Improving Banking Supervision within the EU

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Abstract

Improving banking supervision in the EU has three main requirements to supplement the new Basel proposals: improvements in corporate governance to make responsibility clearer and information more transparent; the introduction of more market discipline particularly through a regime of public disclosure of risks and risk management; a reduction in moral hazard by establishing an efficient route for bank exit. These issues are set out in detail in Mayes, D, Halme, L. and Liuksila, A, Improving Banking Supervision, Palgrave, 2001. This paper concentrates on the third area.

To provide adequate incentives for banks to run themselves prudently the authorities need to demonstrate in advance that they can resolve problem banks by wiping out shareholders and unsecured creditors in the event of insolvency and removing the existing management. Investors will then want to be convinced that the bank is being well run and managers will want to run the bank well to preserve their jobs. However, the incentive problems from 'too big to fail' and 'too many to fail' remain as the central bank has to preserve systemic stability.

The EU faces four problems in achieving this:- overcoming a history of bailing out banks; insufficient information to anticipate difficulties adequately; insufficient coordination through the principle of 'home country control'; a lack the power to act rapidly.

The information problem can be resolved by a combination of greater public disclosure by banks and improved cooperation among the member states through new Memoranda of Understanding. Coordination can be improved by agreeing prior principles for giving the home country responsibility subject to taking the interests of

other countries into account. The problem of lack of power can be addressed by adopting a version of existing US legislation, which involves automatic appointment of an administrator with sweeping powers, taking over from the general meeting of shareholders.