Summary for non-specialists
Economic Papers No. 495 / April 2013
Economic Papers index

An Integrated Financial Framework for the Banking Union: Don't Forget Macro-Prudential Supervision

by Dirk Schoenmaker, Duisenberg School of Finance, Amsterdam

In this essay, we propose an integrated framework for the Banking Union with two dimensions: a *macro* dimension covering monetary policy and macro-prudential supervision, and a *micro* dimension covering the regulation, supervision and resolution of individual banks.

In the run-up to the 2007-2009 financial crisis, we overlooked the bigger picture of the stability of the wider financial system. Yet macro-developments, such as unconstrained credit growth and/or fast rising housing prices, can have a detrimental impact on the overall soundness of the banking system. New theories suggest that monetary policy and financial stability policies are closely linked. Balance sheets of financial intermediaries provide a window on the transmission of monetary policy through capital market conditions, reinforcing the important role of financial intermediaries in the financial system. It is argued that monetary and financial stability are two sides of the same coin. After the financial crisis, central banks, including the ECB, have taken up the financial stability role (the macro-prudential dimension).

In addition, central banks are increasingly taken up a role in micro-prudential supervision. With the advance to Banking Union, the ECB will be the central player in the Single Supervisory Mechanism. To avoid reputation risk, the head of the monetary policy side (typically the governor or president of the central bank) and the head of the supervisory side (typically the head of the supervisory division of the central bank) are separated.

This essay addresses three outstanding policy issues: 1) resolution of ailing banks, 2) division of labour between macro- and micro-prudential supervision, and 3) the degree of centralisation of macro-prudential policy.

On resolution, an old Scottish saying notes that 'he, who pays the piper, calls the tune'. A Single Resolution Mechanism (the paymaster) should thus set the tune of the Single Supervisory Mechanism (SSM). While there is general agreement on the need for a Single Resolution Mechanism, there is no consensus on the shape of such a new European Resolution Authority. In this essay, we propose that the scope of the new authority should be identical to the scope of the ECB in the SSM (that means the same banks would fall under both regimes). Next, the European Resolution Authority should have central resolution powers similar to the supervisory powers of the ECB under the SSM. Finally, a central fund is needed, as national resolution funds have no incentive to contribute to the bailout of European banks from another country. For efficiency reasons, we propose to combine the resolution and deposit insurance functions into a European Deposit Insurance and Resolution Authority (EDIRA), akin to the Federal Deposit Insurance Corporation (FDIC) in the US, which has broad resolution powers.

The next policy issue is macro versus micro. Until recently, the prevalent approach to financial stability has implicitly assumed that making individual financial institutions safe will make the system as a whole safe. But in trying to make themselves safer, financial institutions can behave in a way that collectively undermines the system (for example, a fire sale of risky assets). When there are conflicts between macro-prudential and micro-prudential supervision, we propose a hierarchy of objectives: the macro-prudential concerns should override the micro-prudential concerns. But the leading practice is that day-to-day micro supervision of individual institutions gets more attention than the monitoring of macro-trends, such as unwarranted credit growth or excessive increases of house prices. Yet, a credit and/or housing boom-bust cycle can bring down even the best-managed institutions. We propose that the macro-prudential function should be executed by a committee reporting directly to the ECB's Governing Council, separate from the micro-prudential function of the new Supervisory Board.

Finally, there is an issue of coordination between the European and national level. The financial cycle tends to differ between countries, also within the euro area. House prices, an important driver of the financial cycle, are local in Europe. The same is true for the US, where house price developments can differ significantly between states. Next, interfering in housing is political. While the ECB was allowed to develop its own definition of price stability, there should be political involvement of the relevant authorities in the setting of macro-prudential policies. We argue for a centralised model in which the ECB has effective control over the relevant macro-prudential tools, with input from the national competent authorities. The latter allows for the much needed differentiation in the application of macro-prudential tools. We also favour a centralised model for reasons of coherence since the ECB will be in charge of micro-prudential instruments that will also be used for macro-prudential purposes.