THE ROLE OF CENTRAL BANKS IN FINANCIAL SUPERVISION.
THE EUROPEAN UNION PERSPECTIVE

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Abstract
There are two main arguments for the regulation and supervision of banks and other credit institutions: consumer protection and the existence of systemic risk in the financial market. The systemic risk potential in the European Union single financial market has increased. Hence, the following questions emerge: What is the role of central banks in financial supervisory framework? And, in general, how should national financial (banking) supervisor be organized, inside or outside of national central bank?
This paper is about the role of central banks in financial supervision which are playing in strengthening the European Union financial architecture – a term which includes the setting up of new institutions and changing the mandate of existing institutions in the area of safety and stability financial system.
I argue that cooperation between national central banks and supervisors is a main basis of the new financial architecture and absolutely essential for safeguarding financial stability in the European Union.

Keywords
central bank, financial supervision, financial regulation, European Union, financial Safety Net, EU financial architecture

Background
Financial crises at the national level, often involving systemic bank collapses, have long been a feature of the world, sometimes spilling over into international crises. The past two decades have seen major financial crises in many industrial and developing countries. There is a growing volume of work on the very high costs of financial, mainly banking, crises. International financial community have to consider more carefully the threats of financial
crises to financial stability, to put in place better incentives for avoiding such crises, and to bring together three key elements of financial Safety Net: central banks, supervisors and guarantee schemes.

If banks or other credit institutions are in financial difficulties, the Safety Net limits the negative effects and contagion of the potential crisis upon third parties. The financial Safety Net comprises deposit insurance and the lender of last resort (LOLR) function, usually provided by the central banks. The central bank can operate as a LOLR either by giving liquidity assistance to an individual bank or by maintaining liquidity to the banking system as a whole using the usual monetary policy instruments. Supervision is the more general prevention of the financial crises.

In crisis prevention, the supervisor has the instruments for regulating and supervising the financial institutions, while the central bank might play a supporting role through monitoring the financial stability of the system and the links to the real economy. In crisis management, the supervisor lacks the financial resources to back any intervention, while the central bank has the power to act as a Lender of Last Resort.

**The principles of financial supervision in the European Union**

In the European Union the institutional provisions for the supervision of financial markets are based on the principles of home country control and mutual recognition.\(^1\) According to the home country principle every credit institution has the right to provide services in the whole integrated area using a single license, under the supervision of the authority that has issued the license.

The approach which has been adopted by the European Parliament and of the Council in Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions\(^2\) is to achieve only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems, making

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\(^1\) K. Lannoo, Supervising the European Financial System, CEPS Policy Brief 2002 No. 23.

\(^2\) O.J. L 126/1
possible the granting of a single license recognized throughout the Community and the application of the principle of home member state prudential supervision.

The member states shall provide that the banking activities may be carried on within their territories, in accordance with the Directive 2006/48/EC either by the establishment of a branch or by way of the provision of services, by any credit institution authorized and supervised by the competent authorities of another member state, provided that such activities are covered by the authorization.

According to this Directive responsibility for supervising the financial soundness of a credit institution, and in particular its solvency, rests with the competent authorities of its home member state. The host member state's competent authorities retain responsibility for the supervision of liquidity and monetary policy. The supervision of market risk must be the subject of close cooperation between the competent authorities of the home and host member states.

**Financial supervision architecture in European Union**

The integration of financial markets in the European Union, especially since the introduction of the euro, has increased the systemic risk potential at the European level. The direct relation between this increase in EU-wide systemic risk and the current national based supervisory structure calls for a reform of the European Union supervisory framework.

The arrangements for the supervision of financial markets in members states changing. A review of the present financial supervision architectures in members of European Union indicates a trend toward a gradual concentration of supervisory powers. At the national level in the majority of countries installed integrated supervisory agencies replacing different former specialized authorities for banking, insurance and securities. In whole Europe this trend toward the unification of supervisory powers has been rather strong in recent years.

The Norway was the first country to establish a single supervisor in 1986, the Iceland in 1988, five other countries, members of the European Union - Austria, Denmark (1988), Germany (2002), Sweden (1991) and United Kingdom (2001) - have assigned the task of supervising the entire financial system to a single supervisor (single authority) as a different and
independent institution from the central bank. Also new members of EU - Estonia (1999), Latvia (2001), Malta (2002), Hungary (2000), Czech Republic (2006), Slovakia (2006) and Poland (2006) - have reformed their structures, concentrating all the powers in a single authority, while out of Europe the unified agency was established in Korea (1997) and Japan (2001).

At the European level there is also another one decisive question: Is there a need for a truly European supervisory framework? And, how should a potential Single European Supervisor (financial supervisory authority) be organized?

The UE financial supervision architecture needs to develop in some important ways, for example to ensure effective lead supervision for all financial conglomerates providing cross-border activity in Europe, to cause closer links between the supervisory agencies concerning the banking, securities and insurance sectors and to achieve completely harmonization of the rules governing financial institutions in the different sectors. Same thinks that If the EU supervision framework develops in this way, the setting up of European-wide supervisory institutions should not be necessary.³

**The problem of retaining bank supervision in the national central banks**

The past analysis confirms that central banks are, in general, extensively involved in supervisory activities.⁴ In fact, since the 2003 review, the number of countries where central banks have supervisory powers has increased. More specifically, two new EU Member States – Czech Republic and Slovakia transformed their central bank into a single financial authority. The main reasons for allocating all the supervisory responsibilities to the central bank are linked to its independence, safeguarded by the Treaty establishing the European Community, its credibility and the experience of its staff.⁵

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³ H. Evans, Plumbers and Architects. A supervisory perspective on international financial architecture, Occasional Paper Series, Financial Services Authority, No 4., January 2000, s. 28
⁴ Recent developments in supervisory structures in EU and acceding countries, ECB Report, October 2006, p. 3.
⁵ See ECB Opinion of 22 September 2004 at the request of Národná banka Slovenska on a draft law on supervision of the financial market and on amendments to certain laws (CON/2004/31), and ECB Opinion of 28 October 2005 at the request of Česká národní banka on a comprehensive proposal to amend the draft law on the amendment of laws in connection with the integration of financial market supervision (CON/2005/39), available on the ECB’s website http://www.ecb.int/ecb/legal/opinions/html/index.en.html
In almost all member states of the European Union where the central bank is not the only one authority responsible for taking final decisions in the field of banking supervision, institutional arrangements with a range of options that include: sharing of staff, financial budget resources or other resources such as databases are in place through which the central bank’s involvement is nevertheless ensured.

It is worth noting that in general, national central banks play a significant role in assuring financial stability, even if they are not responsible for prudential supervision. Formal arrangements to ensure coordination, cooperation and the sharing of information between central banks and banking supervisors are now in place in nearly all the member states. However, different methods have been chosen by each UE member to formalize this cooperation: memoranda of understanding, cooperation committees, or cooperation agreements.6

General arguments for retaining supervision in the national central bank (NCB) are: independence, revenues, technical expertise and good staff of the NCB; information-related synergies between supervision and core central banking especially the NCB monetary policy; focus on systemic risk - the central bank is often running or overseeing the large value payments system which is important if the central bank is requested to provide liquidity support in a crisis situation.7

But there three arguments are most frequently presented against retaining bank supervision in the NCB – the major is a conflict between supervision and monetary policy, and moral hazard; second is the tendency towards conglomerations and the blurring of the distinctions between financial products and intermediaries; and third - the need to avoid an excessive concentration of power in the central bank.8

6 Domestic cooperation arrangements between non-supervisory national central banks and supervisory authorities in the EU Member States, Recent developments in supervisory structures in EU and acceding countries, ECB Report, October 2006, Table 2, p. 6
7 S. Ingves, Is there an optimal way to structure supervision? 2007.05.15; http://www.riksbank.se/pagefolders/30411/070515e.pdf
Financial stability and prudential role of central banks under the regulation of the Treaty establishing the European Community.

Article 105(5) of the Treaty establishing the European Community assigns to the European System of Central Banks the task of contributing to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system as a whole.

In accordance with the above, the European Central Bank (ECB) has consistently favoured and supported the involvement of central banks in prudential supervision of credit institutions, expressing the view that an institutional framework in which the Eurosystem’s responsibilities for monetary policy in the euro area are coupled with general supervisory responsibilities of national central banks in domestic markets, and with improved cooperation at a euro area-wide level, is most appropriate for tackling the changes triggered by the introduction of the euro.9

Prudential supervision focuses on the solvency and safety and soundness of financial institutions whereas the focus of conduct of business supervision lies on how financial institutions conduct business with their consumers.

In the past opinions on draft national legislation reforming the institutional framework for prudential supervision of in member states ECB have highlighted that central banks have traditionally been closely involved in the prudential supervision of credit institutions due to their pivotal role in the financial system, in particular regarding implementing monetary policy and ensuring the proper functioning of payment systems and maintaining a close involvement of national central banks in prudential supervision is an important condition for allowing the Eurosystem to contribute adequately to monitoring the risks to financial stability in the euro area in accordance with Article 105(5) of the Treaty, and to safeguard a smooth coordination between the central banking functions exercised at the Eurosystem’s level and the supervisory functions carried out at national level.10

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10 See, e.g. paragraph 6 of ECB Opinion CON/2003/23 of 24 October 2003 at the request of the Ministry of Finance of the Netherlands on a draft law on provisions concerning the merger of De Nederlandsche Bank and the Pensions and Insurance Supervisory Authority Foundation and paragraph 4 of ECB Opinion CON/2001/10
The European Central Bank also recognizes that the nature and scope of risk in the financial sector is widening, due to closer links between credit institutions, insurance companies, investment firms and pension funds. In this context, the ECB has welcomed and promoted institutional frameworks established in member states that recognize the essential role of central banks in supporting the safety and soundness of financial institutions and the stability of the whole EU financial system. In line with this the ECB considers that more effective coordination between supervision of all financial sectors could be pursued also with means that do not imply a reduced role of the central bank in this field.

Conclusions

Future development of single financial market in the European Union will be an important test of how far national institutions involving in Safety Net, common laws and standards, and much informal cooperation can evolve to meet the developing challenges to financial supervision, especially from financial institutions that providing cross-border and cross-sectoral activity. I am confident that both supervisors and central banks are well aware of the new financial architecture in which their tasks and responsibilities now have to be performed. To summarize, the present institutional setting for financial supervision in the European Union can rather cope with the challenges brought about by the increasingly integrated banking and financial system, as well as the issues raised by the separation of monetary policy and supervisory functions in the Eurosystem.

First of all, it is necessary to underline that the financial stability is a public good which should be under the protection of all member states of European Union, so at present it is the main aim of national central banks and European Central Bank policy.
Secondly I would like underscore the necessity of close cooperation between the institutions involving in financial Safety Net: central banks, supervisors and deposit guarantee schemes. I think that the increased EU-wide systemic risk calls for greater cooperation between national central banks and supervisors within the financial Safety Net, especially at European level.

Finally, I think that in many countries there is a political pressure to change the supervisory structure and financial and especially banking supervision may in such cases be moved out of the central bank or, at other times, into it. In this context must be highlighted that there isn’t an optimal way to structure supervision. The different supervisory structures reflect the specific situation of their countries, which may change over time, and there is no globally agreed best practice.

Literature:

[9] O.J. L 126/1

[10] Recent developments in supervisory structures in EU and acceding countries, ECB Report, October 2006; http://www.ecb.int


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