Who should act as systemic risk regulator?: The importance of regulators' incentives

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Motivation

- Policymakers and researchers have devoted a great deal of attention to the design of bank regulations.
- But, paid only limited attention to the importance of the institutional allocation of regulation: “Who should be responsible for each regulation?”
- As a result, bank regulation has become increasingly harmonized, but the institutional allocation of regulation across countries remains quite different
- These differences are particularly evident in supervision and deposit insurance management

Does it matter?

- Probably yes
- The case of the authority to close banks
  - The assignment of the authority to close banks to an institution other than the DI provider may result in a “looser” closure policy.

Why so little attention to institutional allocation?

- Rely on the following assumptions:
  - Regulatory agencies have their incentives perfectly aligned
  - They all work for the “common good” (maximize welfare)

Regulatory solutions

- Policymakers have addressed the conflicts between authorities through regulations that protect one regulator from another's policies
  - Give the DI provider the right to withdraw insurance coverage
  - Adopt depositor preference laws
  - Adopt PCA schemes to reduce the discretion of the regulator charged with the authority to close banks
  - Introduce regulations aimed at increasing the LLR's incentive to extend liquidity support only to solvent banks, by making it potentially liable for the losses of its policy

Regulatory solutions (cont.)

- An alternative way to address these conflicts is by altering the institutional allocation of regulation
- The debate in the 1990s on who should supervise banks raised policymakers' awareness for the importance of considering the conflicts of interest that may arise between authorities
- This debate was dominated by the issues arising from placing supervision in the central bank or in an independent agency and by the questions of whether there was a need for a lender of last resort and banking supervisor at European level.

Academic literature

- Studies that account for the incentives of regulators

Chan and Marino (1992), Mailath and Mester (1994), Pages and Santos (2005)

- Studies of the interplay between DI pricing and other regulations

Pennacchi (1987), Allen and Saunders (1993) and Acharya and Dreyfus (1989), Kanatas (1986) and Sleet and Smith (2000)

- Studies of the optimal allocation of regulation

Repullo (2000), Kahn and Santos (2005)

- Studies of regulators' incentives to gather and share information

Kahn and Santos (2006)

Some useful insights from academic literature

- Repullo (2000), Kahn and Santos (2005)
  - Regulators' objectives (and incentives) should play a role in the decision to attribute regulatory responsibilities
- Kahn and Santos (2006)
  - The incentive of an agency to collect information is not independent of the potential uses it has for that information
  - Agencies may not have incentives to share the private information they gather with other agencies

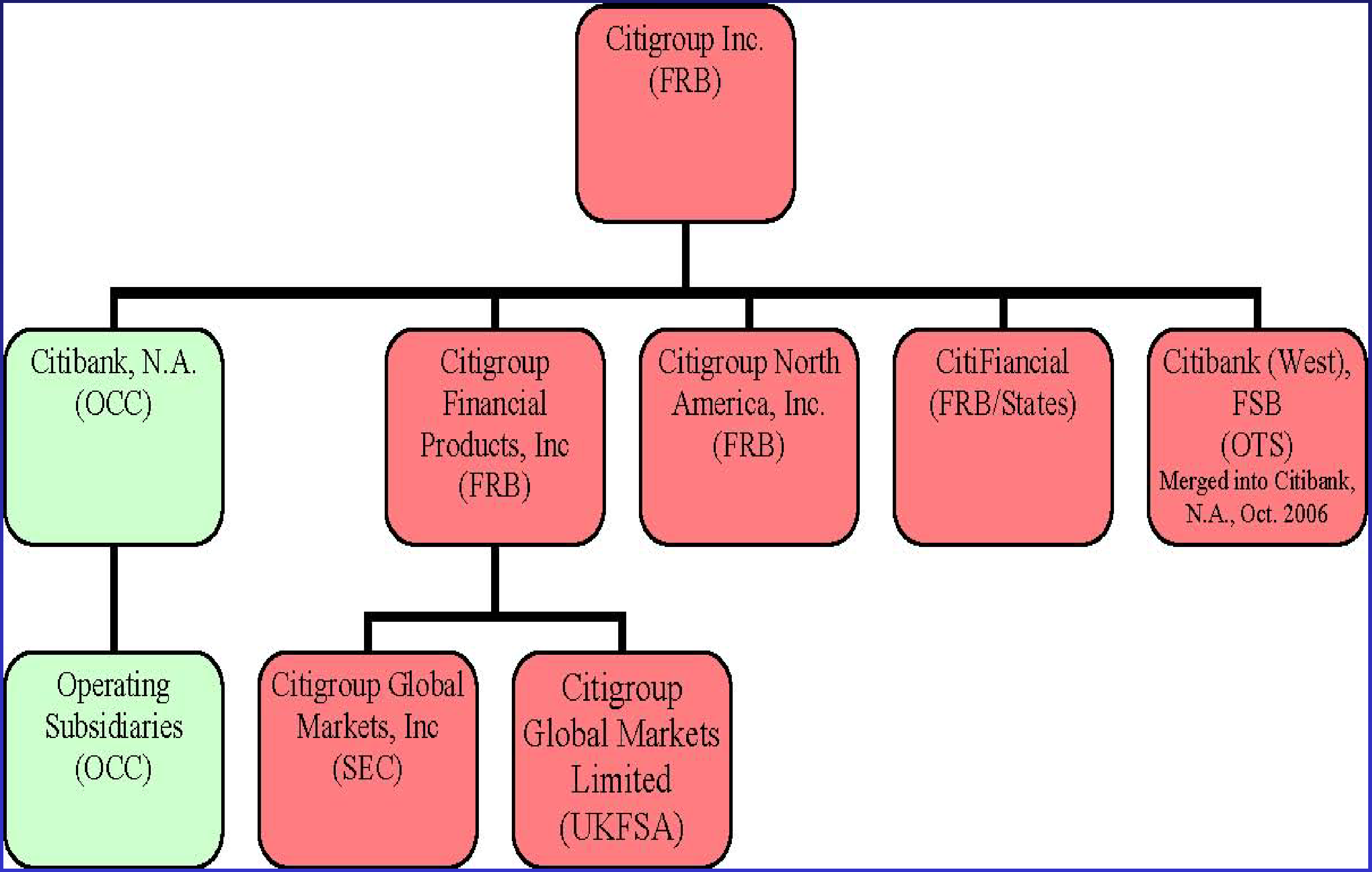
Recent crisis

- Showed the limitations of the existing regulations for not taking into account systemic risk
- It also showed the limitations of regulatory infrastructures that assume that the incentives of regulators are aligned and that they all share relevant information
- We saw evidence of these problems in the UK (Northern Rock), as well as in the US.

OCC testimony to the Financial Inquiry Commission, April 8, 2010

- As an initial matter, it is important to be clear, as the chart below depicts, that the OCC's jurisdiction extends only to the national banks within Citigroup, and the subsidiaries of those national banks (the green boxes). The remainder of the company – …… – is subject to the jurisdiction of the Federal Reserve, various other federal functional regulators, and state regulators.
- As described in detail in Appendix E, some of Citigroup's exposures to subprime mortgages and securities backed by subprime mortgages arose from the bank's direct activities. However, a significant part of that exposure resulted from activities of holding company affiliates that, due to extraordinary market events, caused losses in the bank.

Oversight of Citigroup



Vega, Kahn, Matta and Sole's paper

- Extend previous studies to consider one form of systemic risk
- Confirm the results of previous studies:
  - Single regulator is less forbearing than a multi-regulator structure, except for high liquidity shocks
  - Regulators may not have incentives to gather and/or share information with other regulators
- One important new result: Assigning the responsibility for systemic risk to a regulator may exacerbate the regulator's excessive forbearance problem
- Would be interesting to consider other arrangements: CB with supervisory powers; stand alone supervisor; stand alone systemic risk regulator
- To what extent the results hinge on the form of systemic risk considered?

Erlend Nier's paper

- Correctly points out the importance of having a regulator with responsibility for systemic risk and the importance of this regulator having authority to collect information (preferably directly) from all relevant financial services providers
- The author leaves some important questions unanswered:
  - Who should be the systemic risk regulator?
  - How should this regulator be incentivized to share the information it gathers with the other regulators?
- The author is not very clear about the mandate of the systemic risk regulator. According to him the mandate should include
  - Primary objective: safeguarding systemic stability
  - Secondary objectives: have regard to the need to maintain a level of financial services conducive to balanced growth

Chris Cumming's paper

- Correctly points out that as institutions become more interdependent, information on individual institutions becomes more valuable (to other institutions as well as to supervisors)
- The challenge is how to establish this "Commons" of information
  - Do institutions have an incentive to participate in such "Commons"?
  - Do they have an incentive to reveal accurate information?
- The insights of the studies on regulators' incentives to gather and share information suggest these questions are difficult to address

Final remarks

- The recent crisis:
  - showed the importance of information on the entire financial system
  - showed the need to design regulations that account for systemic risk
  - showed the importance of having regulators focusing on systemic risk
- The papers presented in this session highlight the importance of these factors for the stability of the financial system.
- Some of the regulatory changes that have emerged since the eruption of the crisis seem consistent with the insights of the literature.
- However, it is not clear that the objectives/incentives of regulators were taken into account in these changes, which may hinder the effectiveness of these regulatory changes.