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Do not trust politicians to supervise Europe's banks

When the Bank of England was made independent in 1997 it had to surrender its power to supervise the banking system. Parliament used two main arguments to justify this. The first was that there is a conflict of interest between monetary policy and the conduct of banking supervision. The second was that banking supervision cannot be as independent as monetary policy, and therefore needs to be much more accountable to the political authorities.

Both arguments proved wrong, not only in theory but also in practice. And not only in England.

Rather than a conflict of interest between monetary policy and bank supervision, the opposite has turned out to be true in recent years. The lack of information on the solvency of the banking system made it much more difficult for central banks, such as the BoE, to interpret market developments and to provide liquidity to sound institutions only. National supervisors had the tendency to paint a rosy picture of their financial system, which enabled banks to easily qualify as counterparties for central bank operations.

It is also unlikely that independent central banks that are accountable for their monetary policy objective, in terms of price stability, would seek to use monetary instruments for other reasons. Trying to address banks' solvency problems by extending central bank liquidity support is not very effective over time. Furthermore any attempt to manipulate monetary policy for other purposes would become apparent if there were sufficient transparency of central banks' operations.

The conflict of interest argument might have been an issue in the old days of politically dependent and non-transparent central banks. It is less relevant today. The opposite may actually be true. Without bank supervision powers the

central bank may nevertheless be induced to use monetary policy to resolve problems created by ineffective bank supervision out of fear that those problems might impact on financial stability and, as a consequence, on price stability.

The argument that the prudential supervision of banks requires a "different type" of accountability – in other words less independence – than monetary policy, because taxpayers' money is at stake is also flawed. The taxpayers' money argument could also be valid also for monetary policy. A decision to raise the policy rate or cut it at the wrong time might cost the economy – and thus the taxpayers – even more than rescuing a failed bank.

Bank supervisors should apply regulations and take early action, presenting the political authorities with the available options in case of bank resolution, at an early enough stage that the appropriate solution can be taken, with a view to minimise the burden on taxpayers. The Basel principles on banking supervision state that independence is essential in order to perform such a task properly.

Bank supervisory authorities that are not sufficiently independent, and are too closely associated with the political authorities, are generally under pressure to delay the identification of insolvent banks, for the fear that taxpayers would get upset. The problem thus tends to be postponed, and the cost to the taxpayer rises. The experience of the recent crisis has shown that taxpayers have paid most in countries where supervision was less independent and where the political authorities are most closely associated with the banking system.

So why, in spite of this evidence, and the lack of serious analysis, are these arguments still used, for instance in the discussion about the attribution of supervisory powers to the ECB? Why are the proposals which have been put on the table so insistent on the separation between monetary policy and supervisory activity?

Being slave of some defunct economist –to paraphrase Keynes – might be part of the answer. A more likely reason is the fear of creating a too powerful institution at the heart of Europe, with both monetary policy and bank supervision powers, that "nobody can control". Every time a campaign has started to move responsibilities to the European level, opposite forces mobilised to water down the effort and try retain some powers in the hands of the national authorities.

When the euro was created, several academics and commentators suggested that a single currency and a single market required a single regulator. The issue was analysed by European Finance ministers at least twice over the last few years, on the basis of the Lamfalussy report in 2001 and the De la Rosière report in 2009. The reform process was each time slowed down by the argument that the existing, decentralised system had worked well and would

continue to work well, possibly strengthened by some form of enhanced cooperation. The underlying attitude was: "If it ain't broke, don't fix it".

The crisis has shown that the system is indeed broken.

Had there been a single supervisor from the very start of the euro, independent like the ECB, the truth about some of the most problematic banks would probably have come out earlier. The excess leveraging accumulated in some countries would not have been tolerated for so long. The stress tests conducted since the start of the crisis would have been applied seriously, in a homogeneous way across countries. The cleaning up of banks' balance sheet would have started earlier.

A single supervisor would probably have confronted several governments at an early stage of the crisis with clear-cut decisions aimed at ensuring an adequate capitalisation of their banking systems, as happened in the US. Maybe that's what some actually did not want. But that's what the eurozone needs in order to solve the crisis and avoid new ones in the future.

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