Finance

College of Business at Illinois

Comments on Rafael Repullo "Hierarchical Bank Supervision"

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The issue

- What is the effect of having joint regulatory authority when regulators' objectives differ?
- Specific application: European/National banking supervision
- Single Supervisory Mechanism in EU

Previous work

- Repullo "Who Should Act As Lender of Last Resort? An Incomplete Contracts Model" JMCB, 2000
- Kahn & Santos "… : Comment" JMCB 2006
- _____ , *European Economic Review*, 2005
- Boyer and Ponce , Journal of Financial Stability 2011
- Ponce, Journal of Financial Intermediation, 2010

Previous Work

Kahn and Santos, "Allocating Lending of Last Resort and Supervision in the Euro Area." in von Furstenberg et al *Monetary Unions and Hard Pegs: Effects on Trade, Financial Development and Stability*, Oxford: Oxford University Press, 2004

The Model: Single decision maker

- Exerts effort to discover information about bank
- Chooses whether to close bank.

- Local vs Centralized Supervision

- Assume centralized regulator less bias against closure but cost disadvantage in gathering information
- With a heavy bias against closure, disinclination to gather information
- So if bias is great and/or cost differential small—choose central authority

- Welfare comparison

- Hierarchical supervision best when neither supervisor has large efficiency advantage.
- Fixed costs are crucial for this

The Model: Multiple regulators

- Each level puts effort into discovery
- Information automatically flows to central authority, who decides on closure
- Nash equilibrium in effort choices.

Strategic Interactions

From point of view of centralized regulator effort is clearly strategic substitute

From point of view of local regulator, more complicated because local effort influences center’s leniency

Strategic interactions: reaction function

- Puzzle: Would think the local would react *more*
  - marginal cost increases more slowly
  - increase in center’s diligence would make local even more eager to pull back.

Strategic interactions more generally

- Could there be multiple equilibria: if the local puts in a little extra effort, might the center cut effort to zero? And might this not be a very good thing for the local?

- Difference in crisis times

- In the model, in absence of info bank is kept open.
- Suppose in absence of info bank is closed (Then with better info regulator will be able to be <u>more</u> lenient).
- How far does this reverse comparative statics?

Other results:

- Equivalent to reporting <u>if</u> reporting has to be truthful, BUT incentives not to report truthfully (Kahn Santos JMCB)
- Limiting size of central supervisor is good for inducing more effort from locals (only if this doesn't limit ability to verify local results!)

- Summary

- Relevant analysis for current environment
- Clean model, clear results
- Limitations:
  - Strategic transmission of information
  - Crisis vs non crisis periods

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