Towards a supranational bank supervisory scheme

In a very short time, the creation of a Europe-wide bank supervisory system has become one of the main priorities on the political agenda. Speed in its design and implementation now seems to be vital to resolve the sovereign debt crisis once and for all. Why such haste? And, especially: what are the factors that will determine whether this new supervisory model will succeed or fail?

After 10 years of the single currency, Europe's banking sector is still fragmented. The creation of the euro encouraged capital market integration but maintaining bank supervision at a national level, among other factors, has stopped this trend from also occurring at the level of banks. In this respect, the creation of a supranational supervisory authority will help to advance the integration process as it would level the playing field for all European financial institutions and would also strengthen the independence of supervision. Fortunately or unfortunately, the crisis we are going through is speeding up events. In fact, the current urgency to adopt a European supervisor is due to the need to break the link between bank and sovereign risk. To achieve such an objective, banks with problems must be able to be directly recapitalized by European rescue funds without this affecting the country's level of public debt. However, receiving financial aid always entails conditions and some loss of control. Within this context, the need has arisen for a supranational mechanism with the authority to supervise banks that may potentially receive such financial aid. This supranational supervisor would have up-to-date information on the financial situation of institutions and would also be empowered to impose corrective measures that ensure bank solvency without having to attend to individual national considerations.

It should be remembered that, in addition to unified regulation and centralized supervision, in order to completely break the destabilizing link between bank risk and sovereign risk, effective centralized mechanisms need to be adopted that can prevent and handle bank crises. In other words, banking union also requires an integrated deposit guarantee scheme and a common crisis resolution system, aspects that are dealt with in other boxes in this Report.

In spite of the consensus regarding the need to advance towards common banking supervision, the broad features of such an initiative have yet to be defined. The institutional design of the European supervisor is very important to ensure its effectiveness.

The first question raised is which institution should take on the work of supervision. The most usual practice is for the central bank to assume this role, thereby taking advantage of the synergies generated between supervising the banking sector, preserving financial stability and monetary policy. In this respect, the ECB appears to be the natural candidate to assume these new powers.

Recent experience has shown that the gains derived from having the supervisory function integrated within the central bank are particularly relevant at times of financial turbulence. For example, the proactive approach of the US Federal Reserve after the events of autumn 2008 is attributed partly to its dual function of supervisor and monetary authority. The role of supervisor ensures up-to-date, reliable information on financial institutions, particularly on the value of assets and their potential losses. On the one hand, this allows the central bank to evaluate the solvency and liquidity of financial institutions and thereby better fulfil its function as a lender of last resort. On the other, the central bank can assess banks' stress level, essential for monetary policy to be effective.

However, there is a current of opinion against giving this supervisory function to the ECB due to a concern to preserve the independence of this institution and the possibility of conflicts between monetary policy objectives and surveillance of the banking system. For example, monetary policy decisions could be affected by supervisory errors or problems of financial stability.

The alternative would be to broaden the supervisory powers of the European Banking Authority (EBA), set up in January 2011 and based in London. At present, the EBA has limited powers in terms of bank supervision as its role focuses on coordinating supervision between the different countries of the European Union. To take advantage of the above-mentioned synergies with monetary policy, the EBA should be linked institutionally with the ECB, for example following the new supervisory model of the Bank of England's Prudential Regulation Authority (PRA).

A second question, which isn't simple either, is the definition of the scope of responsibilities that should be assumed by the new supranational supervisor. A similar option to the role currently fulfilled by the EBA would consist of «coordinated supervision», in which the European supervisor acts as a coordinator of national agencies, issuing common regulations, harmonizing application criteria and resolving any conflicts that may arise. This alternative runs the risk of not being enough in circumstances such as the current ones, where agreements need to be adopted quickly that are highly complex in technical terms and especially political terms. In this respect, a model of «integrated supervision» would be more effective.

Another crucial element is that of the new European supervisor's powers. There is consensus that these should be structured on three levels. Firstly, responsibility for macroprudential supervision and financial stability. The European supervisor should have the authority to promote corrective measures for systemic risks identified by the European Systemic Risk Council. It is probably a good idea to set up centralized supervision for all those institutions identified as systemic at the level of the euro area, the so-called E-SIFI (European systemically important financial institutions). Secondly, the harmonization of microprudential supervision, whose aim is the financial soundness of each institution individually. Given that national supervisory authorities have a comparative advantage in this area, the challenge lies in harmonizing microprudential supervision at a European

level and, at the same time, taking advantage of local knowledge due to their proximity to institutions. In the short and medium term, supervision of institutions of essentially national scope, such as D-SIFI (domestic systemically important financial institutions) or local institutions will probably continue to be decentralized, albeit based on highly harmonized systems and principles. In the long term, it would be desirable for D-SIFI supervision to be passed on to the European area since, during the crisis, it has become evident that even medium-sized institutions can have problems that are too big to be resolved effectively by national authorities. In third and last place, the adoption of an arbitration system that can resolve any conflicts that may arise between national supervisors. This supervisory system could resemble the distribution of powers in the competition policy between European and national institutions.

The bank supervisory systems of many European countries have been considerably criticised for their inability to prevent the risks accumulated over the boom years and to resolve the problems during the crisis. Within this context, it would be a good idea to thoroughly reform the supervisory system. The challenge of designing a supervisory system at a European level is not to be underestimated. European authorities now have the chance to adopt an effective supervisory system that balances the benefits of strict bank supervision with the essential function of banks as providers of credit for households and firms, thereby avoiding further excesses of credit that may lead to financial instability.

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