The Design and Governance of Bank Supervision

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Central Bank Governance

- Basel II is a mistake
  - Contrast between
    - The statements of bankers, economists, regulators in private vs.
    - Public commitments of authorities that they will adopt more sophisticated versions of Basel II
    - Now, empirical evidence supports the former
- This mistake could have implications for central bank independence

Outline

- Central banks still supervise!
- Market monitoring, however imperfect, works best. Official supervision, not.
  - All in 1 slide (plus a book)
- Framework for considering regulatory choices
- Implications for central banks and their independence

Central Bank as a Supervisory Authority

Americas

Central Bank only	Central Bank Among Multiple Supervisors	Central Bank Not a Supervisory Authority
Argentina Brazil Guyana Suriname Trinidad and Tobago Uruguay	United States	Bolivia Canada Chile Colombia Costa Rica Ecuador El Salvador Guatemala Honduras Mexico Nicaragua Paraguay Peru Venezuela

Central Bank as a Supervisory Authority

Africa

Central Bank only	Central Bank Among Multiple Supervisors	Central Bank Not a Supervisory Authority
Botswana Burundi Egypt Gambia Ghana Guinea Lesotho Libya Namibia Rwanda South Africa Sudan Swaziland Tunisia Zimbabwe	Morocco Nigeria	Algeria Benin Burkina Faso Cameroon Central African Republic Chad Congo Côte d'Ivoire Equatorial Guinea Gabon Guinea Bissau Kenya Madagascar Mali Niger Senegal Togo

Central Bank as a Supervisory Authority

Europe

Central Bank only	Central Bank Among Multiple Supervisors	Central Bank Not a Supervisory Authority
Armenia	Albania	Austria
Azerbaijan	Czech Republic	Belgium
Belarus	Germany	Bosnia and Herzegovina
Bulgaria	Macedonia	Denmark
Croatia	Slovakia	Estonia
Greece		Finland
Ireland		France
Italy		Hungary
Lithuania		Iceland
Moldova		Latvia
Netherlands		Luxembourg
Portugal		Norway
Romania		Poland
Serbia and Montenegro		Sweden
Slovenia		Switzerland
Spain		Turkey
Ukraine		United Kingdom

Central Bank as a Supervisory Authority
Offshore Centers

Central Bank only	Central Bank Among Multiple Supervisors	Central Bank Not a Supervisory Authority
Aruba Bahrain Belize Macau, China Mauritius Oman Seychelles	Anguilla Antigua and Barbuda Commonwealth of Dominica Cyprus Grenada Montserrat Saint Kitts and Nevis Saint Lucia Saint Vincent and the Grenadines Vanuatu	British Virgin Islands Gibraltar Guernsey Isle of Man Jersey Liechtenstein Malta Panama Puerto Rico

Central Bank as a Supervisory Authority

Asia/Pacific

Central Bank only		Central Bank Among Multiple Supervisors	Central Bank Not a Supervisory Authority
Bhutan Cambodia Fiji Hong Kong, China India Israel Jordan Kuwait Kyrgyzstan Malaysia New Zealand Pakistan Papau New	Samoa Saudi Arabia Singapore Sri Lanka Tajikistan Tonga Turkmenistan United Arab Emirates Guinea Philippines Qatar Russia	China Taiwan, China Thailand	Australia Japan South Korea Lebanon

Regulatory Choices in the Dark?

- Emerging market countries encouraged to adopt Basel II with no evidence.
- Where is the debate?
  - Does B-II fit emerging markets today?
  - Is it practical to have supervisors with state-of-the-art risk modeling skills without much higher compensation?
  - Any concern that rich countries became rich without Basel?

When you can measure what you are speaking about, and express it in numbers, you know something about it; but when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meager and unsatisfactory kind: it may be the beginning of knowledge, but you have scarcely, in your thoughts, advanced to the state of science. … If you can not measure it, you can not improve it

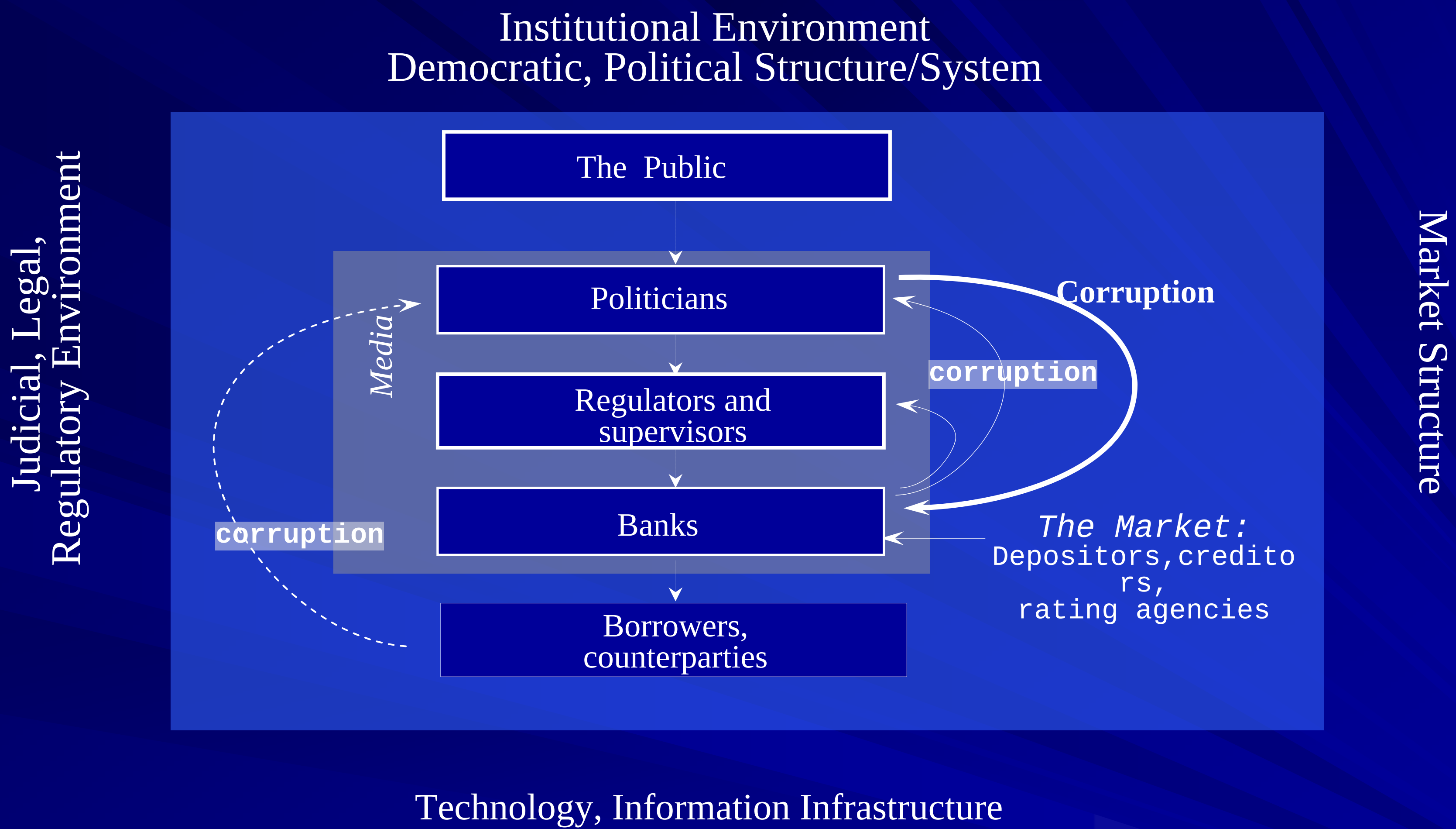
Lord Kelvin

Summary

	Bank Development	Efficiency	Stability	Lending Integrity
Capital Regulation				
Supervisory Power	-			- -
Private Monitoring	++	++		++
Activity Restrictions	- -		- -	
Entry Restrictions		- -		
Deposit Insurance			- -	
Government Banks	- -	-		
Diversification			++	

Basel II: Remember Pillar III

Private vs. Public interest: Suggests wariness of relying on official intervention



A Framework for Bank Regulation

If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.

James Madison, Federalist Papers, Number 51

Debate about government’s role

Public interest view	Private interest view
Gov’t maximizes social welfare	Gov’t maximizes Gov’t welfare; so do regulatees
Gov’t has incentives / ability to ameliorate market failures	Gov’t does not necessarily have incentives / ability to fix failures
If we identify “best practices,” countries will change.	Need more than “best practices”: – Combination of incentives for regulators and regulatees will not maximize social welfare

Laissez-Faire : Market failures minor -- no need for government

Public interest at work

- Regulate to
  - Improve efficiency of intermediation
  - Protect from negative externalities: Crises
  - Protect individuals (Ponzi schemes).

Basel: Assumes Public Interest

- **Basel II Pillars – “Best Practices”**
    1. Capital
    2. Supervisory oversight
    3. Market Discipline

- **World Bank / IMF – Apply “Best Practices” in DCs**

    … to foster growth & poverty alleviaton

    … to reduce fragility & contagion

Private interest at work

- Survival of the sovereign
- Finance government
- Finance cronies

Public or private interest in bank regulation?

- Likely varies over time
- Evidence supports private interest view
- If true, central banks that have very strong supervisory powers will attract political interference and invite corruption.

Governance of Supervision

- Monetary policy focuses on aggregates
- Most bank supervision is specific
  - Corruption in supervision vs. corruption in monetary policy
- Pillar II holds out the promise of greater discretion for supervisors, and gives much power in pillar I
- Demands an incredibly high degree of oversight, well-developed institutional framework

Alternative Model for Supervision

- Central banks
  - Shed supervisory function or
  - Recast it!
  - Basel Committee: start over
- Supervisors to focus on supporting market monitoring, not replacing it
  - Demand high degree of disclosure
  - Verify accuracy of information disclosed
  - Penalize when disclosure faulty/incomplete
- Can governments oversee supervision without interfering with monetary policy independence?