Discussion of "Effectiveness of Bank Supervision"

William W. Lang
Managing Director
Promontory Financial Group
wlang@promontory.com

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The Question

Very limited research on the effectiveness of supervision.

Multiple reasons:

- Data availability
- Ambiguity may be beneficial for political reasons and/or internal bureaucratic reasons
- Multiple objectives that are not clearly identified.
- Multiple objectives without a clear optimization framework to assess potential tradeoffs

Sometime the objective is stated as increased bank safety. This eliminates the problem of tradeoffs but there still is some ambiguity

Commonly defined objective is lower risk or bank safety

This could mean a number of possible objectives (not mutually exclusive):

- Reduce risk of individual bank failures or distress (view of banks playing a “special role” in the local economy)
- Reduce risk of large number of regional or national failures to protect the economy (think S&L crisis)
- Reduce risk to the taxpayer or insurance fund
- Reduce risk of financial instability/crisis

In principle, objectives should consider tradeoffs

Is improved safety generated efficiently?

Effect on provision of financial services:

- Cost/benefit assessment of gains from additional safety vs. provision of financial services Reduce risk of individual bank failures or distress (view of banks playing a “special role” in the local economy)

Banks could be made safe through very high capital or severely limiting risk-taking activities (e.g., narrow bank) that could significantly reduce provision of bank services.

It is true that there is not necessarily a tradeoff as good supervision and safe organizations may produce better provision of services. Nevertheless, the potential for tradeoffs exist.

This may suggest “counter-cyclical” or “lean-against-the-wind” supervision or regulation. Is this macroprudential supervision? There are pitfalls to such an approach.

Authors all make some very good steps in going where angels fear to tread.

Session papers use lower risk or improved safety of banks (as broadly described above) as the metric for effectiveness.

This is probably ok but clearly less problematic if, as in White presentation, supervisors primarily serve an auditing or verification function.

Effective Bank Supervision: A Case Study in the Use of Supervisory Authority to Curb Risk in Banks with Commercial Real Estate Lending Concentrations

Overview

Paper looks at the impact of 2015 Q4 statement on CRE lending.

A few points:

The statement was a reiteration of policy not a new policy.

Was this different than the period after December 2006 when the relevant CRE guidance was issued? Looks like the two periods are very different in terms of impact on bank concentrations.

Bank concentrations continued to rise for two years after December 2006 guidance while they begin to fall almost immediately after the 2015 statement.

Note that timing issues for the 2015 statement is less severe compared to 2006 guidance . The 2006 guidance was slow in finalizing and it was clear that supervisory concern had increased significantly prior to the 2006 guidance.

Actions relate to small banks. Supervisors generally have had an easier time affecting behavior of smaller banks.

Have regulators been transparent in the objective of reducing concentrations? In 2006? In 2015? Why or why not?

Paper Findings

Looks at pre- and post-2015 Q4 statement banks with CRE concentrations

Strong visual evidence that guidance had a clear and measurable impact on CRE exposures.

Paper looks at regression analysis to control for other factors with focus on potential "regression-to-the-mean" by controlling for non-performing loans

Regressions confirm visuals – guidance had a strong impact on number of banks with CRE concentrations

Some Comments

Consider controlling for pre-statement growth rate for the bank. Different type of regression to the mean.

Paper could include more discussion of what was different relative to 2006 guidance. The differences suggest that issuing the statement alone is not a sufficient explanation

Other issue relate to political pressures and organizational incentives – think Ed Kane.

Political/organizational incentives may encourage ambiguity and lack of accountability. This may explain the relatively slow and weak reaction in response to the 2006 guidance which articulated the same policy that was restated in 2015

Paper should discuss the potential for supervisors to be wrong and therefore the need to have accountability and transparency on the part of regulators.

The Economics of Bank Supervision

Thomas M. Eisenbach, David O. Lucca and Robert M. Townsend

Overview

Develops a very clever theoretical model where supervisors monitor (think rate/assess condition) and then act.

This captures central elements of supervision (rating/action) and use data on hours and outcomes to test hypotheses.

I have a quibble about distinction between “verifiable” and “observable but not verifiable”. Agree very much that verifiability is a critical issue in regulatory design but this is more of a continuum than distinct states. Example: measuring capital levels.

Overview

Then investigate primarily two questions:

How supervisors allocate resources relative to:

- Bank condition (RATING)
- Size (proxy for systemic externalities), technical economies of scale, complexity

Then look at outcomes (probability of becoming 4/5 or volatility of ROA) to estimate resource allocations and affect of resources on outcomes.

Exploit two things:

1. Post 2008 shift of resources away from small BHC
2. Share of Problem District Assets

Are these both signals of the state of the economy relative to pre-2008 and/or cross-sectional variation?

Some Comments

1. Paper doesn't have performance measures on the effectiveness (timeliness and accuracy) of monitoring.

Relationship between supervisory resources and "timely" identification of problems. May need a longer horizon and/or how supervisory ratings compare to other signals (bond ratings, ratings model)

2. Regulatory objective function could also explain "over-investment" in community bank supervision:

a. Turf/jobs

b. Perceived political vulnerability

c. Within organization incentives

The Purpose and Effectiveness of Bank Examinations in Late 19th and Early 20th Century America

Eugene N. White

Overview

Asks the critical question: What should be the purpose of supervision?

White emphasizes issue of feasibility. To what extent can supervisors be expected to uncover risks or effect managerial decisions?

Might also raise the issue of problems of political or bureaucratic incentives that might produce poor outcomes for more expansive supervisory objectives..

Emphasizes role of supervision in verification/auditing of accounts. If done effectively, produces early and accurate statement of condition

Statement of limits of supervision

Supervision by examination does not, however, carry with it control of management and can not, therefore, be held responsible for either errors of judgment or lapses of integrity. Examination is always an event after the act, having no control over a bank's initiative, which rests exclusively with the executive officers and directors, and depends entirely on their business ability, judgment, and honest of purpose"

James Forgan, President, First National Bank of Chicago (1910)

In his text book, Ken Spong, KC Fed wrote: "Provided insured depositors can be protected and adequate banking services can be maintained, preventing the failure of individual banks is not a primary focus of banking regulation."

Do these statements carry over to systemically important banks?

Some Comments

Written reports from examiners seem to include significant “forward looking” role for supervision and examiners addressing risk management. Is that good or bad?

Central National Bank report: The most unfavorable feature of the Bank is that its stock is too widely scattered and not a sufficiently large amount in the hands of any of its strong holders o ensure an efficient attention to the bank's interests as their important demands.

Phenix Bank report: I doubt if there can be much permanent betterment without considerable change in management. It's business is of a character suitable for a small bank in the Jobbing Districts of the city but its location is in the center of the Wall Street district. The best thing for the Bank would be to consolidate with some neighborhood institution: as it is too small and weak to hold its own under present conditions. The management has recently been investing in Trust Company and other stocks, which I do not think they should do.

Possible methods of handling limits of supervisory resources

Risk focusing

Creating incentives for risk taking

Examples: London Whale

Examples: Wells Fargo

White raises critical questions about goals/limits of supervision

These questions are typically ignored.

Economists often ignore:

- Limits to resources – quantity and quality
- Limits to observability/verifiability
- Incentive problems at regulatory agencies

Very important questions to illuminate