

Discussion of
“Optimal Supervisory Architecture and Financial Integration in a
Banking Union”
Jean-Edouard Colliard (2015)

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This Paper: Overview

- A theoretical framework for analyzing supervision and regulation in a banking union (e.g., across EU countries or the US states)
- **Main Question:** optimal allocation of supervisory responsibilities between “local” and “centralized” supervisors.
- **Main Point:** the *incentives* and *abilities* of the regulators have to be considered when designing optimal supervisory institutions.

This Discussion

- (1) An overview of the main ingredients of the model.
- (2) Some comments on commitment.
- (3) (Some random thoughts on) possible directions to pursue.

Model

- A single bank with both domestic and foreign investors.
- The bank invests in a project with return R with success probability p
- The project can be liquidated prematurely and recover a fraction $\ell < 1$.

Supervisors

- A *local* and a *central* supervisor
- The supervisors do not know the success probability p
- They can pay a cost to obtain this information
 - local supervisor: c_0
 - central supervisor: $c_0 + c$
- c captures, e.g., the informational advantage of the local supervisor.
- Depending on p , they can then decide whether to force the bank to liquidate or not.
- The local supervisor only internalizes the impact on domestic investors.
- The central supervisor internalizes the impact on all investors.

Supervisory Architectures

- (a) **Centralized:** the central supervisor does the inspection.
- (b) **Delegated:** the central supervisor delegates to the local supervisor.
- (c) **Joint architecture:** at some extra cost, the centralized supervisor obtains an extra signal on p , and decides who does the inspection based on its realization.

Main Results: Optimal Supervisory Architecture

- If the cost of off-site monitoring is low → **joint supervision**.
- With a high cost of off-site monitoring
 - if the informational advantage of the local supervisor is large relative to the size of the externalities → **delegated supervision**.
 - if the informational advantage of the local supervisor is small relative to the size of the externalities → **centralized supervision**.

Main Results: Market Response

- The supervisory architecture determines the equilibrium behavior of the market participants.
- There are **strategic complementarities** between supervision and integration:
 - centralized supervision → more cross-border lending → centralized supervision.
- Such complementarities lead to multiple equilibria:
 - (i) low integration + local supervisory architecture
 - (ii) high integration + centralized supervisory architecture

Comment: Commitment to Architecture

- The multiplicity of equilibria is due to the fact that the paper models the interaction between the regulators and the banks as a simultaneous move game.
- However, in reality, the regulators have access to commitment power (at least limited, if not full).
- The allocation of supervisory responsibilities can be built into legislation upfront, essentially ruling out equilibrium multiplicity (of the nature envisioned in the paper).
- For example, all national banks in the US are regulated by the OCC and the Fed.

Comment: Commitment to Actions

- Of course, committing to the allocation of supervisory responsibilities is not the same thing as full commitment.
- Much harder to commit to the actions taken by the regulators
 - would the regulator follow through with the supervision as intended?
 - can the regulator commit to force liquidation (in the context of the paper, committing to p^* and p^{**})?
- Not explored in the paper, but can be of first-order importance.

Comment: Commitment and Information Solicitation

- To the extent that the regulators depend on the banks' self reports, it matters what the regulators do with the reported information.
- Plausible to assume that the regulator cannot commit to what he/she does with the reported information.
- How to design a regulatory framework that incentivizes banks to reveal information to supervisors truthfully when the supervisor had limited commitment power?

Comment: Regulatory Arbitrage

- Even if regulators can commit to the architecture and to the actions....
- ... banks can still engage in regulatory arbitrage.

- Prominent example: Countrywide switched its regulators from OCC and the Fed to OTS

- Relevant question: how to set up the regulatory architecture to minimize the possibility of regulatory arbitrage?

Comment: Endogenous Risk-Taking and Opacity

- The paper takes the balance sheets of the banks as exogenously given.
- The nature of the supervision may have an impact to the **extent of risk-taking** by the banks the and **opacity** of their balance sheets.
- The appendix studies how banks choose the mix of their domestic and foreign investors to avoid one regulator or another.
- Interesting to investigate a similar question regarding the extent of risk-taking and the opacity of their balance sheets.

Summary

- Paper makes the key point that the incentives of the regulators have to be considered when designing optimal supervisory institutions.
- The main trade-off at the center of the paper: the better knowledge of local supervisors versus the internalization of all externalities by the centralized supervisors.
- One possible direction to think about: the role of commitment. Commitment to the overall architecture is easy; commitment to take some specific action is hard; commitment to what you do with information is even harder.
- Interesting to think about the importance of regulatory arbitrage and what to do about it.
- Endogenous risk-taking and opacity