DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

New Roles and Challenges for the ECB

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NOTE

Abstract

The ECB's new role of banking supervisor for the euro area greatly complicates the work of the organisation both in terms of its internal structures and its relationships with various other organisations. In this paper, I review the arguments relating to synergies and conflicts of interest between monetary policy and bank supervision. I argue that the synergies are much more important than the conflicts of interest. While the new structures proposed for bank supervision at the ECB are cumbersome and somewhat unnecessary, they should still allow for important synergies in the coming years. The ECB will need to hit the ground running in its supervisory role and co-ordinate fully with national governments and the ESRB to make the upcoming stress tests a success. One task the ECB should give up, however, is designing and monitoring structural adjustment programmes.

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1. INTRODUCTION

While commentators regularly express frustration at what is perceived as the slow pace of policy changes in response to the ongoing European economic crisis, it is also the case that, viewed from a longer historical perspective, recent years have seen a series of unprecedented policy actions and enormous shifts in economic policy structures of the EU and the euro area. Four different countries have received financial assistance from euro area governments as part of adjustment programmes and a new permanent sovereign bailout has been put in place; a new fiscal compact treaty has been agreed as well as enhanced macroeconomic surveillance procedures. Most recently, events in Cyprus have seen depositors experiencing large losses and the imposition of capital controls inside the euro area. These are changes that could not have been imagined as recently as six years ago.

For the ECB in particular, the last few years have seen huge changes. New monetary policy tools such as the Outright Monetary Transactions (OMT) programme have been put in place and the ECB is now playing a key role in macro-prudential policy by providing the secretariat for the European Systemic Risk Board (ESRB). The ECB has participated in designing and monitoring adjustment programs as part of the so-called "troika" with the IMF and European Commission.

Most importantly, the ECB is in the process of taking on the role of the Single Supervisory Mechanism (SSM) for banks in the euro area. Taking on the SSM task represents a major organisational challenge for the ECB and will clearly involve a significant increase in staff numbers. Even with the decisions to limit direct supervision to roughly 150 larger banks and to leave "non-essential" supervisory tasks (such as payments, regulating markets in financial instruments and consumer protection) some reports have indicated that perhaps up to two thousand new staff may be required.

As an increase of this size would more than double staff numbers and cause significant adjustment problems, not least in relation to long-standing plans to move all ECB staff to a new premises. With a host of tasks being transferred to the ECB but many still remaining with national regulators, the new regime will require a wide range of new relationships to be established between the ECB and bodies such as national regulators, national parliaments, the European Parliament and the ESRB. These will take time to work out.

In this paper, I discuss a number of issues related to the ECB's new roles. In light of the influence that concerns about conflicts of interest between monetary policy and banking supervision had in the new structures being put in place, I first review the arguments for and against combining these two policy functions in one institution and then discuss the new structures for banking supervision that are being put in place at the ECB.

I then discuss some of the new relationships and challenges for the ECB due to its new role as banking supervisor. New relationships with national regulators, parliaments and governments will need to be established. In particular, the ECB will be playing a number of roles in the upcoming stress tests (supervisor, provider of emergency liquidity, guardian of financial stability) and it will be hugely important that it co-ordinates well with other bodies to maintain stability in the European banking system through this process.

Finally, I discuss the ECB's role in designing and monitoring adjustment programmes. I recommend that this role should not be continued.

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2. SYNERGIES VERSUS CONFLICTS OF INTEREST

Over the past few decades, there has been plenty of debate in policy circles about whether central banks should be involved in bank supervision. In the years before the global financial crisis, international practice was moving somewhat towards the practice of having separate bank regulators.[1] In this section, I review the arguments for why there are significant synergies between banking supervision and monetary policy and also discuss the question of conflicts of interests that may arise from pursuing these goals.

2.1. Synergies between Banking Supervision and Monetary Policy

A good starting point for understanding the relationship between banking supervision and monetary policy is the special role that banks play in monetary policy. In the modern era, central banks implement monetary policy by setting a target for short-term money market interest rates and meeting this target generally requires monitoring of the short-run liquidity needs of banks.

More generally, however, 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 banks' 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

[1] See Goodhart and Schoenmaker (1995) and Peek, Rosengren and Tootell (1999) for two pre-EMU examples of papers that debated this question.

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Eurosystem now provides as much credit to banks as they request, provided they can pledge sufficient amounts of eligible collateral. While the large expansion in base money associated with this change in lending policies has yet to translate into a fast growth rate of broader measures of the money supply (such as M3) or into inflationary pressures, concerns that they could yet do so cannot be dismissed as irrelevant. This makes monitoring of the factors that influence banks' balance sheets important for achieving the ECB's key policy goal of price stability. These connections all point to strong synergies between the monetary policy and banking supervisory tasks.

The lender of last resort role is another important element of monetary policy. Given the dependence of many banks on ECB borrowing at present and the huge influence that this borrowing has on the supply of base money, there is now a clear connection between monetary policy and lender of last resort policy in the euro area. And it is in the public interest for lenders of last resort to have as much useful information as possible about the banks they are assisting.

The problems with Northern Rock in 2007 provide a good example of the problems that can arise when the lender of last resort is distant from the supervisory process. Co-ordination difficulties between the UK Treasury, the Financial Services Authority and the Bank of England 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 to monetary policy and banking supervision is increasingly viewed as a failure.

The current institutional arrangements are not well-designed for the ECB to get the best possible information about the euro area banks. Some of the affiliated national central banks act as banking supervisors but some do not. Among those that act as supervisors, the underlying supervisory cultures may differ, including the amount of information about troubled banks that is relayed to the ECB. Because bank failures often end up costing national governments money and because disclosure of problems with these banks can undermine financial stability, national supervisors may be reluctant to share information about these banks with other European bodies. This has perhaps lead the Eurosystem to adopting inappropriate lending policies in the past: For example, would the ECB Governing Council have approved the provision of over €40 billion in Emergency Liquidity Assistance to Anglo Irish Bank if they had been acting as its supervisor and better understood the scale of the bank's solvency problem?

2.2. Conflicts of Interest?

The most commonly cited argument against central banks being bank supervisor is that there is a potential conflict of interest between the goals of monetary policy and banking supervision. 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.

Despite the frequency with which the "conflict of interest" argument is aired, I find it hard to see much merit in it as an argument for separation. A number of points are worth making about the potential conflict of interest.

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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, there are 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 (2000) outlined in his well-known 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 pro-cyclicality 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 (2010) has argued 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.

2.3. The New Structures for Monetary Policy and Bank Supervision

Despite little in the way of concrete explanation of their importance in the preparatory work done for the SSM agreement, concerns about conflicts of interests had a significant role on the new supervisory arrangements approved by the European Council.

The new structures will see monetary policy and banking supervision "*carried out in full separation, in order to avoid conflicts of interests and to ensure that each function is exercised in accordance with the applicable objectives*."

The key body carrying out the work on supervisory tasks given to the ECB will be a Supervisory Board featuring representatives from each national supervisory body, four representatives of the ECB, a Chair and a vice-Chair. While the Vice-Chair of the Supervisory Board will be a member of the ECB Executive Board, the four representatives of the ECB will not have any duties related to monetary policy and the Chair will be a full-time position with no involvement in other work performed by the ECB. The Governing Council must hold separate meetings to discuss monetary policy and banking supervisory issues and its involvement in the decision-making process will be limited to either approving or objecting to decisions recommended by the Supervisory Board.

My assessment is that these structures are cumbersome and unnecessary and may limit the beneficial synergies that can be obtained from combining monetary policy and banking supervision. Given the strong inter-relationships that I discussed above, it is hard to see why involvement in monetary policy should disbar an ECB representative from taking a place on the Supervisory Board. Indeed, a "macro" perspective may prove crucial when considering some of the recommendations that the Supervisory Board can make such as imposing macro-prudential-style capital buffers in countries where there are concerns about a boom-bust cycle.

In the same way, the requirement that the Governing Council operate in "a completely differentiated manner" in relation to monetary policy and banking supervision including "strictly separated meetings and agendas" could also be considered a barrier to effective macro-prudential policy making. For example, these requirements could restrict discussions about the range of options available to the Council to control the flow of credit, e.g. the relative impact of raising interest rates versus imposing high capital requirements.

That said, I still believe the new structures will be a significant improvement and should provide some of the advantages that I listed above. With a harmonised approach to supervision and assessment of asset quality, the ECB Governing Council should have a much clearer idea about the scale of banking problems in Member States than it has had up to now. This should help with the formulation of monetary policy. Similarly, the Governing Council will have direct access to information on banks in distress before approving emergency lending programmes and will not have to rely on potentially compromised local regulators.

Over time, I suspect the concerns about conflicts of interest between monetary policy and banking supervision may fade and the ECB can move towards structures that get the best out of each of the different types of information that it receives, using all of it in the formulation of monetary policy, macro-prudential policy and banking supervision.

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3. NEW STRUCTURES AND NEW RELATIONSHIPS

In this section, I discuss the new structures that are being put in place with at the ECB due to its designation as SSM and some of the implications this will have for its relationships with other organisations.

3.1. Relationships with National Supervisors

The first, and perhaps most complex, set of relationships will be between the ECB and the current national supervisors. Two types of relationships will have to be sorted out: Those for the approximately 150 banks that are going to be directly supervised by the ECB and those for the rest of the euro area's approximately 6000 banks that are not going to be directly supervised.

In relation to banks that will meet the criteria for being directly supervised by the ECB, the new supervisors have to work out the correct balance of staffing and responsibilities between the new staff in Frankfurt and the current supervisors in the national regulators. The agreed proposal contains lots of sections on co-operation and information sharing but it is unclear how this will work in practice.

One possibility is a structure in which almost all the staff involved in direct supervision remains at the national regulator with a very small number of staff at the ECB involved in overseeing supervision and making policy decisions. However, from the very start of the SSM, with the asset quality review and stress tests, the ECB need to be in a position to make assessments that could be very different from those of existing staff. Getting the balance right in these relationships will likely be very tricky and may work better with some countries than others. Ongoing co-operation with existing staff at national supervisory staff will be crucially important but so will the ability to question past assessments by these staff members and adopt new approaches. In the opening few years, ECB staff will need to maintain good relationships with existing supervisory staff but this cannot come at the expense of an honest assessment of asset quality.

In relation to banks that are not being directly supervised by the ECB, the nature of the ECB's involvement is not clear to me at this stage. The early discussions on the SSM suggested simply that some banks would be supervised by the ECB and others would not. The final agreement is somewhat more complex. Some banks will be directly supervised by the ECB. And the rest? We are told that

> *Safety and soundness of large banks is essential to ensure the stability of the financial system. However, recent experience shows that smaller banks can also pose a threat to financial stability. Therefore, the ECB should be able to exercise supervisory tasks in relation to all credit institutions authorised in, and branches established in, participating Member States.*

It is unclear what exactly this means but it suggests that the ECB can choose to supervise smaller banks if it wishes. However, what is perhaps more important than the ability to intervene at specific small banks, is that ECB staff monitor overall banking developments in each country. Collections of small banks with similar characteristics can often act in the same way so that the sector as a whole can occasionally presents a threat. This has been a familiar story running from small bank failures during the Great Depression to the Savings and Loans debacle of the 1980s. While none of the individual institutions may matter

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much, the ECB needs to be able to assess the full scale of problems with Spanish Cajas and German Landesbanks and be able to intervene across these sectors.

3.2. Relationships with Parliaments

The ECB will be publicly accountable in its role as bank supervisor with the proposals containing a complex set of relationships with the European Parliament, the Eurogroup, European Council and national parliaments. I have two concerns about the proposed plans.

The first relates to oversight by the European Parliament. The Monetary Dialogue with the ECB President likely provides a template for how the European Parliament's monitoring of the ECB's banking supervisory role will operate. If so, this does not provide much encouragement. The Dialogue sessions often feature the ECB President avoiding answering the questions and the limited time and large number of questions generally rule out follow-up questions. I would hope that a committee interrogating the Chair of the Supervisory Board on the complex questions relating to baking supervision would perhaps have a small number of members, be given a relatively large amount of time for questioning and allow for follow-up questions. (For example, each member of the committee could be allowed up to fifteen minutes for questioning.)

The second concern relates to the role of national parliaments. Parliaments will be allowed to address questions to the ECB in relation to its SSM role and also to request that relevant ECB officials appear before parliamentary committees. However, my reading of the plans is that the ECB is under no obligation to accept. In the case where a bank is in severe financial difficulties, the ECB will now be involved in supervisory decisions that can have major implications for investors, depositors and taxpayers in the country where that bank is located. Given this, I would have hoped for a stronger right for national parliaments to be involved in questioning the ECB's actions as a bank supervisor.

3.3. The ECB, Bank Resolution and Financial Stability

The ECB will not have much time before its ability to juggle all its roles will be severely tested. The upcoming asset quality review and stress tests will require the ECB to co-ordinate its roles as banking supervisor, provider of emergency liquidity and protector of financial stability.

Senior ECB officials, including President Draghi, are to be commended for their honesty in publicly admitting that previous rounds of stress tests have been unsatisfactory and have failed to convince financial market participants of the soundness of the European banking system. Executive Board member Joerg Asmussen has been quoted as saying that the upcoming stress tests are "our third and last chance" to restore confidence in the system.[2]

Accepting that previous stress tests were not tough enough in terms of their assessments of asset quality or riskiness, these comments suggest that the new ECB-overseen stress tests will be tougher than previous exercises. If this is the case, however, it is likely that the outcome will see a large number of banks fail the tests with outcomes ranging from a requirement to raise capital to a requirement to implement haircuts on bank liabilities.

If this process works well, it could set in a number of positive processes that would help to get bank credit flowing again in Europe. Banks that have passed the tests and are seen as well-capitalised may find it easier to raise long-term funds in the bond market and thus

[2] http://www.bloomberg.com/news/2013-09-04/asmussen-says-ecb-stress-tests-last-chance-for-confidence.html

make progress towards the Basel III targets on stable funding without having to cut down on lending. Equity funds may also be more willing to invest in European banks after these banks have been through a realistic process of asset write-offs and this may help banks move towards the Basel III capital goals without shrinking their balance sheets.

However, it will be difficult for this process to go smoothly. Ideally, the announcements would come with a set of steps from the ECB and national governments that will reassure investors and depositors about the stability of the banking system. However, previous rounds have generally announced results and left a waiting period in which banks are required to raise capital, so one could also imagine a period of damaging uncertainty.

A post-results period in which the public knows that many leading banks are under-capitalised and possibly may end up imposing haircuts on liabilities (perhaps including deposits) would be a recipe for instability. If deposits flowed out of banks perceived as particularly weak in light of the stress tests results, the ECB would come under pressure to provide replacement funding, possibly in the form of ELA. The precedents set by Anglo Irish Bank and Bank of Cyprus have shown this tends to produce very poor outcomes for citizens of the country in which the receiving bank resides.

Given the risks involved, it is important that the ECB conduct extensive discussions with national governments and also uses its role in the European Systemic Risk Board to see that everything that is possible is done to maintain financial stability both before and after the stress tests.

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4. THE ECB AND FINANCIAL ADJUSTMENT PROGRAMMES

The "Troika" as the combination of European Commission, ECB and IMF has come to be known, was born during the negotiations for the Irish adjustment package in 2010. While everyone is now used to the idea of this Troika being involved in monitoring financial assistance programmes, it is worth noting that the involvement of the ECB in negotiating and monitoring of such a deal is actually something of an anomaly.

Ireland's EU-IMF programme involved borrowing of €45 billion from the EU (in the form of the EFSF and EFSM) and €22.5 billion from the IMF. For these reasons, it was clear that the programme should be monitored by the IMF and also by the EU, in the form of the European Commission.

What was less clear was why the ECB is involved in programme design and monitoring. The ECB did not lend money to the Irish government as part of the programme, as such loans would be illegal. Instead, the Eurosystem lends money to Irish banks. The terms and conditions for such loans come from the Eurosystem's common monetary policy guidelines and so, at first glance, it is unclear what role the ECB should have had in monitoring an adjustment program.

In practice, the ECB appears to have been willing to use its risk control framework to cut off lending to Irish banks and appears to have made compliance with the adjustment programme a condition for its continued willingness to provide liquidity to Irish banks. Given the importance of this liquidity, the ECB ended up playing a large role in designing and monitoring the Irish programme.

I believe this level of involvement for the ECB was a mistake for a number of reasons. First, the involvement of the ECB in monitoring adjustment packages gave it a role in monitoring the fiscal policies that was not envisaged as part of the European Treaties. As an indication of how various lines were blurred due to the ECB's involvement in programme design and monitoring, consider the following quote from Klaus Masuch, former head of the European Central Bank mission to Ireland, as spoken to the BBC:[3]

> *People in Ireland were not aware of the enormous support that they get from the Eurosystem. This is a privilege, of course. The partners in the Eurozone also expect that every partner – every government in the Eurozone – is doing its own homework. This means keeping public finances stable and, of course, keeping the banking sector stable.*

It is hard to imagine a representative of the Federal Reserve telling the citizens of Texas they should realise that it is a privilege that their banks can borrow from the Fed so one might ask why ECB officials believe there is a good reason to lecture Irish citizens in this manner. These officials publicly linking the provision of liquidity to certain banks to the performance of the public finances in that country was a development that was inconsistent with the operational policies that the ECB is supposed to be pursing.

Second, the involvement of the ECB in the Irish programme led to considerable confusion in Ireland and elsewhere about the conditionality associated with the EU-IMF programme. It is well known that the ECB insisted on all senior bond creditors of the Irish banks being repaid in full as a condition of continuing to supply funds to these banks. Given its involvement in monitoring the programme, many people believed that repayment of these private bank debts was an explicit condition of the programme.

[3] See http://www.thejournal.ie/the-bbc-bailout-documentary-some-choice-quotes-126048-Apr2011/

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In fact, the Irish programme documents made no reference to the requirement that private unguaranteed bondholders be repaid. Indeed, such a clause would unprecedented in an IMF programme document. However, this perception significantly undermined the popularity and legitimacy of the programme.

Given the unsatisfactory nature of the ECB's involvement in the Irish programme, I recommend that the ECB explicitly stay out of designing and monitoring any future adjustment programmes. Lending to banks should be assessed on a bank-by-bank basis as determined by the usual guidelines relating to collateral and risk control and should not be tied to fiscal adjustment programmes. While the ECB is free to comment on national fiscal policies, it is not lending money directly to these countries and should not get involved in areas outside its mandate.

Future adjustment programmes should be agreed purely with the European Commission and the ESM and be monitored by staff from those institutions. It is my understanding that a shortage of well-trained economists at the European Commission in the macroeconomic, financial and banking fields was one reason for the involvement of the ECB, with the Bank supplying much of the staff to do the analytic work for the European element of the programme monitoring. This, however, is not an argument for the ECB to be a formal member of programme monitoring team. It is an argument for more economics staff at the Commission or perhaps a system of secondments from the ECB to the Commission.

With so many new challenges facing the ECB due to its new role as bank supervisor, its leadership should be happy to stay away from the additional problems associated with monitoring structural adjustment programmes.

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