ECONOMIA E POL. INTERNA

Better supervision is key to stability

The EU needs to step up co-operation on financial supervision? That is what is required to prevent crises and maintain the soundness of financial institutions and markets, says Tommaso Padoa-Schioppa

In the field of financial stability, debates about European or international co-operation usually focus on crisis management. However, the way in which co-operation functions in a crisis depends crucially on the way it operates in ordinary times. Therefore attention should shift from emergency to ordinary circumstances, from the resolution to the prevention of crises. Ordinary times and crisis prevention are the fields in which co-operation should step up.

Supervision can be defined as the implementation and enforcement of regulation aiming at the safety and soundness of financial institutions and markets. It consists of monitoring the state of health and the activity of regulated entities, authorising operations, giving advice, exerting moral persuasion and receiving confidential information. It operates through on-site and off-site examinations, interviews, confidential meetings, fulfilment of reporting obligations and interpretation of rules.

Unlike other industries, finance is called a system – a set of connected things. Connection is provided by multiple elements: confidence, interbank relations, payment circuits, monetary policy impulses, etc. The stronger such elements are, the more the industry forms a system. The tighter the system, the more it needs uniform rules and consistent enforcement. Such a need becomes clearer as countries move from a global scale, to a single market (the EU), to a single currency area, to a nation state.

Financial systems are not only geographically segmented, they are also tiered vertically. In countries such as Germany and the US there are thousands of locally, largely unconnected banks and few banks that operate nationwide. It can be argued that JPMorgan, Deutsche Bank, UniCredit and perhaps two dozen other global financial institutions form a system among themselves, with the plethora of minor institutions operating in their respective home countries.

Since the first banking crisis after World War II, there has been great progress in making regulation international – be it in Basel for the world or in Brussels for the European single market. Capital requirements, supervision on a consolidated basis, criteria for licensing banks, and deposit insurance are some of the fields in which international rules have been agreed.

Supervision left behind

However, no equivalent progress has been made in the field of supervision. Understandably so because, although rule-making is, by definition, a legislative task that can be performed by committees of national officials meeting occasionally, rule enforcement is an executive function that needs to be conducted on a continuous basis by large bureaucracies, established on the ground close to the regulated entities, entrusted with large discretionary powers linked to the structure of government – which is expected to have the final word when taxpayers' money may be required to bear the cost of a crisis.

The dividing line between regulation and supervision is conceptually clear – but elusive in practice. In Europe there is a common and seemingly very precise regulation 'carved in the marble' of directives. Yet the main banks, which operate in 10 or more countries find it impossible to organise compliance with rules from their group headquarters in a structured way because rules and requirements are completely different across countries. Yet, true harmonisation would save a lot of money and provide these institutions with a much better picture of themselves.

Co-operation is a much more difficult exercise for supervision than for regulation. Yet it is becoming increasingly necessary. Ways need to be invented, just as they were invented in the 1970s, to write common rules.

In the EU, the recent financial turmoil was a revealing test. While, in the monetary field, the European Central Bank (ECB) has acted quickly and decisively, the supervisory function has been almost absent: no effective sharing of evidence, not even special meetings to form a common assessment of the events and upcoming risks, and no relevant exchanges of information between the ECB and the supervisors of the eurozone. The bank lacked the key information on counter-party soundness that is normally available to national central banks and prudential advisers.

Last December, the EU decided that co-operation should be strengthened. It will address this issue again this month, hopefully making steps forwards. TB

Tommaso Padoa-Schioppa is the minister of economy and finance of Italy and is a former ECB board member