



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Should Monetary Policy be Separated From Banking Supervision?

NOTE

Abstract

There was an international debate in the 1990s on the question of whether monetary policy should be separated from banking supervision. Most leading academics came down against separation the global financial crisis has swung matters decisively back in favour of central banks playing a key role in supervising banks. The arguments for separation put forward by European politicians citing conflicts of interest, reputational argument, economies of scope or the numbers of banks in the euro area are weak and ignore the many real benefits from the integration of monetary policy with banking supervision. The level of separation doesn't strike me as a source of concern but proposals for "Chinese walls" would be damaging.

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1. INTRODUCTION

The decision of the June summit of Euro area leaders to establish a "single supervisory mechanism involving the ECB" re-opened a debate about the appropriate role for central banks in banking supervision.

A number of senior European policy makers, in particular from Germany, have stressed that there is a conflict of interest between monetary policy and banking supervision. For example, on December 4, German finance minister Wolfgang Schäuble said "*Again and again, we have made clear that a Chinese wall between banking supervision and monetary policy is an absolute necessity.*"¹

The most detailed proposal for how a single supervisory mechanism would work, from the European Commission, appears to agree that this separation is an important principle.² While the Commission proposes that the ECB be given the task of supervising banks, it also proposes that "*Monetary policy tasks will be strictly separated from supervisory tasks to eliminate potential conflicts of interest between the objectives of monetary policy and prudential supervision.*"

Personally, I am quite surprised that this idea (that conflicts of interest require separating banking supervision and monetary policy) has been so widely accepted so quickly in the debate about how a European banking union might work. While it is true that there was an international debate about this issue during the 1990s and it's also true that a wide range of different models of banking supervision exist around the world, my sense of past debates on this topic was that the majority of informed opinion favoured the integration of monetary policy and banking supervision. Furthermore, I believe the global financial crisis has swung matters decisively back in favour of central banks playing a key role in supervising banks.

In this paper, I begin by outlining what I see as the numerous arguments in favour of a close involvement of central banks in banking supervision. Having done so, I address the arguments against this position and conclude that, by and large, the potential conflicts of interest that have been cited are minimal and that other arguments against a key role for central banks in banking supervision are weak. I conclude by briefly discussing the current state of play in relation to European banking union proposals.

2. ARGUMENTS FOR CENTRAL BANKS AS BANKING SUPERVISORS

This section sets out the arguments for why central banks should play a key role in banking supervision.

2.1 Reserve Requirement, Payments and Lender of Last Resort

It is worth remembering how central banks got their name. Long before monetary policy (as currently understood) was seen as their key task, central banks played a crucial role in the financial system through operating payments systems and preventing crises via lender of last resort facilities. These crucial roles usually required them to be centrally located in the banking district and to be kept well-informed about developments in the banking sector.

¹ See Reuters story here <http://www.reuters.com/article/2012/12/04/eu-banking-union-schaeuble-idUSB5E7LR01A20121204>

² See European Commission (2012).

A major element of the historical evolution of the major central banks was their gradual emergence as protectors of financial stability and lenders of last resort. The Bank of England's successes and failures in its role as the protector of financial stability lead to Walter Bagehot's (1873) famous *Lombard Street* and its still-relevant prescription to "lend freely against sound collateral at a high rate".³ After a long sequence of bank panics in the United States in the late 19th and early 20th centuries, the Federal Reserve System was also founded with the goal of keep the banking system stable.

Even during the decades of relative financial calm that followed the Second World War, central banks were still the best-placed institutions to monitor the stability of the banking system. While reserve requirements have generally declined in importance as a regulatory tool, the role that central banks played in implementing these requirements meant that they had access to balance sheet data, which could help with early detection of unusual behaviour at individual banks. Central banks also played a key role in the evolution of modern payments architecture as systems such as Fedwire and TARGET used reserve accounts to process payments between banks. This provided central banks with a further comparative advantage when dealing with problems that arose in the banking system.

However, what is odd about the recent insistence on separating banking supervision from monetary policy is that these arguments are being put forward during a period in which the role that central banks play as lender of last resort to the financial system has been more crucial than perhaps ever before in history.

Not that long ago, Charles Goodhart (2000) noted that most modern lender of last resort operations had involved central government providing funds directly to failing banks and argued that this provided a possible reason to separate central banks from banking supervision. The global crisis that began in late 2007 firmly reverses this argument. We know now that the modern financial system can go through systemic crises that are more severe than those seen in the past. An integral feature of the global financial crisis (and now the euro crisis) has been systemic "runs" on a wide range of financial institutions, leaving these organisations requiring large emergency injections of liquidity to avoid collapse.

Some of the institutions that required emergency liquidity during the various crises of recent years have subsequently required capital injections from central government but it is important to distinguish between the liquidity and solvency implications of a financial crisis. A systemic crisis generates a demand for enormous amounts of on-demand liquidity that are far larger in size than subsequent recapitalisation requirements after insolvent institutions are put through a resolution process. As Anil Kashyap (2010) emphasised in testimony to the US Congress, central banks are, by definition, the only institutions that can provide these large amounts of liquidity on demand and are thus the only credible lender of last resort.

Kashyap's testimony argued against removing the Fed from banking supervision using a helpful analogy:

"As the lender of last resort, you are never sure who is going to come through the door and ask for a date. When you meet your date on a Friday night and your date is AIG, the question at hand is whether you'd like to know something about them before you have to pay \$85 billion to buy them dinner. If we mandate that the Fed is not involved in supervision then we make hasty, uninformed decisions inevitable when it is called upon as a lender of last resort."

³ Andy Haldane's (2012) speech on the history of the Bank of England provides a nice summary of the Bank's history with lender of last resort operations.

The public interest is ill-served by a lender of last resort with limited first-hand supervisory experience because large bailouts can see risk creditors repaid in full before the authorities realise the extent of a solvency problem. The absence of access to both hard supervisory information and the soft knowledge built up by individual supervisors can make it difficult to stick to Bagehot's guidance that the lender of last resort should assist institutions that are illiquid rather than insolvent.

In theory, the problems associated with the lender of last resort not being involved in supervision can be solved via effective co-ordination between the various agencies involved. Experience during the financial crisis has generally suggested that co-ordination between agencies is less effective in reality than it is in theory. The co-ordination difficulties between the UK Treasury, the Financial Services Authority and the Bank of England in relation to Northern Rock in 2007 lead to slow decision-making that ended up producing a retail bank run that was damaging to the banking sector around the world. That the 1997 removal of banking supervision from the Bank of England is now being reversed is a telling sign that the "Chinese Walls" approach is increasingly viewed as a failure.

Finally, I should note that while a number of the euro area's national central banks are directly involved in banking supervision, there is little doubt that there is significant room for improvement. To paraphrase Professor Kashyap, if ECB ever has a date with a future version of Anglo Irish Bank and they want €35 billion, they really should be as well-informed as possible. Instead, the ECB Governing Council sanctioned providing Emergency Liquidity Assistance (ELA) to a bank that had a serious solvency problem of unknown size. Paying back this assistance is burdening Irish citizens with a debt worth 20 percent of their GDP.

This outcome partly reflected a reluctance of the Irish authorities to realise (or admit to) the full scale of the losses incurred by their banks. However, it also reflected an informal ECB policy of ensuring that all senior bank creditors were repaid, even if the ultimate burden ended up being passed on to the citizens of the bank's country of residence. The proposal for a single supervisory mechanism thus needs to be combined with enhanced bank resolution procedures and the end to the ELA issuance at the sole risk of taxpayers of the country of the issuing central bank. If the ECB Governing Council decides that the Eurosystem must act as a lender of last resort to a bank, then the risk associated with non-standard loans should be shared among all euro area member states, rather than falling only on the bank's local Member State. Perhaps if there had been an understanding that Anglo Irish's losses would be shared widely among the euro area's taxpayers, the Governing Council may have been less enthusiastic about the mis-use of its lender of last resort facility to prop up this bank.

2.2 Monetary Policy

Leaving aside lender of last resort tasks for a moment, the argument that monetary policy outcomes will be better if the central bank is separated from banking supervision runs counter to most of what we know about monetary policy affects the economy.

Monetary policy generally targets short-term money market interest rates and this requires monitoring of the short-run liquidity needs of banks. However, beyond this obvious linkage, the banking sector plays a crucial role in transmitting changes in monetary policy to the macro-economy. Relative to the total economy, very little money is borrowed in the Euribor or Federal Funds markets. The key interest rates that influence the economy are the rates at which households and businesses borrow to fund purchases of houses, consumer durables and business equipment and the institutions that determine these interest rates are banks. Indeed, banks play an even more crucial role in these areas in Europe than in the United States.

The idea that the health of the banking sector plays a key role in the transmission of monetary policy has become a standard part of macroeconomic theory and practice. Banks that are under-capitalised or facing liquidity funding pressures will seek to cut back on lending so banking sector problems tend to make credit expensive or difficult to access even if the central bank is targeting a low money market interest rate. For these reasons, central banks collect a range of hard and soft information on current bank lending conditions as well as future lending plans.

The most obvious external signs of this monitoring of lending conditions are surveys such as the ECB's Bank Lending Survey and the Fed's Senior Loan Officer Survey. However, there is evidence to suggest that more qualitative information obtained from the supervisory process is useful for monetary policy purposes. Federal Reserve economists Peek, Rosengren and Tootell (1999) showed that confidential information from supervisors can improve forecasts of inflation and unemployment. They argued that this information was actively used by members of the Federal Open Market Committee (FOMC) and that the information is best accessed directly by the central bank rather than indirectly through a separate regulator.

These arguments suggest that supervisory information is useful for monetary policy purposes even during normal business cycles. However, current conditions in the euro area are anything but normal. The crisis in the euro area has led to a breakdown in European interbank markets as well as the longer-term bank funding markets. This has left much of the banking system heavily dependent on the ECB for its funding.

The weakness in the banking system has led to fundamental change in how the ECB implements its monetary policy. Instead of auctioning off fixed amounts of credit, the Eurosystem now provides as much credit to banks as they request, provided they can pledge sufficient amounts of eligible collateral (and these collateral guidelines have been weakened). The amount of credit provided by the ECB to banking system has increased from below €200 billion in 2008 to well over €1 trillion. The terms of these loans have also changed fundamentally, going from predominantly short-term one-week loans to the current situation in which most of the credit stems from the three-year Long-Term Refinancing Operation (LTRO).

While this expansion in base money has yet to translate into a fast growth rate of broader measures of the money supply or into inflationary pressures, concerns that they could yet do so cannot be dismissed as irrelevant. So there is no point in pretending that monetary policy in the euro area is somehow separate from the problems associated with overseeing weak banks. At present, monetary policy and lender of last resort policy are essentially the *same thing* in the Eurosystem. And, as noted above, it is beneficial for lenders of last resort to have as much useful information as possible about the banks they are assisting.

2.3 Macro-Prudential Policies

One of the outcomes of the global financial crisis has been a widespread acceptance in policy and academic circles that policy makers of all kinds performed poorly in assessing the risks to the financial system building up during the years prior to 2007. The period since has seen a vigorous debate about the idea of "macro-prudential" regulation that looks beyond maintaining the soundness of individual financial institutions to focusing on safeguarding the financial system as a whole.⁴

As with most pieces of terminology, the origins of the term "macro-prudential policy" are a bit uncertain. However, I believe it was popularised by a speech in 2000 by Andrew

⁴ I have taken this definition from the excellent survey paper by Hanson, Kashyap and Stein (2011).

Crockett, then general manager of the Bank for International Settlements. An extensive quote outlining the differences between micro-prudential and macro-prudential policy is worth providing:

the macro-prudential paradigm stresses the possibility that actions that may seem desirable or reasonable from the perspective of individual institutions may result in unwelcome system outcomes. This is a logical contradiction in the micro-prudential vision as defined here.

Illustrations of such fallacies of composition are not hard to find. For instance, for a single bank it is only natural to tighten lending standards in a recession, but if all banks do the same the resulting impact on economic activity can lead to a further deterioration in the credit quality of its portfolio. The mirror image during the upswing could generate an unsustainable lending boom, sowing the seeds of subsequent financial instability. Likewise, cutting exposures as market prices fall can deepen the decline in those prices, leading to a drying up of liquidity and exacerbating financial distress. And similar mechanisms explain why the aggregation of short-maturity credits on a single counterparty might actually increase the risk profile of the individual exposures compared with portfolios with a longer maturity.

The quintessential micro-prudential dictum is that "financial stability is ensured as long as each and every institution is sound". From a macro-prudential perspective, two objections can be levied against this, on the surface, compelling statement. First, it may strive for too much; second, it may deliver too little.

It may strive for too much, because the occasional failure of individual institutions is not the problem. Trying to avoid such outcomes risks providing excessive protection, with the result that market disciplinary and allocative mechanisms are weakened.

The statement may deliver too little, because while at one level it is a truism, how the soundness of each individual institution is pursued is crucial. Unless the authorities take into account the impact of the collective behaviour of institutions on economic outcomes, they may fail to monitor risks and take remedial action appropriately.

One example of macro-prudential policies is the adjustment monetary policy rates in light of the risks in the financial risks but most of the tools that are considered appropriate involve banking regulation and supervision. For example, institutions that are obeying micro-prudential liquidity and solvency guidelines may still be asked to adjust the composition of their lending or their funding if a concentration of certain types of exposures becomes seen as a threat to the financial system.

It is, of course, possible that macro-prudential policy could be carried out by a committee that co-ordinates the "macro view" brought by the central bank with the "micro view" brought by banking supervisors. In practice, it seems likely that macro-prudential policies are designed to be implemented by a central bank with full access to supervisory information.

Again, the recent changes at the Bank of England provide a guide to how best practice is likely to evolve. In addition to having its bank supervisory powers restored, the Bank has introduced what Andy Haldane (2012) describes as "an entirely-new piece of policy machinery" -- the Financial Policy Committee or FPC. Haldane describes the FPC as follows:

It was put on earth to do macro-prudential policy, to act as the bridge, to provide the missing link, to monitor the punchbowl before it is emptied and before aspirin needs administering.

In considering their banking union proposals, euro area policy-makers should be wary that is important not to impede progress on macro-prudential policy making capacity.

3. ARGUMENTS AGAINST CENTRAL BANKS AS BANKING SUPERVISORS

Having set out what I see as the arguments in favour of central banks also playing the role of bank supervisors, I now discuss some of the arguments against this idea.

3.1 Conflicts of Interests?

The most commonly cited argument against central banks being bank supervisors, an argument apparently accepted by the European Commission (2012) is that there is a potential conflict of interest between the goals of monetary policy and banking supervision. Despite the frequency with which this argument is aired, I find it hard to see much merit in it as an argument for separation.

Banks tend to benefit from low short-term interest rates and an upward-sloping yield curve as it allows them to pay low short-term rates on liabilities and earn higher long-term rates on their assets. Thus, as documented by Goodhart (2000), the claim is often made that monetary policy decisions can be distorted by a central bank having close involvement with the banking sector because it sometimes leads to central banks setting low interest to assist weak banks.

A number of points are worth making about this as a potential conflict of interest.

First, the fact that central banks have been observed keeping policy rates low when banking sectors are weak does not mean there has been a conflict of interest. As noted above, a weak banking sector tends to increase the cost of credit to the private sector and to reduce the supply of such credit. A central bank focused on reaching a medium-term inflation target will have to take such weakness into account when setting monetary policy. Even if a central bank has no explicit supervisory role, it may react to banking weakness by adopting looser policy as well as specific measures aimed at combating weakness in the banking sector. So removing bank supervision from the central bank is unlikely to end the linkage between monetary policy and financial sector health that apparently bothers those who wish to see a separation. Conversely, access to the information obtained in the supervisory process can only help with calibrating monetary policy during periods of banking weakness.

Second, one can point to arguments against the common presumption that the involvement of central banks means a less stringent approach to banking supervision (and thus an increased risk of moral hazard). As Andrew Crockett outlined in his description of macro-prudential policy, a central bank that is monitoring the financial system during a lending boom should be able to detect weaknesses that may not be obvious to individual supervisors. When asset prices are high and default rates are low, standard supervisory diagnostics can suggest that all the institutions in the financial system are well capitalised. Indeed, as pointed out by Danielsson et al (2001), the reliance of the Basle capital adequacy regulations on credit agency ratings and on Value-at-risk calculations that use short samples introduces a procyclicality into risk-weighted capital ratios that can leave banks surprisingly short of capital when a boom turns into a recession.

An examination of the risks at a macroeconomic level can reveal fragilities not picked up by measuring the capital position of individual banks. While macro-prudential policies have not featured heavily in central bank thinking in the past, there are good reasons to hope that the involvement in banking supervision of central banks that have a wider view of the economy and the financial system will, in future, result in tighter supervision of banks during booms.

These arguments suggest that, rather than representing a conflict of interest, monetary policy and banking supervision are largely compatible tasks and that their joint execution

by a single agency can improve both monetary policy outcomes. Monetary policy is improved by access to supervisory data and the use of micro-prudential tools to prevent damaging financial crises. Bank supervision is improved by the use of aggregate data and macro-prudential analysis.

Still, let's assume that, on occasion, there is a conflict of interest between the goals of monetary policy and the supervisory goal of maintaining the long-run soundness of banks. How does separating the central bank from supervision solve this problem? Is having two different government agencies pursuing contradictory policies necessarily the best solution to this tension? Former Fed Vice-Chairman Alan Blinder argues that it is not:

what some people see as a worrisome conflict of interest between bank supervision and monetary policy might be viewed instead as the rational balancing of two competing objectives. If so, shouldn't a single agency do the balancing? And who can balance those competing objectives better than the central bank?

Economic policy formulation is undoubtedly a difficult business because various goals need to be balanced against each when taking policy decisions. However, separating off related areas of policy formulation into "silo organisations" that pursue their own goals independently is unlikely to provide the best outcome.

More recently, Bundesbank president, Jens Weidmann has discussed a slightly different version of the "conflicts of interest" idea. In a recent article in Handelsblatt, Weidmann (2012) asserts that supervision needs to be separated from monetary policy because otherwise a central bank could not "stand the heat" associated with debt crisis. Implicitly, it appears that Weidmann believes that an ECB tasked with supervising banks would be an ECB that fails to meet its inflation target.

I find this argument difficult to understand. The ECB has the maintenance of price stability as its primary objective. Despite its involvement in many other activities and despite the legal requirement to "support the general economic policies" of the EU (without prejudicing price stability) there has been no reason to question the ECB's commitment to price stability. It is hard to see why the addition of bank supervisory tasks would undermine this commitment.

3.2 Reputational Effects

An argument discussed by Goodhart (2000) and, more recently, by Eijffinger and Nijskens (2012) is that taking on banking supervisory tasks could damage the central bank's reputation for achieving its inflation goals. As Goodhart puts it

A supervisor is only noticed when either he/she angers the regulated by some restrictive or intrusive action, or when supervision 'fails' in the sense that a financial institution collapses or a customer gets ripped-off ... If an independent Central Bank feels the need to achieve credibility and a good reputation, then being yoked with simultaneous responsibility for banking supervision may not be advisable.

As best I can tell, this is a purely speculative argument. To my knowledge, nobody has pointed to a central bank that lost inflation-related credibility purely because of failures in relation to banking supervision and without a deterioration in inflation outcomes. Indeed, one can point in recent years to central banks such as the Federal Reserve that experienced serious supervisory failures without any noticeable impact on inflation expectations.

While people may not be the rational calculating machines that economic theory sometimes paints them as, it is hard to see why they would assume without good reason that a banking supervisory failure should automatically imply that a central bank can't meet its inflation target.

3.3 Accountability for Bank Supervisors

An argument that has been expressed in recent months for why the ECB should not be involved in banking supervision is that supervisors need to be accountable to politicians. This argument suggests that because bank failures can lead to losses for taxpayers via deposit insurance or recapitalisation requirements, there is a need for political oversight. In contrast, the ECB's monetary policy is legally independent of politicians. Taken together, these points could suggest that the ECB is not an appropriate body for taking on the task of bank supervision.

There are a number of problems with this argument. First, the fact that public money is at risk does not actually distinguish banking supervision from monetary policy. Money created by the Eurosystem in monetary policy operations could be used for other purposes, such as direct acquisition of securities and profits made by central banks are generally passed back to national treasuries. For this reason, one can just as easily argue that the ECB's monetary policy operations place large amounts of public money at risk and yet it is widely agreed that these operations should be free from political control.

Second, as former ECB Executive Board member Lorenzo Bini Smaghi discusses in a recent Financial Times article, political control over the bank supervisors can have negative consequences. As he puts it:

Bank supervisory authorities that are not sufficiently independent, and are too closely associated with the political authorities, are generally under pressure to delay the identification of insolvent banks, for the fear that taxpayers would get upset. The problem thus tends to be postponed, and the cost to the taxpayer rises. The experience of the recent crisis has shown that taxpayers have paid most in countries where supervision was less independent and where the political authorities are most closely associated with the banking system.

For these reasons, it is best to have limits placed on the involvement of politicians in overseeing bank supervisors.

Third, the type of oversight that is perhaps most desirable—the requirement that the heads of the supervisory authority are asked to appear in public and explain their performance to publicly-elected representatives—already exists for the ECB. Political independence is not the same thing as never having to explain your actions and Mario Draghi's press conferences and appearances at the ECON committee provide a clear model for how an ECB-centred banking supervisor could communicate its decisions to the public.

3.4 Economies of Scope

Another theme in this debate is the idea that the combination of banking supervision and monetary policy leads to an organisation that is simply too large to function effectively, i.e. that economies of scope dictate the need for separation.

This aspect of the debate about the appropriate structure for supervision goes back to regulatory changes that took place in the 1980s and 1990s. Deregulation around the world changed the nature of the leading financial institutions. Instead of clearly-defined separate industries dedicated to banking, insurance, asset management, equity issuance and so on, unitary financial institutions emerged that undertook all of these activities under one roof. This meant there would be multiple regulators examining different parts of a single institution's business, perhaps without any of them being able to step back and assess the institution's soundness as a whole or its impact on the financial system.

As Goodhart (2000) discusses in detail, these considerations lead to proposals for the introduction of supervisory organisations tasked with overseeing the whole financial system. Because many of the activities overseen by unified financial supervisors would lie outside the scope of traditional central bank activities, some argued that this provided a case for removing supervision from central banks. A unitary organisation that attempted to implement monetary policy, banking supervision, non-bank financial supervision and consumer protection and regulation could possibly be too large to function efficiently.

For a number of years, this argument gained traction around the world. As documented by Masciandaro and Quintyn (2009) the introduction of unified financial supervisors located outside central banks accelerated in the period prior to 2007. A number of Scandinavian countries lead the way in introducing these agencies in the 1980s but the UK's creation of the Financial Services Authority (FSA) in 1997 appears to have been particularly influential in triggering reform in supervisory structures around the world.

I believe this is an area where the global financial crisis has undermined the argument for a unified supervisor separate from the central bank. Many of the key problems that triggered the crisis were caused by institutions that technically were not banks. However, central banks ended up having to deal with the systemic risks posed by insurance companies such as AIG as well as various "shadow banks." Insurance-like financial products such as credit default swaps also turned out to play an important role in spreading the systemic risk associated with the sub-prime mortgage meltdown. Plagued by a patchwork regulatory framework, the Federal Reserve ended up having to bail out multiple institutions that it did not supervise (Fannie Mae, Freddie Mac, AIG and Bear Stearns). The re-integration of the FSA with the Bank of England reflects a tacit acceptance in the UK of the failure of the separation approach.

This is not to understate the organisational problems associated with housing monetary policy and supervision of the whole financial sector under one roof. Here again, the UK may be leading the way. The part of the FSA that is tasked with consumer protection is being kept as a separate body, the Financial Conduct Authority, separate from the Bank of England. Effectively, the UK is now implementing the "Twin Peaks" approach first suggested by Michael Taylor (1995).

While there are still formidable challenges in making a combined monetary policy/prudential regulation organisation work effectively, there are also a number of important synergies. In particular, as documented by Goodhart, Schoenmaker and Dasgupta (2001), central banks tend to have more economists and fewer lawyers involved in banking supervision. The involvement of economists that can take a macro-prudential view may help to avoid some of the failures associated with an excessively micro-prudential approach.

3.5 Too Many Banks?

The final argument for keeping the ECB out of bank supervision that has been raised over the past few months, most notably by German officials, relates to the practical implementation problems associated with the ECB taking over the supervision of about 6000 banks.

I believe these practical implementation difficulties are overstated. An analogy with the common monetary policy is relevant. One could argue that taking over running monetary policy operations supplying liquidity to 6,000 different banks and involving the work of tens of thousands of central bank staff would lead to severe implementation problems and require a huge centralised staff. In practice, most of the day-to-day work of the Eurosystem is still done in the national central banks and the ECB itself operates as a form of centralised secretariat rather than a huge bureaucracy.

In the same way, even if the ECB becomes the official supervisor of all euro area banks, the majority of day-to-day supervisory tasks would remain with local supervisors, with a much smaller number of head office staff at the ECB designing common policies, setting a common supervisory ethos and taking occasional decisions in relation to specific problem banks.

4. CURRENT PROPOSALS AND DISCUSSIONS

Having discussed the arguments for and against the desirability of separation of supervision from monetary policy, and come down firmly on the side of the undesirability of this separation, I am somewhat relieved to be able to say that the extent of the separation of these tasks envisaged in the European Commission proposals does not seem likely to cause serious problems.

The legal basis for the Commission's proposals is Article 127.6 of the European Treaty which allows the ECB to be conferred with tasks related to prudential supervision of credit institutions. For this reason, despite the Commission document's discussion of the need for separation of monetary policy and banking supervision, in practice the proposals do not seem likely to generate a dangerous disconnect between these two areas of public policy.

Specifically, the proposal for separation is as follows:

To implement the necessary separation between both tasks and ensure appropriate attention to supervisory tasks, the ECB will ensure that all preparatory and executing activities within the ECB will be carried out by bodies and administrative divisions separated from those responsible for monetary policy. To this end a supervisory board will be set up that will prepare decisions on supervisory matters. The Governing Council will be ultimately responsible for taking decisions but may decide to delegate certain tasks or decision-making power to the supervisory board. The supervisory board will be led by a Chair and a Vice-Chair elected by the ECB Governing Council and composed in addition to them of four representatives of the ECB and of one representative of each national central banks or other national competent authority.

On balance, this level of separation doesn't strike me as a source of concern. The ECB Governing Council is a very high level organisation that can only devote so much time to individual policy issues. The Commission's proposal should still allow the Governing Council to appoint enough representatives on the advising supervisory board to allow the Council to be well-informed about important supervisory issues. Furthermore, it keeps the Council as the ultimate responsible body.

Unfortunately, the current debate on banking union is not about adapting the Commission's plans. The rhetoric of senior policy makers from Germany and other countries about "Chinese walls" seems to suggest a far more serious separation of monetary policy and banking supervision is being sought.

In addition to being sub-optimal in many important ways, it is unclear what the legal basis would be for a new single supervisory mechanism not based at the ECB. The European Treaty clearly allows for banking supervisory tasks to be transferred to the ECB (though not insurance supervision). Establishing a separate supervisory institution would probably require treaty change, which could take years to be ratified. The fact that this delay would perhaps suit some of those advocating "Chinese walls" is worth keeping in mind.

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