

**19TH ANNUAL INTERNATIONAL CONFERENCE ON POLICY CHALLENGES
FOR THE FINANCIAL SECTOR, JUNE 5-7, 2019 WASHINGTON, D.C.**

Session 6: Independence, 7 June, 10:00-12:00

Agency independence and accountability are at the core of an effective and successful supervisory function. However, lessons learned from the IMF/WB BCP assessments show a low degree of compliance with the Basel core principles for an effective supervision. Can it be claimed that the system is globally safe enough when there are still many instances in which politics or private interests can threaten the operational independence of the supervisor? How to ensure that supervisors have the right powers to act boldly in the interest of safety and stability while being accountable for their decisions and actions?

Moderator:

Mr. Alfonso García Mora, Global Director, Finance, Competitiveness and Innovation Global Practice, the World Bank

Speakers:

1. Ms. Chiara Zilioli, Director General Legal Services, ECB
3. Mr. Jacek Jastrzebski, Chair of the Board, Polish Financial Supervision Authority
4. Mr. Mauricio Costa de Moura, Deputy Governor, Central Bank of Brazil
5. Mr. Nicolas Veron, Peterson Institute for International Economics & Bruegel

Good morning Ladies and Gentlemen,

I. Introduction

Thank you very much for having invited me to the panel and for the opportunity to present the experience and perspective of the Polish Financial Supervision Authority (PFSA, Pol. *Urząd Komisji Nadzoru Finansowego*, UKNF). I am pleased and honoured to participate in this discussion.

I have been encouraged by the hosts to share my thoughts on the advantages and disadvantages stemming from having supervisor embedded in the central bank, and I would like to talk about it in the first part of my address. Later I would like to briefly touch upon some matters related to the independence of the financial supervisor and respective recommendations issued for the PFSA under the Financial Sector Assessment Program (FSAP). I would like to mention the changes that entered into force during the term of my office, which I took in November 2019. I will also talk about certain ongoing and planned actions aimed at reinforcing the PFSA's independence. These actions and changes go back to the leading question of our session which

is “how to ensure that supervisors have the right powers to act boldly in the interest of safety and stability while being accountable for their decisions and actions?”

II. Advantages and disadvantages stemming from having supervisor embedded in central bank (with a Polish perspective)

1. Background information

The current Polish system of financial market supervision is an integrated system outside the central bank. This was not always the case. Until 2002, Poland used the concept of specialised supervisory authorities: the financial market was overseen by four, and starting from 2002, three institutions. The decision to fully integrate financial supervision outside the central bank was implemented in two stages: In 2006, the insurance and pension supervision was consolidated with capital market supervision, and finally, in 2008, the KNF incorporated banking supervision. Full integration of supervisory powers with regard to the entire financial market was completed, with a single authority operating outside the central bank.

Currently the PFSA and its board (Pol. *Komisja Nadzoru Finansowego*, KNF) supervise banking, capital market, insurance and pension sectors, payment institutions and payment service offices, electronic money institutions and credit unions. The PFSA’s tasks include also supplementary supervision (of financial conglomerates) as well as mortgage credit intermediaries, benchmarks and securitisation. The PFSA is an authority responsible for micro-prudential supervision. Macro-prudential supervision in Poland falls within the responsibility of the Financial Stability Committee (FSC), appointed for that purpose under separate laws. The activities of the FSC follow two tracks. The FSC is responsible for both guiding the macro-prudential policy and for coordinating crisis management. The macro-prudential supervision activities are presided over by the Governor of the National Bank of Poland (NBP), while the crisis management activities are presided over by the Minister of Finance. Four major institutions of the financial safety network are represented in the Financial Stability Committee: the National Bank of Poland, the PFSA, the Ministry of Finance, and the Bank Guarantee Fund.

2. Outline of further discussion

Now I would like to discuss the main advantages and disadvantages stemming from having financial supervisor embedded in the central bank. Let me refer to a broader context, without limiting myself to the description of a situation in one country only.

According to a survey published in 2018 by Harvard University¹, there is no single universal model of supervision. The prerequisite for effective operation is operational independence of the supervisor. The question whether the supervisor should be embedded in the central bank or

¹ Ed Balls, James Howat, Anna Stansbury, Central Bank Independence Revisited: After the financial crisis, what should a model central bank look like?, April 2018, Harvard University, pp. 53–54
https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/x87_final.pdf

remain outside the central bank depends mainly on institutional conditions and political arrangements adopted in a given country.

I fully agree with that statement, and considering the European background and the system operating in Poland, I can see a strong preference for an integration of the supervision outside the central bank. Therefore, I am going to structure the presentation as follows.

Firstly, I will point at a few significant drawbacks stemming from having financial supervisor embedded in the central bank. Secondly, I will balance them against certain benefits stemming from having the financial supervisor embedded in the central bank. Thirdly, I will conclude by talking about the key advantages of having an integrated supervisor outside the central bank.

3. Arguments against having the financial supervision embedded in the central bank

One of the key objections raised against the model of financial supervisor embedded in the central bank is that too wide powers are vested in a single institution. Having supervisor embedded in central bank may blur the lines of defence against crisis in the financial sector, because they become cumulated in a single institution. In my description of this issue, let me use the European context.

The first line of defence is macro-supervision of the financial system defined as prevention of systemic risk, where systemic risk means a risk of disruption to the financial system, which may generate major negative effects for the internal market and the real economy. Currently, eleven EU countries entrust the task of macro-prudential supervision to the central bank². Such systemic arrangement is in line with the Recommendation of the European Systemic Risk Board (ESRB) of 2011, which is effective in the European Union³ and which clearly states that EU Members States must ensure that the central bank plays a leading role in the macro-prudential policy of each EU Member State. The second line of defence is micro-prudential supervision, normally exercised by national supervisory authorities. Such supervision is exercised until there is a need for recovery and resolution of a specific financial institution. Combining those two lines of defence (macro-prudential supervision and micro-prudential supervision) within a single institution leads to blurred accountability for supervisory activities undertaken at various stages. In case of trouble or emergency in the financial market, we would not really know who should be held responsible for the lack of proper prevention of those problems.

Since we are using the example of the European Union, I have to refer to the recommendations of the de Larosière Group Report⁴. This report was published in February 2009 as a set of findings and recommendations concerning the necessary legislative and institutional changes in the EU in the area of financial supervision, aimed at ensuring financial stability. The report stated that although the European Central Bank (ECB) should be entrusted with important tasks

²https://www.esrb.europa.eu/national_policy/shared/pdf/esrb.170825_list_national_macroprudential_authorities_national_designated_authorities_in_EUMemberStates.en.pdf

³ Recommendation of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3);

https://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_3.en.pdf

⁴ The de Larosière Group Report, Brussels, 25 February 2009, paragraph 171, p. 43

https://ec.europa.eu/info/system/files/de_larosiere_report_en.pdf

relating to macro-prudential supervision, that is chairing the European Systemic Risk Board, the ECB should not be entrusted with tasks relating to micro-prudential supervision. A central bank which also exercises micro-prudential supervision of financial market exposes its own authority and credibility to reputational risk. Such risk may materialise where potential errors in financial supervision (in particular the most spectacular ones, which involve failure of a supervised institution) may affect the perceived performance of the central bank as a guardian of price stability. A wide range of supervised entities and powers concentrated in a single institution (from the banking, insurance, capital, pension sectors, payment institutions through certain functions regarding supervision of market practices) significantly increases the probability of minor or major issues in financial supervision. Any such issue may have an impact on the central bank's reputation.

Moreover, assigning the function of financial supervision to the central bank may lead to conflicts between the objectives of the monetary policy, which is to ensure price stability (to prevent high inflation), and the objectives of micro-prudential supervision (stable situation of supervised entities). The risk of this conflict has been identified in many publications, including the IMF papers⁵⁶. To use an example relevant for the banking sector: a central bank which also exercises prudential supervision may be subject to a pressure to implement a lax monetary policy with regard to money supply, to keep the banking sector healthy. In the long term, such measures may lead to increased inflation rate in a given country and compromise the key function of the central bank, which is to safeguard the value of money. On the other hand, a strict monetary policy may constrain banks' lending and thus negatively affect their profits, and in a broader context, reduce money supply to the economy.

Additionally, the doctrine claims⁷ that, as a rule, instruments guiding the monetary policy are procyclical, while prudential regulations are countercyclical. This conflict may therefore result in a pressure on the supervisor to ease strict supervisory regulations during an economic slowdown.

The historical and organisational conditions, in particular the performance of its natural function of 'bank of banks', may incline central bank to give the banking sector priority when performing its supervisory tasks. Focusing on the banking sector may result in less attention being given to other areas of supervision, which have their own characteristics. If the supervision exercised by the central bank is to cover the entire financial sector, the risk of disproportionate focus on only one sector as area of supervision (at the cost of other sectors) might contribute to the materialisation of reputational risk, in case systemic problems materialize in the other market segments.

⁵ Martin Čihák, Richard Podpiera, Is One Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision, IMF, 2006, p. 14

<https://www.imf.org/external/pubs/ft/wp/2006/wp0657.pdf>

Marc G Quintyn, Michael W Taylor, Should Financial Sector Regulators Be Independent?, IMF, 2004

<https://www.imf.org/external/pubs/ft/issues/issues32/index.htm>

⁷ Hanna Gronkiewicz-Waltz, On The Conflict Of Interest Between Supervision And Monetary Policy, Ruch Prawniczy, Ekonomiczny i Socjologiczny, 2016

http://cejsh.icm.edu.pl/cejsh/element/bwmeta1.element.ojs-doi-10_14746_rpeis_2016_78_3_2

Finally, there is legitimate fear that with a single institution, which has powers of key importance to the country's financial markets and the monetary policy, an excessively high level of independence will reduce accountability for its actions. In fact, when the Single Supervisory Mechanism to supervise the banking sector in the euro area was being developed, claims were made—to reject the questions about the accountability of the ECB for supervisory activities—that such accountability might have an adverse effect on the ECB's independence, which is the primary value. The traditionally strong independence of the central bank may be difficult to be reconciled with the clear need for accountability of financial supervisors. Establishing an authority vested with the traditionally rooted strong sense of independence, with a very wide mandate and a very complex structure, whose actions may raise doubts as to the deficit of accountability and operational transparency. This in turn increases the risk of misconduct⁸.

In my opinion, building the financial supervisor within the structure of a central bank entails significant risks. Such supervisory architecture does provide, however, certain advantages, which I would like to briefly present now.

4. Arguments in favour of supervision embedded in central bank

Having financial supervisor embedded in central bank involves certain benefits. I will try to mention here about the main advantages of such model of integration.

The first argument *pro* is a flipside of one of the arguments *contra* which has just been discussed. In general, the central bank is believed to be an institution which enjoys a special status in each country. This is also determined by historical factors, which have contributed to the high position of the governor of the central bank. Institutional independence increases the comfort of making bold decisions. For that reason, when implementing their mandate, central banks may extend that independence to prudential supervision. A central bank typically enjoys an appropriate level of independence. As mentioned though, it is extremely important to strike the right balance between those two features.

Central banks, since they use sources of income which are not related to the state budget, are seen as public institutions with the highest economic status among all public bodies in the country, which implies strong financial independence. Appropriate funds and high level of discretion in managing those funds allow central banks to implement an appropriate staff policy. Banks can attract top professionals, who must be provided with appropriately high remuneration, to prevent excessive turnover of staff and transfers to the private sector. Considering the importance of competences of staff, i.e. the human capital, in ensuring appropriate quality of financial supervision, the financial resources and the guaranteed independence which allow for attracting staff could be considered an advantage.

⁸ Donato Masciandaro, Marc Quintyn, The Evolution Of Financial Supervision: The Continuing Search For The Holy Grail,

https://www.suerf.org/doc/doc_8e296a067a37563370ded05f5a3bf3ec_1919_suerf.pdf

One of the advantages of having financial supervisor embedded in the central bank is that the staff of such institution can have direct access to a wide range of market data, both data collected for the purposes of the monetary policy and data obtained for the purposes of prudential supervision⁹. This may create certain synergies in terms of communication and increase the efficiency of operation based on a wide range of available data. Where prudential supervision and central bank exist separately, the need arises for the exchange of data, which may be hindered or entail time inefficiencies.

5. Arguments and considerations related to integrated financial supervision outside the central bank

We should also take a look at the advantages of having integrated supervisor outside the structures of central bank. The adoption of the model of integrated supervisor outside central bank is justified, first of all, by the effectiveness of that model, which is related to a clear trend of shifting from decentralised supervision (focusing on one financial sector only) toward integrated supervision. This is a global trend but I will focus on examples from the European Union. In terms of geographical distribution, in Europe there is a sort of a division into Northern European countries, especially Baltic and Nordic countries (Latvia, Estonia, Finland, Sweden, Denmark, and Norway), which have chosen the model of supervision fully separate from the central bank, and Southern European countries, which apply model of fragmented supervision (Greece, Spain, Portugal, Italy).

The Nordic supervisory authorities are integrated supervisors operating outside central banks. They mainly deal with prudential supervision but they are also responsible for market conduct supervision. That model is viewed as beneficial both in terms of increased efficiency and the economies of scale. Establishing integrated agencies has improved the standing of financial regulation and created better opportunities for career development, which has ultimately helped to overcome staff recruitment and retention problems¹⁰. It should also be noted that the financial crisis and the sovereign debt crisis have affected Nordic countries less harshly than the southern European countries. The supervisory model was not the only factor determining the effects of the crisis but it should not be disregarded.

Today in Europe we can identify both examples for consolidation of supervision within a central bank as well as illustrations for an opposite trend – a separation of the supervisor from the central bank. The example of the first trend is Ireland, where after the financial crisis in 2008–2009, banking supervision returned to the Central Bank of Ireland. The change was criticised by some commentators, who claimed: ‘a mere change of the supervisory structure, without changing the organisational culture, will not improve the security of financial markets.’ The

⁹ Donato Masciandaro, Marc Quintyn, The Evolution Of Financial Supervision: The Continuing Search For The Holy Grail,

https://www.suerf.org/doc/doc_8e296a067a37563370ded05f5a3bf3ec_1919_suerf.pdf

¹⁰ Michael Taylor, Alex Fleming, Integrated Financial Supervision, Lessons of Scandinavian Experience, Finance & Development, December 1999

<https://www.imf.org/external/pubs/ft/fandd/1999/12/pdf/taylor.pdf>

Irish example, although reproduced in Lithuania and Hungary, is not predominant, and the arrangements based on consolidation of an integrated supervisor with the central bank are still less popular. Most European countries, including Poland, have decided to choose the model of integrated supervision of financial markets outside central bank¹². A current example of an attempt to separate banking supervision from the central bank and to incorporate the former into integrated supervision is Austria. In November 2018, the Austrian government put forward their plans for an institutional reform of the financial market supervision, which is subject to ongoing discussions. The purpose was to transfer all supervisory powers and resources relating to banking supervision (previously shared between the Austrian central bank – Österreichische Nationalbank and the Financial Market Supervision Authority – FMA) to the FMA by 2019. Financial market supervision would then be fully integrated within the FMA.

Now I am going to mention the context of the evolving European regulatory landscape. Regulations on financial markets in the European Union are becoming more and more inter-sectoral. Examples include the CRD IV/CRR package, concerning both credit institutions and investment firms, BMR (the Benchmarks Regulation), EMIR (Regulation on OTC derivatives), as well as other legal acts relating to packaged retail investment and insurance products (PRIIPs), financial conglomerates or securitisation. Some of those acts are adopted by the European Parliament in the form of regulations, which do not require implementation at national level and which are applied directly. Moreover, these regulations tend to become more and more conduct-oriented or product-oriented and as such not substantially sector-specific (i.e. specific for banking, insurance or securities business) as financial regulations used to be in the past.

An integrated supervisor may effectively adapt its tasks to new regulatory requirements. For example, where an inter-sectoral perspective is required, an integrated supervisor has the best measures to apply regulations in a consistent manner – considering the specific nature of each segment of the supervised market, but with the aim of achieving consistency. An example is the supervision exercised by the PFSA over a financial conglomerate run by an insurance undertaking – which is rare; usually, in Europe and elsewhere, the parent undertaking of a conglomerate is a bank. Such supervision requires coordination of activities in relation to entities from all sectors, being part of a group of companies. Activities of this type, conducted by one institution in relation to the entire group, may be carried out much faster, using much more simple methods, and in closer cooperation at both working and decision-making levels. At the same time, unlike in the case of central bank, such supervision is free from disproportionate focus on the approach and the analytical tools specific to banking, which would be inadequate due to the dominant role of the insurance undertaking in the group. It is therefore easier to face regulatory and supervisory challenges in the case of integrated supervision. A consistent supervisory standard is maintained for all entities operating in each segment of the financial market, with less temptation to give priority to banking. With a supervisor outside the central bank, the inter-sectoral regulations can be applied in a consistent manner in all or several segments of the financial market. There is no conflict between implementation of the monetary policy and implementation of the objectives of financial

supervision. I should repeat that prudential supervision and monetary policy are in many respects two completely different functions. The differences include also the nature and frequency of decision-making as well as the type of information necessary to make decisions and the methods used to implement decisions¹³. Implementation of the objectives of monetary policy and undertaking activities in that respect take place with different frequencies and at different pace. Undertaking supervisory measures, especially in case of emergency, requires that decisions be made much more frequently and in a very short time. Moreover, an integrated supervisor outside central bank does not generate the risk that – unlike a central bank, dealing with both monetary policy and macro-prudential supervision at the same time – it might not notice increasing risks in a sector ‘in good times’ as it will be more focused on the price pressure.

Finally, an integrated supervisor operating outside the central bank is better positioned to put more focus on the conduct-oriented or product-oriented supervision activities and expand the scope of activities aimed at protecting the integrity of the markets and the interests of its participant. The trend towards a growing relevance of conduct based supervision appears clearly in European regulations and it also meets the expectations of many market participants. Given the inter-sectoral nature of both conduct- and product-oriented supervision, this evolution provides for a clear argument supporting the integration of financial supervision outside the central bank.

What is relevant, though, is that the financial supervision located outside the central bank does not directly benefit from the traditionally strong and institutionally guaranteed independence of the central bank. Therefore, key element is to provide such supervisor with appropriate level of independence.

II. Independence of the financial supervision – a brief update from Poland

As mentioned in the beginning, I would also like to share some thoughts on the recent, current and potential future developments in the field of independence of the PFSA. Strengthening the independence of the Polish supervisor is one of my personal goals in the office. Several changes in this respect entered into force in the last months, while others are being implemented or are subject to legislative process as we speak. There are also measures which I consider absolutely crucial and which still have to be designed and proposed for the legislative actions. In particular, we work towards proposing measures to increase the level of legal protection of the PFSA board members and its staff.

The independence of the PFSA has been reviewed and commented on by the IMF and the WB; for example, under the 2012 FSAP, recommendations were made to increase the PFSA’s independence. The FSAP assessment of 2018 reiterated the need to address the identified deficiencies. We appreciate the recommendations in that respect as they also facilitate the national dialogue aimed at introducing the necessary institutional changes regarding the financial supervision in Poland.

While changes are never easy or quick, in January 2019, a set of very significant amendments was made to the Polish Act on Financial Market Supervision, resulting in a series of key changes. It was in fact a very deep reform of the organization of the PFSA – the first since the establishment of the authority in 2006. The most relevant organizational changes are the following. Firstly, the PFSA has acquired the status of a legal entity, thus it has been legally separated from all other administrative structures. Secondly, changes were made to the methods of financing the PFSA. It may now manage its funds much more efficiently. The PFSA is now financed directly from the fees paid by supervised financial market entities, not (as previously) from contributions but through the state budget. Thirdly, the new legal status of the PFSA means that it has gained independence in managing the funds, which allows for a more flexible allocation of funds, according to current requirements. Financial independence also allows for a greater independence of staff, as the PFSA will now be able to better implement its human resources policy.

As regards the composition of the PFSA board, the amendment has increased the number of board members. Some of them act in an advisory capacity, without the right to vote. Currently, members of the PFSA board fall into three categories: firstly – professional, internal full time board members, being the chair and two deputies, who all are employees of the PFSA, secondly – external board members with a voting right, who include the representatives of the central bank and other institutions (e.g. the President of Poland, the Prime Minister, the Ministry of Finance and the National Bank of Poland), and thirdly – external board members acting in an advisory capacity (including the representative of the Bank Guarantee Fund, the Office for Competition and Consumer Protection and the coordinator of the state security services). The broadening of the board composition is considered positively, allowing the PFSA board to benefit from various professional backgrounds and competences of its members, as well as to foster efficient data flow. I believe however, it would be beneficial to further strengthen the professional core of the board by adding another member who would be involved on the daily basis in the operations and activities of the PFSA. I have recently initiated actions to establish the position of the third deputy chair, who – in the current setup – would be responsible for the insurance market. Such an increase in the number of professional, full time members of the PFSA board would have a positive effect on the board's decision-making process and would ensure that each sector of the financial market will be supervised by a PFSA division reporting to a dedicated professional board member.

Another essential issue is that the legal protection of the PFSA staff should be strengthened. This matter was also raised in the FSAP report, which recognises that: (i) the Polish legal system fails to provide protection to the employees of the supervisory authority after the term of their function is over, and (ii) it fails to ensure that legal costs, including defence costs, are paid. We agree that the regulations concerning this issue are insufficient and must be improved immediately. This is one of my objectives for the months to come.

The PFSA has examined regulations concerning the protection of staff of supervisors in more than 30 countries. The examination of laws shows that the approach to that issue varies considerably across the countries, and there is no single model. Few countries have incorporated

comprehensive solutions into their legal framework. In some countries, the law requires prior consent before such costs may be borne; in some countries insurance contracts are concluded to cover the losses caused by the staff of supervisory authorities.

I have initiated work on new draft legislation, which will allow to ensure a high level of independence of the members of the PFSA board and staff, including the requirement of a prior consent of an authorized body to being detained or arrested by law enforcement authorities or being held criminally liable in connection with the discharge of their supervisory duties. Moreover, in order to improve the situation immediately, to the extent possible within the limits of my powers, I have entrusted the Legal Department of the PFSA with a task to create a special team of legal counsels to provide legal support to the PFSA employees who will act as witnesses in courts, public prosecutor's office and before law enforcement authorities in connection with the actions they took or in which they participated.

No supervisory model is perfect, and the organization of the PFSA - as every organization – requires permanent monitoring and changes if needed, to keep the highest level of efficiency and independence and to meet the legitimate expectations of our stakeholders. I do believe that the changes I have mentioned, those which have already been made, those which I have initiated recently, as well those that are yet to be proposed, show that the PFSA is able to quickly adapt to the requirements and it considers its independence as a very important feature. I am glad that as part of this exchange of views I had the opportunity to share my thoughts regarding the independence of supervisory authorities and well as present my main priorities in this field in my capacity as the Chair of the PFSA board.

Thank you.

The document was prepared at the Polish Financial Supervision Authority.