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 $\rightarrow$ more cross-border lending $\rightarrow$ centralized supervision.

- Such complementarities lead to multiple equilibria:
  1. low integration + local supervisory architecture
  2. high integration + centralized supervisory 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 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