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Eduardo Lundberg

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Edited by:

Research Department (Depep)
(e-mail: conep.depep@bcb.gov.br)

General Control of Subscription:

Banco Central do Brasil
Demap/Disud/Suimp
SIG - Quadra 8 - Lote 2025
70610-400 - Brasília (DF)
Telefone (61) 344-1554
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Banco Central do Brasil Information Bureau

Address:	Secre/Surel/Dinfo
	Edifício-Sede, 2º subsolo
	SBS - Quadra 3, Zona Central
	70074-900 - Brasília (DF)
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Monetary Policy and Banking Supervision Functions on the Central Bank

Eduardo Lundberg[1]

In our case, the debate on withdrawal of the banking supervision functions from Banco Central is backed by a good deal of political opportunism and very little reflection on the pertinent issues. (Gustavo H.B. Franco, O Banco Central e a supervisão bancária, Jornal do Brasil, 05.16.99, pg. 16).

I – Introduction

As the institution charged with monetary and exchange policy implementation and national financial system (SFN) regulation and supervision, Banco Central do Brasil's (BCB) role is one of enormous importance. In the first grouping of responsibilities, the institution acts as a classic central bank and performs the task of ensuring internal and external currency stability. In its supervisory role, however, it's responsible for preserving financial system stability and soundness, a task not always shared by the central banks of other nations. In the light of international experience, this paper will analyze the advantages and disadvantages of maintaining these supervisory functions at BCB.

In historical terms, there are two reasons that justify the creation and existence of a central bank: preservation of price stability and microeconomic questions in the

[1] Banco Central do Brasil. The author is grateful for the collaboration, comments and suggestions offered by Sérgio Mikio Koyama and Victório Yi Tson Chu. Special thanks to Sérgio Mikio Koyama who performed the research and prepared the appendix on international empirical evidence.

framework of banking and financial system stability.[2] At the time of the gold standard, the primary stabilizing role of central banks was ensuring the health of the banking system. Today, many countries have opted to create distinct institutions, one charged with ensuring currency stability and the other with banking supervision.[3]

Many analysts hold the position that, even though central banks are the lenders of last resort to the banking community, these institutions should not perform the task of financial system supervision. However, one cannot ignore the fact that the preservation of monetary stability and banking system stability are two sides of the same coin. A central bank would be clearly unable to preserve currency stability if the banking system is fundamentally unstable. Thus, one can understand that, even though legislation may not reserve bank supervisory functions to these institutions, central banks are always interested in this question. On the other hand, as recent Brazilian experience had demonstrated, a country cannot hope to have solid and efficient financial institutions in an environment of monetary instability.

There are currently two universal tendencies as regards the question of governmental structures designed to operate monetary policy and bank and financial institution supervision. The first and clearest tendency is to withdraw supervisory functions from the "guardian of the currency". This solution is normally seen as one of the institutional decisions capable of strengthening "central bank independence".[4] The second trend – and one that seems to be gaining strength - is merger of the agencies charged with banking, securities and insurance supervision into a single agency. This is viewed as an instrument for further enhancing capacity to perform the financial groups' consolidated supervision.[5]

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[2] For an analysis of central bank creation, see GOODHART (1988), SMITH (1936) and LUNDBERG (1993).

[3] For an overview of the institutional structure of different countries, see GOODHART & SCHOENMAKER (1995) and HAUBRICH (1996). For an overview of the situation in Latin America, see AGUIRRE (1997).

[4] For a discussion of the major institutional aspects that define an independent central bank, see SWINBURNE & CASTELLO-BRANCO (1991).

[5] The most significant experience with these two trends is the English banking reform announced in May 1997, which withdrew the bank supervisory functions previously exercised by the Bank of England and granted the institution independence for monetary policy purposes. The tasks of supervising banks and the other financial system segments, including insurance and private pension funds, were merged into a single agency – the Financial Services Authority (FSA).

In the case of Brazil, these matters are now being discussed in the framework of a new financial system law, as required by article 192 of the Federal Constitution. At some point in the near future, the government and Congress are going to have to sit down and negotiate and approve new national financial system legislation. We are well aware that, in ultimate analysis, this reform will have an eminently political character. What truly concerns us in all this is the possibility of coming to a decision on the organization of our institution without an adequate technical debate and with little or no attention to the progress and extremely rich experience garnered within the international community. For a structural reform that involves monetary policy and national financial system supervision, it is our understanding that due consideration must be given to the two major and universal tendencies – central bank independence and consolidated supervision of financial groups.

Based on these tendencies, banking supervision should be withdrawn from Banco Central do Brasil, thus strengthening the institution in its task of preserving price stability. Parallel to this, the functions of supervising banks, financial institutions, securities, insurance companies and private pension funds should be brought together under a single roof, making it possible to supervise economic groups in all these areas much more effectively.

Below, we have prepared a brief analysis of the ongoing debate and international experience regarding both monetary policy and banking supervision. In the first place, we will present a discussion of the advantages and disadvantages of maintaining the banking supervision on the central bank or removing it from that institution. This question is viewed from the point of view of both monetary policy and banking supervision. Following that discussion, we will discuss the question of international tendencies as related to central bank reforms and the respective supervisory systems. Finally, in the conclusion to this paper, we will evaluate our position in light of the situation in Brazil.

II – Survey of literature

II.1 – The monetary policy perspective

From the monetary policy point of view, "central bank independence"[6] constitutes a strong argument in favor of excluding banking supervision from the responsibilities reserved to a monetary authority. To a greater or lesser extent, this argument of protecting the "guardian of the currency" has historically explained the political option made by many countries to withdraw banking supervision from the central bank and transfer it to another government agency.

In a strict sense, since currency was a commonly accepted commodity (gold or silver) up to the middle of the 19th century, the concepts of central bank and monetary policy were born in the 20th century. Monetary policy became viable only when bank notes and accounting money came into use or, in other words, when the commonly used commodities were substituted by credit bills (bank notes) or accounting records (demand deposits).

The first stage of the transition from one system to the other featured the "rule of convertibility", known in history as the period of the gold standard. Issuing banks were able to issue currency and commercial banks were able to accept demand deposits used in check-based transactions, provided that these liabilities were convertible into legally accepted money (metallic money minted by the government). In other words, there was no real monetary policy, but rather a law or rule that determined the nature of currency and the guaranty underlying that currency (in this case, precious metals).

The adoption and acceptance of fiduciary money (legal tender with no effective backing) were by no means a painless process. The hyperinflation that racked Germany and several Eastern European nations in the 1930s were episodes that called the attention of the public opinion, government authorities, politicians and all the developed

[6] This term is used in economic literature to describe a central bank's autonomy in conducting monetary policy, as an instrument designed to protect the "guardian of the currency" against the actions of its sole stockholder: the government.

world in general. Fearful of taking the plunge into a currency without backing, a last attempt was made to preserve at least a resemblance of "monetary rules" within the Bretton Woods system. With this decision, the American dollar was made convertible into gold and all other currencies were tied to the dollar.

The postwar period was one of enormous progress and big economic transformations and was powerfully impacted by the ideas of Lord Keynes. It was at that time that economists divided into two distinct views with regard to the role of money supply in an economy. The position of the Keynesians was that the real economy was impacted by a bigger or smaller money supply, thus demanding discretionary monetary policy. On the other hand, the monetarists convinced themselves that currency had little impact on the real economy and, consequently, backed the adoption of monetary rules.

It was at this point in time that the debate regarding central bank independence came to the surface and rules versus discretion debate was incorporates into the discussion. Rigid monetary rules should be adopted or monetary policy should be implemented in a responsible and flexible manner in light of the circumstances prevailing in an economy. With the end of the gold standard, a void had to be filled: a new and rigid set of rules or the granting of discretionary powers to an independent central bank? The fact of the matter is that economists do not have a clear and unequivocal answer to this query even today. Theoretical evidence exists to support monetary policy rules[7], but there has never been a consensus as to the definition of a specific rule.[8] Though there is evidence to support central bank independence, there has never been a consensus regarding the institutional format of that independence.[9]

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[7] See KIDLAND & PRESCOTT (1977).

[8] The most emphatic and best known defense of monetary rules was put forward by Milton Friedman in his discussion of constant monetary growth (see FRIEDMAN, 1968).

[9] There are many highly distinct images of the role of a central bank and monetary policy. The monetarists (e.g. FRIEDMAN, 1968) defend a dependent central bank with preordained rules to avoid the discretion of an independent monetary authority. The Keynesians, on the other hand, defend an autonomous central bank embodied with this discretionary powers and some degree of basic coordination with the Treasury. For detailed presentations of the positions involving "rules versus discretionary authority" and "central bank independence versus macroeconomic coordination", see BRYANT, 1980, chapter 18.

In this framework, what would seem to prevail is the tendency to maintain a discretionary monetary policy, in which the money supply is fine-tuned according to the needs of the economy. At the same time, in the more democratic societies, the population would not seem willing to grant such discretionary authority to the government, prefering to delegate this power to an independent central bank. There is a sense of concern and misgiving rooted in a consensus among economists: monetary stability is an important precondition for long-term growth and inflation is a socially regressive tax.

Two major aspects must be stressed when discussing the question of central bank "independence". In the first place, one must keep in mind that the concept of central bank autonomy is basically a monetary policy matter. Secondly, this autonomy is a question of degree, since we are in an obviously interdependent world. There is also a fundamental "democratic" concern in this aspect: how can a government institution have a mandate with potential for conflict with other areas of a democratically elected government? In this sense, central bank independence reflects a higher degree of autonomy granted by society to that institution with the greater objective of preserving an enhanced level of price stability.[10]

Since there is a direct relationship between central bank independence and monetary policy, the dimensions of the institution's power to formulate and implement that policy are obviously the elements of greatest importance. When other objectives and functions, such as responsibility for banking supervision, are imposed on a central bank, the result will be an institution with multiple objectives competing for priority. Such a situation, evidently, is fraught with potential for generating detrimental impact on the fundamental goal of monetary stability. Those central banks that have bylaws that specify that their greatest and only goal is to preserve monetary stability are considered to have the

[10] According to CUKIERMAN (1992, chapter 3), among the objectives of government economic policy is price stability. However, other objectives of the same government tend to conflict with that goal. In this sense, a central bank that is given a certain degree of autonomy and that has a preponderant concern with price stability will tend to prioritize that objective over all others pursued by the government.

highest degree of independence. And this independence is seen to be even greater when banking supervision is excluded from the institution's responsibilities.[11]

Though it is unanimously accepted that banking supervision should not be included among the responsibilities of an "independent central bank", there is no consensus as to whether monetary policy is more effective when the central bank is not the supervisory entity. The last two chairmen of the North-American Federal Reserve System – a notorious independent central bank – are vehement in defense of their bank supervisory powers.[12] As we will see below, their positions are usually based on macroeconomic concerns as monetary and payment systems stability, aside from the question of discount window operations.

However, those who defend the position of central banks with supervisory powers do not restrict their arguments to questions typical of the supervisory area. During a testimony on Banking, Housing and Urban Affairs Committee of the United States Senate in 1994, Alan Greenspan stated that "joint responsibilities make for better supervisory and monetary policy than would result from either a supervisor divorced from economic responsibilities or a macroeconomic policy maker with no involvement in the review of individual banks' operations".[13]

If the "bank of banks" had better information on the health of individual banks, it would certainly avoid "discount window" operations with insolvent institutions and, consequently, better protect monetary policy. However, this is not the only advantage: access to the confidential information obtained through supervisory activities can be an important monetary policy instrument not only in light of the important role banks play in an economy, but also because problems perceived within banks can often be the harbinger of significant difficulties in the economy as a whole. Evidence exists that a

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[11] Several studies that have attempted to demonstrate an inverse correlation between inflation and the varied degrees of central bank independence have utilized this position as their underlying premise. See, for example, ALESINA & SUMMERS (1993) and CUKIERMAN (1992).
[12] For instance, both Paul VOLCKER (in VOLCKER, MANCERA & GODEAUX, 1991, pg. 47/52), and Alan GREENSPAN (see HAUBRICH, 1996) explicitly defend greater central bank involvement in bank supervision activities.
[13] See PEEK, ROSENGREN & TOOTELL (1997), pg. 01.

central bank's privileged access to confidential banking supervision data can be extremely useful to that institution in conducting monetary policy.[14]

II.2 – The supervisory perspective

There is no clearly defined concern or debate in specialized literature on banking supervision, dealing with the question of whether this responsibility should be included among a central bank's function. Based on the essential complementary relation that exists between these objectives (currency and banking system stability), there are strong and well-founded reasons for opposing a complete dissociation between a central bank and the bank supervisory authority,[15] particularly in light of the central bank's role as lender of last resort to banks. However, when the concept of moral hazard, drawn from literature on deposit insurance, is injected into this scenario, it becomes somewhat more difficult to defend this position.

Aside from commercial banks being part of the payment system, banks and other financial institutions are the intermediaries of money and credit operations of economic agents, where the interest rate are formed. And it is precisely here that one perceives the strong correlation between macroeconomic stability and financial system health.[16] A nation's macroeconomic difficulties affect the solvency and liquidity of the banking system, at the same time in which insolvent banks and financial institutions can imperil both the efficient operation of an economy and the effectiveness of a government's economic policy.

In general, banking insolvency is caused by poor management, excessive risk taking, fraud and unforeseen changes in the economic environment that generate negative impacts on loan and investment returns. It is with the latter item in mind that many

[14] The study by PEEK, ROSENGREN & TOOTELL (1997) seeks to demonstrate the hypothesis that privileged access to information on the financial health of banks can affect the economy's response to monetary policy.
[15] See DUQUESNE (1997) and LINDGREN, GARCIA & SAAL (1996), pg. 134.

observers consider the financial system to be a highly sensitive thermometer of a country's economy, since alterations in the overall situation or in the real side of the economy have a powerful impact on the solvency of banks and financial institutions, as reflected in their operations with clients and, principally, in the quality of their loans.

Economic policy, in turn, is impacted by financial system fragility and unsoundness, particularly in terms of the fiscal and monetary impacts caused by bank failures. Insolvent financial institutions no longer have the capacity to respond coherently to market incentives and economic policy stimuli, especially in the area of monetary policy. Banking system fragility stands as an important obstacle to interest rate increases and, therefore, to implementation of a restrictive monetary policy. The impacts caused by banking and financial systems on the economy as a whole are a source of growing concern in all countries. With the exponential increase in international economic and financial transactions in recent years, concern with financial system stability and soundness has become a question of international scope. As the economic and financial systems of the different markets and countries become increasingly interdependent, the risk of contagion generated by problems initially circumscribed to specific localities has increased.

Since it would not be feasible to create an international supervisory entity, the Basle Committee on Banking Supervision was founded in 1977 under the auspices of the Bank for International Settlements (BIS). Known as the Basle Committee, this entity has fostered introduction of various types of mechanisms and information exchanges among national supervisory agencies, in an attempt to attain at least some degree of control over the international financial system by establishing mechanisms of control over the banking systems of each country. The Basle Committee has disseminated qualitative standards to be followed by bank supervision authorities,[17] including recommendations with respect to the question of the "independence" of the supervisory

[16] For a more complete study on the interrelations between a country's economy and the solvency of its banking system, see LINDGREN, GARCIA & SAAL (1996), chapters 4 and 5.

[17] See the 25 "Core Principles for Effective Banking Supervision", issued by the BANK FOR INTERNATIONAL SETTLEMENTS (1997).

entity itself,[18] without going into the question of whether supervision responsibility should be assigned to the central bank or another organization.

Bank insolvency is the primary concern. There are no significant problems as regards the traditional instruments included in the bank "safety net"[19]: licensing, regulations and financial institution supervision. The roots of current conflicts and difficulties are found in other components of the "safety net": discount window operations, bank intervention and liquidation mechanisms and deposit insurance. In this case, one can utilize the classic discussion applicable to deposit insurance: the problem of moral hazard.

In one form or another, all countries extend some type of "safety net" for their banks, but not all of them have specific deposit insurance mechanisms. In general, these "safety nets" encompass central bank discount window operations and deposit insurance mechanisms.[20] Though these "safety nets" do provide certain benefits, they can also be a source of serious problems, particularly in terms of moral hazard or, in other words, they can encourage bankers, managers and depositors to become increasingly imprudent and even dishonest, since they are not always held accountable for the consequences of defaults at their institutions.[21]

The protection offered through deposit insurance is frequently condemned on the basis of the argument of "moral hazard", principally when this protection is unlimited. However, in the absence of this type of mechanism, the negative impact of "moral hazard" can be even greater, if large scale depositors and banks become convinced that the government will eventually intervene and rescue all concerned.[22] A good deposit

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[18] "Independence" in the sense of "operational autonomy" to perform its functions free of political pressures, but with due accountability. This recommendation is part of the first of the 25 principles listed under the "Core Principles for Effective Banking Supervision".

[19] According to DEMIRGÜÇ-KUNT & KANE (1997), the concept of deposit insurance can be much broader and be used to define a complex of instruments aimed to provide a "safety net" to depositors (deposit insurance, lender of last resort, banking supervision, bank restructuring instruments, etc.). See LUNDBERG (1999) for a more detailed discussion of these instruments.

[20] See ENOCH, STELLA & KHAMIS (1997), pg. 10/11.

[21] In his analysis of bank "safety nets", CALOMIRES (1997) also questions deposit insurance mechanisms since they make it more difficult to impose market discipline and generate problems of moral hazard.

[22] An interesting comparative analysis between a system of indemnity paid to depositors without deposit insurance (implicit protection) and a formal system of protection can be found in TALLEY & MAS (1990), pg. 13/14.

insurance system not only frees the government from the burden of providing coverage to depositors but also greatly reduces the discretionary content of the solutions provided to depositors and can even reduce "moral hazard" caused by the government having to constantly ride to the rescue.[23]

In summary, from the banking supervision point of view, it is recommended to have cooperation between the supervisory authority and the monetary authority, since the central bank is still the lender of last resort, which is one of the classic instruments of the banking "safety net". In this case, specific literature on deposit insurance indicates that the only question remaining is that of moral hazard, meaning that the central bank must avoid granting loans to insolvent banks.

II.3 – Advantages and disadvantages of banking supervision within the central bank

The argument most commonly utilized to defend the separation of banking supervision from the monetary authority is that of conflict of interest. Evidently, the premise underlying this type of argument is that of "central bank independence" or, in other words, preservation of the "guardian of the currency". Financial assistance to banks through discount window operations may, in some cases, become excessive and jeopardize monetary policy as a whole.[24] With the influence banks often have over the central bank, the institution may be tempted to give greater priority to bank protection than to the public interest.[25]

The most significant conflict, however, involves the setting of interest rates. If the central bank is also the supervisory authority, it may encounter difficulties in raising interest rates to avoid inflation, since this can also be detrimental to the financial health of banks. The greater the operational gaps found among financial institutions – the lack

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[23] ENOCH, STELLA & KHAMIS (1997), pg. 10/11, explicitly defend maintenance of some ambiguity only in the definition of the nature of the large banks for purposes of offering differentiated protection.
[24] See DUQUESNE (1997), pg. 393, and GOODHART & SCHOENMAKER (1995), pg. 545.

of compatibility between short-term or indexed liabilities and long-term loans and assets at preset value, the greater will be the losses and difficulties encountered in raising interest rates.[26]

On the other hand, some observers utilize the argument of conflict of interest to defend maintenance of supervisory activities within the central bank. A central bank without supervisory authority would tend to neglect the impact of monetary policy on the banking system and, consequently, on the economy.[27] However, those who are in favor of central bank independence argue that, in most cases, the difficulties experienced by the banking system are not caused by monetary policy, but rather by the poor quality of assets, insufficient capital, fraud, etc.[28] or, in other words, deficiencies within the banks themselves or within the supervisory institution.

Those who defend placing bank supervision responsibilities in the hands of the monetary authority utilize two fundamental arguments. The first involves the strategic role of the payment system in the economy, since systemic risks are transmitted precisely through the payment clearing system. This was the principal argument put forward by Alan GREENSPAN on his testimony to the Congress in 1993-94, defending the role of the FED in banking supervision.[29]

The second argument involves the question of resolving systemic crises, since the central bank is the “lender of last resort” to the banking system. The key question is that of identifying when discount window operations can be used legitimately to aid banks, when viewed against the backdrop of the other alternatives available to the supervisory authority in its efforts to avoid moral hazard.[30]

Banks do not necessarily have a right to discount window operations. The monetary authority should base these operations on the principle of only lending to illiquid banks, but with no solvency problems. This rule applies to liquidation of small and medium

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[25] See HAUBRICH (1996), pg. 3.
[26] See DUQUESNE (1997), pg. 393/4 and GOODHART & SCHOENMAKER (1995), PG. 546/7.
[27] See HAUBRICH (1996), pg. 3 and DUQUESNE (1997), pg. 397.
[28] See SWINBURNE & CASTELO-BRANCO (1991), pg. 439.
[29] See DUQUESNE (1997), pg. 395/6.

banks but not to large banks, since the failure of one of these institutions could generate systemic risks. The question that arises, therefore, is how is the central bank to know if a bank is insolvent, if it is not the supervisory entity? How is one to identify and decide which cases involve systemic risk[31] and which, therefore, justify central bank and even government assistance.

These situations are used by those who defend concentrating supervisory authorities in the central bank to support their position. They argue that a central bank with supervisory authority is important in times of crisis, since the institution is able to provide needed information rapidly. At such times, it becomes very difficult to translate information and diagnoses rapidly into written form for transmission to another institution. The preservation of supervisory authority within the central bank makes it possible for that institution to react much more quickly than would be possible were it necessary to coordinate measures with another independent entity.[32]

On the other hand, those who defend the separation argue that better quality information is obtained when the two types of authority are distributed into different institutions.[33] Those who support an independent central bank use practically the same argument, claiming that, in moments of crises, a central bank that is also charged with supervision would be much more vulnerable to a vast array of political pressures.[34] With the same intention of safeguarding the guardian of the nation's currency in times of crisis, those who defend "central bank independence" argue that the monetary authority should not be involved in bank interventions and liquidations, since such operations have potential for damaging the good name and reputation of the central bank itself.[35]

Finally, the question of market discipline is raised as an additional and important argument for separating the monetary authority from the supervisory authority. This

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[30] See GOODHART & SCHOENMAKER (1995), pg. 549/9 and DUQUESNE (1997), pg. 393.

[31] One of the explanations for systemic risk is that it is often a consequence of asymmetric information between the bank and its clients, making it difficult for clients to identify the quality of a bank's assets. Given this uncertainty, any doubts whatsoever with respect to the solvency of a bank can easily trigger a run on that institution (see DUQUESNE, 1997, pg. 397).

[32] See HAUBRICH (1996), PG. 3-4.

[33] Idem, pg. 4.

[34] See SWINBURNE & CASTELO-BRANCO (1991), pg. 439/40.

[35] See GOODHART & SCHOENMAKER (1995), pg. 548 and HAUBRICH (1996), pg. 5.

argument is based upon the literature dealing with deposit insurance and the question of moral hazard. If more rigid regulations were adopted with respect to discount window operations, making it much more difficult for financial institutions to access central bank credits, even in times of crisis, there is little doubt that banks, financial institutions and even the bank supervisory authority would become more efficient and effective in their operations, since they would be held accountable for possible deficiencies and errors.[36]

Unfortunately, however, separating banking supervision from the central bank does not necessarily result in elimination of the problem of moral hazard. Supervisory authorities and the banks may well believe that the central bank will always come to the rescue and, with this in mind, they may well be tempted to become more lax in relation to supervision or to neglect the need for market discipline. The larger the bank experiencing difficulties, the greater will be the problem of moral hazard ("too big to fail"), thus creating situations in which the central bank will be obligated to intervene to avoid systemic risk. Though a deposit insurance system outside the central bank would help to minimize the dangers of this situation, it would not resolve the problem entirely.[37]

However, the market discipline/moral hazard argument was, unfortunately, unable to survive the empirical tests performed by Professors Charles Goodhart and Dirk Schoenmaker.[38] They came to the conclusion that, in countries in which the central bank is the supervisory authority, there were less bank failures. They also uncovered evidence in these countries that there was less use of public resources in resolving the problems of insolvent banks, by greater utilization of central bank and commercial bank resources. One possible explanation for this evidence may be that a central bank with supervisory powers may well be in a position to respond more rapidly to banking difficulties and to cope with them before they evolve into more serious situations.[39]

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[36] See DUQUESNE, 1997, pg. 394/5.
[37] Idem, pg. 395. See also ENOCH, STELLA & KHAMIS (1997).
[38] See GOODHART & SCHOENMAKER (1995), pg. 549/55, in which the authors summarize a study they carried out in 1993 dealing with 104 failed banks in 24 countries dating to the 1980s and early 1990s.
[39] It is interesting to note that, in Japan where the central bank does not have supervisory powers, the banking system now has one of the largest known problems loans in the world.

III – Empirical evidence

III.1 – Supervisory authority outside central bank

International empirical evidence would seem to indicate a clear tendency to withdraw supervisory authority from central banks and delegate it to specialized agencies. A 1995 survey by Goodhart and Schoenmaker[40] shows that supervisory authority still remained within the central bank in approximately half the countries surveyed. According to these researchers,[41] the German tradition has impacted many countries, particularly those located within Germany's sphere of influence (Austria, Switzerland and the Scandinavian countries) while, with the exception of Canada, the English tradition of maintaining supervisory authority within the central bank dominated in countries under its influence (Australia, New Zealand, Hong Kong and Ireland).

However, in 1997, England went against its own tradition and decided to withdraw banking supervision from the monetary authority. In the following year, Australia and Korea moved in the same direction. It is important to take a closer look at this process. A different study was carried out by Ernesto Aguirre, dealing with the Latin American banking systems.[42] According to this 1997 survey, out of a total of 17 nations studied, only five (including Brazil) maintained banking supervision authority within their central banks. The authors opted to include Argentina among these five countries, even though supervisory authority was removed from the central bank and placed within a Superintendency, considered by the authors to be a full subsidiary of the central bank.

Based on information we have been able to gather over the Internet (see appendix), we have managed to collect data on 40 countries. Of these, banking supervision authority in 25 is concentrated in an organization outside the central bank, while 13 have opted to

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[40] Idem, appendix to pg. 558/59.
[41] See pg. 544.
[42] See Aguirre (1997).

leave this authority in the hands of the central bank. Two countries have institutional arrangements that are not very clear: Argentina has transferred authority to a central bank subsidiary and France has three Councils that hold decision-making authority in the area of banking supervision, though the activity itself is performed by the Bank of France.

If we classify Argentina has having its supervisory authority outside the central bank and France as having it within the central bank, we conclude that about two-thirds of the countries (26 out of 40, or 65%) have adopted the model of banking supervision authority outside the central bank. At the moment, we are trying to identify the dates on which these countries decided to separate monetary and supervisory authorities, so as to be able to perceive whether this is a tendency that has marked recent years. Though the study has not yet been completed, there is sufficient evidence to conclude that the situation has changed greatly in the last 10 or 15 years. Prior to that period, the situation was just the opposite with about two-thirds of the countries involved concentrating supervisory authority within their respective central banks.[43]

In our survey of international experience with respect to the separation of supervisory activities from the monetary authority, particular attention was given to the question of how countries were resolving the question of payment system supervision. Among the countries in which supervisory authority has been removed from the central bank (including Argentina and France), we were able to identify the solution adopted in just 18 of them. Among these, only in Mexico supervision of the payments system is shared by more than one institution. The Banco de Mexico regulates the system and performs inspection with the help of the Comisión Nacional Bancaria y de Valores. In all of the other 17 countries, the regulating and inspection of clearance services for large transactions is always the responsibility of the monetary authority, which means that, though central banks are clearly losing their bank supervisory powers, they are evidently maintaining control over the payment systems of the various countries.

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[43] Australia and Korea withdrew banking supervision from their central banks in 1998. England followed suit in 1997, Mexico in 1995, Argentina in 1992, Venezuela in 1993. As demonstrated by AGUIRRE

III.2 – Consolidated supervision

One of the major contributions of the Basle Committee on Banking Supervision is the recommendation regarding consolidated supervision of financial groups. Concerned with the question of the solvency of financial banking groups, the first Basle Accord (1975) defined the principle of consolidated supervision of international financial groups. The question is considered so important that it was included as the 20th of the 25 basic principles for effective banking supervision: *"An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis".* This recommendation encompasses nonbanking activities, since these can imperil banking activities.[44]

This concern, obviously, is not restricted only to financial banking activities, but also encompasses other segments of the financial system (securities and insurance markets), since they must also allocate capital to cope with the risks implicit in their activities. It was with this in mind that the Joint Forum on Financial Conglomerates was founded in 1996, under the auspices of the Basle Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

The Joint Forum has produced a series of documents containing recommendations.[45] Among these, we would highlight the "Capital Adequacy Principles", the "Principles for Supervisory Information Sharing" and "Coordinator", the latter of which is a guide for coordinating the joint supervisory operations of different supervisory agencies during inspections at large scale financial conglomerates. With the exception of support for some degree of autonomy for supervisory agencies, one should note that these institutions foster international cooperation in the supervision of banks, securities and

(1997), many Latin American countries opted to do this in the same period, though it has not been possible to come to a precise date on which this occurred in each of these nations.

[44] See "Core Principles for Effective Banking Supervision" of the BANK FOR INTERNATIONAL SETTLEMENTS (1997).

insurance markets and have avoided making any recommendations regarding the institutional and political organization of each member country, while concentrating exclusively on the technical and operational aspects of supervision.

Nonetheless, it would seem clear that the best coordination of consolidated supervision of large financial groups is obtained when these functions are integrated into a single agency. With the exception of several position statements regarding the merger of supervisory entities[46], there is very little discussion of this subject in pertinent literature. However, these merger processes are being implemented, principally in countries in which the financial system is not divided into segments, as in the case of the United States.

According to a survey covering 40 countries (see appendix), of the 26 countries in which banking supervision is not the responsibility of the central bank, we were able to identify 18 in which the bank supervisor is also charged with another important segment of the financial system (securities or insurance market). In the same survey, we identified 12 countries in which the supervision of financial institutions is fully performed by a single agency. In the majority of these countries, the decision to merge them within a single institution was taken in the past 15 years.[47]

IV – Conclusion and recommendations in light of the Brazilian experience

Literature on the subject comes to no firm conclusion as to whether banking supervision is more effective under the control of the central bank or another institution. However, it does seem that the argument in favor of "central bank independence" now prevails and there is a strong international trend toward leaner and more efficient central banks, with supervisory functions being transferred to a highly technical specialized institution. It

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[45] See "Supervision of financial conglomerates", issued by the BANK FOR INTERNATIONAL SETTLEMENTS (Feb. 97).
[46] See DAVIES (03.11.1999) and RODGERS (May 1998).

seems that the loss of the supervisory function has often been a political bargaining chip sacrificed in the interest of central bank independence, avoiding to have the central bank transformed into a “fourth power” of government.

Obviously, in modern democracies, “central bank independence” is a restricted concept targeted at ensuring a single objective: the stability of the currency or prices. The institution’s mandate is to wield discretionary power in the implementation of monetary policy and be held accountable for the measures taken and results achieved. Authority is restricted to monetary policy (freedom with responsibility to issue currency) and includes no other type of power, particularly that of spending scarce public funding. In a democracy, the power to spend is necessarily subjected to the budget ritual and requires prior approval and supervision on the part of the Congress. This could well be considered the political explanation of why this “independence” in other countries does not include banking supervision.

The assumption of bank supervision and inspection responsibilities generates costs, risks and responsibilities. Banking supervision is a highly complicated task that requires a type of competence and skill levels quite different from those demanded at a classic central bank. Monetary and exchange policies belong to the world of the economists, while banking supervision pertains to the world of the auditors. Though there are strong arguments in favor of maintaining the two functions at a single institution due to the complementary nature of the objectives involved (stability of the currency and of the financial system), the final result of this option may well be a loss of efficiency, without even mentioning the burdens and responsibilities that would have to be borne as a consequence of banking sector difficulties.

However, the major concern is found in the costs of liquidating banks and, principally, the risk of insolvency of large banks with the potential to generate harmful consequences for the system as a whole and the need for structuring rescue operations. These outlays can be very high and, if they are not covered by fiscal resources, they are

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[47] Australia and Korea in 1998, England in 1997, Mexico in 1995, Denmark in 1988, Canada in 1987 and Norway in 1986. According to AGUIRRE (1997), other Latin American countries did the same thing in the period, though it was not possible to identify the precise dates on which these changes occurred.

capable of jeopardizing monetary policy as a whole. To a great extent, this concern can be resolved through an adequate deposit insurance system. However, final responsibility will always be placed at the government and central bank which, as lender of last resort to the banking system, will always have a role even when it is not charged with supervisory responsibility.

In this light, we have strong restrictions regarding the withdrawal of banking supervision from Banco Central do Brasil in the form usually proposed in Brazilian political circles, without granting independence to the institution. Aside from the fact that this would not generate any significant advantages, we would run the risk of weakening monetary policy implementation and the institution's capacity to cope with crisis situations or financial system problems. Based on both international and Brazilian experience, it would only make sense to separate these two functions if the central bank were to be given greater independence and the functions of supervision of financial institutions, including the securities, insurance and private pension funds, were to be merged within a single agency.

In the international framework, the tendency has been to remove banking supervision from central bank responsibility in order to preserve and strengthen that institution's role as "guardian of the currency". This is a tendency that makes good sense in Brazil, a country that, for many years, suffered the effects of a weak central bank totally subservient to the whims of central government authorities. The argument in favor of an "independent central bank" can certainly be used as a way of protecting Brazilian society from the eventual irresponsibility of future governments. Price stability is a greater good, obtained at the cost of enormous sacrifice of great part of our population, and it must not be imperiled to eventual election of a bad government.

Joint financial system supervision is another tendency commonly found on the international experience. This involves the merger of bank supervision authority with the other entities responsible for regulating and supervising other financial market segments (securities, insurance and private pension funds), thus facilitating the consolidated supervision of financial groups. This is an interesting alternative for Brazil, since it simply would not make sense to withdraw supervision from the central bank and create another supervisory entity without giving it the power and prestige required to perform its tasks. If this were to be done, the new institution would become just one more weak supervisory authority among the several that already exist, such as the CVM (Securities and Exchange Commission) and SUSEP (Private Insurance Authority).

If a decision is to be taken in this direction, we have to be sure that the separation of the monetary authority and the supervisory authority will not result in two weak institutions. The first step would be to establish obligatory channels of coordination between the two entities so that Banco Central do Brasil would continue having privileged access to information on bank solvency. The second is the question of retaining responsibility for regulating and supervising the major systems of clearance and liquidation of financial transactions at Banco Central (check clearance services, the SELIC government bond' clearing house and CETIP securities clearing house, etc.). The underlying reasons for this position are the simple fact that Banco Central's responsibility for monetary policy demands that it monitor the health of the nation's banks and payment systems.

A further source of concern is the question of resolving problems found to exist at financial institutions. Great care will have to be taken in coordinating the authority of the supervisory authority with that of Banco Central, since the latter will continue bearing the burden of "lender of last resort". Parallel to this, there is a need for discussing the entire question of deposit insurance, which is now managed by a non-central bank private sector entity. Once access to discount window operations is no longer available, it might be interesting to place management of deposit insurance under the authority of the supervisory agency, since this would clearly enhance its capacity to respond to specific problems as they arise. Finally, a great deal of discernment must be used in distinguishing between regulatory responsibility for banking supervision and responsibilities that are typical of credit and exchange policy, so that there are no undesirable gaps between the two.

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Appendix: Institutional Organization of Central Banks and Supervisory Agencies

Country	Monetary Policy	Supervision: Banking	Payments System	Insurance	Securities	Comments
Argentina	Banco Central de la República Argentina	Superinten-dencia de Entidades Financieras y Cambiarias	Banco Central de la República Argentina	Superinten-dencia de Seguros de la Nación	Comisión Nacional de Valores	Independent CB (currency board) The Superintendencia is subordinated directly to the CB governor (Art. 43 of law 24.144, dated 09.23..1992)
Australia	Reserve Bank of Australia	Australian Prudential Regulation Authority (APRA)	Reserve Bank of Australia	Australian Prudential Regulation Authority (APRA)	APRA e Australian Securities and Investments Commission (ASIC)	Independent CB since 1959 1998 – withdrawal of banking supervision from RBA and merger with Insurance and Superannuation Comission
Austria	National Bank of Austria	Ministry of Finance				Independent CB (European CB)
Belgium	National Bank of Belgium	Banking and Finance Commission	National Bank of Belgium		Banking and Finance Commission	Independent CB (European CB)
Bolivia	Banco Central de Bolivia	Superinten-dencia de Bancos y Entidades Financieras	Regulation by the BCB	Separate	Shared	Independent CB since 1995 1987– creation of the Superintendência de Bancos y Entidades Financieras
Canada	Bank of Canada	Office of the Superinten-dent of Financial Institutions	Bank of Canada	Office of the Superinten-dent of Financial Institutions	Office of the Superinten-dent of Financial Institutions	Independent CB 1925–Creation of the Office of the Inspector General of Bank (OIGB) 1987–merger of the OIGB with the Department of Insurance
Chile	Banco Central de Chile	Superinten-dencia de Bancos y Institu-ciones Financeiras	Banco Central de Chile	Superinten-dencia de Valores y Seguros	Superintendencia de Valores y Seguros	Independent CB since 1989 1925 – Creation of the Superintendência
Colombia	Banco de La Republica de Colombia	Superinten-dencia Bancaria de Colombia (MF)	Banco de La Republica de Colombia	Superinten-dencia Bancaria de Colombia	Superinten-dencia Bancaria de Colombia	BRC is a independent CB since 1991, though the Minister of Finance is the governor of the Junta Monetaria (7 members of which 6 are from the BRC)
Costa Rica	Banco Central de Costa Rica	Superinten-dencia General de Entidades Financieras		Separate	Superinten-dência General de Valores	The CB is not independent The Superintendencia General de Entidades Financieras is a subsidiary of the CB
Denmark	Danmark Nationalbank	Danish Financial Supervisory Authority	Danmark Nationalbank	Danish Financial Supervisory Authority	Danish Financial Supervisory Authority	Independent CB (European CB) 1988 – creation of DFSA through merger of the Supervisory Authority for Banks and Saving Banks and the Insurance Supervisory Authority 1990 – merger with the Supervisory

Country	Monetary Policy	Supervision				Comments
		Banking	Payments System	Insurance	Securities	
						Authority for Mortgage Credit Institutions
Ecuador	Banco Central del Ecuador	Superinten-dencia de Bancos	Banco Central del Ecuador	Superinten-dencia de Bancos	Superinten-dencia de Compañías del Ecuador	The CB is not independent 1927 – creation of the Superintendencia following separation from the CB
El Salvador	Banco Central de Reserva de El Salvador	Superinten-dencia del Sistema Financiero		Superinten-dencia del Sistema Financiero	Superinten-dencia de Valores	The CB is not independent
England	Bank of England	Financial Services Authority	Bank of England	Financial Services Authority	Financial Services Authority	Independent CB since 1997 1997 – withdrawal of bank supervision from Bank of England and merger of supervisory agencies
Finland	Bank of Finland	Financial Supervision Authority	Bank of Finland		Financial Supervision Authority	Independent CB (European CB) 1922 – creation of the Bank Inspectorate 1993 – creation of FSA through merger of the bank and securities supervision functions
France	Banque de France	Banking and Financial Regulatory Committee/ Credit Institutions and Investment Firms Committee/ Banking Commission	Banque de France		Banking and Financial Regulatory Committee/ Capital Markets Council/ Stock Exchange Commission	Independent CB (European CB) 1996 – Independence of the Banque de France
Germany	Deutsche Bundesbank	Federal Banking Supervisory Office			Federal Securities Supervisory Office / Federal Supervisory Office for Securities Trading	Independent CB since its creation in 1957. Now part of the European Central Bank
Greece	Bank of Geece	Bank of Geece	Bank of Greece			Independent CB (European CB)
Guate-mala	Banco de Guatemala	Superinten-dencia de Bancos		Superinten-dencia de Bancos	Shared	The CB is not independent Banco de Guatemala and Superintendencia de Bancos are subordinated to a Junta Monetaria
Holland	De Neder-landsche Bank	De Neder-landsche Bank	De Neder-landsche Bank		De Neder-landsche Bank	Independent CB (European CB)
Honduras	Banca Central de	Bank Supervisor		Bank Supervisor	Bank Supervisor	See Aguirre (1997)

Country	Monetary Policy	Supervision: Banking	Supervision: Payments System	Supervision: Insurance	Supervision: Securities	Comments
	Honduras					
Hong Kong	Hong Kong Monetary Authority	Hong Kong Monetary Authority	Hong Kong Monetary Authority		Hong Kong Securities and Futures Commission	BC independente (currency board) 1993 – merger of the bank supervision with central bank
Ireland	Central Bank of Ireland	Central Bank of Ireland	Central Bank of Ireland			Independent CB (European CB)
Israel	Bank of Israel	Bank of Israel	Bank of Israel			Independent CB
Italy	Banca d´Italia	Banca d´Italia	Banca d´Italia			Independent CB (European CB)
Japan	Bank of Japan	Financial Supervisory Agency	Bank of Japan	Financial Supervisory Agency	Financial Supervisory Agency	The CB is not independent
Korea	Bank of Korea	Financial Supervisory Commission	Bank of Korea	Financial Supervisory Commission	Financial Supervisory Commission	Independent CB 1998 – withdrawal of bank supervision from BK and merger of the supervisory agencies (Securities & Exchange Commission and Insurance Supervisory Commission)
Luxem-bourg	Luxembourg Monetary Institute	Luxembourg Monetary Institute	Luxembourg Monetary Institute			Independent CB (European CB)
Mexico	Banco de México	Comisión Nacional Bancaria y de Valores	Banco de México / Comisión Nacional Bancaria y de Valores	Comisión Nacional de Seguros y Fianzas	Comisión Nacional Bancaria y de Valores	Independent CB since 1993 (constitutional reform) 1995 – creation of CNBV, through merger of banking and securities supervision
Nicaragua	Banco Central de Nicaragua	Bank Supervisor		Bank Supervisor	Bank Supervisor	See Aguirre (1997)
New Zealand	Reserve Bank of New Zealand	Reserve Bank of New Zealand	Reserve Bank of New Zealand		Reserve Bank of New Zealand	Independent CB since 1989
Norway	Norges Bank	Banking, Insurance & Securities Commission	Norges Bank	Banking, Insurance & Securities Commission	Banking, Insurance & Securities Commission	Independent CB (European CB) 1986 – creation of the Banking, Insurance and Securities Commission
Panama	Central Bank	Bank Supervisor		Separate	Separate	See Aguirre (1997)
Paraguay	Central Bank	Central Bank		Separate	Separate	See Aguirre (1997)
Peru	Banco Central de Reserva del Perú	Superintendencia de Banca y Seguros	Banco Central de Reserva del Perú	Superintendencia de Banca y Seguros	Comisión Nacional Supervisora de Empresas y Valores (CONASEV)	The CB is not independent 1931 – creation of the superintendencia 1979 – administrative and functional independence of the Superintêndencia
Portugal	Banco de Portugal	Banco de Portugal	Banco de Portugal			Independent CB (European CB)
Spain	Banco de Espanã	Banco de Espanã	Banco de Espanã	la Dirección General de Seguros	la Comisión Nacional del Mercado de Valores	Independent CB (European CB) 1994 – independence of Banco de Espanã
Sweden	Sveriges Riksbank	Swedish Financial	Sveriges Riksbank	Swedish Financial	Swedish Financial	Independent CB (European CB)

Country	Monetary Policy	Supervision				Comments
		Banking	Payments System	Insurance	Securities	
		Supervisory Authority		Supervisory Authority	Supervisory Authority	1991 – merger of the Bank Inspection Board and of the Supervisors of Bank Securities and Insurance Companies
Switzer-land	Swiss National Bank	Federal Banking Commission	Swiss National Bank			Independent CB
Uruguay	Central Band	Central Bank	Central Bank			See Aguirre (1997)
Venezuela	Banco Central de Venezuela	Superintendencia de Banca y Otras Inst. Financieras		Separate	Separate	1993 – creation of the Superintendencia