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The ECB's role in financial supervision

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The ECB's Role in Financial Supervision

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The ECB's Role in Financial Supervision¹

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Abstract: The European Council's decisions to implement the De Larosiere recommendations for a reformed approach to micro-level financial supervision and a new European Systemic Risk Board (ESRB) are to be welcomed. The ECB's central role in the ESRB is also to be welcomed. However, the limited role envisaged for the ESRB means that it may not actually help much in preventing future crises. The ESRB should be given a central role in the implementation of counter-cyclical capital ratios and in promoting (and then overseeing implementation of) other changes such as maximum leverage ratios and limits on non-core funding.

¹ This is a briefing paper delivered by the author in his role as a member of an Expert Panel of advisors to the European Parliament's Committee on Economic and Monetary Affairs in relation to its Monetary Dialogue with the European Central Bank.

1. The EU COUNCIL'S RECOMMENDATIONS

The Council of the European Union has agreed with the recommendations of the De Larosiere report that Europe's financial regulatory framework should be enhanced by the establishment of a new macro-prudential body (the European Systemic Risk Board) and by the establishment of a new European System of Financial Supervisors which will be enhanced and better resourced versions of the existing Level 3 Committees.

The Council's recommendations envisage a central role for the ECB in the new Systemic Risk Board, with the President of the ECB chairing the Board and ECB staff providing the analytical and logistical support. In contrast, no direct role is envisaged for the ECB in the new micro-prudential structures.

While I am happy to endorse the recommended role of the ECB in the proposed Systemic Risk Board, and will discuss the issue of macro-prudential regulation in further detail below, I have more mixed attitude in relation to its exclusion from the new micro-prudential system.

Moreover, I suspect that expectations for the new macro-prudential body may be too high. Analysis of various past Financial Stability reports suggests that the type of macro-prudential analysis envisaged for the ESRB may do little to prevent the recurrence of financial crises. A more fruitful approach may be to augment the new institutional structures with clear and transparent financial regulations aimed at making the system more robust.

2. The ECB and Micro-Prudential Supervision

2.1 Central Banking and Micro-Supervision: General Considerations

Section 171 of the De Larosiere report lists various arguments for excluding the ECB from a formal role in micro-prudential supervision. The first argument listed is that the addition of micro-supervisory duties may impinge on the ECB's fundamental mandate for price stability. I do not agree with this argument. In contrast, I would agree with the assessment of Guillermo de la Dehesa (2009) that the current financial crisis has provided a lot of reasons to favour a regulatory structure in which the monetary policy and financial supervision are undertaken under the same roof.

There are a number of reasons to favour an integrated approach to monetary policy and financial supervision. Firstly, given the crucial role that financial institutions play in the macroeconomy, it is essential that central banks have as much information as possible about the health of these institutions as well as any potential frailties and instabilities. Such information---which can be provided as a natural byproduct of the central bank taking a lead role in financial supervision---should *enhance* rather than weaken a central bank's performance in relation to monitoring the economy and implementing its mandate for price stability.

Secondly, the current crisis has established again the crucial role that central banks play in maintaining financial stability via their role as lender of last resort. The integration of central banking with financial supervision allows

for interventions to provide assistance to troubled financial institutions to be done in as efficient a manner as possible. In contrast, examples such as the Northern Rock situation have shown how the separation of central bank and supervisory powers can lead to slow and overly bureaucratic responses to crisis situations.

2.2 The ECB and Micro-Prudential Supervision

Of course, these are general considerations. In reality, any recommendation for a role for the ECB in relation to prudential supervision must start from the current institutional setup and these realities argue against introducing a direct role for the ECB at this point for a couple of reasons.

First, there is the fact that current supervisory frameworks vary significantly across the Eurosystem, with some countries adopting the traditional integrated model, while others using independent financial regulators. Without an involvement of all of its constituent central banks in micro-prudential supervision, it is hard to countenance a direct role for the ECB in this process.

Second, there is the question of the fiscal costs associated with financial crisis. The crisis has demonstrated that the European Union's current agreed procedures for dealing with financial crises (as outlined in the Memorandum of Understanding) are completely inadequate. The result has been a sequence of ad hoc interventions, the scale and nature of which have varied widely across countries, with governments directing their fiscal support

almost completely on their own domestic banks. These interventions have set a series of very dangerous precedents and taxpayers across Europe are now aware that they are likely to suffer the costs associated with failures of their domestic banks.

Against this background, it is hard to see how the European Central Bank can have the *moral* authority to play a lead role in micro-prudential supervision. With national governments “on the hook” for the fiscal costs associated with financial failures, it is hard to see how they can be asked to give up national control of supervision. In addition, states that have adopted a more aggressive approach to assisting troubled financial institutions may wish to impose a more restrictive regulatory framework in the future.

The De Larosiere report recommends that some progress be made in dealing with the current patchwork of financial regulatory frameworks. The report (and the EU Council’s recent statement) suggests that the Commission and the level 3 committees should work to establish a core set of financial rules, eliminating unnecessary diversity in areas such as definitions of regulatory capital and accounting practices. The report also recommends the establishment of “a coherent and workable regulatory framework for crisis management in the EU.”

These recommendations are to be supported but, to my mind, they do not go far enough. I would rather view them as first steps towards a more comprehensive restructuring of financial regulation in the Euro Area. This restructuring would see all Eurosystem National Central Banks take over financial supervision. This system could then lead to a more direct role for

the ECB in micro-prudential supervision. For instance, supervision of all financial institutions over a certain size could be required to have ECB involvement.

In addition, I would like to see any common framework for crisis management go beyond the commonly-discussed issues relating to resolving issues relating to cross-border financial institutions to also providing explicit limits on the various types of financial supports (liquidity supports, asset support programs) that can be provided. This would fit well with a common central-bank-focused approach to dealing with financial crises.

3. Macro-Prudential policy

The EU Council has recommended setting up a European Systemic Risk Board (ESRB) chaired by the President of the ECB, supported by staff from the ECB, and with a steering committee and board featuring chairs of the new European Supervisory authorities, the 27 EU Central Bank Governors and a representative of the European Commission.

The ESRB will be charged with analysing “all the information relevant for identifying, monitoring and assessing potential threats and risks to financial stability in the EU that arise from macro-economic developments and developments within the financial system as a whole” and to issue risk warnings and recommendations on measures to deal with these risks.

I agree with the suggestion to set up an ESRB and to give the ECB a central role in it. I worked for five years (from 2002 to 2007) as an economist at the

Irish Central Bank and visited the ECB many times. The ECB's economics staff is undoubtedly the finest collection of economic and financial talent in Europe and I have always been impressed by their work ethic and dedication to public service. The reports and recommendations of the ESRB will undoubtedly become an important input into policy formulation for central banks and financial supervisors throughout Europe.

That said, I think the vision of the ESRB set out in the EU Council's statement of 10 June 2009 and in the De Larosiere report is disappointingly limited and, as such, the new Board is unlikely to be as effective in preventing future crises as it could be.

3.1 Previous Macro-Prudential Analysis

The ESRB's role will be to undertake macro-prudential analysis. This involves going beyond micro-level examinations of whether individual financial institutions are in good financial shape and complying with regulations to examining the financial system as a whole and whether the interconnections between its various components can lead to macro-level instability.

It is hardly surprising that the recent financial crisis has led many to believe that there should be an increased focus on macro-prudential analysis and this is hard to disagree with. However, it would be wrong to argue that such analysis had not been undertaken prior to the crisis. In fact, the ECB, the IMF and many individual country central banks regularly produce macro-

prudential analyses in the form of Financial Stability reports. As such, it is instructive to take a look at some of the Financial Stability reports released prior to the onset of the recent crisis.

As a first example, consider the following statement from the overview of the June 2007 edition of the ECB's Financial Stability Review²

In late February and early March 2007, against a background of rising delinquencies in the US sub-prime mortgage market and increasing uncertainty about the US macroeconomic outlook, equity prices fell, credit spreads widened and market volatility rose across a host of asset classes – including foreign exchange markets, where some carry trades were unwound. Improvements in the risk management practices of financial firms appear to have contributed to ensuring that higher financial market volatility did not prevent capital markets from facilitating the intermediation of capital.

It concluded that

With the euro area financial system in a generally healthy condition and the economic outlook remaining favourable, the most likely prospect is that financial system stability will be maintained in the period ahead.

In other words, just two months before the global financial system began to fall apart---and much of the early action revolved around European banks---the ECB's financial stability analysts concluded that the system was in a

² Available online at <http://www.ecb.int/pub/pdf/other/financialstabilityreview200706en.pdf>

healthy condition and that banks had improved their “risk management practices.” These same practices are, of course, today viewed as hopelessly flawed.

The ECB Financial Stability Review is a document prepared with the close involvement of the Banking Supervision Committee and is thus likely to be similar in style to the documents that will be produced by the ESRB. If these analysts could not see the last crisis coming, it is legitimate to question whether they will get it right the next time.

The ECB team were by no means on their own. Consider the following statement from the IMF’s *Global Financial Stability Report* of April 2006:

There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient. The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently, the commercial banks may be less vulnerable today to credit or economic shocks.

In other words, just a little more than a year before the onset of a global financial crisis triggered largely by securitisation and structured finance, the IMF’s analysts believed that these instruments made the global financial system less vulnerable to instability.

My point here is not to criticise those involved in preparing these reports or to argue that better analysis would have seen the full dangers associated with structured finance. In fact, I would argue quite the opposite. Both the ECB's Financial Stability Review and the IMF's Global Financial Stability Report are excellent publications, full of hugely informative analysis, and the staff that produce them are to be commended.

Rather, my point is to flag that even the smartest analysts may fail to see underlying sources of systemic risk before it is too late. If the highly trained staff of the ECB and the IMF failed to see that the world financial system was on the brink of extreme instability in 2007, how can we be so confident that they will correctly call the next major event?

One possible answer is to equip the new ESRB with more resources. This is a good idea but it is by no means certain to produce much better outcomes. Unfortunately, the poor risk assessments prior to the recent crisis are not just random examples but illustrate the general difficulties associated with financial stability analysis. Most of the time, thankfully, the financial system is stable. As such, it is particularly difficult to examine the system at such a time of stability and make the correct call about a particular aspect of the system that is likely to trigger instability at some point in the near future.

Moreover, Financial Stability practitioners are well aware that their business can lead them to be seen as "Boys who cry Wolf." The ESRB will undoubtedly be conscious of the damage that could be done to its reputation if it repeatedly issues warnings about instabilities that then don't arise.

To sum up on this issue, while I welcome the establishment of the European Systemic Risk Board, and the ECB's role in it, I fear that its envisaged role--which principally involves issuing warnings---is unlikely to help much in preventing future crises. In the rest of the paper I propose some additional measures which can be taken by European authorities, either via the ESRB or in addition to it.

3.2 The ESRB and Counter-Cyclical Capital Buffers

It is now widely agreed that requirements for counter-cyclical capital buffers should be adopted: Both the De Larosiere and Turner reports come out in favour of this approach. The idea behind this recommendation is that banks should be forced to use good times to build up capital reserves and to allow banks to fall back to lower levels of capital during recessions.

A similar idea that is being widely discussed is dynamic provisioning: This sees banks set aside larger provisions for bad loans during good times than are warranted by prevailing rate of loan losses and to run down these provisions during recessions. These suggestions are designed to prevent the problem of banks running into solvency problems during recessions, leading to credit crunches and interventions paid for by taxpayers.

I recommend that beyond issuing analyses and warnings, the new ESRB become directly involved in achieving the implementation of counter-cyclical capital requirements throughout the EU. This would be a challenging task, involving getting agreement on this point from all the

relevant supervisors, establishing a harmonised methodology to estimate were each economy stood in relation to its business cycle and deciding the extent to which capital buffers should fluctuate over time.

By co-ordinating the implementation of this important measure, the ESRB may do more to contribute to financial stability than could be achieved by any number of reports.

4. Beyond Committees: What Else is Needed?

One lesson that we can take from this and previous financial crises is that it is hard for regulators to design sophisticated regulatory frameworks that keep up with a banking industry that is constantly being transformed by financial innovation. Of course, many lessons have been learned about the risks associated with specific new products, risk management techniques and business models and we are clearly already on the road to a Basle 3 that will attempt to deal with these.

However, I think there is now a strong argument for accepting that ever more sophisticated financial regulation is not likely to deliver improved financial stability, or at least that it cannot do so on its own.

I recommend that the new ESRB should become a focal point for the discussion (and hopefully implementation) of a range of policy options aimed at making the financial system fundamentally more robust. Some of the options that I would recommend include two that have been proposed by Lord Turner in his superb review document of March 2009:

1. *A Maximum Gross Leverage Ratio*: One of the main reasons financial instabilities went undiagnosed in the recent crisis was that the Basle procedures allowed risky products to be classified as though they were safe. Thus, many institutions that ran into trouble had massively expanded their balance sheets and become highly leveraged, while at the same time maintaining their risk-weighted capital ratios. Because risk-weighting will never be a perfect tool, Turner recommends a gross maximum leverage ratio as a “backstop” to the Basle system. Canada, which has survived the financial crisis better than most, imposes a maximum leverage ratio of 20. This would have to be imposed in conjunction with a greater regulatory effort to minimise off-balance sheet activities driven by regulatory avoidance.
2. *A Minimum Core Funding Ratio*: Throughout the crisis, various banks got into trouble because of their reliance on sources of funding that quickly disappeared once market sentiment turned against them. Turner recommends a minimum limited ratio of “core funding” defined as deposits plus certain types of longer funding.

Three other potential suggestions that I would put forward for consideration are:

1. *Limits on Credit Growth*: Setting limits on how fast individual firms can expand their credit, with limits getting smaller as banks increase in size, is one way to limit the problems associated with irresponsible lending that may not be caught by supervisors.

2. *Increasing Capital Requirements with Size*: The too-big-to-fail problem is a difficult one to deal with directly but we can at least establish that large institutions (which are more likely to end up being rescued by the state if they fail) be required to hold higher capital levels.

3. *Credit Concentration Rules*: Basle 2 requires that, as part of the Pillar 2 supervisory process, supervisors assess whether banks have excess concentrations in particular areas, leading to large amounts of highly correlated risks. Example such as the huge exposure to property lending of the Irish banks, which then needed to be rescued by the Irish government, show that it may be helpful to outline specific quantitative rules in this area.

Perhaps some of these suggestions have a bit too much of the “sledgehammer” about them. However, they all seem to be worth discussing and potentially implementing in some form. Without a body such as the European Systemic Risk Board to analyse these proposals and then get them implemented, they seem likely to remain talking points rather than reality.

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