks in supervision of the banking sector, something which is borne witness to by the fact that in half of the EU states the function of the central bank as implementer of monetary policy and the function of performing bank supervision are separated and in the other half are combined (see table 1). While in some countries the responsibility for bank supervision has been taken away from central banks, in many states they are legitimately involved in this.

Arguments in favour of supervision under the direction of central banks

There exist three groups of arguments for a combination of the functions of bank supervision and central banking (pursuant to its main function as implementer of monetary policy):

- synergies resulting from the combination of functions,
- the issue of systemic risk,
- independence and professional activity.

Synergies resulting from the combination of the functions of banking supervision and central banking are connected with specific information, to which a central bank has privileged access for reason of its authority in supervision. This confidential information plays an important

¹ Norway established a consolidated institution for financial supervision back in 1986, Denmark in 1988, Sweden in 1991, Great Britain and Iceland in 1999 and many other countries are moving towards this step or are preparing to make it in the near future (for example Germany, Austria and Switzerland).

Table 1: Supervision of Banking, Securities Brokers and Insurance in Europe, North America, Japan and Australia

Country	Banking	Securities Brokers	Insurance
B	BS	BS	I
DK	M	M	M
D	B	S	I
GR	CB	S	I
ESP	CS	S	I
F	B/CB	S	I
I	CB	S	I
IRL	CB	CB	G
LUX	BS	BS	I
NL	CB	S	I
A	G	G	G
P	CB	S	I
FIN	BS	BS	I
SW	M	M	M
UK	M	M	M
CH	BS	BS	I
CZ	CB	SI	SI
H	M	M	M
N	M	M	M
SR	CB	SI	SI
PL	CB	S	I
SLOE	CB	S	G
ISL	M	M	M
USA	B/CB	S	I
J	M	M	M
AUS	BI	S	BI
CAN	BI	S	BI

Note: CB = central bank; BS = banking and securities brokers supervision; M = sector-wide single supervisory agency; B = specialised banking supervision; BI = integrated banking and insurance supervision; S = specialised supervision of securities brokers; I = special supervision of insurance; SI = integrated supervision of securities brokers and insurance, G = government department.

Source: Challenges to the Structure of Financial Supervision in the EU. Report of a CEPS Working Party, 2000.

role in supervision over the correct functioning of the system of payments and controlling the security of market infrastructures, which has a positive effect on the smooth course of monetary policy management. Central banks' access to confidential information of banking subjects is important also in the case of carrying out analyses aimed at identifying systemic risk. For a central bank confidential information on the financial situation of banks is essential in order to forestall moral hazard from the side of banks where the central bank fulfils its function as lender of last resort. Peck et al (1999) presented empirical evidence that confidential information on the financial situation of American banks enables more precise estimates of inflation and unemployment, thanks to which the central bank can implement a more appropriate monetary policy. It is arguable thereby that a central bank can gain the respective information directly from an independent supervi-

sory institution, if it requests this. The speed of delivery and quality of interpretation of this information can however be threatened, particularly in crisis situations.

From the aspect of owners (shareholders) in a bank the less the volume of capital invested by them in the bank subject to risk in the conduct of its business, the less their potential loss in the case of bankruptcy. Due to the leverage effect of outside sources however, possible profits may be very high (with the help of a leverage effect it is possible to transform an ROE of 2% into an ROA in the value of 100 to 200 per cent). Banks managed in a non-transparent manner thus have a tendency to retaining short-term liabilities (for example cheap primary deposits) and long-term assets (non-tradable and illiquid loans with a higher yield). If, for example, as a consequence of cyclical economic development loans stop being repaid, in such an unregulated structure of assets and liabilities bankruptcy will follow with financial consequences mainly for small depositors. Consequences can however have also a more extensive, systemic nature (threatening the stability of the whole economy in consequence of a disruption to confidence in the banking system as a whole). Banks also play an important role in implementing a central bank's monetary policy as a component of its transmission mechanism. The specific nature of the business of commercial banks in a system of fractional reserve banking and their "publicly beneficial" function confronts banks, but also the public with the existence of systemic risk². Through the necessity to forestall this risk in the interest of maintaining economic stability at an economically reasonable level of regulation of banking business is both excusable and rationally justifiable.

Also in countries where the functions of supervision are not assigned to central banks, central banks remain responsible for systemic stability. Despite this, independent supervisory agencies focus mainly on relations between a financial institution and its clients with the objective of protecting savers (these activities take up 70% of the working time of employees at the British supervisory agency the Financial Services Authority). According to Briault however it is not rational to divide the macro and micro aspects of supervision into two separate agencies, because an event and its consequences are closely connected and their subject is often the same.

Independence and professional scientific activity are significant activities, whereby central banks handle and through them can contribute to effective supervision. The

² It is difficult to decide, with the functioning of which financial institutions systemic risk is most frequently connected. Some authors are for "broad" systemic regulation, since a number of various firms may potentially cause a systemic breakdown. Or narrower range of firms falling under systemic regulation may seriously disrupt competitiveness in the financial services sector, because consumers may give preference to those firms in which their deposits are protected.



requirement to endue supervisory authorities with a satisfactory degree of independence in their activity is encoded in the fundamental principles of the effective performance of banking supervision prepared by the Basel Commission for banking supervision. This independence of central banks, which guarantees protection against political influence as well as in the conduct of banking supervision functions, contributes in large measure to preventing prior to excessive losses to society, which are a consequence of incompetence intervention in the conduct of supervision with the aim of satisfying individual political economic interests. Independence, however, in democratic conditions cannot exist without responsibility and does not mean a complete exclusion of government action in a crisis situation, for the resolution of which taxpayers' money is used. With this is connected one of the arguments for the removal of banking supervision competences from the central bank and their transfer to an independent supervisory institution: only the government, not the central bank, should be responsible for financial support to banks in distress. Recently the ability of central banks to carry out rescue operations has worsened, because the financial demands of these operations have exceeded the possibilities of central banks, or the private sector³ this is borne witness to by evidence from the beginning of the Nineties in Finland, Norway and Sweden, but also previously in Italy and France. The only alternative was to rely on taxpayers' funds, which leads to the requirement for political control over the functions of banking supervision⁴.

An argument in favour of the combination of banking supervision and central banking is generally a recognition of central banks as a source of quality research and analyses in the field of banking and the whole financial sector. Their active presence in financial markets of a given country provides them with a good picture of the functioning and structure of the domestic financial market.

Arguments in favour of a separation of banking supervision and central banking

The following arguments exist in favour of a shifting of competences in the field of banking supervision under an independent single institution of financial supervision other than the central bank:

³ Empirical evidence on the fact that if supervision is in the competence of the central bank private sources are more frequently used for the resolution of possible crises.

⁴ This requirement however may amount to little more than the avoidance of political responsibility. If politicians should have an influence in decisions on measures in the field of banking supervision, they should at the same time state explicitly (by statute) responsibility defined for losses caused by mistakes and shortcomings in the performance of banking supervision. The same responsibility should be brought also by employees (political) of independent bank supervision. (Author's note).

- a possible conflict of interests and moral hazard,
- the conglomeration of providers of financial services and a clouding of the functional divisions between individual financial products.
- the need to avoid a concentration of an excessive range of competences in central banks.

A conflict of interests between the performance of the functions of an implementer of monetary policy and concurrently the function of supervision over the banking sector can lead to a looser monetary policy than that which would be necessary for achieving price stability. Thereby an impulse is given to inflation growth only in order for the central bank to avoid a serious disruption to the financial health of a specific bank. The central bank can suffer a loss of confidence caused by mistakes in the performance of banking supervision, and which can threaten also the credibility of its monetary policy. The experience has however been that the empirical evidence does not support the mentioned theoretical arguments.

The essence of the argument that there exists the threat of moral hazard lies in the possibility that commercial banks will get into a situation of excessive risk in their investment activity. Banks count on the fact that in the case of a crisis the central bank, in order to avoid damaging its reputation and cover up possible mistakes in its performance of supervision will intervene in providing liquidity or through manipulation of interest rates. With this argument is closely connected also the fact that other banks can perceive the allocation of central bank funds under preferential conditions to a bank in trouble as a violation of the conditions of competition. A moderating counterpoint to these arguments may be that experience in the provision of emergency liquidity is that it has been provided against the collateral of a commercial bank at equitable (as well as punitive) interest rates.

In the case of candidate countries however the preceding two arguments are from the long-term point of view irrelevant, or their significance is lowered with regard to the potential lapsing of monetary-political functions of national central banks with their incorporation into euroland. Moreover the threat of moral hazard is much more likely to emerge in connection with the legislative and legal environment of the state (weak enforcement of lenders' rights, insufficient legal regulation and a willingness to avoid materials and criminal liability of shareholders and managers of banks for losses and damage caused through incompetent management, and poor legislation in the field of deposit protection).

An oft-stated argument in favour of the creation of a single institution of financial supervision with the incorporation of banking supervision competences the process of conglomeration in the financial services sector. As a consequence of financial innovations, technological development and market liberalisation the functional divisi-

ons between individual institutions in the financial sector is becoming blurred, there is occurring their conglomeration⁵, internationalisation and intensification of their mutual market competition. A result is new hybrids (more complex) financial products and new methods of distribution and sales connected with these. A single integrated supervision agency is in these conditions more effective in monitoring the wide range of risks connected with the business conduct of large financial groups, enabling a significant saving of expenses connected with regulation and supervision on both sides and the easier forestalling of unwanted duplications and overlapping of regulatory tasks.

Although many countries in the world are moving towards the creation of a single supervisory institution and other states are intensively preparing for this, the function of systemic supervision continues to remain under the management of central banks. It is thus apparent that the path to quality supervision and regulation is by way of one institution of an integrated and independent regulator. The last argument however clearly does not exclude the fact that this institution could not be also the central bank. Quite the opposite. Although it is not too common in the world, that central banks are responsible for first supervision and regulation of securities traders and insurance companies (table 2), some countries (Ireland, Singapore) given the specific nature of their legal and economic environment and the mentioned trend in financial business they have undertaken institutional and functional integration of regulation and supervision of their financial services sectors in their central banks. The argument against excessive concentration of competences in the hands of central bankers is connected with the possible violation of the basic principle of democratic control and balance, adherence to which should forestall the possible abuse of competences of public actors. In connection with this there is also the argument, according to which the more functions a central bank fulfils, the greater is its political pressure established, which can lead to an undermining of the independence of its monetary policy. It is precisely this independence that is in some instances interpreted as undemocratic.

The functional and personnel independence of the central bank in its performance of monetary policy, the effects of which have an impact on the whole population of a given state, nevertheless guarantees protection against decisions being influenced by political short-sightedness and thereby contributes to price stability, for which the central bank bears responsibility to parliament and thus indirectly to the whole population.

⁵ Financial conglomerates are a consequence of mergers and acquisitions, most frequently between banks and securities brokers and between banks and insurance companies. These are groups of firms inter-connected through their ownership and which conduct business in at least two main fields of the financial services sector.

Table 2: Supervision of Banks 1999 (data in %)

	Central Bank	Not Central Bank
Banks Only	51	6
Banks and Securities Brokers	6	5
Banks and Insurance Companies		
Companies	13	11
Banks, Insurance Companies and Securities Brokers	2	6
Total:	72	28

Sample size: 123 countries

Source: Consolidated Supervision In Theory and Practice. DAFFE/CMF, 2001.

Conclusion

Supervision and regulation of banking institutions contributes to ensuring stability in the financial sector regardless of who fulfils these functions. There exist many arguments for and against the merging of supervisory functions and the implementer of monetary policy in the central bank.

Although the manner of the institutional arrangement of supervision over the banking sector depends on the political, economic and cultural conditions of the given a state, through the trend there appear to be being built consolidated unified financial supervisory authorities on the basis of an objective- or risk-oriented approach. This trend of functional and institutional arrangement of financial supervision is a reflection of developments in financial markets and in the financial sector, where through the influence of market integration, financial innovations and technological progress there are occurring the processes of conglomeration and functional blurring of the differences between the various types of financial services.

The level of quality of financial or banking supervision among others given also by its institutional structure influences to a large extent the stability and efficiency of the financial (banking) sector, and thereby also the whole economy.

Sources used

1. The role of central banks in Prudential supervision, ECB, 2001.
2. Challenges to the structure of financial supervision in the EU. Report of a CES Working Party, 2000.
3. Consolidated supervision in theory and practice. DAFFE/CMF took, 2001.
4. BRIAULT, C.: The rationale for a single national financial services regulator, FSA Occasional Paper, 1999.
5. GOLIN, J.: The Bank Credit Analysis Handbook: a guide for analysts, bankers and investors. John Wiley & Sons (Asia) Pte Ltd., 2001.