Discussion of "The Design and Governance of Bank Supervision" by James R. Barth, Gerard Caprio, Jr., and Ross Levine

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- Barth, Caprio, Levine have undertaken an important research agenda into the optimal structure of bank supervision and regulation.

  - Banking systems play an important role in furthering economic development.

  - How should bank regulation be organized to ensure it best furthers the social weal?

  - Bank supervisors themselves are faced with multiple and potentially conflicting goals.

- Commendable work in building an important data set and in providing it to researchers and policymakers.
    - Cross–country measures and descriptions of banking industry supervisory and regulatory structures for 152 countries.
        - Information on banking powers, bank entry requirements, capital regulations, bank supervisor powers, deposit insurance, liquidity requirements, private monitoring, accounting practices, disclosure requirements, external governments, and the structure of supervision.
        - Measures of banking sector development, efficiency, stability, and integrity of the banking sector.

Some of the data from Barth, Caprio, and Levine, 2006

	Sweden	**United States**	**Mexico**	**United Kingdom**
Income	High	High	Upper Middle	High
Bank Supervisory Authorities	Single	Multiple	Single	Single
Central Bank as Supervisory Authority	No	Yes (among others)	No	No
Single Financial Supervisory Authority for Financial Sector	Yes	No	No	Yes
Degree of Supervisory Independence	Medium	Medium	Low	Low
Minimum Risk-Based Capital Requirement	8%	8%	8%	8%
Is Court Approval Required for Supervisory Actions	No	No	No	No
Can Bank Shareholders Appeal to Court after Decision of Bank Supervisor	No	No	Yes	Yes
Are Banks Prohibited from Making Loans Abroad	No	No	No	No
Applies International Accounting Standards	Yes	No	Yes	No
Applies US Generally Accepted Accounting Standards	Yes	Yes	Yes	No
Percentage of Bank Assets at Government-Owned Banks	0%	0%	0%	0%
Percentage of Bank Assets at Foreign-Owned Banks	?	19%	82.7%	46.0%
Percentage of Bank Assets at Privately Owned Banks	?	81%	17.3%	54%

- Key finding: private monitoring is associated with higher levels of bank development, efficiency, and lending integrity, but not financial stability.

- Restrictions on the activities in which a bank can engage and a higher level of discretionary powers given to supervisors are associated with lower bank development and stability.

- Lord Kelvin: “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…”

- Plato: “A good decision is based on knowledge and not on numbers.”

- Tempting to misinterpret the findings as saying more about causality than they may.

- Potential endogeneity of regulations => best to view results as correlations.
  - Instrumental variables – but difficult to know if you've come up with good instruments.
    - Can authors exploit panel data?
- Potential omitted variable problem: Omitted variable that is correlated with characteristics of the bank supervisory scheme and with bank performance.
  - Geography, macroeconomic shocks.

- Strength of approach is that it looks at 152 countries.
  - Results for average country

- Is one regulatory scheme optimal for all? Are there multiple equilibria?
  - Optimal type of bank supervision likely depends on the degree of development of banking, financial markets, and legal rights and institutions.
  - Various components of a bank supervisory system are interrelated and their effectiveness depends on one another and also on the other institutions in the country.
  - Country that faces more severe aggregate shocks because of the nature of its economy may need a different kind of bank supervisory process.
  - Some countries more bank-centric than others.
    - Banks specialize in less transparent assets, so some limit to the use of market discipline to monitor and supervise banks.
    - Do market-centric economies have lower social welfare?

- Where should bank supervisory functions be housed? In the central bank or in a separate entity outside the central bank?
  - Overall stability of financial and payment systems will remain a responsibility of the central bank even if separate entity is response for micro prudential bank supervision.
    - Banks are beneficial to economic growth precisely because they are willing to take risks and are highly leveraged. But this sets up the possibility of systemic problems.
    - Financial instability arising out of market imperfections in the financial system that threatens the functioning of the financial system, hurts real economic activity, and imposes significant economic costs differs from the normal ups and downs of the market or failures of individual financial firms because of poor management.

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- Arguments can be made for and against housing day-to-day bank supervisory responsibilities within or outside of the central bank.
    - Main tradeoff: difficulty in ensuring information flows between the supervisory agency and the central bank if separate vs. the difficulty in stemming conflicts of interest if supervisory responsibilities are housed within the central bank.
        - Would a central bank with supervisory responsibilities be tempted to set too accommodative monetary policy to help out a fragile banking system?
        - Would poor supervisory performance by a central bank undermine its overall credibility and hurt its ability to implement sound monetary policy?

- Skeptical that in <u>normal</u> economic circumstances where responsibility for bank supervisory activities lies has many first-order effects. Differences are exaggerated.
    - In the U.S., the Fed supervisory function has been shifting focus to potential systemic concerns
    - Many of the largest banks in the U.S. have national bank charters, which means OCC exams them and passes info to Fed, which supervises the holding company.
    - In the event the information were not passed the Fed has statutory authority to example any member banks, including national banks.
    - If there is a conflict of interest between the goals of prudential supervision and price stability, it is similar to the potential conflict the Fed already faces in setting monetary policy given it has the dual mandate of price stability and full employment.
    - Bigger issue is lack of knowledge and metrics regarding financial stability.

- During <u>financial crises</u>, it may matter where supervisory activity is housed.

  - Ability of the central bank to obtain information from the supervisory authorities in a timely manner becomes crucially important.

  - Central bank personnel need firm understanding of how banking actually works – it is an open question about how important actually examining banks is for fostering that expertise.

  - Central bank handling a financial crisis must have <u>credibility</u> with bankers. Does involvement in bank supervision foster that credibility? Is credibility gained in monetary policy transferable?

- Optimal supervisory structure should work well in normal circumstances and foster conditions that lower the likelihood of financial crises, but also work well in a crisis situation – in tail events.

- Paper and research agenda make the important point that the incentives of the regulators have to be considered when designing optimal institutions.

    - Transparency and public accountability can lead to better banking sector performance than reliance on supervisory discretion.

    - Paper provides empirical support for this view and is part of an ongoing and important research agenda.