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ECONOMIC AND MONETARY AFFAIRS

Adjustments to the Accountability and Transparency of the European Central Bank

NOTE

Abstract

The new structure of European financial supervision will require adjustments to the accountability and transparency of the ECB. We would advise to establish a Financial Dialogue with the President of the ESRB/ECB for discussing macro-prudential supervision in the EU on a bi-annual basis after the publication of the *Financial Stability Review*. In conjunction with this a Financial Dialogue could be established with the Chairs of CEBS, CEIOPS and CESR to discuss micro-prudential supervision in the EU on a bi-annual basis.

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AUTHOR

Prof. Sylvester Eijffinger
CentER and European Banking Center, Tilburg University and CEPR

RESPONSIBLE ADMINISTRATOR

Arttu MAKIPAA
Policy Department Economic and Scientific Policies
European Parliament
B-1047 Brussels
E-mail: arttu.makipaa@europarl.europa.eu

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ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to: poldep-esc@europarl.europa.eu

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DISCLAIMER

1. INTRODUCTION

It is a widely acknowledged fact that central banking should not be subject to "political business cycles". Consequently, in the last decades, it has become an integral part of modern central banking policy that full operational (or functional) independence of central banks is a welfare-enhancing quality. However, given such a degree of independence, the objectives of the central bank should be clearly defined from the outset, the bank should be accountable for its actions and the public should have a solid trust in the actions taken by it. The ongoing crisis may well have made central banking in general more complicated. Specifically, with the European Central Bank (ECB) probably about to gain more powers in financial supervision (see e.g. discussions on a European Systemic Risk Board), ECB objectives may in the future no longer be as clear and monothematic as the under pre-crisis conditions of "simply and only price-stability". The ECB has little formal procedures of accountability to the European Parliament or to anyone else. Is the present setting of accountability that has evolved over the last few years a sufficient condition for accountability also after current events and prospective changes to the ECB's tasks? Recently in March 2009, the European Parliament (EP) commissioned a study on "Accountability and Transparency in Central Banking", written by Paul de Grauwe and Daniel Gros. The authors propose, inter alia, that the ECB formally and practically differentiate in its policy and objectives between normal and crisis times, and they also propose some changes to the accountability of the ECB and its relation with the EP. First, we will review financial supervision in the United States and the United Kingdom. Second, we will discuss financial supervision in the euro area and the European Union (EU). Third, we will evaluate the new structure of European financial supervision and whether it will really work. Finally, we conclude on adjustments to the accountability and transparency of the ECB with respect to financial supervision, in particular regarding macro-prudential supervision.

2. FINANCIAL SUPERVISION IN THE UNITED STATES AND THE UNITED KINGDOM[1]

The US government now envisages another role for the Federal Reserve System (Fed). To protect financial stability, the latter will primarily focus on macro-prudential supervision of financial institutions (banks, insurance companies, hedge funds and investment funds), while detailed supervision of solvency (micro-prudential supervision) will be assigned to a new authority that takes over the tasks of the various current supervisors. The envisaged design of the US system resembles that of the Dutch model in which the Authority Financial Markets (AFM) and the DNB are jointly responsible for supervision of the solvency of financial institutions. The model with two separate supervisors is sometimes called the 'twin peaks' model. Kremers and Schoenmaker (2008) prefer this system not only at the national level, but also at the European level. They support their position by referring to the coordination problems between the British Financial Services Authority (FSA) and the Bank of England (BoE) after the collapse of Northern Rock. The FSA became responsible for financial sector supervision about twelve years ago, while the BoE would look only after financial stability. However, the British Finance Minister has recently announced measures to adjust the British supervisory model. The BoE will be given more power to avert financial instability. Financial supervison in the US is a patchwork that has spontaneously evolved after the Civil War. However, decentralised supervision leads to fighting over competencies and hampers communication among the various authorities. While one might expect resistance from those who stand to lose responsibilities, in the longer run the consolidation of competencies will lead to a better-working model. The potential weakness of the plan is

[1] Sections 2 and 3 of this briefing paper are mainly based on Beetsma and Eijffinger (2009).

the possible conflict between the traditional and new tasks of the Fed. In the case of a bank failure, the Fed might feel pressurized to provide liquidity, while from the perspective of monetary stability this might be undesirable. This problem manifested itself during the Savings & Loans (S&L) crisis in the 1980s when the portfolios of the US savings banks featured a large share of weak debtors and the US federal government was forced into a large bail-out (600 billion dollars or even more). After the S&Lcrisis the Fed kept the official interest rate (the Federal Funds Rate) low for longer than would have been desirable from the perspective of monetary stability. By keeping interest rates artificially low, interest rate margins and reserves of the savings banks and loan associations could increase to improve their balances. In other words, financial sector supervision may have spill-over effects (*externalities)* onto monetary policy. In fact, when banks realise that the Fed is both responsible for financial supervision and has the means to act as a lender of last resort, they may be tempted into taking on additional risks (*moral hazard*) from which they will reap the full benefits if things go well, while in the case of failure the losses will be limited by intervention from the Fed. Moral hazard has also played a role in the emergence of the current crisis. Financial institutions that took too much risk in providing mortgages are now helped out by the Fed's interest rate decreases.

Given that the US plans for the restructuring of financial supervision still need to be worked out further, it is hard to judge them at the current moment. The preferred format would be one in which both macro- and micro-prudential supervision of individual institutions are brought under the roof of a single and independent authority that is not responsible for monetary policy and that is also not able to independently decide about the possible rescue of institutions in trouble. Given the potential risks to the financial system, this does not imply that a rescue will never take place. The Fed remains responsible for the stability of the financial system as a whole, but has no role in the prudential supervision of individual institutions. The likelihood of an individual rescue becomes smaller, which suppresses the incentive for moral hazard. Further, because an authority other than the supervisor needs to provide the resources for any rescue, the consequences for price stability will be more explicitly taken into account. Also with the Fed and the new supervisor both having to assess the need for the rescue, judgmental errors will be reduced. Finally, the independence of both authorities limits the likelihood of interference by politicians.

Of course, separating the supervision of individual institutions from the Fed also has its disadvantages. In the event of a crisis, it will be important for the central bank to be able to immediately judge the amount of liquidity to be supplied to the banking sector. For these situations one could construct crisis scenarios. However, one might also consider the possibility of an obligation to provide the Fed with the necessary information about the liquidity of individual institutions without making it jointly responsible for the supervision of these institutions. As mentioned earlier, there exists also the British model of a separate financial supervisor (FSA), which exerts both macro- and micro-prudential supervision on the financial sector, while the BoE is only responsible for financial stability. This model of a separate supervisor is the legacy of the BCCI failure. BCCI was the only internationally-operating, pan-Arabic bank, which failed on a large scale. Because BCCI's headquarters were located in London, the BoE was the main supervisor involved, although it was hardly informed about problems with this bank. The failure had a negative effect on the BoE as a monetary policymaker and for this reason the Finance Minister at the time decided to separate the responsibilities for financial and monetary stability by setting up the FSA and making it responsible for financial supervision in the UK.

3. FINANCIAL SUPERVISION IN THE EUROPEAN UNION

Also Europe can draw a number of useful lessons from the current crisis. Financial supervision in Europe is even patchier than in the US. Responsibility for financial supervision is at the national level in Europe. In principle, each country is free to design its supervisory system to its own liking. This should be clear from Table 1, which provides an overview of the national responsibilities of financial stability and financial supervision in the European Union. Clearly this patchwork of supervision will become more and more difficult to maintain due to the ongoing economic and financial integration in Europe. Internationally operating financial institutions have to simultaneously fulfil requirements imposed by different national supervisors. It would be a missed opportunity to not exploit the current crisis as an instrument to undertake a substantial step towards uniform financial supervision in Europe under the responsibility of a single authority.

Table 1: The role of central banks in the European Union in promoting financial stability

Country	CB responsible for financial stability?	Supervisor
Austria	Yes	Ministry of Finance
Belgium	Yes	Banking and Finance Commission
Denmark	Yes	Financial Inspectorate
Finland	Yes	Bank Inspectorate/Bank of Finland
France	Yes	Banque de France/Commission Banqaire
Germany	Yes	Federal Banking Supervisory Office and Deutsche Bundesbank
Greece	Yes	Bank of Greece
Ireland	Yes	Central Bank of Ireland
Italy	Yes	Banca d'Italia
Luxembourg	Yes	Commission de Surveillance du Secteur Finance (CSSF)
Netherlands	Yes	De Nederlandsche Bank
Portugal	Yes	Banco de Portugal
Spain	Yes	Banco de España
Sweden	Yes	Swedish Financial Supervisory Authority
UK	Yes	Financial Services Authority
EMU	No	National supervisors

Source: Eijffinger (2007), based on update of Goodhart and Schoenmaker (1995).

A number of developments, in particular the ongoing financial integration and the growing number of banks with cross-border activities, have led to initiatives to strengthen agreements at the EU level for maintaining financial stability in the medium run. These agreements are intended to bolster financial crisis management in line with the strategic framework by the European Council of Finance Ministers (ECOFIN) in October 2007 and the extension of the Lamfalussy-framework for regulation and supervision. The framework was installed in 2001 for the purpose of regulating the asset markets and extended in 2004 to include the insurance sector and the banking sector. In 2007 the framework was evaluated from different angles (among others, the European Commission and the ECB), resulting in a number of suggestions for improvement that were put on the ECOFIN agenda for December 2007. These proposals concern in particular the Level-3 Committees of supervisors aimed at convergence and collaboration in supervision. These committees will be enforced on three accounts. First, their legal basis will be strengthened. Second, their accountability is enhanced by making their objectives explicit and requiring them to report

annually to the Commission, the ECOFIN and the European Parliament. Also the possibility of taking decisions by qualified majority will be introduced. These adjustments should lead to more convergence of supervision and improved international collaboration in this area. The current European framework to guard financial stability consists of three layers: (1) crisis prevention, (2) crisis management and (3) crisis resolution. These are described in Table 2. Crisis prevention is initiated by the supervisors, who guard the solidity of financial institutions, and the central banks, which guard the stability of the financial system as a whole. There exist a number of instruments for crisis management. The supervisors may raise the required capital to be held by a financial institution or they may impose a reorganisation, while the central bank may provide liquidity. Financial stability has a distinct international dimension because the failure of one institution may produce a domino effect of failures through the cobweb of obligations financial institutions have towards each other. Hence, collaboration at the EU-level is inevitable. Currently, this is based on a framework that has been largely harmonised via EU law and that is supported by the Level-3 Committees of the Lamfalussy framework.

Table 2. The EU framework for safeguarding financial stability

Functions	**Structures for cross-border cooperation between authorities**
Crisis prevention	
Supervisory functions	Level 3 Committees for the convergence of supervisory practices Colleges of Supervisors
Financial stability monitoring by central banks	ESCB Committees
Crisis management	
Supervisory measures	Colleges of Supervisors EU MoUs
Provision of liquidity by central banks	Eurosystem
Actions on payment systems	ESCB Committees EU MoUs
Crisis resolution	
Private sector solutions	EU MoUs
Public sector measures by finance ministers	EU MoU's
Reorganisation and winding up of financial institutions	Bilateral relationships between the competent authorities of Member States
Deposit guarantee schemes	Bilateral relationships between the competent authorities of Member States

Source: ECB (2008, Table 1). Note: MoU = Memorandum of Understanding

Crisis management and crisis resolution mainly concern sharing information and the procedures for collaboration among the various national supervisors. In this connection, in 2005 the various parties have signed a memorandum of understanding (MoU) for collaboration during a crisis. A new MoU is in the pipeline as part of the aforementioned strategic framework of the ECOFIN. One part will be a set of common principles for cross-border crisis management in the case of an internationally operating bank. For example, in solving the crisis, priority will be given to a private sector solution and, in those cases

where public money is involved, the direct costs will be shared across the Member states that are affected. The new MoU also foresees the use of a recently developed common analytical model that will be used to assess the effects of a potential crisis on the financial system and the real economy. This will facilitate the comparison of the views of the various authorities on the consequences of the crisis. Finally, the MoU will provide a number of practical guidelines for crisis management, such as the exact prcedures for sharing relevant information and the coordination of decisions. The recent turbulence on the financial markets has given rise to a number of new initiatives at both the EU and the global level. The ECOFIN has agreed on a list of concrete actions aimed at enhancing transparency, improving valuation of financial instruments, strengthening the role of markets into various dimensions and improving risk management by banks (as expected, through adjustment in the Capital Requirements Directive). Parallel to this, and at the global level, Financial Stability Forum (FSF), which is composed of representatives from national and international financial and monetary policy institutions, has recently published a report that recommends certain actions in the aforementioned and other areas. Unfortunately, these developments have given insufficient rise to a serious discusion about restructuring financial supervision in Europe.

4. THE NEW STRUCTURE OF EUROPEAN FINANCIAL SUPERVISION: WILL IT REALLY WORK?

Almost three months ago the European Heads of State and Government convened to decide about financial sector supervision in Europe. To prevent this financial crisis from repeating itself, banks and insurers that operate cross-border within Europe are subjected to stricter rules and stricter supervision, starting next year. After a long negotiation process, on June 19th, 2009 the Heads of State and Government of the European Union agreed on a new supervisory structure for the European financial sector. This structure is mainly based on the recommendations of the High-level Working Group chaired by Jacques de Larosière. This committee has accommodated too much to the desires of Germany and the United Kingdom, who oppose transferring responsibilities to a central European body. The recommendations have not gone far enough. In an earlier stage Onno Ruding, former Dutch finance minister and member of the De Larosière group, already admitted that the recommendation to set up a real European supervisory authority would be a political bridge too far. National supervisors now coordinate their supervisory activities through three colleges of supervisors for banking, insurance companies and pension funds, and financial markets, respectively: CEBS (Committee of European Banking Supervisors), CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) and CESR (Committee of European Securities Regulators). In the future, these colleges have to cooperate more closely on micro-prudential supervision of banks, insurers and pension funds that operate cross-border. For now, this will be arranged in setting up a European System of Financial Supervisors that will be a "coordinating and steering group" for supervising European financial institutions, although the EU leaders have not decided on a central body that will coordinate these different supervisory colleges. Ultimately, these colleges will be transformed into authorities that will be able to impose decisions in case national supervisors disagree. However, the current colleges as well as the future authorities do not have the instruments to act in bad times, as they are not allowed to influence the autonomous budget of member states. The solvency instrument will remain under the responsibility of individual member states. Additionally, it is not at all clear who will be in charge of these colleges or authorities. We can easily envisage a situation in which forty people meet to discuss a single bank, without anyone being in the lead. The best solution is to give the home supervisor of the supranational bank the role of *lead supervisor*. When there are troubles at for instance ING, taking an arbitrary case, the Dutch central bank (*De Nederlandsche Bank*) should have decision rights. When *Banco Santander* is concerned, the Spanish central bank is responsible. Fortunately, the European solution for macro-prudential supervision is a lot better. The so-called *European Systemic Risk*

Board (ESRB) will guard financial stability in Europe and should warn European banks and insurers when they are taking too many systemic risks. This board will be indirectly governed by the ECB, but is not formally a part of the institution. Since the ESRB is connected to the ECB, it is indirectly able to make use of the liquidity provision instrument. The Board consists of the central bank governors of all EU member states and thus has a complete overlap with the ECB's General Council. Its chairman can be the president ECB, but this is not necessarily so. Clearly, the British thought this was a step too far. However, an important question is how macro-prudential supervision by the ESRB will have to be coordinated with micro-prudential supervision of the separate banks, insurers, pension funds and financial markets by the current colleges as CEBS, CEIOPS and CESR or the envisaged supervisory authorities. Although the European heads of government are very confident about the new supervisory structure, which protects the European financial system against future systemic risks, they have not found any solution for the burden-sharing problem. This problem involves the issues of how to divide the bill of a bank failure between the countries in which it operated. Without a solution to this problem it is impossible to set up solid European Supervision. Clearly, the EU leaders have postponed deciding about this problem. The recent capital injections and nationalizations have made very clear how high the bill of these actions may be. In the Netherlands, for instance, the government debt (as percentage of GDP) has already risen with 15 to 20 percentage points because of the support to the financial system. Will the new European supervisory structure really work? I am afraid that this structure will not help in a systemic crisis as we have seen recently. Sadly, Europe has not learned enough from this crisis.

5. ADJUSTMENTS TO THE ACCOUNTABILITY AND TRANSPARENCY OF THE EUROPEAN CENTRAL BANK

The new structure of European financial supervision will require, of course, adjustments to the accountability and transparency of the ECB within the framework of the Monetary Dialogue with the Committee on Economic and Monetary Affairs of the European Parliament. De Grauwe and Gros (2009) propose, inter alia, that the ECB formally and practically differentiate in its policy and objectives between normal and crisis times, and they also propose some changes to the accountability and transparency of the ECB and its relation with the European Parliament. In practice it is very hard to distinguish between normal and crisis times and, therefore, we would advise the Committee on Economic and Monetary Affairs to establish a Financial Dialogue with the President of the ESRB/ECB for discussing macro-prudential supervision in the euro area and the EU on a bi-annual basis after the publication of the *Financial Stability Review* by the ECB.[2] Article 105(6) of the Treaty explicitly mentions the possibility for the Member States to decide to confer upon the ECB specific tasks in the domain of financial supervision. In conjunction with this a Financial Dialogue could be established with the Chairs of CEBS, CEIOPS and CESR to discuss micro-prudential supervision in the EU on a bi-annual basis. Preferably, the Financial Dialogue should take place in June and December after the bi-annual publication of the Financial Stability Review.

[2] The issue of the Financial Stability Review of June 2009 describes the main endogenous and exogenous trends and events that characterised the operating environment of the euro area financial system over the period from November 28th, 2008 until May 29th, 2009. The Financial Stability Review is bi-annually published by the ECB.

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