Synergies and separation ï Monetary policy and banking supervision at the ECB

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Views expressed are not necessarily reflecting those of the ECB

Introduction

- **Monetary policy and supervisory objectives are interdependent**
- **Monetary/price stability and financial stability go hand in hand:**
  - sound banks/counterparties
  - functioning (funding) markets,
  - healthy financial system overall,
  - appropriate level of regulation, etc.
- **é but there may also be potential conflicts, e.g. when**
  - Monetary policy tightening (e.g. interest rate decisions/exit from non-standard measures) may push ailing bank(s) over the edge
  - Supervisory intervention may trigger negative market reactions and pro-cyclical spirals, which affect the monetary policy transmission channel
  - The monetary policy side may want banks to lend more (but is constrained by ZLB to loosen monetary policy), while supervision may want to discourage new risk taking
  - New regulation may negatively impact monetary policy implementation
- **Therefore, the question is whether both functions should be combined in one institution and which institutional design can maximize net benefits.**

Overview

Sharing of information between functions yields important benefits (1)

- **Disaggregated bank data improve monetary policy**
  - Disaggregated bank data **improve insight in the state of the economy and the transmission mechanism**
    - Almost 2/3 of euro area NFC assets are financed by bank loans.
    - Supervisory data increase breadth, depth and granularity of information about the functioning of the banking sector and its capacity to extend credit
    - Permits a better assessment of macroeconomic state and can improve forecasts
  - Enhances the **design of (non-standard) monetary policy measures**
- **Access to timely and detailed information on banks can be critical during a financial crisis**

Sharing of information between functions yields important benefits (2)

- **Disaggregated bank data reduces risks in monetary policy implementation**
  - better monitoring of **financial soundness** of counterparties
    - Protects the central bank’s balance sheet and indirectly safeguards central bank’s independence
    - In addition, good supervision as such is in the interest of a central bank as it mitigates counterparty risk
  - identifying “**close links**” reduces risk of accepting inadequate collateral

Synergies benefitting the supervisor

- **Central bank market operations information improves supervision**
  - High frequency bank-specific data on recourse to monetary policy operations, bidding behaviour and collateral provide **early stress signals for supervisor**
  - **Market intelligence** provides early information on financial innovations and market developments, which are important for the supervisor's comprehensive risk assessment.
- **The macroeconomic approach of monetary policy analysis can complement the focus on individual institutions in supervision**

Overview

Joint responsibility for monetary policy and supervision may lead to conflict of interest

1. **central bank may postpone monetary policy tightening to protect ailing banks**
   - Å A central bank may postpone tightening of monetary policy/exit from non-standard measures as it could push ailing banks over the edge
   - Å Leading potentially to an inflationary bias, excessive risk taking by banks and financial stability risks.
   - Å In case of supervisory failures, there could be an incentive to continue lending and forbear resolution in order to avoid exposure

2. **supervisor may postpone intervention as it may counteract the monetary policy stance, leading to supervisory forbearance**

3. **diverging views may lead to too late and too little regulation**
   - Å New regulation may negatively impact monetary policy implementation

Academic research in this area is sparse and inconclusive

Overview

Academic research on the topic (1)

Goodhard (2000) ñThe organisational Structure of Banking Supervisionò

Å ñInternalisation of supervisory concerns may lead to worse, wrong, monetary decisions. This is an argument that gets quite a lot of air-time from some economists, but not one that I find appealing. é ò

Å ñThe claim has been made that this conflict becomes particularly apparent in periods that require more restrictive monetary policy but when large banks are undercapitalized and weak. It is argued that the Federal Reserve unduly delayed tightening for this reason.ò

Å ñThe historical evidence instead suggests that periods of financial instability, and of major, continuing failures among banks are those where monetary policy has been too tight, e.g. Japan since 1991, USA between 1930 and 1939. Declines in the monetary aggregates occur at times of bank failures. Per contra, rapid credit expansion is simultaneously a danger signal for macro-monetary policy and for supervisory concern at the micro-level of the individual bank. It would seem to be natural for the micro concerns of supervisors and the macro concerns of the monetary authorities to reflect and complement each other, rather than conflict.ò

Academic research on the topic (2)

Beck and Gros (2012), ñMonetary policy and banking supervision: Coordination instead of separationò

Å ñCombining prudential supervision and monetary policy could result in an excessively loose monetary policy, since the central bank might want to avoid the adverse effects on bank earnings and credit quality é . In the current crisis, one could argue that the ECB might not necessarily be a tougher supervisor than national authorities. It might actually be more lenient, as it is concerned about contagion across the Eurozone and because it has more resources available since it is also the lender-of-last-resorté On the other hand, it is not clear whether monetary and financial stability policies conflict with each other with the rise of macro-prudential regulation as an additional policy tool.ò

⇒ **As monetary and financial stability are complements, coordinated actions achieve better results than uncoordinated ones by separate institutions**

Å If monetary policy and supervision have *independent* instruments, both objectives of price and financial stability can be achieved (Tinbergen principle)

Institutional setup in other major central banks

Key common features

Å Interaction **Monetary Policy ï Prudential Supervision:**

  Å Structural separation

  Å Policies and actions under one function take due consideration of policies and actions under the other

  Å Strong channels of communication between policy functions

  Å Need for closer integration at crisis times

  Å Supervisory information: separation principle and ñneed to knowò rule

Å **Examples: Bank of England and US Federal Reserve**

Monetary policy and banking supervision under one roof: Assessment

	US Federal Reserve
Mandate	Price stability, employment, financial stability, banking supervision, regulation
Organisational structure	Board of Governors; FOMC; Supervision decentralised: Large Institution Supervision Coordinating Committee (LISCC), Banking Supervision Regulation Group, Federal Reserve District Banks
Policy making	Federal Open Market Committee; Board ï supervision and regulation (segment of) banking industry; structural separation in reporting lines Joint decisions and more integration at crisis times
Policy Preparation	Strong channels of communication - monetary and prudential policy functions ìNeed to knowò principles governing information sharing
	Analysis ï Fed and FDIC (public) statistics and banking data ï harmonised supervisory information on individual basis Central bank liquidity provision ï Supervisory ratings are input to determination of financially sound banks (primary and secondary credit) Analytical input to micro-supervisory stress tests and capital planning

Monetary policy and banking supervision under one roof: Assessment

	Bank of England
Mandate	Primary: monetary stability, financial stability; secondary: growth employment
Organisational structure	Monetary Policy Committee (MPC) charged with monetary policy decision making; Twin Peaks model for supervision Prud. Reg. Authority (PRA) and Fin. Conduct Auth. (FCA); Financial Policy Committee (FPC) oversees PRA-FCA
Policy making	Separate reporting lines <u>but well integrated</u>: MPC-FPC structurally <u>separated but significant overlap in membership</u>
Policy preparation	Strong channels of communication - monetary and prudential policy functions Strong macro- micro-prudential policy interaction
	Analysis ï Financial stability analysis on individual bank data to a large extent based on banksô financial reports (for transparency, comparability) Policy communication ï FPC core indicator tables (to guide market expectations) on publicly available data for greater transparency

Historically: central banksô supervisory responsibility typically starts/expands after major banking crises:

- **Bank of England**: failure of Overend and Gurney Bank (1866) forced BoE to intervene with £4mn in ñCityò banks to contain acute market panic; subsequently, BoE started ordering solvency assessments for individual banks
- Banking supervision was separated from BoE and transferred to the FSA in 1997 and re-integrated with the BoE in 2013, in response to the financial crisis.
- **Federal Reserve**: establishment of Federal Reserve (in 1913) in response to 1907 bank panic episode (Knickerbocker Crisis); Federal Reserve Act (section 21) subjects banks to examinations of their safety and soundness

Main rationale for micro-prudential supervision at CBs

- **Monitor** expansion of credit in market based financial system
- **Prevent** situations in which CBs have to act as ñlender of last resortò
- **Control** central banksô balance sheet risk (in normal operations but also when CBs act as ñlender of last resortò)

Monetary policy and banking supervision under one roof: Assessment

Summary

Interaction	Policy-making	Policy-preparation
Monetary vs. micro-prudential policy	Suboptimal outcomes *if* concern for individual institutions lead to accommodating monetary policy	Synergies at policy preparation level
	Suboptimal outcomes *if* concern for monetary policy stance postpone supervisory actions	
	Suboptimal outcomes *if* policies are pursued without taking into account interdependencies	
	⇒ Independent instruments to pursue different objectives should be available ⇒ Manage potential conflicts by institutional design	⇒ Exchange of info/expertise yields very significant benefits, in particular during a crisis and in a predominantly bank-financed economy.

Monetary policy and banking supervision under one roof: Assessment

Managing conflicts of interest is a challenge in *any* institution

Tools include:

- Clear statement of **objectives**
- Clear **mandates** to organisational substructures
- **Decision making process** based on clear processes and objectives, full ownership of decisions
- **Transparency** through adequately designed information systems and documentation/records management
- Specific **governance** features (e.g. audit function, adequate segregation of functions such as market operations and risk management)

Overview

Institutional design of the ECB: separation principle

Legal basis: ‘SSM regulation’ (Council Regulation (EU) No 1024/2013)

Separation of Objectives

Article 25.1: The ñ*ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks*.ò

Separation of Tasks

Article 25.2: SSM-related tasks ñ*shall neither interfere with, nor be determined by, its tasks relating to monetary policy*ò or ñ*with its tasks in relation to the ESRB*ò

Organisational Separation

- **Article 25.2:** Staff ñ*organisationally separated from, and subject to, separate reporting lines*ò
- **Article 26**: ñ*The planning and execution of the tasks conferred on the ECB shall be fully undertaken by [é]Supervisory Board*ò
- **Article 29.1** ñ*Expenditure [é] separately identifiable within the budget of the ECB*ò

Procedural Separation

- **Article 25.4**: ñ*ensure that the operation of the Governing Council is completely differentiated as regards monetary and supervisory functions. Such differentiation shall include strictly separated meetings and agendas*ò

Internal Rules

- **Article 25.3**: ñ*Adopt and publish any necessary internal rules, including rules regarding professional secrecy and information exchanges between the two functional areas*ò

Conflict Resolution

- **Article 25.5**: ñMediation Panel *[é] to resolve differences of views expressed by the competent authorities [é] regarding an objection of the Governing Council to a draft decision by the Supervisory Board*ò

Legal basis: Separation principle/internal rules (1)

(Decision ECB/2014/39)

Article 6 (excerpt): Exchange of confidential information between policy functions:

The ECB's policy functions shall not disclose confidential information containing assessments or policy recommendations to the respective other policy function, except upon request **on a need to know basis**, and **ensuring that each policy function is exercised in accordance with the applicable objectives**, and where such disclosure has been **expressly authorised by the Executive Board**.

The ECB's policy functions may disclose confidential **aggregated** information containing neither individual banking information nor policy-sensitive information related to the preparation of decisions to the respective other policy function upon request on a need to know basis, and ensuring that each policy function is exercised in accordance with the applicable objectives.

Legal basis: Separation principle/internal rules (1)

(Decision ECB/2014/39)

Article 8 (excerpt): Exchange of confidential information in emergency situations:

Notwithstanding Article 6, in an **emergency situation** as defined in Article 114 of Directive 2013/36/EU, the ECBôs policy functions shall communicate, **without delay**, confidential information to the respective other policy function of the ECB, where that information is relevant for the exercise of its tasks in respect of the particular emergency at hand.

Legal basis and governance: Governance of SSM