Inside Out: Supervision Inside and Outside the Central Bank

Central Banking Seminar, The Implications of Divergent Monetary Policies
Federal Reserve Bank of New York

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Context

Global financial crisis 2008/09:
- Differences regarding the impact on banking systems
  - Several reasons... one quite important: (in) effective supervision

The international response to the crisis has focused on the need of more and better regulations:
- Capital
- Liquidity
- Provisioning
- Etc.
Context

- But the international response has not been so strong in other important matters of oversight such as supervision.

- As regulation improved, the supervisory framework faces additional challenges:
  - Both for central banks and other regulators with supervisory responsibilities.

- Objective: Preserve both economic and financial stability (aka: avoid the next financial/banking crisis).
Question 1:
Banking supervision inside/outside the Central Bank.....Does it matter?

Soundness of Banks, OECD Countries (Ranking WEF):
Supervision Inside Central Bank (red)
Supervision Outside Central Bank (blue)
Question 1: Banking supervision inside/outside the Central Bank.....Does it matter?

• Not really
Question 1:
Banking supervision inside/outside the Central Bank.....Does it matter?

- Not really
- There is no much evidence to conclude whether there is a best practice
- What it matters is a plain vanilla... good supervision
Question 2: What should be good supervision?

Two pillars:

The obvious (necessary but insufficient)

• Operational independence
• Budgetary autonomy
• Accountability
Question 2: What should be good supervision?

The challenging (now is becoming a must)

- Risk-based approach
  - Intrusive
  - Skeptical
  - Comprehensive
  - Corrective
- Coordination with other agencies
  - Lead Supervisor (conglomerates)
  - Financial Stability Councils
When supervision is inside the Central Bank

- Need for functional segregation between
  - Monetary/Financial issues. Macro-prudential policy
  - Supervisory issues: Micro-prudential policy

Issues for discussion

- When supervision is inside the Central Bank
  - Separate committees?
  - Monetary Policy Committee (MPC) and Financial Policy Committee (eg., UK)
  - Prompt reaction on supervisory issues (eg., UK PRA)
  - The Case for Two Committees (Kohn, 2015)
  - Separate decision-making bodies essential with separate goals and instruments (Svensson, 2015):
    - In good times: Nash equilibrium rather than coordinated equilibrium (joint optimization)
    - In crisis: full cooperation and coordination
Issues for discussion

· When supervision is outside the Central Bank
  ▫ Need for coordination arrangements with
    · Central Bank
    · Other agencies
  ▫ Independence is a must (nobody challenges that monetary policy (central banks) should be independent)
    · Avoid political and industry pressures
    · Regulatory capture / Cultural capture
Issues for discussion

- When supervision is outside the Central Bank
  - Financial Stability Councils:
    - Members: Ministry of Finance, Central Bank, Financial Regulators
    - Forum for discussion and exchange of information, not decisions
    - Careful and transparent communications (minutes, reports, etc.)
    - It will lead in crisis
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