Comments on Three Papers About Banking Supervision

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Slides and remarks are Carey's opinions, not those of the Federal Reserve.

All three papers are good!

Three Kinds of Supervision

- "Compliance:" Evaluate whether banks are conforming to laws and regulations (of which there are a wide variety). Not much judgment.
  - Leave this one aside.
- "Traditional:" Review assets to identify bad ones, in order to close insolvent banks in a timely manner.
  - Backward looking; a smaller fraction of activity than 25 years ago.
- "Modern:" Inspect banks' risk management and the quality of other management and operations in order to evaluate whether they know the risks they are taking and are prepared to manage them.
  - Forward looking

Basic Questions

- Does modern supervision “work?”
  - If not, what should we do instead?
    - Taking as given that backward-looking supervision alone is not enough to prevent banks from taking imprudent risks.
- If so, how well?
- What’s the impact on firm value?
- How should it be organized?
- How do banks respond to it?

Hirtle, Kovner & Plosser 1: Authors' message

- Top-5 BHCs in a Fed district get more supervisory attention
  - Diff-in-diff: Compare them to otherwise-similar non-top-5 BHCs
  - "All banks are subject to similar rules" so supervision is the difference
- More supervisory attention is associated with:
  - Less volatile earnings and returns, but not lower earnings or asset growth
  - Less risky loan portfolios and larger ALLL
  - Lower equity returns in some specifications
- Though not said, the marginal supervisory effort that is the focus is almost all "modern" supervision.

Hirtle, Kovner & Plosser 2: Carey's Takeaway

- Modern supervision doesn't work at the margin, and it's costly:
  - A marginal increase in supervision appears to reduce the volatility of accounting ROA (but does not improve the level).
  - If we believe supervisory effectiveness (or other factors) differ across districts, it reduces equity returns (by a lot, 3.6% per year) and volatility (by a little).
  - Not much in the way of other effects…NPL results don't grab me.
- Maybe supervision overall is worthwhile…this is a marginal analysis.
- Other potentially valuable aspects of modern supervision
  - Information and understanding, both in normal times and especially bad times.
  - But if information alone is the goal, perhaps it should be organized differently.

Hirtle, Kovner & Plosser 3: Concerns

- The part of the paper that persuades that top-5 banks get more attention is persuasive that their extra attention is not due to risk
- "Small" sample: Period is 1991 (2006) to 2014, 30ish matched-pairs per quarter
  - Moderate-size traditional banks only: Largest is about $100 billion in assets
- Please tabulate the results with the New York district omitted

Frame, Mihov and Sanz 1: Authors' message

- During 1995-2013, U.S. BHCs tended to set up subsidiaries in countries with weaker supervision and regulation.
- Though banks with weak risk management are not likely to do so.
  - It's a stretch to say that "strong" risk management firms set up in weak-supervision jurisdictions.
- Banks with higher VaR and CoVar have subs in countries with weaker supervision and regulation.
  - Heckman correction for selection-based reverse causality.
  - But still, risk might rise BECAUSE the BHC is operating overseas.
  - Such BHCs are more profitable at the margin.

Frame, Mihov and Sanz 2: Carey's Takeaway

- If we believe the measures of supervisory strength, and if weak supervision is associated with more profit opportunities in a country, then U.S. BHCs might simply be pursuing profitable opportunities. Is this regulatory arbitrage?
- But I don't believe Barth et al's measures reflect differences in the strength of modern supervision.
- Maybe a financial-center effect?

Excepts from Table 1

Country	Sup&Reg	Sup alone	Number subs
Mean	0.032	0.054	12,485
Caymans	0.036	0.080	2,637
Luxembourg	0.033	0.038	774
Australia	0.032	0.046	555
Japan		0.040	637
Netherlands	0.045	0.068	542
Ireland	0.040	0.070	441
United Kingdom	**0.043**	**0.058**	**1740**
Canada	**0.052**	**0.081**	**498**
Hong Kong	**0.051**	**0.070**	**367**
India	**0.025**	**0.061**	**123**
Poland	**0.024**	**0.034**	**94**
Malaysia	**0.024**	**0.026**	**78**

Do we really believe that India, Poland and Malaysia have weaker sup&reg than U.K., Canada, Hong Kong?

Calzolari, Colliard & Loranth 1: Authors' Message

- In the long run, multinational banks will strategically react to the structure of supervision by changing organization and locations.
- Information costs, liquidation values, and DI resources all matter to monitoring and intervention choices.
- Supranational supervision reduces profitability of subsidiaries relative to branches (because the subs are monitored more) and thus may lead to less internationalization.
- Many distortions might be reduced by making DI premiums sensitive to organizational form (and all other parameters of the model).

Calzolari, Colliard & Loranth 2: Carey's Takeaway

- In a centralized multinational supervision framework, centralized deposit insurance seems good but might not be
- Cross-border supervisory cooperation is fashionable. How do we think about the knock-on effects of that?
- Even with very limited supervision, incentives for supervisors (and banks) are very sensitive to details of the institutional setup (DI coverage, sovereign credibility in backing the DIs, liability of parent for subsidiary liabilities, etc.).
  - And bank choices are influenced by what supervisors do and what liabilityholders expect and price.
- We need more modeling and thinking about these matters for a larger set of permutations and definitions of "supervision."

Calzolari, Colliard & Loranth 3: Concerns

- I want the paper to be about modern supervision
  - Side note: The ECB appears to me to be practicing modern supervision
- But it seems more about traditional supervision
  - At the intermediate date, the supervisor uses the information they produced to decide whether to liquidate
  - That sounds like traditional supervision: Evaluate the quality of the portfolio, write down the bad stuff, maybe put the bank into receivership
- What if information is used to force portfolio changes, management changes, etc.?

Overall takeaways

- These are good papers
- We need to know what works and what doesn’t about modern supervision
- We need better cross-border measures of the “strength” of supervision, regulation, activity restrictions, etc.
  - Or at least we need to understand Barth et all better
- We need models of modern supervision

Calzolari, Colliard & Loranth 3: Concerns

- The presumed arrangements do not hold everywhere
  - FDIC does not insure deposits at U.S. banks' foreign branches
  - Foreign branches get some supervision in the U.S.
- "Monitoring" means both "learn value" and "don't liquidate"
  - Thus, "supervision" is NOT about directly influencing bank capabilities…it is NOT, e.g., CCAR
- DI arrangements are a key factor driving branching decisions – this seems unrealistic to me…I don't think insured depositors are so sophisticated
- Information costs should change with supranational supervision